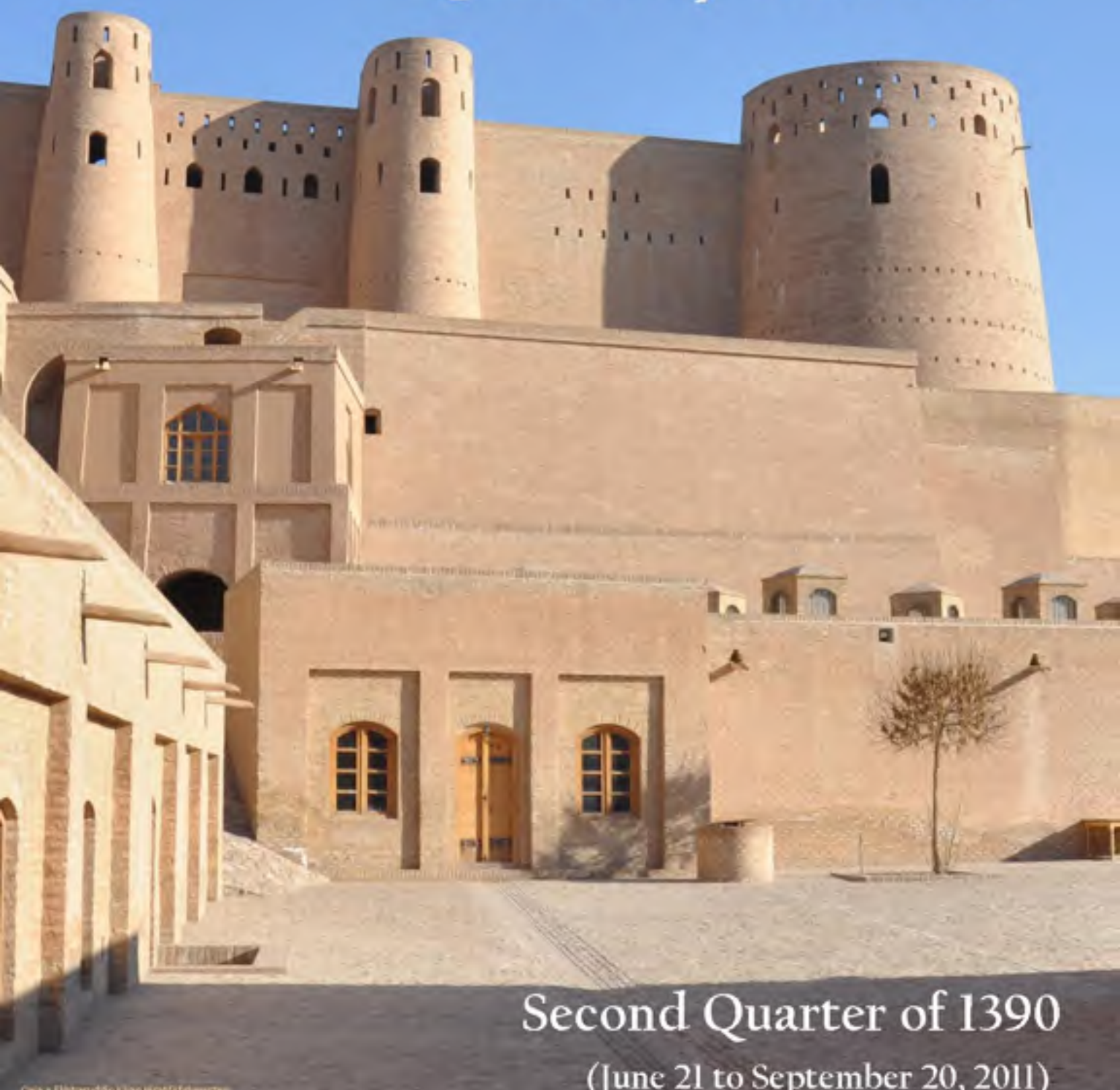
Da Afghanistan Bank

Quarterly Bulletin



Second Quarter of 1390

(June 21 to September 20, 2011)

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(June 21 to September 20, 2011)

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Note:

Afghanistan Fiscal year is Solar Year which begins on March 21 each year. This Quarterly Bulletin describes developments in the second quarter of 1390 which is equivalent to June 22 to September 21, 2011.

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ABBREVIATIONS

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

GOVERNOR'S STATEMENT

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Quarterly Economic and Statistical Bulletin

On behalf of the Supreme Council, I am proud to present this release of the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for the second quarter of 1390 (June 21 to September 20, 2011). This quarterly bulletin serves as DAB's primary tool to disseminate information and analysis for government and non-government agencies and economic units in Afghanistan and abroad. The expansion of global economic activity moderated in the second quarter of 2011 underpinned by uncertainty in the global growth prospects and slowdown in the global trade and manufacturing. Economic activity in Afghanistan remains robust, well in line with the projected growth of about 6 percent for 2011/12.

Inflation experienced an upward trend throughout the second quarter of 1390, registering a year-on-year inflation rate of 5.3 percent.

Monetary aggregates exhibited mixed performance. Reserve money (RM), had almost a similar trend as of the currency in circulation. In the first quarter of 1390, the reserve money increased dramatically above the program ceiling and carried over the effects to the second quarter of 1390. On the other hand, narrow money (M1) had an increase of 22.4 percent (Y-o-Y), and broad money (M2) demonstrated similar behavior growing by 21.8 percent.

In the meantime, the nominal exchange rate of afghani against U.S. dollars depreciated in the second quarter of 1390. Following a substantial expansion in imports, Afghanistan's merchandise trade deficit widened in the second quarter of 1390. However, the trade deficit as percentage of GDP remained unchanged at 7 percent.

The banking sector performance was relatively weak in the quarter under review, with a 2.9 percent decrease in total assets of the banking system. Gross loans declined by 51 percent mainly from splitting of the crises stricken bank into New Kabul Bank and Kabul Bank Receivership and its impact on spill over effect on a number of financial institutions. Deposits of the banking system increased by 10.4 percent in the quarter under review compared to the same period of last year. Deposits were largely

denominated in USD (62.75 percent) with afghani denominated deposits lagging at 34.5 percent.

At the end, I would like to appreciate the tireless efforts of numerous individuals from several departments of the Bank that contributed to this publication.

Kabul, January 2011

Noorullah Delawari

Governor, Da Afghanistan Bank

(Central Bank of Afghanistan)

EXECUTIVE SUMMARY

This publication constitutes DAB's Quarterly Economic and Statistical Bulletin for Q2 1390 (June June 21 – September 2011). 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.

In the quarter under review, the global economic growth slowed down. For the 2011, the Fund staff anticipated an annual global growth rate of 4.0 percent. For the Western industrial states the GDP growth rate is expected to be 1.6 percent. The economic growth was slowed down by European debt crisis coupled with the political standstill due to the household debate in the US. Impulses for the global economy keep coming from the developing countries and emerging markets, whose economy is expected to keep growing in the year 2011 by an average of 6.4 percent.

According to the latest U.S. Bureau of Labour Statistics report on productivity and labour costs, real hourly compensation fell by 3.2 percent in the third quarter of 2011, reflecting a 0.2 percent decline in hourly compensation and a 3.1 percent increase in consumer prices. World manufacturing production increased slightly in the third quarter compared to the second quarter of 2011. Consistent growth of manufacturing output in major economies indicates that a further worldwide downturn in industrial production is not imminent, according to a report released by the United Nations Industrial Development Organization (UNIDO).

The global trade decelerated further as trade volumes dropped by 1.3 percent (quarter-on-quarter), recording USD 2,106 billion in Q3 2011. The deceleration in import and export growth affected all the G7 nations and the emerging markets, except China and India. Euro zone experienced a drop in their total trade by 2 percent on a quarter on quarter basis in Q3 2011, as growth of exports was constrained by an appreciating euro.

In Afghanistan, monetary aggregates exhibited mixed performance, reserve money (RM), the primary target, had almost a similar indifference curve as of the currency in circulation which is the quantitative performance criteria under the poverty reduction and credit facility – extended credit facility (PRGF-ECF) program. Currency in circulation constitutes almost 85 percent of the reserve money with a significant correlation. In the first quarter of 1390, the reserve money increased dramatically above the target level and the situation continued

throughout the second quarter mainly due to influx of afghani in Kabul Bank's current account, where DAB acted as the lender of the last resort to safeguard public's deposits with the bank. Therefore, DAB was not able to achieve the primary target in the second quarter of 1390. On the other hand, narrow money (M1) increased by 22.40 percent on a year-on-year basis. Broad money (M2) demonstrated similar behaviour growing by 21.78 percent.

In the meantime, the exchange rate of afghani against U.S. dollars depreciated by 3.2 percent in the second quarter of 1390 – the exchange rate of afghani moved in a corridor of AF45.99 per U.S. dollar at the end of the first quarter to AF47.46 at the end of the second quarter of 1390.

Foreign exchange auction is the primary instrument used by DAB to control money supply growth. In the first two quarters of 1390, DAB's intervention reached a total of USD 1,023.40 million.

Capital notes are the other instruments used by DAB in order to control liquidity in the local market. The weighted average interest rate on 28 day capital notes (CNs) fell down from 2.28 percent at the end of the first quarter of 1390 to 2.15 percent in the second quarter and from 3.36 percent to 3.3 percent for 182 day CNs respectively.

The stock of Afghanistan's net international reserves (NIR) increased by 1.17 percent (Y-o-Y) in the second quarter of 1390. The NIR stood at USD5.554 billion in the first quarter and increased to USD5.619 billion at the end of the second quarter, which is well above the floor of USD 4.3 billion for the second quarter of 1390.

The Kabul headline CPI, measured on a year-on-year basis increased dramatically in the second quarter of 1390, when compared to the second quarter of 1389. The year-on-year percentage change in Kabul CPI stood at 10.3 percent in the quarter under review, representing a sharp increase from 5.3 percent inflation in the same quarter of last year. **The increase in headline inflation was attributed to sharp increases in both, food and non-food price indices.** The food price index which comprises 61.3 percent of the CPI basket increased by 6.5 percent (Y-o-Y) in the second quarter of 1390 compared to 4.7 percent in the same quarter of last year. This represents 1.82 percentage points increase. The non-food price index which comprise 38.70 percent of the CPI basket, displayed significantly higher rate of increase in the reporting period.

In the external sector, merchandise trade deficit widened in the second quarter of 1390 following a substantial expansion in imports compared with the similar period last year. Merchandise trade deficit expanded by about 20 per cent from USD 1,133.55 million in the second quarter of 1389 to USD 1,355.87 million in the second

quarter of 1390. However, the trade deficit as percentage of GDP remained unchanged at 7 percent.

In the second quarter of 1390, exports decreased by 15 percent to USD 61.45 million from USD 72.15 million in the second quarter of 1389. Exports were mainly dominated by medical seeds and others that decreased by almost 13 percent, and food items which slightly decreased by 4 percent in the second quarter of 1390 compared with the similar period last year. On the other hand, imports of goods increased by about 18 percent from USD 1,205.7 million to USD 1,417.3 million in the quarter under review.

At the end of the second quarter of 1390, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,375.60 million which shows slightly decrease of 1 percent compared with the same period of last year. During the quarter, loan principal repayments made only to the Asian Development Bank (ADB) while service charges paid to the ADB and IDA (World Bank). Moreover, ADB and IDA (World Bank) as major multilateral creditors to Afghanistan made significant debt forgiveness on principal amount and service charges during the second quarter of 1390.

The net international reserves (NIR) increased notably by almost 32.45 percent in the second quarter of 1390 compared with the similar period of last year. This figure was USD 4,242.16 million in the second quarter of 1389 which increased to USD 5,618.89 million in the second quarter of 1390.

The fiscal policy is used by the Government to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment and economic growth.

The main 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 budget at the end of the second quarter of 1390 was in surplus according to the report received from Ministry of Finance. Total revenues exceeded core expenditure in the quarter under review, leading to a budget surplus of AF 13,316 million.

Total domestic revenues increased by 27.8 percent at the end of the second quarter of 1390 compared to the same period of last year. Total domestic revenues was recorded AF 67,835.11 million at the end of second quarter of 1390 up from AF 53,066.57

million end of the second quarter of 1389,. Total domestic revenues in the quarter under review accounted for 12 percent of GDP. Total core expenditures in the quarter under review increased by 21 percent. Total expenditures in the quarter under review accounted for 10 percent of GDP. The total donor contribution (grants) allotted to both operating and development expenditures increased by 4 percent 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 had a weak performance in the quarter under review. Total assets of the banking system registered a decrease of 2.9 percent (Y-o-Y) at the end of the second quarter of 1390 (September 2011). Total asset of the banking sector stood at AF 218.09 billion (USD 4.57 billion) at the end of September 2011 compared to AF 224.69 billion (USD 4.99 billion) in the same period last year. Gross loans decreased by 51 percent in the second quarter of 1390, which has come from a number of financial institutions, but mainly from the splitting of crises stricken bank into New Kabul Bank and receiver. Total deposits increased by 10.4 percent from the same period of last year. Deposits were largely denominated in USD (62.75 percent) with afghani denominated deposits lagging at 34.5 percent. The capital adequacy ratio (CAR) of the banking sector was at 16.3 percent. On a cumulative basis, the banking sector has registered losses of AF 1.91 billion where it was profitable (AF 1.82 billion) in the previous period (September 2010), resulting in an ROA of -1.87 percent annualized which was 1.91 percent in the same period of last year. Only branches of foreign banks ended up with profit, while private banks and state-owned banks ended up with losses for the quarter ending September 2011.

CHAPTER I

GLOBAL ECONOMIC ENVIRONMENT

1

GLOBAL ECONOMIC ENVIRONMENT

The global economic growth slowed down during the third quarter of 2011. For the year 2011, the International Monetary Fund (IMF) anticipates an annual global growth rate of 4.0 percent. For the Western industrial states the IMF expects a GDP growth rate of 1.6 percent. The economic growth was slowed down by the European debt crisis on one hand, and by the political standstill due to the household debate in the USA on the other. Impulses for the global economy keep coming from the developing- and emerging countries, whose economy is expected to keep growing in the year 2011 by an average of 6.4 percent.

According to the latest U.S. Bureau of Labor Statistics report on productivity and labor costs, real hourly compensation fell 3.2 percent in the third quarter of 2011, reflecting a 0.2 percent decline in hourly compensation and a 3.1 percent increase in consumer prices. According to Economic Outlook Europe, a clear global risk stems from the rise in oil prices, caused, since the beginning of the year, mostly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur.

World manufacturing production increased slightly in the third quarter compared to the second quarter of 2011. Consistent growth of manufacturing output in major economies indicates that a further worldwide downturn in industrial production is not imminent, according to a report released by the United Nations Industrial Development Organization (UNIDO).

According to Capgemini Consulting, global trade growth decelerated further as trade volumes dropped by 1.3 percent (quarter-on-quarter), recording USD 2,106 billion in Q3 2011. The deceleration in import and export growth affected all the G7 nations and the emerging markets, except China and India. Euro zone experienced a drop in their total trade by 2 percent on a quarter on quarter basis in Q3 2011, as growth of exports was constrained by an appreciating euro.

1. THE GLOBAL ECONOMY

The global economic growth slowed down during the third quarter of 2011. For the year 2011, the International Monetary Fund (IMF) anticipates an annual global growth rate of 4.0 percent. For the Western industrial states, the IMF expects a GDP growth rate of 1.6 percent. The economic growth slowed down by the European debt crisis on one hand, and by the political standstill due to the household debate in the USA on the other. Impulses for the global economy keep coming from the developing- and emerging countries, whose economy is expected to keep growing in the year 2011 by an average of 6,4 percent.

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

Despite the clouded economic prospects, worldwide demand for automobiles showed an upward trend up to September 2011. All sales regions with the exception of Western Europe reported growth in their car markets.

According to Central Bank of Nigeria, the global economic growth decelerated in the third quarter of 2011. This was due to transient factors, such as the impact of the natural disasters in Japan on global supply chains, the dampening effect of high commodity prices on disposable incomes and the unrest in the Middle East and North Africa (MENA) region. The rise in oil prices in the preceding quarter and the supply-chain disruption caused by the natural disaster in Japan caused reduced output in advanced economies. Emerging and developing economies performed well as per forecast, though with considerable variation across regions. Surging commodity prices also propelled Latin America to high growth rates. Activity in developing Asia, however, weakened modestly in response to global supply chain disruptions and destocking in the face of more uncertain demand from advanced economies.

1.1 Global Industrial Production

Fears of another recession due to instability in European financial markets, world manufacturing production increased slightly in the third quarter, compared to the second quarter of 2011. Consistent growth of manufacturing output in major economies indicates that loa further worldwide downturn in industrial production is not imminent, according to a report released by the United Nations Industrial Development Organization (UNIDO). The report states that world manufacturing output rose by 5.5 percent in the third quarter of 2011, compared to

the same period of 2010. This growth is mainly attributed to developing countries, whose manufacturing output increased by 13 per cent. China's manufacturing, which accounts for almost half of that of all developing countries combined, grew by 14.5 percent in the third quarter.

The manufacturing output of industrialized countries rose by an average of 3.3 per cent in the third quarter. U.S. manufacturing grew by 4.1 per cent. Japan's manufacturing performance improved significantly in recent months. Its output grew by 4.3 per cent in the third quarter, compared to second quarter of 2011, but it has not yet reached the level of last year.

The impact of Euro zone financial instability was limited to just a few countries so far. In Europe, strong growth of manufacturing output was observed in Austria (7.2 per cent), the Czech Republic (5.5 per cent), Germany (9.6 per cent), and in Sweden (6.4 per cent). Relatively higher growth performance was observed in Eastern Europe. The manufacturing output of Poland and Romania grew by 6.5 per cent and 6.1 per cent, respectively. The manufacturing output of the Russian Federation grew by 7.2 per cent. Among developing countries, strong growth was seen in Malaysia (5.2 per cent), Turkey (7.8 per cent), and Viet Nam (7.4 per cent). However, the growth of leading developing economies was moderate. The manufacturing output of Argentina increased by 3.8 per cent, Brazil by 0.1 per cent, India by 3.1 per cent, and Mexico by 4.6 per cent.

1.2 Global Inflation

According to Economic Outlook Europe, a clear global risk stems from the rise in oil prices, caused, since the beginning of the year, mostly by political instability in the Middle East and North Africa (MENA). Although, uncertainty remains high and protests in the region are still unfolding, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will slowly, but gradually, be reduced, given still ample OPEC spare production capacity and OECD inventories, both above historical means. Nonetheless, oil prices could remain high at around 110-120 dollars per barrel during most of 2011, then slowly easing down to around 100 dollars in 2012. In addition, we think that the recent hike in oil prices may be thought of as precautionary demand shock and not just a supply-side shock, because we are observing a sharp increase in crude oil prices not accompanied by a fall in supplied quantities, since most lost production in Libya has been covered by other OPEC producers. As a consequence, the impact of such shock should be moderate on both activity and inflation

According to J.P. Morgan, around the world, developed and developing nations continue to expand at different paces. Fast growth and rising commodity prices have raised fears of higher inflation and interest rates in developing nations, while slow growth in developed nations is increasing the burden of rising government debt, generating concerns about another debt crisis.

According to the latest U.S. Bureau of Labor Statistics report on productivity and labor costs, real hourly compensation fell 3.2 percent in the third quarter of 2011, reflecting a 0.2 percent decline in hourly compensation and a 3.1 percent increase in consumer prices. Real hourly compensation is the ratio of hourly compensation to consumer prices. Compared to the third quarter of 2010, real hourly compensation is down by 2.3 percent, which is the largest drop in the series recorded since the series began in 1948.

1.3 Global Trade and Investment

According to Capgemini Consulting, Global trade growth decelerated further as trade volumes dropped by 1.3 percent on a quarter-on-quarter basis, to touch USD 2,106 billion in the third quarter of 2011.

The deceleration in import and export growth affected all the G7 nations and the emerging markets, except China and India.

Euro zone experienced a drop in their total trade by 2 percent (quarter-on–quarter) in third quarter of 2011, as growth of exports was constrained by an appreciating euro.

Due to current financial turmoil, US dollars is expected to weaken further especially against growing market currencies, impacting its trade volumes, with total trade reducing by 2 percent (quarter-on–quarter) in third quarter of 2011.

India was the only country to see a sharp pickup in export growth, from -4.5 percent in the second quarter to 1.2 percent in the third quarter of 2011, led by demand for cars, petroleum products and precious stones.

2. ADVANCED ECONOMIES

2.1 The United State Economy

The U.S. economy expanded at an annual rate of 2.5 percent in the third quarter of 2011. Real gross domestic product (RGDP) -- the output of goods and services produced by labor and property located in the United States -- increased at an annual rate of 2.0 percent in the third quarter of 2011 according to the "second" estimate released by the Bureau of Economic Analysis.

The increase in real GDP in the third quarter primarily reflected positive contributions from personal consumption expenditures (PCE), non-residential fixed investment, exports, and federal government spending that were partially offset by negative

contributions from private inventory investment and state and local government spending. On the other hand, imports, which are a subtraction in the calculation of GDP, increased.

The annual inflation rate in the United States was reported at 3.9 percent ending September 2011. The inflation rate refers to a general rise in prices measured against a standard level of purchasing power.

The unemployment rate in the United States was reported at 9.1 percent as of September 2011. While slightly better than prior months, the September employment report continued the trend of weak jobs growth as only 103,000 jobs were added compared to the roughly 250,000 needed just to keep up with population growth.

The U.S. monthly international trade deficit decreased in October 2011, according to the U.S. Bureau of Economic Analysis and the U.S. Census Bureau. The deficit decreased from USD 44.2 billion (revised) in September to USD 43.5 billion in October, as imports decreased more than exports. The previously published September deficit was USD 43.1 billion.

2.2 The Euro Area Economy

According to a second revision of the data from the EU's statistics office, growth in the 17 countries sharing the euro was just 0.2 percent between July and September, the same pace as in the second quarter of 2011. Household spending and exports kept the euro zone's economy just in positive territory in the third quarter, adding 0.2 percentage point and 0.6 percentage point respectively to the final figure.

For many economists and the ECB, which cut rates by a quarter points to 1.25 in November, a recession is all but a certainty, as the euro zone's sovereign debt crisis drags the economy down.

According to the trading economics website, the inflation rate in Euro area was last reported at 3.0 percent in November of 2011. The unemployment rate in the Euro area was last reported at 10.3 percent in October of 2011.

According to the Euro stat, in the third quarter of 2011, the EU27 external balance of trade in goods was in deficit by € 34.5 billion, compared with a deficit of € 31.1 billion in the third quarter of 2010. In the third quarter of 2011, the external balance of trade in services was in surplus by € 25.1 billion, compared with a surplus of € 22.6 billion in the third quarter of 2010.

2.3 Germany

According to the Federal Statistics Office, the German economy grew by 0.5 percent in the third quarter of 2011 on a seasonal and calendar-adjusted basis, continuing "strong growth" that began at the beginning of the year. In addition, the second-quarter gross domestic product was

revised up by 0.2 percentage point to reflect growth of 0.3 percent. On an adjusted annual basis, GDP rose by 2.5 percent in the third quarter, and was also revised up by 0.2 percentage point to reflect growth of 3 percent in the second quarter. The third quarter growth came from final consumption expenditure of houses as well as capital formation in machinery and equipment, though capital formation in construction fell slightly.

The main factor contributing to GDP growth was the increase in final consumption expenditure of households. Also, capital formation in machinery and equipment was up, whereas capital formation in construction decreased slightly, following a strong growth at the beginning of the year. Foreign trade continued its expansion. However, as the increase in exports of goods and services roughly equaled the increase in imports, the impact of the balance of exports and imports – upon price, seasonal and calendar adjustment – on economic growth in the third quarter of 2011 was hardly measurable.

According to first provisional calculations, the economic performance in the third quarter of 2011 was achieved by about 41.2 million persons in employment in the domestic territory, which shows an increase of 495,000 persons or 1.2 percent from last year.

The unemployment rate of Germany for the total civilian labor force amounted to 6.4 percent in November which represents a decrease of 0.5 percentage points against last year.

In October 2011, the consumer price index for Germany was up by 2.5 percent compared to October 2010. The inflation rate as measured by the consumer price index remained markedly above the 2 percent threshold.

2.4 The Economy of France

According to the Trading economics website, the gross domestic product (GDP) in France expanded by 0.4 percent in the third quarter of 2011 over the previous quarter. France, as with many modern industrialized nations, has a large and diverse industrial base. Economic growth rates in France have been steady for decades due to conservative planning of the economy which in comparison to other western European countries is more centralized by the government.

According to the Trading economics website, France had a trade deficit equivalent to € 6,248 million in October 2011. The main exports are: machinery and transportation equipment, aircraft, plastics, chemicals, pharmaceutical products, iron and steel, beverages, wheat, beef, pork, poultry, dairy products and wine. French principal imports are: machinery and

equipment, vehicles, crude oil, plastics and chemicals. The trade with European Union countries accounts for 65 percent of French trade.

According to the Trading economics website, the unemployment rate in France was last reported at 9.7 percent in the third quarter of 2011. According to Trading economics website, the inflation rate in France was last reported at 2.5 percent in November of 2011.

2.5 United Kingdom

The UK gross domestic product (GDP) expanded by 0.5 percent in the third quarter of 2011 over the previous quarter. Services, particularly banking, insurance, and business services, account by far for the largest proportion of GDP, while industry continues to decline in importance. Over the past two decades, the government greatly reduced public ownership and contained the growth of social welfare programs.

According to Bloomberg news, U.K. unemployment jumped in the third quarter as the number of young people looking for work climbed above 1 million for the first time in at least 19 years. According to the U.K. Office for National Statistics, unemployment as measured by International Labor Organization standards rose by 129,000 to 2.62 million, the most since 1994. The jobless rate climbed to a 15-year high of 8.3 percent.

According to the tradingeconomics.com, the inflation rate in United Kingdom was 4.8 percent in November of 2011. From 1989 until 2010, the average inflation rate in United Kingdom was 2.72 percent reaching an historical high of 8.50 percent in April of 1991 and a record low of 0.50 percent in May of 2000.

The U.K. annual inflation stands at 5.0 percent in October 2011, down from 5.2 percent in September. The largest downward pressures to the change in CPI annual inflation between September and October came from falls in the cost of food (due to significant and widespread discounting by supermarkets and good harvests for certain produce), air fares and petrol.

The U.K. reported a trade deficit equivalent to GBP 1,552 million in October of 2011. The United Kingdom is the world's fifth-largest trading nation, highly dependent on foreign trade. It must import almost all its copper, ferrous metals, lead, zinc, rubber, and raw cotton and about one-third of its food.

2.6 Japan

Japan's economy rebounded in the third quarter of 2011 at a slightly slower pace than initially estimated as companies pulled back on capital spending, worried that yen

strength and slowing global growth will hurt exports.

Gross domestic product grew by 1.4 percent between July and September 2011 from the previous quarter equivalent to an annualized rate of 5.6 percent, slightly slower than a preliminary 1.5 percent increase. Capital spending fell a revised 0.4 percent, against a preliminary reading of 1.1 percent increase and economists' forecast for a 0.1 percent decline. Consumer spending, which comprises almost 60 percent of Japan's GDP, rose by 0.7 percent compared to a preliminary 1.0 percent gain, because spending on items such as cars turned out to be less than initially estimated.

According to the journal of commerce, the number of people employed stood at 62.46 million, unchanged from September. The number of unemployed was up by 250,000, or 9.4 percent, reaching 2.92 million. The non-workforce population, meanwhile, was down by 220,000, or 0.5 percent, to 44.96 million. The jobless rate for men in the reporting month rose to 4.8 percent from 4.4 percent, while that for women grew to 4.0 percent from 3.6 percent.

Japan suffered a trade deficit of USD 3.56 billion in October, as exports fell amid a slowdown in the global economy and a stronger yen, according to the Japanese government. In September, Japan posted a trade surplus of USD 3.85 billion, and many analysts had expected Japan to post a trade surplus again in October.

According to the tradingeconomics.com, the general inflation rate in Japan was last reported at -0.2 percent in October of 2011.

The consumer price index for Japan in October 2011 was 100.0 (2010=100), up 0.1 percent from the previous month, and down by 0.2 percent over the year. The consumer price index for Ku-area of Tokyo in November 2011 (preliminary) was 99.3(2010=100), down by 0.6 percent from the previous month, and down by 0.8 percent over the year. Core consumer prices (All items, less food (less alcoholic beverages) and energy) declined by 1 percent over one year earlier.

3. EMERGING ECONOMIES

In emerging and developing countries, economic activity was performing closely to forecasts despite some disparities across regions. In developing Asia, economic activity decelerated a bit after supply chain disruptions and partly due to destocking to deal with uncertain demand from advanced economies, while Sub-Saharan Africa continued to grow at a high rate in the third quarter of 2011.

Growth in the developing economies led by China maintained fairly robust momentum. This continued to provide support to a wide range of commodity prices, alongside the impact which the financial turmoil in the

euro area and tensions in the Middle East and North Africa had on the price of gold. In sub-Saharan Africa, available data suggest that economic growth continued at a fair pace, supported by favorable prices of export commodities, financial systems that were not overly exposed to the problems of the advanced economies, and improved economic policies.

3.1China

The gross domestic product (GDP) in China expanded by 2.3 percent (Y-o-Y) in the third quarter of 2011 over the previous quarter. China's economy is the second largest in the world after that of the United States. During the past 30 years, China's economy changed from a centrally planned system that was largely closed to international trade to a more market-oriented with a rapidly growing private sector. A major component responsible for China's rapid economic growth is exports.

In the first three quarters of 2011, the total value added of the industrial enterprises above designated size was up by 14.2 percent (year-on-year) at comparable prices, 0.1 percentage points lower than that in the first half of this year.

The inflation rate in China stood at 4.2 percent in November of 2011. From 1994 until 2010, the average inflation rate in China was 4.25 percent reaching an historical high of 27.70 percent in October of 1994 and a record low of -2.20 percent in March of 1999. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power.

3.2 India

The India's gross domestic product (GDP) expanded by 6.9 percent in the third quarter of 2011 over the previous quarter. India's diverse economy encompasses traditional village farming, modern agriculture, handicrafts, a wide range of modern industries and a multitude of services. Services are the major source of economic growth, accounting for more than half of India's output with less than one third of its labor force.

The inflation rate in India was reported at 9.36 percent in October of 2011.

The unemployment rate in India was last reported at 9.4 percent in 2009/10 fiscal year. From 1983 until 2000, India's unemployment rate averaged 7.20 percent, reaching an historical high of 8.30 percent in December of 1983 and a record low of 5.99 percent in December of 1994.

The Indian Rupee depreciated by 5.71 percent against the US dollar in the last month of the third quarter. During last 12 months, the Indian Rupee depreciated by 14.27 percent against US dollars.

4. ASSETS AND COMMODITY PRICES

4.1 Financial Markets

Global markets have taken a turn for the worse as the 2Q draws to a close and we think investor uncertainty remains high going into the third quarter. Economic data in the major economies (US, Europe, UK and Japan) all showed signs of deterioration over the last couple of months, undercutting prospects for the global recovery as a whole. Key emerging markets, which had been the primary source of global growth in the first half of the year, are showing signs of the effects of higher interest rates and other policy measures, like China's increases to its Required Reserve Ratio to curb bank lending. To us, this suggests emerging economy growth, especially out of Asia, may be unable to pick up the slack from any further weakness seen in the major economies, and this biases our view for global growth to the downside in the months ahead.

4.2 Global Commodity Markets

GLOBAL risk is currently in thrall of fiscal crises in the US (growth slowdown, debt ceiling short-term, budget reduction longer term) and Europe (peripheral sovereign debt, bank exposure, EU governance, fiscal austerity and growth imperative). China is a dark horse, with a leveraged banking system, hot property market and over-reliance on infrastructure investment and export.

Global resource constraints give an upward bias to food and energy prices, and thereby inflation.

4.3 Global Exchange Rate Movements

Over the course of 2010, US dollar has experienced some volatility against major currencies. In the third quarter of 2011, US dollar has remained same against Euro from Euro 0.735 in third quarter of 2010 to EUR 0.735 in the third quarter of 2011, US dollar appreciated only 0.1 basis point against British pound from GBP 0.598 in third quarter of 2010 to GBP 0.639 in third quarter of 2011, and US dollar depreciated only 0,1 basis point against Chinese Yuan from Chinese Yuan 6.487 in third quarter of 2010 to Yuan 6.388 in third quarter of 2011. Similarly, US dollar remained stable against all other trade partners' currencies.

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

Currency	Code	Q1-2010	Q2-2010	Q3-2010.	Q3-2011
Euro	EUR	0.743	0.819	0.735	0.735
Swiss Franc	CHF	1.064	1.085	0.976	0.897
British Pound	GBP	0.663	0.664	0.598	0.639
Japanese Yen	JPY	92.670	88.640	83.650	76.62
Chinese Yuan	CNY	6.816	6.789	6.487	6.388

Source: OANDA.COM

CHAPTER II

MONETARY AND CAPITAL MARKET DEVELOPMENTS

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

Monetary and capital market developments evaluates monetary program under Extended Credit Facility (ECF) program, monetary aggregates, foreign exchange rates, net international reserves (NIR) as well as open market operations. DAB's ultimate goal is to maintain domestic price stability, to achieve its goal; DAB uses, both primary and indicative tools. In the second quarter of 1390, monetary aggregates exhibited mixed performance, reserve money (RM), the primary target, had almost a similar indifference curve as of the currency in circulation which is the quantitative performance criteria under the poverty reduction and credit facility – extended credit facility (PRGF-ECF) program. Currency in circulation constitutes one of the crucial components of the reserve money with more than 85 percent contribution to the reserve money with a significant correlation.

In the first quarter of 1390, the reserve money increased dramatically above the target level and the situation continued throughout the second quarter mainly due to influx of afghani in Kabul Bank's current account, where DAB acted as the lender of the last resort to safeguard public's deposits with the bank. Therefore, DAB was not able to achieve the primary target in the second quarter of 1390. On the other hand, narrow money (M1) increased by 22.40 percent on a year-on-year basis. Broad money (M2) demonstrated similar behavior growing by 21.78 percent.

In the meantime, the exchange rate of afghani against the U.S. dollars depreciated by 3.19 percent in the second quarter of 1390 – the exchange rate of afghani moved in a corridor of AF45.99 per U.S. dollar at the end of the first quarter to AF47.46 at the end of the second quarter of 1390.

Foreign exchange auction, the primary instrument used by DAB to control money supply growth. In the first two quarters of 1390, DAB's intervention reached a total of USD 1,023.40 million.

Capital notes are the other instruments used by DAB in order to control liquidity in the local market. The weighted average interest rate on 28 day capital notes (CNs)

fell down from 2.28 percent at the end of the first quarter of 1390 to 2.15 percent in the second quarter and from 3.36 percent to 3.3 percent for 182 day CNs respectively.

The stock of Afghanistan's net international reserves (NIR) increased by 1.17 percent (Y-o-Y) in the second quarter of 1390. The NIR stood at USD5.554 billion in the first quarter and increased to USD5.619 billion at the end of the second quarter, which is well above the floor of USD4.3 billion for the second quarter of 1390.

1 - PRGF-ECF MONETARY PROGRAM

Reserve money (RM), which is the primary target for the monetary authority and performance criteria under PRGF-ECF program stood at AF167,857.16 million compared to its target of AF165,202.89 million at the end of the second quarter. The ultimate objective of monetary policy is to maintain price stability aims to influence the reserve money-- the operational target (performance criterion) -- in order to achieve its ultimate goal. The reserve money growth is calculated based on the expected economic growth and inflation rate. Reserve money equals to the sum of currency in circulation, current accounts of commercial banks with central bank, overnight deposit facility (ONDF) and the required reserves of commercial banks.

For the year 1390, the target for reserve money growth has been revised to 18.8 percent and for currency in circulation growth it was revised to 17.7 percent respectively, based on discussion with IMF taken into account the inflationary pressure in domestic economy mostly because of the external shocks.

Central bank was not able to achieve its target, both for first and second quarters due to Kabul Bank crises, where central bank acted as the lender of last resort in order to guarantee public deposits. The actual reserve money ended at positive growth of 10.25 percent for the first quarter and 11.16 percent for the second quarter, while the PRGF-ECF target was at 4.7 percent and 9.40 percent respectively.

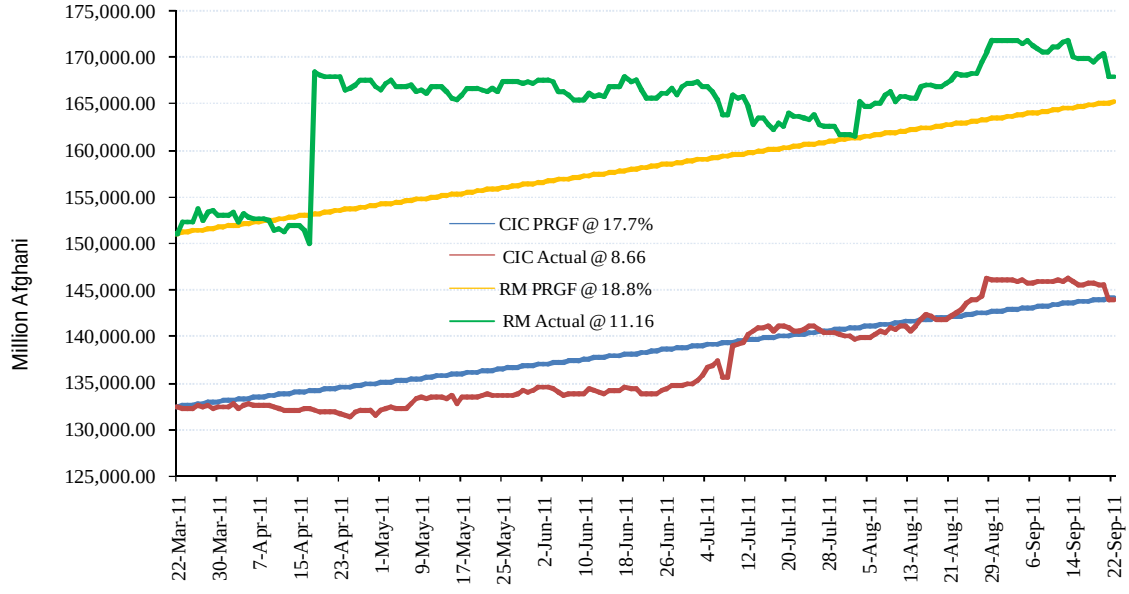
Table 2.1 and Figure 2.1 depict reserve money growth at the end of second quarter 1390.

Table 2.1: Reserve Money Summary

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

Source: Monetary Policy Department/DAB

Figure 2.1: Reserve Money and Currency in Circulation, Q2 1390



Source: Monetary Policy Department/DAB

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

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

ceiling on currency in circulation growth it is 17.7 percent.

2. MONETARY AGGREGATES

The monetary aggregates -- narrow money and broad money -- are compiled based on the MFS methodology and definition. Narrow money as referred (M1) grew by 22.40 percent (Y-o-Y) in the second quarter of 1390 compared to 21.5 percent in the same quarter of last year. The increase in M1 is attributed mainly to the increase in demand for the local currency and people's confidence to use afghani as medium of exchange and store of value. The demand deposits, a component of M1, increased from 10.4 percent in the second quarter of the 1389 to 21.34 percent in the second quarter of the year under review.

On the other hand, the stock of broad money (M2) grew to AF293,073 million. The overall growth in M2 in the second quarter of 1390 was 21.78 percent (Y-o-Y) down from 25.9 percent growth in the second quarter of 1389. M1 is the main contributor to the growth in M2 since M1 constitutes one of the components of Broad Money (M2).

Quasi money or time deposits of commercial banks which is the other component of M2 grew by 13.65 percent in the second quarter of 1390 compared to the same quarter of last year. However, because quasi money is the smallest component of the M2, therefore, the impact of changes on M2 is negligible. The year on year difference of afghani denominated time deposits for the second quarter of 1390 was AF115 million and foreign currency denominated time deposits difference recorded at AF2,204 million.

Meanwhile, bank deposits as share of broad money grew by 46.43 percent (Y-o-Y) in the second quarter of 1390 down from 46.60 percent in the second quarter of previous year. (Figure 2.2)

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

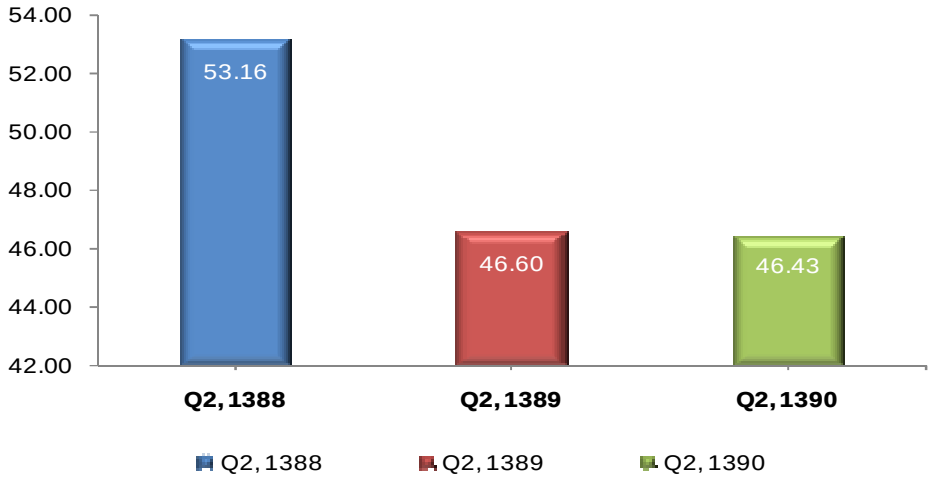


Table 2.2: Monetary Aggregate, Second Quarter of 1389 (in million AF)

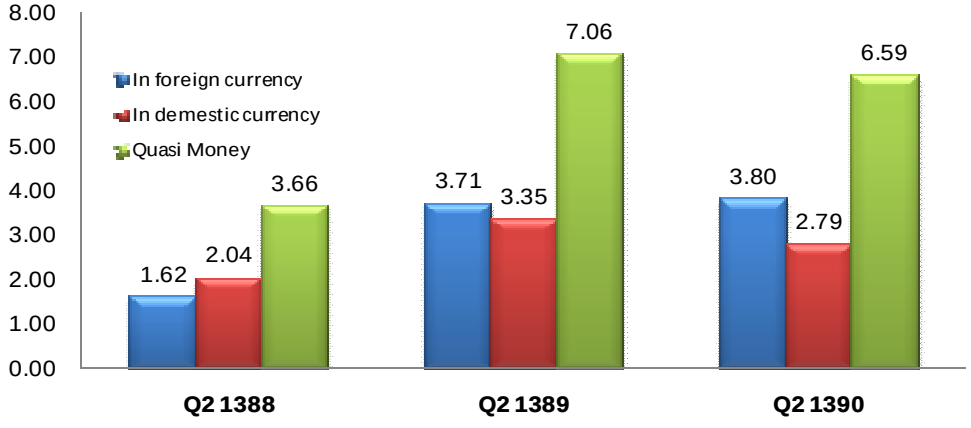
	1388 Q2 Amount	1389 Q2 Amount	Y-o-Y Changes	Difference	1390 Q2 Amount	Y-o-Y Change (Q2 1389 – Q2 1390)	Difference (Q2 1389 –Q2 1390)
1- Net Foreign Assets	**224,479**	**249,463**	**11.1%**	**24,984**	**333,533**	**33.70%**	**84,070**
(a) Foreign Assets	240,447	265,431	10.4%	24,984	354,391	33.52%	88,960
DAB Foreign exchange reserves	200,441	212,914	6.2%	12,473	290,546	36.46%	77,631
Gold	34,641	37,611	8.6%	0.000	45,232	20.26%	0.000
Other	165,800	175,303	5.7%	9,503	245,314	39.94%	70,011
Other foreign assets	40,006	52,517	31.3%	12,511	63,846	21.57%	11,329
(b) Foreign Liabilities	15,968	15,968	0.0%	0	20,858	30.62%	4,890
2. Net Domestic Assets	**-34,622**	**-2,984**	**-91.4%**	**31,639**	**-40,460**	**1256.06%**	**-37,476**
(a) Net Domestic Credit	6,173	16,963	174.8%	10,791	-41,947	-347.28%	-58,910
Net Credit to Nonfinancial Public Sector	-47,371	-63,986	35.1%	-16,615	-81,628	27.57%	-17,642
Net Credit to Central Government	-53,150	-64,161	20.7%	-11,011	-81,913	27.67%	-17,753
Credit to Central Government	17,632	16,034	-9.1%	-1,598	17,507	9.19%	1,473
Liabilities to Central Government	70,782	80,195	13.3%	9,413	99,421	23.97%	19,226
Net Credit to State & Local Government	0	0	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Nonfinancial Corporations	5,779	175	-97.0%	-5,604	286	63.14%	111
Credit to Private Sector	53,543	80,949	51.2%	27,406	39,681.14	-50.98%	-41,268
Net Credit to Other Financial Corporations	0	0		0	0.00		0
(b) Capital Accounts	63,246	51,045	-19.3%	-12,201	47,713	-6.53%	-3,332
(c)Other Items Net	22,451	31,098	38.5%	8,646	49,200	58.21%	18,102
3- Broad Money(M2)	**191,083**	**240,656**	**25.9%**	**49,573**	**293,073**	**21.78%**	**52,417**
Narrow Money(M1)	184,089	223,668	21.5%	39,579	273,766	22.40%	50,098
CiC (Currency outside depository corporations)	82,500	111,519	35.2%	29,019	137,680	23.46%	26,161
Demand Deposits	101,589	112,150	10.4%	10,561	136,087	21.34%	23,937
Other Deposits (Quasi Money)	6,994	16,988	142.9%	9,994	19,307	13.65%	2,319
In Afghani	3,898	8,057	106.7%	4,160	8,173	1.43%	115
In Foreign currency	3,096	8,930	188.5%	5,834	11,134	24.68%	2,204
Securities Other Thank Shares	0	0.000	0.000	0.000	0.000	0.000	0.000

Source: Monetary Survey Section, Monetary Policy Department /DAB

Similarly, quasi money formed 6.59 percent of the broad money in the quarter under review. Afghani-denominated time deposits constitute 2.8 percent of broad money, while share of foreign currency denominated time deposits in M2 stood at 3.8 percent.

In the second quarter of the previous year, the quasi money amounted to AF 16,987 million, (AF8,057 million afghani denominated time deposits and AF8,930 million in foreign currency denominated time deposits), while for the second quarter of current year, it has reached AF19,307 million (AF8,173 million in afghani denominated time deposits and AF11,134 million in foreign currency denominated time deposits) which shows an increase of 16.65 percent (Y-o-Y).

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



Source: Monetary Survey Section, Monetary Policy Department, DAB

3. FROEIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates

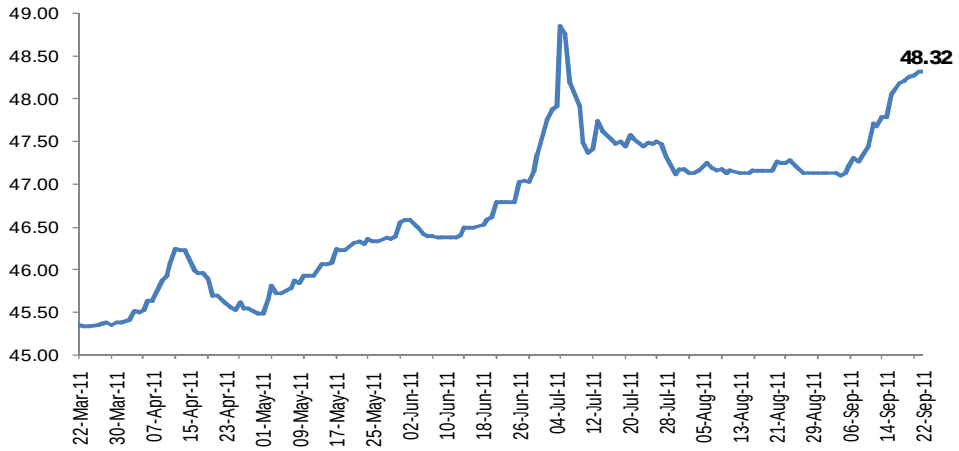
In order to control the money supply, central bank is targeting reserve money through its instruments of FX auction and capital note (CN) auction.

The nominal exchange rate of afghani against USD depreciated by 7.04 percent (Y-o-Y) at the end of the second quarter of 1390 compared to the same period of last year. Afghani was traded at 48.32 per USD on the Sep 22, 2011 compared to AF 45.14 on Sep 22, 2010. The daily historical review of the exchange rate of afghani against USD, as of second quarter of 1390 (September 22, 2011) is shown in Figure 2.4.

The nominal exchange rate of afghanis has depreciated against major currencies particularly against U.S. dollar in local

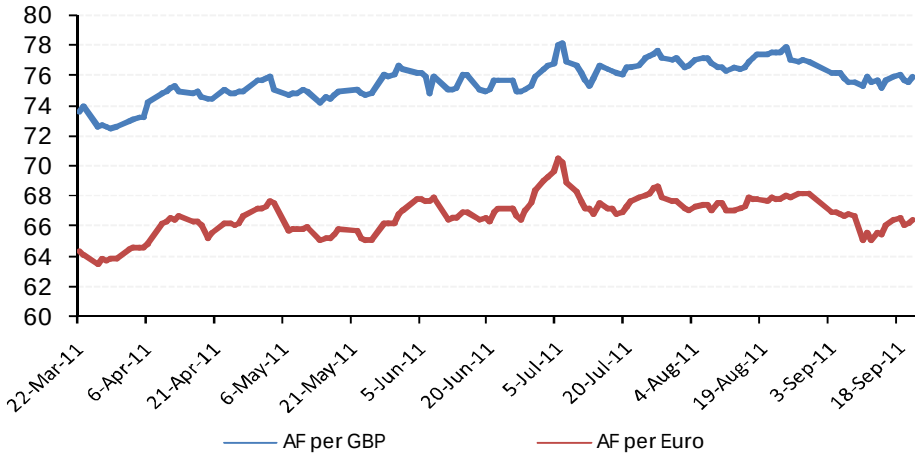
markets which is a market determined factor where DAB's aim is the price stability in domestic economy.

Figure 2.4: Daily Nominl Exchange Rate (AF/USD)



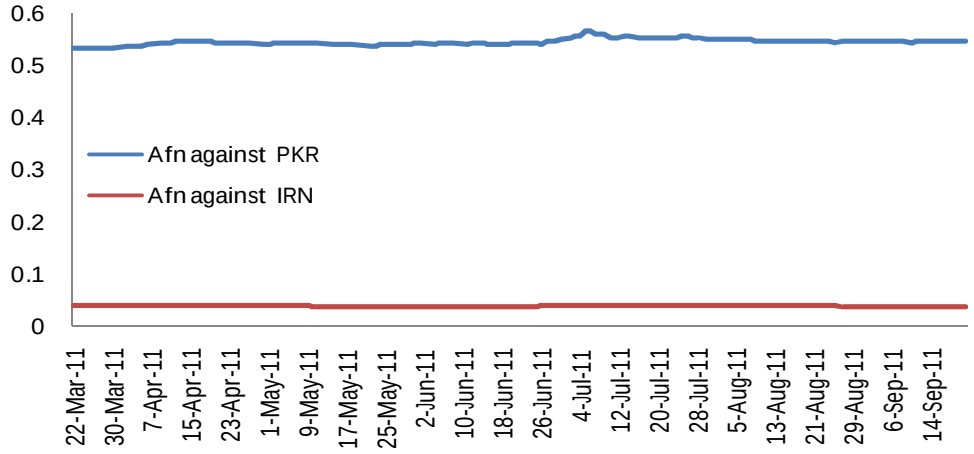
The comparison of historic review of the daily average exchange rate of Afghani against some major currencies for the first two quarters of 1390 (March 22 to September 22, 2011) is shown in Figures 2.5 and 2.6 below:

Fiure 2.5: Afghani against GBP and Euro



Source: Monetary Survey Section, Monetary Policy Department, DAB

Figure 2.6: Afghani against PkR and IRN



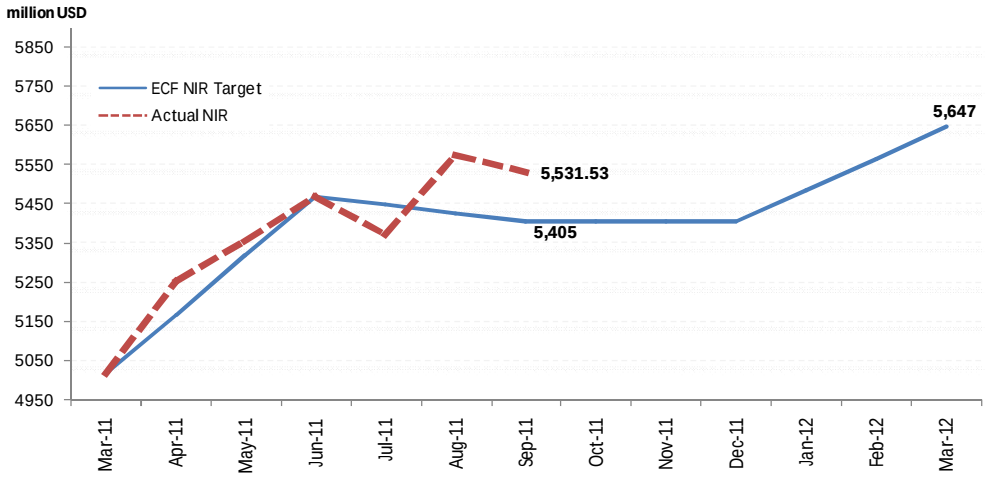
Source: Monetary Survey Section, Monetary Policy Department, DAB

3.2 Net International Reserves (NIR)

Da Afghanistan Bank (DAB) has accumulated USD 514.53 million net international reserves (NIR) at the end of the second quarter of 1390 which is well above the target of USD 388 million. DAB has achieved NIR accumulation target for first and second quarters of 1390 ended at USD5.53 billion at the end of second quarter of 1390 up from USD 5.017 billion at the beginning of year. Accumulation of NIR builds up people's confidence on the domestic currency which indirectly stabilizes the local currency. The NIR position grew by large amounts in the first and second quarters of 1390, but since DAB uses FX auction to control the currency in circulation, a significant portion of the foreign currency (U.S. dollar) is supplied to the foreign exchange market in the form of auction which affects the total amount of net international reserves negatively. Currently, on average, NIR supports about 12 months of imports.

DAB anticipates NIR to be around USD 6 billion by the end of 1390 (2011-12). Furthermore, the gross international reserves stood at USD 6.11 billion at the end of the second quarter (September 21, 2011).

Figure 2.7: Net International Reserves as of Second quarter of 1390



Source: Monetary Survey Section, Monetary Policy Department, DAB

3.3 Foreign Exchange Auction

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

In the first two quarters of 1390, DAB's intervention reached a total of USD 1,023.40 million (USD 441.80 million in the first quarter and USD 581.60 million in the second quarter) awarded amount for bidders, while the total amount announced was USD 1,065 million (USD 495 million in the first quarter and USD 570 million in the second quarter).

DAB has increased the volume of auction due to excess liquidity in local economy, compared to the second quarter of 1389 of USD 834.53 million.

Table 2.3 summarizes the result of DAB foreign exchange auctions for the end of the second quarter of 1390.

Table 2.3: Foreign Exchange Auction History, Second Quarter of 1390 (in million USD)

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Ex Rate	Amount Announced	Amount Awarded	No of Awarded Bidders
27-Mar-11	45	45.38	45.18	45.37	45.37	30.00	31.85	21
3-Apr-11	41	45.52	45.31	45.49	45.52	35.00	26.40	23
10-Apr-11	39	45.92	45.61	45.90	45.93	30.00	24.25	24
17-Apr-11	44	46.05	45.90	45.98	45.96	40.00	40.90	35
24-Apr-11	39	45.60	45.45	45.53	45.57	40.00	38.25	
1-May-11	40	45.50	45.38	45.46	45.49	40.00	25.85	18
8-May-11	40	45.86	45.51	45.84	45.87	40.00	36.55	19
15-May-11	35	46.06	45.90	46.04	46.06	40.00	39.70	18
22-May-11	34	46.40	46.10	46.31	46.33	40.00	38.70	22
29-May-11	44	46.37	46.21	46.34	46.36	40.00	34.60	25
5-Jun-11	45	46.45	46.31	46.41	46.42	40.00	35.00	36
12-Jun-11	42	46.37	46.00	46.35	46.38	40.00	31.85	25
19-Jun-11	45	45.58	46.38	46.55	46.58	40.00	37.90	23
26-Jun-11	44	47.03	46.71	46.93	47.03	40.00	37.25	37
3-Jul-11	50	47.84	47.40	47.76	47.88	40.00	46.80	35
9-Jul-11	48	47.94	47.40	47.88	47.92	25.00	36.00	32
12-Jul-11	44	47.45	47.11	47.37	47.42	25.00	34.20	32
16-Jul-11	46	47.53	47.91	47.40	47.53	30.00	31.60	31
19-Jul-11	46	47.44	47.25	47.42	47.45	30.00	28.05	19
23-Jul-11	47	47.46	47.19	47.43	47.44	30.00	30.55	25
26-Jul-11	54	47.50	47.00	47.48	47.50	30.00	38.65	26
30-Jul-11	39	47.11	46.51	47.07	47.12	30.00	22.75	21
2-Aug-11	50	47.12	46.91	49.09	47.12	30.00	21.90	21
6-Aug-11	47	47.25	47.01	47.21	47.26	20.00	20.95	19
9-Aug-11	41	47.15	46.87	47.11	47.18	20.00	21.10	27
13-Aug-11	43	47.13	46.92	47.10	47.13	20.00	21.75	25
16-Aug-11	42	47.16	46.85	47.14	47.17	20.00	20.90	19
20-Aug-11	32	47.16	47.00	47.14	47.16	20.00	10.95	11
23-Aug-11	41	47.28	46.81	47.25	47.26	20.00	17.85	18
27-Aug-11	39	47.10	46.80	47.07	47.14	40.00	24.65	20
3-Sep-11	33	47.13	46.90	47.09	47.13	40.00	20.20	21
6-Sep-11	40	47.23	47.00	47.22	47.22	20.00	23.30	17
10-Sep-11	38	47.42	47.27	47.41	47.44	20.00	11.45	11
13-Sep-11	34	47.83	47.50	47.78	47.79	20.00	19.80	15
17-Sep-11	32	48.22	48.21	48.15	49.19	20.00	20.40	23
20-Sep-11	42	48.23	47.97	48.23	48.28	20.00	20.55	22

4. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

4.1 Capital Note Auctions

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

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

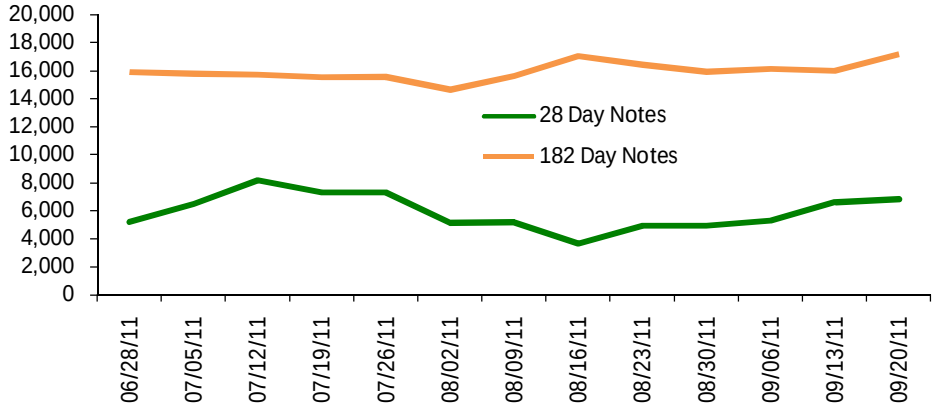
Both notes witnessed an increase in their balances during second quarter of 1390. The 28 day stock outstanding had an increase of AF 1.6 billion. Similarly, the 182 day notes exhibited an increase of AF 1.2 billion during the quarter under review. The stock outstanding for 28 day notes during the quarter under review stood at AF 6.8 billion and AF 17.1 billion for 182 day. These figures were AF 4.4 billion and AF 16.1 billion for 28 day and 182 day notes respectively during the end of preceding quarter.

The outstanding amount gap (the difference between 28 day stock and 182 day notes stock) between these two notes shrunk from AF 11.6 billion to AF 10.0 billion on average basis during the quarter under review. The decrease was due to increase in 28 day CNs outstanding amount.

The total outstanding stock of both maturities stood at AF 23.9 billion at the end of the reporting period. This figure was AF 20.5 billion at the end of preceding quarter.

It is worth mentioning that no secondary market transaction took place before or during the quarter.

Figur 2.8: Capital Notes Stock outstanding (in million AF)



The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, on average the bid amount for 28 days notes was AF 2.1 billion, while the amount awarded was AF 1.8 billion for a cover ratio of 1.16 times. The bid amount for 182 day note was AF 1.2 billion and amount awarded was AF 979 million for a cover ratio of 1.24 times. These figures were AF 1.5 billion, AF 858 million and 1.45 times respectively for 28 day notes during the last quarter. On average, the total bid amount, awarded amount and cover ratio were AF 898 million, AF 675 million and 1.33 for 182 day notes in the preceding quarter.

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

Figure 2.9: 28 Day Capital Notes Demand and Awarded Amount (AF million)

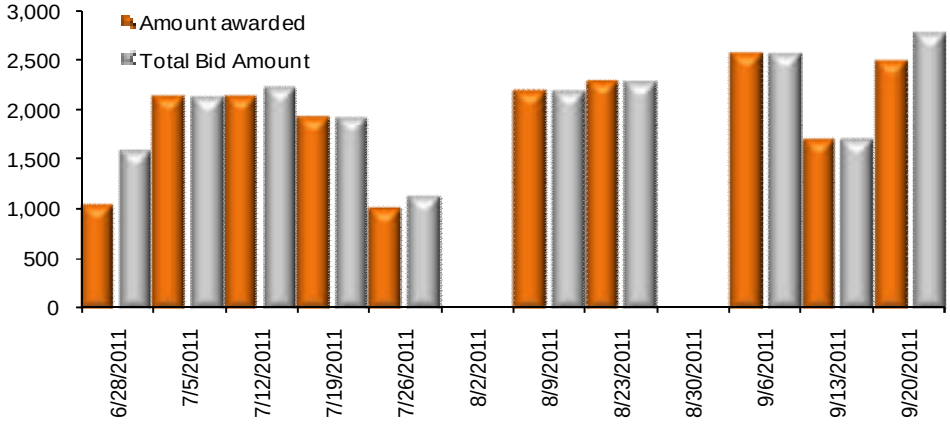
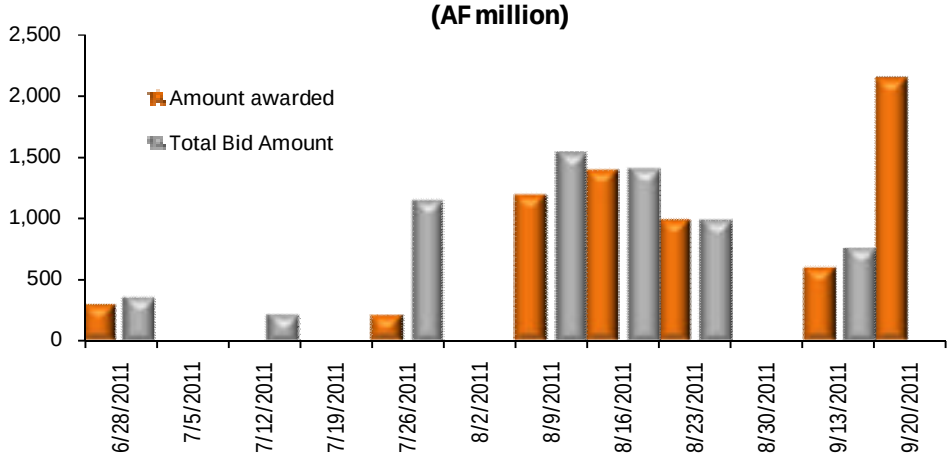


Figure 2.10: 182 Day Capital Notes Demand and Awarded Amount (AF million)

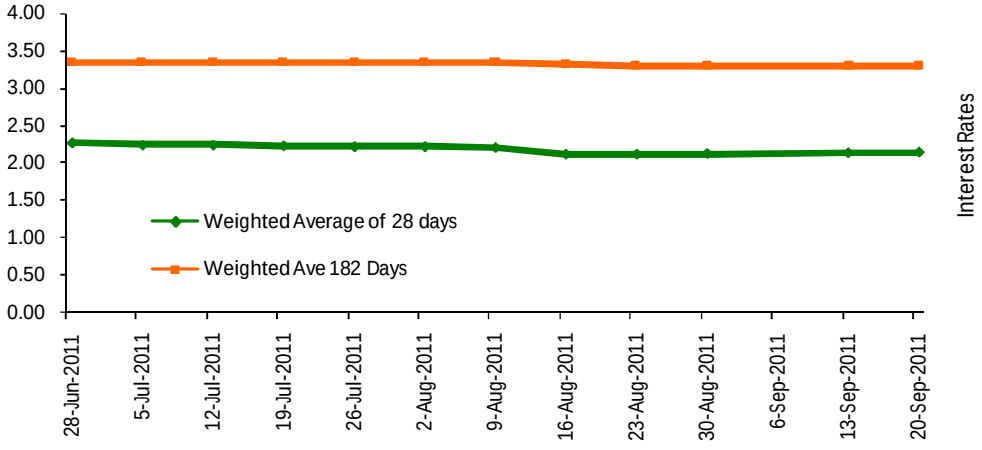


Source: Market Operations Department, DAB

The interest rates for both maturities followed almost a flat shape with minimum decreases for both notes. The 28 day notes noticed a decrease of 12 basis points and decreased by .05 basis points for 182 day notes. At the end of quarter under review weighted average interest rate stood at 2.15 percent and 3.30 percent for 182 day notes. These figures were 2.28 percent and 3.36 percent respectively in the first quarter of year 1390.

Throughout the quarter the average spread between the rates of these securities was 1.14 percent with an increase of 12 basis points compared to last quarter.

Figure 2.11: Weighted Average Interest Rate of 28 day and 182 Day Capital Notes



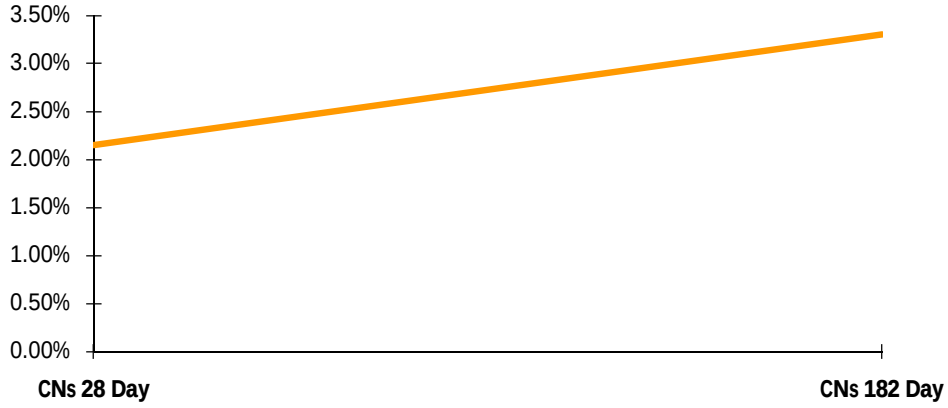
Source: Market Operations Department, DAB

4.2 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 CNs.

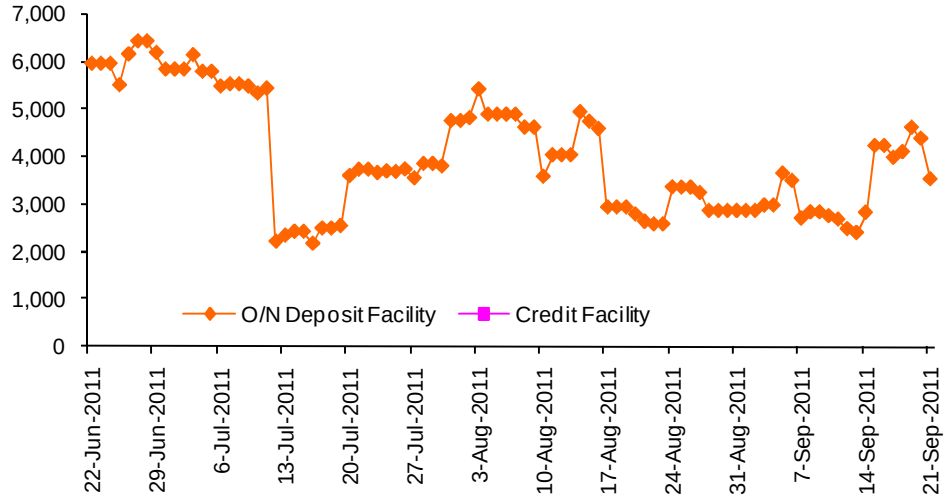
The yield curve as of 22nd Sep, 2010 is positive.

Figure 2.12: Term Structure of Interest Rates Yield Curve Sep 20, 2011



Source: Market Operations Department, DAB

Figure 2.13: Overnight Deposit Facility Balances (in million AF)



Source: Market Operations Department, DAB

4.3 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted towards required reserves. The interest rate on the overnight deposit facility is now 100 basis points below 28 auction cut-off rate (Based on DAB Supreme Council on Jun, 06, 2010).

The outstanding amount for Deposit Facility Account noticed a gradual decrease in the balances throughout the period under review. It decreased from AF 6.2 billion to 3.5 billion throughout the period under review.

The quarter ended with stock outstanding amounting of AF 3.5 billion. This figure was AF 6.1 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 short fall 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 AF 693 million and AF 555 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 rate or equal to the deposit facility rate.

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

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate	Weighted Average Interest Rate
6/28/2011	200	1,050	1,600	3	4	2.27%	2.27
7/05/2011	200	2,150	2,150	3	3	2.26%	2.24
7/12/2011	200	2,150	2,250	2	3	2.24%	2.24
7/19/2011	200	1,940	1,940	3	3	2.26%	2.23
7/26/2011	200	1,025	1,140	3	4	2.23%	2.22
8/02/2011	200	0	0	0	0	0.00%	2.22
8/09/2011	200	2,200	2,210	3	3	2.23%	2.21
8/23/2011	200	2,300	2,300	2	2	2.17%	2.12
8/30/2011	200	0	0	0	0	0.00%	2.12
9/06/2011	200	2,580	2,580	5	5	2.17%	2.13
9/13/2011	200	1,710	1,720	3	3	2.17%	2.14
9/20/2011	200	2,500	2,800	3	4	2.16%	2.15

Source: Market Operations Department, DAB

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

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate	Weighted Average Interest Rate
6/28/2011	100	300	360	3	4	3.36%	3.35
7/5/2011	100	0	0	0	0	0.00%	0.00
7/12/2011	100	0	210	0	2	0.00%	0.00
7/19/2011	100	0	0	0	0	0.00%	0.00
7/26/2011	100	220	1,140	1	3	3.36%	3.35
8/2/2011	100	0	0	0	0	0.00%	0.00
8/9/2011	100	1,200	1,535	3	5	3.34%	3.33
8/16/2011	100	1,400	1,400	4	4	3.33%	3.31
8/23/2011	100	985	985	4	4	3.33%	3.30
8/30/2011	100	0	0	0	0	0.00%	0.00
9/13/2011	100	600	758	2	4	3.32%	3.30
9/20/2011	100	2,150	2	5	5	3.31%	3.28

Source: Market Operations Department, DAB

CHAPTER III

THE INFLATION TREND AND OUTLOOK

3

THE INFLATION TRENDS AND OUTLOOK

The trend toward accelerating inflation in Afghanistan that began in the third quarter of 1389 started to decline in the first quarter of 1390 and continued to decline further in the second quarter of 1390. By all measures, inflation is decreasing, but it is still relatively high.

For example, year-on-year Kabul headline inflation in the second quarter of 1390 was 10.29 percent, which is a high number in itself, and higher than the inflation of 5.30 percent recorded in the second quarter of 1389. This sharp increase in overall inflation over the previous year was led primarily by non-food prices and to a small extent, by increasing food prices. The increase in non-food prices was mainly driven by a shortage in the supply of goods and services from the neighboring countries. Food prices have been increasing throughout the world, causing fears of a sharp increase in food prices like that occurred in 2008. However, core inflation, which excludes the volatile components of bread and cereals, oils and fats, and transportation from the headline CPI, is currently at relatively high level of 12.81 percent (Y-o-Y), suggesting that inflation has spread beyond these basic commodities.

Nationwide inflation also increased significantly from the same quarter of the previous year. Interestingly, inflation in rents and transportation costs were increasing rapidly both, nationwide and in Kabul.

When the quarter-on-quarter changes in inflation are observed, the picture is different. The Kabul headline inflation in the second quarter of 1390 increased significantly from the first quarter at a very high level of 8.2 percent. If these high levels of inflation persist in the third and fourth quarters of 1390, inflation for 1390 will be considered alarming.

The quarter-on-quarter changes in nationwide inflation showed different patterns than that in Kabul. By this measure, nationwide inflation was lower than in Kabul, decreasing slightly over the first quarter. In addition, nationwide inflation in rents decreased from the first quarter, while inflation in food prices

increased, the same pattern was observed in Kabul.

1. INFLATION INCREASED SHARPLY IN AFGHANISTAN

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation increased dramatically in the second quarter of 1390 when compared with the second quarter of 1389. The year-on-year percentage changes in Kabul CPI stood at 10.3 percent in the quarter under review, representing a sharp increase from 5.3 percent inflation in the same quarter of last year.

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

To analyze the contributing factors to the increase in inflation, it is necessary to discuss the behavior of inflation in those components that have the most significant weights in the calculation of the CPI. First, we will analyze those components that showed the largest unfavorable changes in inflation from the previous year, and then we will look at the components that showed favorable changes.

The increase in inflation was primarily attributed to sharp increases in both, food and non-food price indices. The food price index comprises 61.3 percent of the CPI basket increased by 6.5 percent (Y-o-Y) in the second quarter of 1390 compared to 4.7 percent in the same quarter of last year. This represents 1.82 percentage points increase. The non-food price index which comprise 38.70 percent of the CPI basket, displayed significantly higher rate of increase in the reporting period. The year-on-year change in non-food prices was higher, recording 16.21 percent inflation rate in the second quarter compared to a 6.30 percent increase in the same quarter of last year, representing 9.9 percentage points increase The increase of 1.82 percentage points in the rate of inflation in food costs was far lower than the 9.91 percentage-point increase in non-food inflation, reversing a pattern established in previous quarters.

After declining through 1388 and the first quarter of 1389 from a sharp increase experienced in 1387, food prices rose rapidly through the rest of 1389 and in the first two quarters of 1390. The high rate of inflation started to decline during the first two quarters of 1390, but is still high

compared with the same quarter of last year, following the world trends. Regionally, food prices were affected by devastating weather conditions and the political uncertainty in Pakistan and Afghanistan.

Table 3.1: Breakdown of Kabul Headline CPI

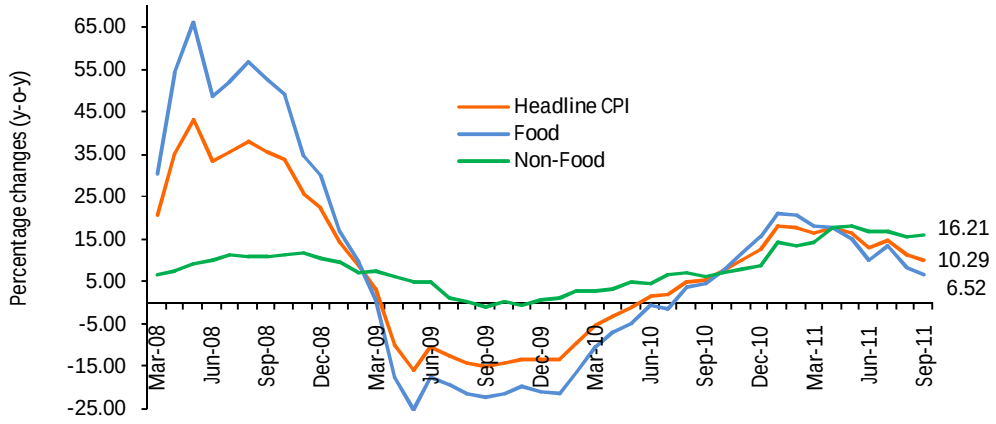
(Percent changes year on year)

Consumer Price Index (March 04=100)

	Weights	1388				1389				1390	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**100**	**-10.0**	**-14.9**	**-13.2**	**-5.2**	**1.5**	**5.3**	12.9	16.6	13.0	10.3
Food and Beverages	**61.3**	**-17.5**	**-21.9**	**-20.7**	**-10.1**	**-0.6**	**4.7**	15.6	18.3	10.3	6.5
Bread and Cereal	28	-30.2	-35.9	-36.0	-22.5	-6.5	3.2	12.5	24.8	7.1	0.9
Meat	6	-0.3	-1.4	-1.7	5.3	7.2	21.5	24.2	20.1	19.3	7.9
Milk and cheese	5.6	4.7	0.6	1.3	-2.6	1.9	2.0	5.5	3.6	8.8	10.8
Oil and Fat	5.3	-17.5	-21.2	-5.5	-0.2	5.1	7.6	28.5	24.4	28.0	35.1
Fresh & dried fruits	4.9	15.4	9.8	0.3	-2.5	-5.7	-6.3	14.0	13.8	17.4	16.3
Vegetables	4.9	-0.1	-1.1	1.2	4.8	14.0	8.0	29.7	13.3	0.8	-2.7
Sugar & Sweets	1.8	16.3	18.2	20.8	22.9	14.1	10.4	13.5	7.9	12.1	11.5
Spices	1.1	8.4	5.6	2.5	7.2	10.2	5.3	6.1	5.3	3.1	2.9
Tea & Beverages	2	2.1	0.3	-0.9	1.2	1.8	-0.5	4.9	7.0	12.9	16.4
Tobacco & Cigarettes	1.7	3.2	2.1	3.1	4.3	5.6	8.6	10.5	9.5	7.8	5.2
Non – Food	**38.7**	**5.0**	**-0.8**	**0.9**	**3.0**	**4.8**	**6.3**	8.8	14.2	17.0	16.2
Clothing	7.2	6.8	3.0	1.3	1.3	0.7	-2.1	1.1	3.5	7.4	9.7
Housing	17.2	7.1	-2.3	0.4	4.5	6.9	11.6	15.5	15.1	16.9	13.4
Rents	7.1	8.6	3.8	4.3	6.4	11.5	19.2	27.5	28.7	30.6	22.6
Construction materials	3.2	1.0	-14.1	-11.5	-2.4	3.9	14.4	14.6	9.6	13.0	7.0
Fuel and Electricity	6.8	7.7	-3.4	0.7	4.9	3.8	4.5	6.2	4.7	5.6	6.5
Household goods	7	3.0	2.5	2.6	1.0	0.3	-0.5	2.1	30.1	42.7	45.4
Health	2	19.3	7.2	4.9	-0.2	-0.5	-0.6	0.6	2.5	2.3	5.1
Transportation	2.3	-14.0	-11.9	-2.3	5.4	14.5	10.3	0.2	14.9	20.8	12.4
Communications	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.2	0.6	0.1	-0.6	-0.4	-1.7	-0.9	0.5	11.7	13.0	12.5
Miscellaneous	0.9	12.6	8.4	4.8	0.1	1.0	-1.3	10.1	13.3	13.1	16.0
Core inflation (28% TM)		**4.2**	**0.5**	**0.8**	**1.8**	**3.8**	**4.1**	**9.0**	**11.4**	**10.8**	**10.0**
Core infl. (headline excluding bread and cereals, oil and fats, and transportation)			**1.4**	**1.5**	**2.9**	**4.6**	**5.9**	**12.6**	**13.0**	**14.6**	**12.8**

Source: Central Statistics Office and DAB staff calculations

Figure 3.1: Breakdown of Kabul Headline inflation, Percentage Changhes (Y-o-Y)



Source: Central Statistics Office and DAB staff calculations

The most unfavorable change was a sharp increase in the rate of inflation in milk and cheese sub-index. Prices of milk and cheese, one of the important food components with 5.6 percent weight, went up by 10.77 percent in the second quarter of 1390, compared to 2 percent in the same period a year ago. The accelerating rate of inflation in milk and cheese in the quarter under review was up by 8.77 percentage points.

Prices of oil and fats also showed sharp increases. Oils and fats, another important component of food sub-index, representing 5.3 percent weight, also displayed significantly higher rates of inflation in the quarter under review. Prices of oil and fat rose by 35.1 percent year-on-year in the second quarter of 1390, again a very sharp jump from an inflation of 7.6 percent in the same period last year. This increase of 27.47 percentage points in the rate of inflation in oil and fats can be attributed to the rise in petroleum prices worldwide, which is thought to have increased demand for all products that can be used to produce heat.

Prices of fresh and dried fruits also showed higher increases. Fresh and dried fruits, which comprise 4.9 percent of the CPI basket, showed higher rates of inflation in the quarter under review. Prices of fruits increased on year-on-year basis in the second quarter of 1390 recording 16.31 percent inflation, a sharp turnaround from a deflation of 6.30 percent in the same quarter of last year. The increase of 22.6 percentage point in the rate of inflation was due to insufficient winter snowfall and less seasonal rainfall in 1389, which affected the agricultural products negatively.

The household goods prices rose sharply, Household goods, the largest non-food components comprising 7.0 percent of the CPI basket, rose sharply by 45.36 percent (Y-o-Y) in the second quarter of 1390, compared to a deflation of 0.50 percent a year ago. This represents 35.31 percentage points increase.

Although, most of the important components of the CPI showed unfavorable changes in the quarter under review over the previous period, there were few components posted decline. These favorable changes helped to offset partially the impact of unfavorable changes. For example:

Bread and cereals, accounts for 28 percent of the CPI basket. Prices of bread and cereals fell on a year-on-year basis in the second quarter of 1390 by 0.86 percent compared to a 3.2 percent increase in the same period last year.

The vegetables prices also declined rapidly. The same factors affecting the prices of bread and cereals have had an impact on the prices of vegetables (4.9 percent weight). After increases in the second quarter of 1389, by 8.0 percent, vegetables prices turned negative on year-on-year basis in the second quarter of 1390, recording a deflation rate of 2.65 percent, a decrease of 10.65 percentage points.

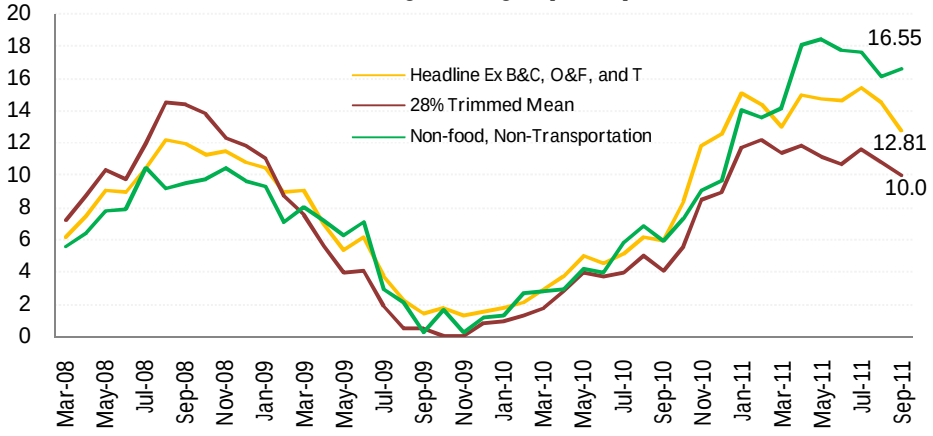
The meat prices have fallen as well. In the second quarter of 1390, meat prices (6 percent of the CPI basket) increased by 7.85 percent (Y-o-Y), compared to 21.5 percent increase in the same period a year ago. The significant 13.65 percentage-point decrease in the rate of inflation in meat price index was mainly caused by the recovery from the last year's devastating flood in Pakistan, combined with partial recovery from flood in Afghanistan, which destroyed thousands of livestock. Another important explanation is that meat prices were affected by the prices of cereal grains, which have been falling slightly.

Increases in core inflation were almost the same as the increases in headline inflation. It is clear from the above analysis that inflation has gained momentum. Increasing our concern is the fact that the core measure of inflation, which excludes the most volatile components, reached the same levels of headline inflation.

For example, core inflation (excluding bread and cereals, oils and fats, and transport) was 12.81 percent (Y-o-Y) in the second quarter of 1390, a bit higher than the headline inflation rate of 10.3 percent, and significantly above last year's core inflation rate of 5.9 percent. When core inflation measured by the 28 percent trimmed mean, the same pattern appears. The increase in core inflation to 10 percent in the second quarter of 1390 from 4.1

percent in the same quarter of last year was almost same as the increase in the headline rate. However, the level of the core inflation rate, measured in this manner, was almost same as the headline rate, for the same reasons mentioned above.

Figure 3.2: Core Inflaiton
Percentage Changes (Y-o-Y)



Source: Central Statistics Office and DAB staff calculations

1.2 Annual Changes in National Headline Inflation

The national headline inflation rate, when measured on a year-on-year basis, showed similar characteristics to the Kabul inflation rate. Prices increased in the second quarter of 1390 by 9.9 percent, compared to 4.9 percent experienced in the same quarter of 1389. The causes of a sharp increase in inflation nationwide were also similar to those affecting inflation in Kabul. Here, non-food played the most important role.

The rise of inflation in milk and cheese was also a significant factor nationwide. Throughout Afghanistan, milk and cheese prices rose in the second quarter of 1390 at a year-on-year rate of 9.4 percent, compared to a 0.7 percent increase in the same quarter a year ago, and in fact was almost the same as the rise in milk and cheese inflation in Kabul.

The oil and fat sub-index experienced rapidly rising inflation, when compared with the previous year. Inflation in oil and fats prices increased by a significant 13.7 percentage points from the previous year, and ended up at 24.2 percent. Both, the level of inflation in this component, and the increase in inflation from the previous period, were quite lower than what observed in Kabul.

Prices of fresh and dried fruits also showed higher increases nationwide same as what was observed in Kabul. The fresh and dried fruits, which comprise 4.9 percent of the CPI basket, showed higher rate of inflation in the quarter under review. Prices of fruits increased on by 18.9 percent (Y-o-Y) in the reporting period, a sharp turnaround from a deflation of 5.9 percent in the same quarter last year. Here, both level of inflation and the increase in the inflation from the previous period, show same pattern as was observe in Kabul.

Similar to the situation in Kabul, increases in the rate of inflation on rents were very moderate. Rental prices increased nationwide in the second quarter of 1389, on a year-on-year basis, by 11.3 percent. This is slightly higher than the 8.4 percent rate of inflation recorded in the previous year. While inflation in rents is rising both in Kabul and nationwide, by about the same number of percentage points, it remains significantly higher in Kabul because of the preference of migrants, both internal displaced and returnees from abroad, to live in the capital city rather than in other places.

Fuel and electricity prices increased nationwide, same as what was observe in Kabul. Prices of fuel and electricity (6.8 percent of the CPI basket) rose by 11.5 percent (Y-o-Y) in the second quarter of 1390 compared with 8.5 percent increase recorded in the same period of previous year. This 3 percentage point increase was largely due to increases in worldwide energy prices and was about the same increase in inflation as what was observed in Kabul.

Household goods prices rose sharply, but lesser than in Kabul. Household goods which is one of the largest non-food components comprises 7.0 percent of the CPI, went up sharply by 26.4 percent in the second quarter of 1390 compared to an inflation rate of 3.5 percent in the same quarter a year ago. This represents a 22.9 percentage point's increase in household goods.

Inflation in transportation costs was increasing nationwide, although, its weight in the overall CPI is not significant. Throughout the country, transportation costs rose rapidly in the second quarter of 1390compared with the second quarter of 1389. The 6.3 percentage point increase in the rate of inflation in transportation was a bit higher than that experienced in Kabul, which is thought to be caused by deteriorating security conditions in the less populated areas.

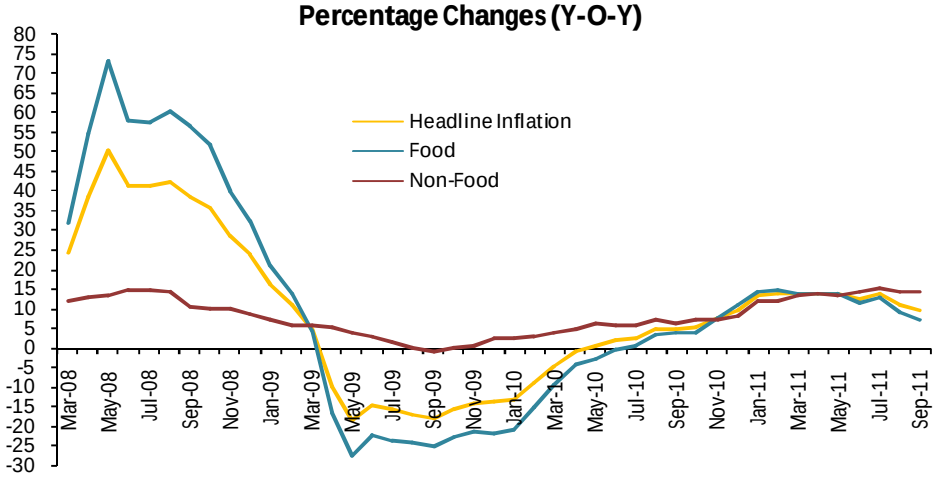
Although most of the CPI components showed increased in the quarter under review, but some components exhibited downward trends. These favorable changes partially offset the impacts of a sharp increase in overall CPI.

For example, nationwide prices of meat (6.0 percent weight) fell to 8.9 percent on a year-to-year basis in the second quarter of 1390, compared to a 15.6 percent increase in the same period of previous year. The vegetables prices (4.9 percent weight) also fell to 2.2 percent, in contrast to inflation rate of 6.3 percent in the second quarter of 1389.

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

		1388				1389				1390	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**100**	-14.6	-17.7	-13.7	-4.5	1.9	4.9	9.8	13.7	12.7	9.9
Food and Beverages	**61.3**	-22.4	-25.2	-21.6	-9.1	-0.5	3.9	11.0	14.0	11.7	7.2
Bread and Cereal	28	-34.9	-38.7	-34.8	-19.0	-6.2	2.1	9.7	15.9	11.5	2.9
Meat	**6.0**	5.6	5.0	5.4	4.9	9.2	15.6	16.6	17.5	15.6	8.9
Milk & Cheese	**5.6**	2.4	-0.9	-2.4	-3.0	-0.5	0.7	3.4	4.5	8.6	9.4
Oils & Fats	**5.3**	-24.0	-27.1	-13.1	1.4	3.0	10.5	25.2	21.6	25.3	24.2
Fresh & Dried Fruits	**4.9**	7.7	10.8	3.1	3.5	-0.4	-5.9	7.6	10.2	15.1	18.9
Vegetables	**4.9**	-6.0	-6.8	-8.6	-0.1	13.6	6.3	17.0	15.6	2.7	2.2
Sugar and Sweets	**1.8**	11.7	16.1	20.4	23.5	18.7	17.5	12.8	7.7	8.1	6.3
Spices	**1.1**	14.4	4.7	1.2	0.0	5.0	4.1	3.7	4.3	13.9	27.2
Tea and Beverages	**2.0**	7.0	3.7	4.5	2.5	2.5	2.5	2.6	6.7	11.5	13.9
Cigarettes and Tobacco	**1.7**	10.3	13.7	10.4	5.7	5.2	3.8	1.9	4.0	4.0	4.8
Non-Food	**38.7**	3.0	-0.8	2.3	3.8	6.0	6.5	8.0	13.3	14.4	14.2
Clothing	**7.2**	9.3	5.6	2.2	2.5	3.4	3.7	3.7	4.3	9.2	15.4
Housing	**17.2**	3.3	-1.9	4.3	5.9	7.9	8.4	11.2	12.4	12.4	11.3
Rents	**7.1**	3.6	6.0	5.1	6.1	11.9	8.4	13.8	13.9	12.8	11.3
Construction Material	**3.2**	0.5	-6.1	-3.6	-0.6	2.5	8.0	10.9	11.6	12.7	10.8
Fuel & Electricity	**6.8**	3.9	-6.9	6.0	7.8	6.1	8.5	9.4	11.4	11.9	11.5
Household goods	**7.0**	3.6	3.2	1.1	0.8	3.4	3.5	9.4	26.4	28.4	26.4
Health	**2.0**	8.3	4.1	1.2	-2.6	-0.8	0.8	0.4	2.6	3.0	3.0
Transportation	**2.3**	-12.3	-16.7	-6.2	4.3	12.2	13.3	2.3	26.3	22.1	19.6
Communications	**0.9**	0.5	1.2	1.2	1.7	-3.1	-3.1	-3.0	-3.8	2.5	2.6
Educations	**1.2**	3.8	3.8	0.1	-0.8	-1.9	-0.6	1.0	4.9	9.6	11.2
Miscellaneous	**0.9**	9.5	11.1	10.4	7.5	6.5	7.0	9.3	9.3	12.4	9.9
Core inflation , 28% TM		**4.3**	**2.0**	**1.4**	**2.3**	**4.0**	**5.0**	**7.2**	**9.8**	**11.2**	**11.1**
Headline excl. B & C, O & F, T		**4.2**	**1.7**	**2.3**	**3.4**	**5.8**	**5.5**	**9.3**	**11.5**	**11.9**	**11.9**

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



Source: Central Statistics Office and DAB staff calculations

1.3 Current Quarter Changes in Kabul Headline CPI

To see more clearly what was happening to inflation in the most recent periods, we may compare the quarter-on-quarter changes in the CPI and its various components in the second quarter of 1390 with the inflation rates experienced in the first quarter of 1390. Overall, the quarterly rate of headline inflation was 3.4 percent, up from 2.1 percent in the previous quarter. Two straight quarters of high inflation in 1390 indicates that inflation has gained some momentum.

Although inflation increased significantly from the previous quarter, the behavior of individual components of the CPI was very mixed. Some components such as bread and cereals, milk and cheese, and oil and fats, experienced sharply higher rates of inflation, while other components, such as rents and transportation, showed significantly lower rates than in the previous quarter.

The bread and cereals prices went up by 3.6 percent in the quarter under review, up from zero percent change in the previous quarter. The milk and cheese prices also rose by 5.8 percent, an increase of 2.9 percentage points from the preceding quarter. In contrast, rental and transportation costs rose moderately in the quarter under review than in the previous quarter. The rent and transportation sub-indices recorded inflation rates of 2.6 percent and 0.8 percent (q-o-q) in the reporting quarter, down from 7.0 and 5.1 percent in the previous quarter respectively. All the components have been volatile over the last few quarters.

Table 3.3: Quarter-on-Quarter Changes in Kabul Headline CPI
(percent changes quarter on quarter)
Consumer Price Index, (March 2004 = 100)

	1388				1389				1390	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	-1.5	2.1	-2.3	-3.5	5.4	5.9	4.7	-0.2	2.1	3.4
Food and Beverages	-2.5	2.3	-5.1	-5.0	7.9	7.8	4.7	-2.8	0.5	4.1
Bread and Cereal	-3.5	-0.3	-8.7	-11.8	16.6	9.9	-0.5	-2.2	0.0	3.6
Milk and Cheese	-6.3	-0.1	1.5	-1.2	-2.0	3.9	4.9	-3.0	2.9	5.8
Oil and Fat	-2.2	-0.1	0.5	1.7	3.0	2.2	19.9	-1.5	6.0	7.9
Non – Food	0.2	1.7	2.3	-1.1	1.9	3.1	4.7	3.8	4.4	2.4
Housing	0.5	1.4	3.7	-1.1	2.8	6.0	7.3	-1.5	4.4	2.8
Rents	0.6	2.2	0.7	2.7	5.4	9.3	7.7	3.7	7.0	2.6
Fuel and Electricity	0.9	2.2	7.6	-5.5	-0.2	2.9	9.4	-6.8	0.6	3.8
Transportation	0.7	2.7	8.3	-5.9	9.4	-1.0	-1.6	7.9	5.1	0.8

Source : Central Statistics Office and DAB Staff calculations

1.2 Current Quarter Changes in National Headline Inflation

Nationwide, inflation did not increase noticeably from the previous quarter, and is still much lower than inflation in Kabul. The headline rate of inflation slightly declined to a 1.7 percent (q-o-q) in the second quarter of 1390, compared to 1.9 percent in the first quarter. The pattern of quarterly changes in the rate of inflation across the components, however, was very different from what was experienced in Kabul.

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

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

For example, nationwide bread and cereals was significantly lower in the second quarter, reaching a deflation of 0.3 percent, compared to a 1.8 percent increase in the first quarter. In the previous section, we noticed that prices of bread and cereals in Kabul increased over the previous quarter. In other words, bread and cereal prices are going up significantly in Kabul and decreasing nationwide.

Prices of milk and cheese, and oils and fats dropped to 2.9 percent and 3.5 percent from 3.6 and 4.3 percent in the previous quarter respectively. Rental and transportation inflation also declined to 1.0 percent and -1.7 percent from 4.5 and 4.1 percent respectively.

2. THE REGIONAL INFLATION

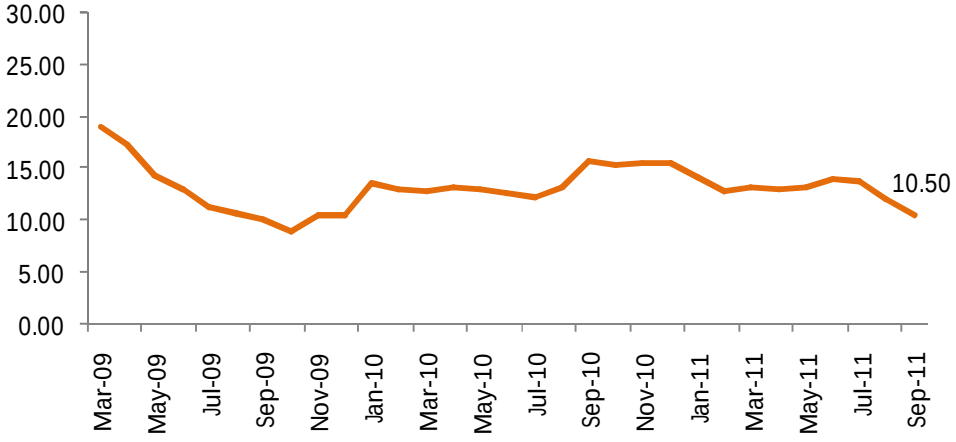
2.1 Inflation Trend in Pakistan

Headline Inflation in Pakistan was pretty similar as that in Kabul as well as national CPI in the quarter under review, recording a year-on-year inflation rate of 10.5 percent.. The headline inflation in Pakistan has been declining steadily ending at 10.5 percent (Y-o-Y) in September 2011, down from 14.9 percent recorded in September 2010, and noticeably lower than the rate of 13.3 percent observed in June 2011.

The 9.9 percent (Y-o-Y) inflation rate in food sub-index was substantially lower than 21.3 percent observed in September 2010, while the non-food inflation rate was slightly higher than the 10.5 percent rate observed a year ago. In other words, the inflation in Pakistan has been persistently lower across components than in Afghanistan, while the decrease in food items was more dramatic than in Afghanistan.

Core inflation, which excludes food and energy, is still quite high and has been increasing somewhat. In September 2011, the core inflation rate was 10.6 percent (Y-o-Y), slightly up from 8.3 percent in September 2010, while to compare with 10.4 percent in June 2011 it is slightly down. Core inflation measured on a month-to-month basis has been slightly increasing in recent months.

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



Source: State Bank of Pakistan

Table 3.5: Breakdown of Pakistan Headline Inflation

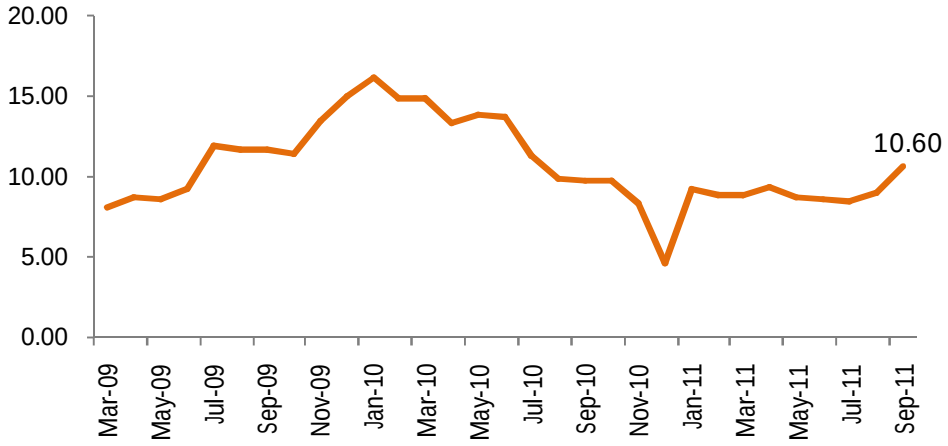
	CPI			Core Inflation @		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Sep 2010	14.9	21.3	10.5	8.3	11.7	18.6
Oct 2120	15.3	20.5	11.8	9.5	12.7	19.5
Nov 2010	15.0	20.0	11.5	9.4	12.8	20.3
Dec 2010	15.5	20.5	12.0	9.8	13.4	22.5
Jan 2011	13.9	20.2	9.7	9.9	12.1	20.9
Feb 2011	12.8	17.6	9.7	9.7	12.0	22.1
Mar 2011	13.0	17.9	9.7	9.7	12.1	24.3
Apr 2011	12.5	16.5	9.8	9.5	12.0	24.9
May 2011	12.6	15.8	10.5	9.8	12.1	22.3
Jun 2011	13.3	15.9	11.6	9.9	12.4	2.8
Jul 2011	12.4	17.1	9.3	9.6	11.9	20.3
Aug 2011	11.6	13.2	10.4	10.1	12.4	18.7
Sep 2011	10.5	9.9	10.9	10.6	11.7	17.0

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

2.2 Inflation in India

India is experiencing a high inflation, although it is comparable to Pakistan and Afghanistan. In September 2011, the CPI for urban non-manual employees rose on a year-on-year basis by 10.6 percent. This high rate of inflation was up from the 8.62 percent rate recorded in June 2011.

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



Source: Reserve Bank of India

3. INFLATIONARY OUTLOOK

Afghanistan is a net importing country, in other words, Afghanistan demands filled with the imports of foreign goods. For instance, Afghanistan needs to import almost 2 million metric ton (MTs) of foodstuff out of 5 million MT in 1390. Therefore, rising international food prices, especially in Afghanistan's trade partner countries will push domestic prices up domestically. Therefore, apart from the seasonal patterns, Afghan economy will be vulnerable to imported inflation. On the other hand, the unfavorable weather conditions can be a barrier for agriculture sector growth.

In light of the above mentioned reasons, inflation rate, measured on a quarter-on-quarter basis, was high in the first two quarters of 1390 compared to 1389. Rising food and non food costs are expected throughout 2011.

CHAPTER IV

EXTERNAL SECTOR DEVELOPMENTS

4

EXTERNAL SECTOR DEVELOPMENTS

Fundamental changes in international flow of goods and services, capital, technology, ideas have fueled a rapid increase in global integration over the past decades and caused that many nations particularly developing countries to boost growth and reduce poverty by stimulating productivity and efficiency, providing access to new markets and ideas, and expanding the range of consumer choice. However, Afghanistan's external sector like other economies was strongly affected by the global financial instabilities over the past periods and experienced many fluctuations. In this chapter, the external sector developments of Afghan economy for the second quarter of 1390 in comparison with corresponding quarter of previous year are examined. Merchandise trade deficit widened in the second quarter of 1390 following a substantial expansion in imports compared with the similar period last year. Merchandise trade deficit expanded by about 20 per cent from USD 1,133.55 million in the second quarter of 1389 to USD 1,355.87 million in the second quarter of 1390. However, the trade deficit as percentage of GDP remained unchanged at 7 percent.

In the quarter under review, aggregate imports and exports stood at USD 1,417.3 million and USD 61.45 million respectively, while these figures were recorded at USD 1205.7 million and USD 72.15 million in the second quarter of 1389. This resulted in the expansion of merchandise trade deficit from USD 1,133.55 million in Q2 1389 to USD 1,355.87 million in Q2 1390. The expansion in trade balance deficit is a reflection of the slow recovery of the global economy.

In the second quarter of 1390, exports decreased by 15 percent to USD 61.45 million from USD 72.15 million in the second quarter of 1389. Exports are mainly dominated by medical seeds and others that decreased by almost 13 percent and food items which slightly decreased by 4 percent in the second quarter of 1390 compared with the similar period last year. On the other hand, imports of goods increased by about 18 percent from USD 1,205.7 million to USD 1,417.3 million in the quarter under review. As the statistics

show, imports of almost all importing categories increased except for consumer goods which decreased about 23 percent. Imports are mainly dominated by industrial supplies and capital goods which increased in the second quarter of 1390 by 60 percent and 3 percent respectively compared with the similar period last year.

At the end of the second quarter of 1390, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,375.60 million which shows slightly decrease of 1 percent compared with the same quarter last year. During the quarter, loan principal repayments made only to the Asian Development Bank (ADB) while service charges paid to the ADB and IDA (World Bank). Moreover, ADB and IDA (World Bank) as major multilateral creditors to Afghanistan made significant debt forgiveness on principal amount and service charges during the second quarter of 1390.

The NIR (net international reserves) increased notably by almost 32.45 percent in the second quarter of 1390 compared with the similar period last year. This figure was USD 4,242.16 million in the second quarter of 1389 which increased to USD 5,618.89 million in the second quarter of 1390.

1. MERCHANDISE TRADE

Afghanistan's merchandise trade deficit widened in the second quarter of 1390 following a substantial expansion in imports compared with the similar period of last year. Merchandise trade deficit expanded by 20 percent from USD 1,133.55 million in the second quarter of 1389 to USD 1,355.87 million in the second quarter of 1390. Total exports in the second quarter of 1390 declined by 15 percent to USD 61.45 million from USD 72.15 million in the second quarter of 1389. Trade statistics show a notable decline in all exporting categories for the second quarter of 1390 compared to the same quarter of last year. Exports are mainly dominated by medical seeds and others which decreased by 13 percent from USD 32.22 million to USD 28.04 million, and food items which includes fresh and dry fruits slightly decreased by 4 percent. Moreover, leather and wool declined from USD 13.52 million to USD 9.30 million in the quarter under review. Regrettably, export of carpets which is being considered one of the most important exporting commodities of Afghanistan has been declining over the past periods. The main reasons behind this fact could be either slow global recovery and low external demand or low competitive capacity of the Afghan carpet producers with other countries producers e.g. Iran, Turkey and etc.

On the other hand, during the quarter, total imports also increased significantly compared with the same quarter of last year. In the same quarter earlier year, total

imports were recorded at USD 1,205.70 million which increased by almost 18 percent to USD 1,417.30 million in the second quarter of 1390. In accordance with the statistics of merchandise trade, imports of all importing categories show increments at different levels. Imports are mainly dominated by industrial supplies which increased by 60 percent (the largest boost) from USD 396.90 million to USD 636.88 million in the second quarter of 1390 compared with the similar period last year. Similarly, imports of capital goods and others slightly increased by 3 percent from USD 595.1 million to USD 612.05 million and imports of fuel and lubricants increased by 6 percent from USD 11.8 million to USD 12.51 million in the quarter under review compared with similar period of last year. Conversely, import of consumer goods decreased considerably from USD 202 million in the second quarter of 1389 to USD 156 million in the second quarter of 1390, roughly 23 percent.

As a result, a significant change in the import structure in favor of industrial supplies has been observed during the second quarter of 1390. The share of industrial supplies in total imports increased from about 33 percent in the second quarter of 1389 to about 50 percent in the second quarter of 1390. Imports of industrial supplies mainly comprise petroleum oil, metals, fertilizer and cement which are the essentials for economic development. High imports of such goods are an obvious evidence of developments in industrial and construction sectors. The second largest share in total imports was recorded for capital goods and others at 43 percent; however it declined form 49 percent in the second quarter of 1389. Imports of capital goods and others slightly increased by 3 percent from USD 595.1 million to USD 612 million in the quarter under review. Furthermore, imports of fuel and lubricants increased by 6 percent in the quarter under review compared with similar period last year while, imports of consumer goods decreased by 23 percent from USD 201.9 million to USD 155.88 million in the quarter under review. Simultaneously, the share of consumer goods in total imports declined from 16.7 percent in Q2 1389 to 11 percent in Q2 1390. Finally, the trade balance deficit as percentage of GDP remained unchanged at 7 percent compared with the same period of last year.

Table 4.1 illustrates main categories of the merchandise trade, percentage share of main categories of exports and imports from 1386 up to the second quarter of 1389.

Table 4.1: Merchandise Trade (in million USD)

Years	1386		1387		1388		Q2 1389		Q2 1390	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**3,021.86**	**100%**	**3,019.86**	**100%**	**3,336**	**100%**	**1,205.70**	**100%**	**1,417.3**	**100%**
Industrial supplies	692.04	22.9%	797.78	26.4%	1001.43	30.0%	396.90	32.9%	636.88	44.9%
Fuel and Lubricants	108.49	3.6%	101.83	3.4%	36.07	1.1%	11.80	1.0%	12.51	0.9%
Consumer goods	641.86	21.2%	689.88	22.8%	692.07	20.7%	201.90	16.7%	155.88	11.0%
Capital goods and other	1,579.47	52.3%	1,430.37	47.4%	1,607	48.2%	595.10	49.4%	612.05	43.2%
Exports	**454.13**	**100%**	**544.56**	**100.0%**	**403.06**	**100%**	**72.15**	**100%**	**61.45**	**100%**
Carpets & Rugs	211.76	47%	153.05	28.1%	68.8	17.1%	7.64	10.6%	6.05	9.8%
Food Items	158.86	35%	283.08	52.0%	201.84	50.1%	18.77	26.0%	18.06	29.4%
Leather & Wool	25.77	6%	29.29	5.4%	24.66	6.1%	13.52	18.7%	9.30	15.1%
Medical seeds & others	57.74	13%	79.14	14.5%	107.78	26.7%	32.22	44.7%	28.04	45.6%
Trade Balance	**-2,567.73**		**-2,475.30**		**-2,933.39**		**-1,133.55**		**-1,355.87**	
Trade Balance as % of GDP	**-26%**		**-21%**		**-23%**		**-7%**		**-7%**	

Source: Central Statistics Office and DAB staff calculations

2. DIRECTION OF TRADE

Major trading partners of Afghanistan in the second quarter of 1390were Pakistan, India, Iran, China and Commonwealth of Independent States (CIS). Direction of exports and imports during the second quarters of 1389 and 1390 is summarized in Tables 4.2 and 4.3. The merchandise trade indicates that the total exports contracted by about 15 percent from USD 72.15 million in the second quarter of 1389 to USD 61.45 million in the quarter under review. This fall in the value of exports thought to be due to low external demand for Afghan products and slow economic recovery in most of the export destinations of Afghanistan. Pakistan remained the largest export destination with about 51 percent share of total exports in the quarter under review compared to nearly 35 percent in the second quarter of 1389.

Exports to Pakistan increased significantly by 26 percent from USD 25 million in the second quarter to 1389 to USD 32 million in the second quarter of 1390. Exports to Pakistan mainly concentrated on raw materials such as medical seeds and others, and leather and wool, however, export of food items such as dry and fresh fruits, and carpets and rugs still remains the important

part of exports to Pakistan. Exports of medical seeds and others to Pakistan increased notably by 170 percent from USD 7.4 million to USD 20 million in the second quarter of 1390. Similarly, exports of leather and wool to Pakistan increased by 14 percent, while, on the other side, exports of food items, and carpets and rugs declined by 57 percent and 30 percent respectively.

India was the second largest export destination for Afghan commodities during the quarter. Exports to India considerably decreased from USD 14.2 million in the second quarter of 1389 to about USD 6.3 million in the quarter under review, approximately 55 percent decline. Export of medical seeds and others to India which forms the largest share declined by 52 percent from USD 7.6 million in the second quarter of 1389 to USD 3.65 million in the quarter under review. Similarly, exports of leather and wool to India declined from USD 0.50 million to USD 0.18 million, exports of food items declined from USD 6.10 million to USD 2.5 million, exports of carpets and rugs decreased from USD 0.1 million to USD 0.03 million, each 64 percent, 59 percent and 40 percent respectively. In fact, export of overall items to India due to lower demand declined during the current period compared with the same quarter last year.

In the quarter under review, Iran got third position in the export destination of Afghan products while Commonwealth of Independent States (CIS) accounted for the fourth position. Exports to Iran increased significantly by 56 percent from USD 3.25 million in the corresponding quarter last year to USD 5.07 million in the reporting quarter. During the quarter, exports to CIS in terms of value of exports and share of exports in total exports both declined unexpectedly. Exports to CIS which mainly encompasses dry fruits, declined from USD 5.57 million to USD 2.93 million, almost 61 percent decline. In addition, exports to China decreased from USD 5.01 million in the second quarter of 1389 to USD 2.70 million in the second quarter of 1390. On the other hand, exports to Germany increased significantly by about 72 percent from USD 0.57 million to USD 0.98 million in the reporting quarter compared with the similar period last year.

Table 4.2: Direction of External Trade: Q2 1389 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	24.90	34.51%	156.40	12.97%	-131.50
India	14.20	19.68%	35.10	2.91%	-20.90
Iran	3.25	4.50%	93.20	7.73%	-89.95
Germany	0.57	0.79%	56.10	4.65%	-55.53
Common Wealth	7.57	10.49%	445.70	36.97%	-438.13
China	5.01	6.94%	125.80	10.43%	-120.79
Saudi Arabia	1.02	1.41%	0.00	0.00%	1.02
Japan	0.00	0.00%	122.70	10.18%	-122.70
England	0.00	0.00%	8.70	0.72%	-8.70
United States	0.00	0.00%	26.20	2.17%	-26.20
Other Countries	15.63	21.66%	135.80	11.26%	-120.17
Total	**72.15**	**100.00%**	**1205.70**	**100%**	**-1133.55**

Source: CSO and DAB staff calculations

Table 4.3: Direction of External Trade: Q2 1390 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	31.49	51.24%	163.68	11.55%	-132.19
India	6.34	10.32%	24.01	1.69%	-17.67
Iran	5.07	8.25%	103.84	7.33%	-98.77
Germany	0.98	1.59%	47.68	3.36%	-46.70
China	2.70	4.39%	174.19	12.29%	-171.49
England	0.00	0.00%	4.00	0.28%	-4.00
Saudi Arabia	0.24	0.39%	0.00	0.00%	0.24
USA	0.00	0.00%	17.87	1.26%	-17.87
Common Wealth	2.93	4.77%	569.35	40.17%	-566.42
Japan	0.00	0.00%	115.95	8.18%	-115.95
Other Countries	11.70	19.04%	196.75	13.88%	-185.05
Total	**61.45**	**100%**	**1,417.32**	**100%**	**-1,35.87**

Figure 4.1: Direction of Exports (% share) Q2 1390

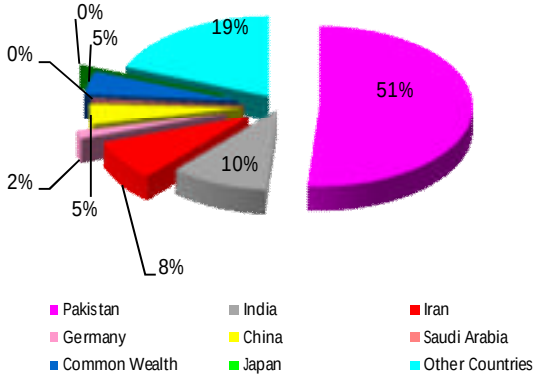
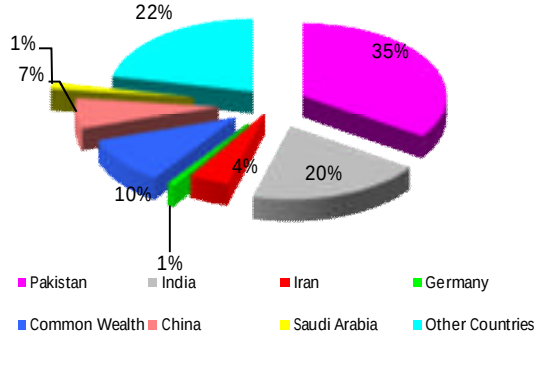


Figure 4.2: Direction of Exports (% share) Q2 1389



2.1 Composition of Trade

The comparison of the composition of imports in the quarter under review with the corresponding quarter of last year is presented in Figures 6.3 and 6.4. The composition of imports is presented in percent share of total imports baskets. Unlike the prior periods, the composition of imports for the current quarter indicates that the industrial supplies were dominating the largest share in the basket of imports; however, typically this figure was recorded for capital goods and others. Notably, imports of industrial supplies increased significantly by about 60 percent from USD 396.9 million to USD 636.88 million in the quarter under review. Moreover, the share of industrial supplies in total imports also increased from about 33 percent in the second quarter of 1389 to about 45 percent in the reporting quarter. This category typically encompasses petroleum oil, metals, fertilizer and cement which are the essentials for implementation of development projects throughout Afghanistan. High imports of such goods are an obvious evidence of developments in the infrastructure and construction sectors of the country.

Imports of capital goods and others increased from USD 595.10 million in the second quarter of 1389 to USD 612.05 million in the quarter under review, about 3 percent increase. However, the share of capital goods and others in total imports declined from 49.4 percent in Q2 1389 to 43.2 percent in Q2 1390. On the other side, imports of consumer goods decreased considerably by about 23 percent. Imports of consumer goods recorded USD 201.90 million in the second quarter of 1389 and USD 155.88 million in the quarter under review. Finally, import share of consumer goods in total imports reduced from 16.7 percent in the second quarter of 1389 to 11 percent in the second quarter of 1390.

3. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,375.60 million as of September 22, 2011. During the second quarter of 1390, loan principal repayments made only to the Asian Development Bank (ADB) while service charges paid to the ADB and IDA (World Bank). Moreover, ADB and IDA (World Bank) as major multilateral creditors to Afghanistan made significant debt forgiveness on principal amount and service charges during the second quarter of 1390. On January 09, 2011, Germany as a member of Paris Club provided Afghanistan with hundred percent debt relief as Afghanistan achieved some certain economic programs with international authorities, achieved certain economic and social benchmarks and somehow reached Completion Point as defined by the Heavily Indebted Poor County (HIPC) initiative. As a result, Afghanistan's total debt to the Paris Club creditors which only includes Russian Federation stood at USD 1,043.94 million at the end of Q2 1390 or Afghanistan's total debt only from the Paris Club members stands at about 43.94 percent of total current external debt. Following table illustrates the overall picture of current external debt of Afghanistan until the end Q2 1390.

Table 4.4: External Debt in the second quarter of 1390 (in units indicated)

	In million USD	Percent of total
Total external debt	2,375.60	100.00
Bilateral	1,175.50	49.48
Paris Club/1	1,043.94	43.94
Russian Federation	1,043.94	43.94
United States	-	0.00
Germany	-	0.00
Non-Paris Club	131.56	5.54
Multilateral	1,200.10	50.52
of which: IDA (World Bank)	417.59	17.58
Asian Development Bank	650.10	27.37
International Monetary Fund	118.56	4.99
Islamic Development Bank	11.86	0.50
OPEC Fund	1.98	0.08

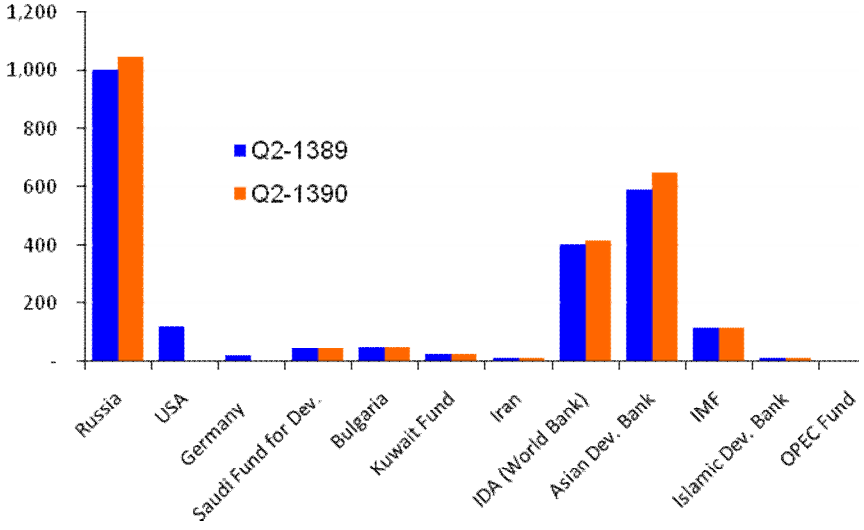
1/ The cancellation of approximately $17.37 million in external debt of Afghanistan by Germany as a member of the Paris Club creditors on January 09, 2011.

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

Furthermore, Non-Paris Club credits which includes Saudi Fund for Development, Bulgaria, Kuwait Fund and Iran stood at USD 131.56 million in the second quarter of 1390.

On the other hand, multilateral credit stood at USD 1,200.10 million compared to USD 1,122.29 million at the end of the similar quarter of last year which shows an increase of about 7 percent. Figure 4.7 compares Afghanistan's external debt stock for the second quarters of 1389 and 1390.

Figure 4.7: External debt comparisons: Q2 1389 and Q2 1390 (million USD)



Source: Debt Asset Management Unit, Ministry of Finance

4. NET INTERNATIONAL RESERVES

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

In the quarter under review, Afghanistan's NIR increased significantly by 32.45 percent to USD 5,618.89 million from USD 4,242.16 million in the second quarter of 1389.

The boost in NIR was mainly dominated in a significant increase in the reserve assets which increased nearly by 30 percent from USD 4,554.08 million in the second quarter

of 1389 to USD 5,925.35 million in the quarter under review. On the other hand, reserve liabilities declined slightly to about USD 306.46 million in the second quarter of 1390 compared to USD 311.92 million in the same quarter last year, approximately 2 percent decline. The decrease in reserve liabilities is mostly attributed to the commercial bank deposits in foreign currency and non-resident deposits in foreign currency.

Commercial banks deposits in foreign currency decreased by almost 5 percent from USD 196.44 million in the second quarter of 1389 to USD 186.87 million in the quarter under review. Furthermore, the reserve liability of non-resident deposits in foreign currency decreased from USD 0.32 million in the second quarter of 1389 to USD 0.11 million in the reporting quarter. While, reserve liability on use of fund resources increased by nearly 4 percent from USD 115.16 million to USD 119.48 million in the second quarter of 1390.

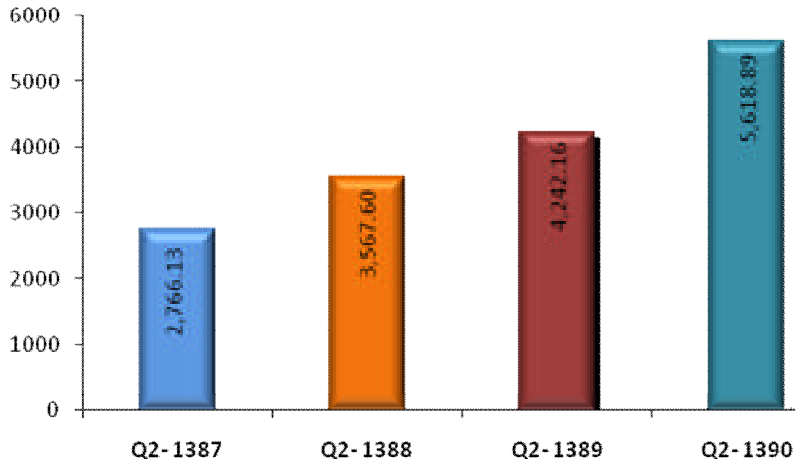
Table 4.5: DAB Net International Reserves, (in million USD)

Changes on the previous quarter	Q2 1387	% change	Q2 1388	% change	Q2 1389	% change	Q2 1390	% change
Net international Reserves (million USD)	2,766.13	25.21	3,567.60	28.97	4,242.16	18.91	5,618.89	32.45
Reserve Assets	2,901.19	26.46	3,719.94	28.22	4,554.08	22.42	5,925.35	30.11
Reserve Liabilities	135.06	59.16	152.34	12.79	311.92	104.76	306.46	-1.75
Commercial bank deposits in foreign currency	38.25	26.85	44.38	16.02	196.44	342.64	186.87	-4.87
Nonresident deposits in foreign currency	1.62	-38.55	0.27	-83.26	0.32	16.93	0.11	-64.74
Use of Fund resources	95.19	82.81	107.69	13.13	115.16	6.94	119.48	3.75
Gross Intl. Reserves (in months of import)					11.33		12.54	
Net Intl. Reserves (in months of import)					10.56		11.89	

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

The increase in NIR could be attributed to considerable inflows of foreign exchange, particularly from international aids. The current level of NIR is providing a good cushion of the maneuverability of monetary policy and support of balance of payments. Currently, NIR on average supports nearly 12 months of imports. Figure 4.8 represents the net international reserves of Afghanistan for the past few quarters.

Figure 4.8: Net International Reserves (in million USD)



Source: Monetary Policy Department, DAB

Box 1: Capital Account Liberalization

Growth of capital flows:

The growth of international financial transactions and international capital flows is one of the most far-reaching economic developments of the twenty-first century. The liberalization of capital markets—and, with it, likely increases in the volume and the volatility of international capital flows—is an ongoing and, to some extent, irreversible process with far-reaching implications for the policies that governments will find it feasible and desirable to follow. It is important to recognize that financial innovation and liberalization are domestic, as well as international, phenomena. Not only have restrictions on international financial transactions been relaxed, but regulations constraining the operation of domestic financial markets have been removed as countries have moved away from policies of financial repression.

There are some powerful forces that caused the rapid growth of international capital flows as follows:

• The removal of statutory restrictions on capital account transactions, which is a concomitant of economic liberalization and deregulation in both industrial and developing countries;

• Macroeconomic stabilization and policy reform in the developing world, which have created a growing pool of commercial issuers of debt instruments;

• The multilateralization of trade, which has encouraged international financial transactions designed to hedge exposure to currency and commercial risk; and

• The growth of derivative financial instruments—such as swaps, options, and futures—which has permitted international investors to assume some risks while limiting their exposure to others.

Above all, technology has played a role. Revolutionary changes in information and communications technologies have transformed the financial services industry worldwide. Computer links enable investors to access information on asset prices at minimal cost on a real-time basis, while increased computer power enables them rapidly to calculate correlations among asset prices and between asset prices and other variables. Improvements in communications technologies enable investors to follow developments affecting foreign countries and companies much more efficiently. At the same time, new technologies make it increasingly difficult for governments to control either inward or outward international capital flows when they wish to do so.

Costs and benefits

Capital mobility has important benefits. In particular, it creates valuable opportunities for portfolio diversification, risk sharing, and intertemporal trade. By holding claims on—that is, lending to—foreign countries, households and firms can protect themselves against the effects of disturbances that impinge on the home country alone. Companies can protect themselves against cost and productivity shocks in their home countries by investing in branch plants in several countries. Capital mobility can thereby enable investors to achieve higher risk-adjusted rates of return. In turn, higher rates of return can encourage increases in saving and investment that deliver faster rates of growth.

At the same time, however, in a significant number of countries, financial liberalization, both domestic and international, appears to have been associated with costly financial crises. This association may be somewhat deceptive, given that financial crises are complex events with multiple causes and have occurred in less liberalized as well as more liberalized financial systems. Still, there have been enough cases where financial liberalization, including capital account liberalization, has played a significant role in crises to raise serious questions about whether and under what conditions such liberalization— particularly capital account liberalization—will be beneficial rather than harmful.

At the theoretical level, the controversy over the benefits of financial liberalization reflects diverging views on whether liberal financial markets bring about an efficient allocation of resources or are so distorted that the benefits they yield to direct participants too often are detrimental to the general welfare. Although a large "efficient markets" literature argues the first hypothesis, others insist that asymmetric information— a situation in which one party to a transaction has less information than the other—pervades financial markets, and that this greatly undermines their efficiency as mechanisms for allocating resources. There is, moreover, good reason to think that asymmetric information is particularly prevalent internationally, because geography and cultural distance complicate the acquisition of information. While the revolution in information and communications technologies—by reducing economic distance—has a profound effect in stimulating international financial transactions, it also leaves international markets—where information asymmetries are attenuated but not eliminated—particularly prone to the sharp investor reactions, unpredictable market movements, and financial crises that can occur when information is incomplete and financial markets behave erratically.

Role of policy

These developments make it critical to accompany financial liberalization with appropriate policies to limit excess volatility and related problems and to contain their potentially damaging effects. As has long been recognized, sound macroeconomic policies are essential for maintaining financial stability. A liberalized financial system is more demanding in this respect than a repressed system in which large financial imbalances may be suppressed for long periods. Recent experience, however, highlights the fact that macroeconomic stability, while necessary, is not sufficient for financial stability, which also requires sound financial sector policies. The first line of defense against financial risk must be sound risk management by market participants themselves.

Banks and nonbank financial intermediaries must manage their balance-sheet risks prudently. Corporate borrowers must recognize and manage risks appropriately, which requires a strong system of corporate governance. Any tendency to take on excessive risk can be contained through market discipline facilitated by the adoption of best-practice accounting, auditing, and disclosure standards. An appropriate environment can be created by adopting policies that mandate proper accounting, auditing, and reporting rules and by taking care not to form a culture of implicit guarantees, so that lenders will face significant capital losses if they fail to assess credit risk prudently.

When risk-management techniques are not well developed, auditing and accounting practices leave much to be desired, and other distortions interfere with the ability of banks and others to manage risk, prudential regulation has an especially important role. The argument for

prudential regulation is reinforced when central banks and governments backstop financial markets and provide a financial safety net that can encourage banks and other market participants to take on excessive risk. A century and more of experience points to the need, in most countries, for central banks to provide lender-of last- resort services to prevent illiquid financial markets from seizing up in periods of general distress. This backstopping function, though essential, is also a source of moral hazard. The appropriate response for national authorities is rigorous prudential supervision and regulation combined with careful design of the lender-of last- resort facility to limit the scope and incentives for financial market participants to take on excessive risk. More generally, pursuing policies to develop a financial system that relies less heavily on banks and other intermediaries and involves more direct risk bearing by ultimate investors can help to reduce the risks of costly crises and moral hazard.

Conclusion

Capital account liberalization and financial liberalization more generally are inevitable for countries that wish to take advantage of the substantial benefits from participating in the open world economic system in today's age of modern information and communications technologies. As recent events have again demonstrated, however, financial liberalization also has its dangers. As liberalized systems afford opportunities for individuals, enterprises, and financial institutions to undertake greater and sometimes imprudent risks, they create the potential for systemic disturbances. There is no way to completely suppress these dangers other than through draconian financial repression, which is more damaging. But they can be limited considerably. Sound macroeconomic policies to contain aggregate financial imbalances and to ameliorate the effects of financial disturbances can be combined with sound prudential policies designed to ensure proper private incentives for risk management, especially in the financial sector. With these safeguards, orderly and properly sequenced capital account liberalization and the broader financial liberalization of which it is part are not only inevitable but clearly beneficial.

Source: International Monetary Fund (IMF) staff study paper

CHAPTER V

FISCAL DEVELOPMENTS

5

FISCAL DEVELOPMENTS

The fiscal policy is used by the Government to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment and economic growth.

The main 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 budget at the end of the second quarter of 1390 was in surplus according to the report received from Ministry of Finance. Total revenues exceeded core expenditure in the quarter under review, leading to a budget surplus of AF 13,316 million.

Total domestic revenues increased by AF 14,768.54 million or 27.8 percent at the end of the second quarter of 1390 compared to the same period of last year. Total domestic revenues was recorded AF 67,835.11 million at the end of second quarter of 1390 up from AF 53,066.57 million end of the second quarter of 1389,. Total domestic revenues in the quarter under review accounted for 12 percent of GDP.

Total core expenditures in the quarter under review increased to AF 75,641 million, up from AF 62,477 million in the second quarter of 1389, which represents 21 percent increase. Total expenditures in the quarter under review accounted for 10 percent of GDP.

Donor contributions are used to finance both operating and development expenditures. The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 41,289.75 million in the quarter under review, up from AF 39,706.50 million in the second quarters of 1389, representing a 4 percent increase.

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

1. REVENUES

The government's primary concern in the past few years was to improve revenue collections. Domestic revenue collected in the second quarter of 1390 indicates that government will be able to hit the target agreed with IMF under the Extended Credit Facility (ECF) program. Total revenues collected in the second quarter exceeded not only from the same period of last year but also is 109 percent or AF 45,878.65 million higher than amount estimated by IMF (AF 42,149 million) for the quarter under review.

The main contributors in domestic revenues were tax revenues and custom revenues of AF 33,348.14 million, social contributions AF 1,071.32 million, donor contributions AF 41,289.75 million and other revenues of AF 12,318.44 million respectively. Total domestic revenues accounted for 12 percent of GDP.

The second quarter gains were driven primarily by improvements to the certain sets of well defined reforms, including expanding the tax bases, improving tax compliance, and enhancing the capacity of tax administration staff, in addition due to strong and sustained real economic growth in the tax collections. Domestic revenue collections in the second quarter of 1390 totaled AF 88,957 million compared to AF 76,326 million collected in the second quarter of 1389 which shows increment of 17 percent or AF 12,631 million in the quarter under review.

Total tax collections showed growth for the year under review, in accordance to receipts, overall tax revenue increased from AF 29,825.63 million to AF 33,348.14 million in the quarter under review from the same quarter of the previous year, which represents 12 percent increase. Total fixed taxes and tax receipts for the second quarter of 1390 were AF 4,505.30 million, compared to AF 4,258.62 million in the second quarter of 1389 which represents improvements of 6 percent. Income tax showed increase of 20 percent with the receipts of AF 4,947.42 million compared to the same quarter of last year receipts of AF 4,128.83 million representing a 20 percent of augment. Property tax collections increased from AF 100.50 million in Q2 1389 to AF 176.26 million with a 75 percent increase in the quarter under review. Total revenues from custom duties increased by 15 percent or AF 1,988.42 million in the quarter under review compared to the same quarter of last year. Custom duties constitute the largest source of revenues in Afghanistan. In addition, higher growth in imports by Herat and other provincial

custom offices as new routes are introduced recently, added into total domestic revenues. However, 14 percent decline was reported in other taxes revenue.

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

Table 5.1: Revenue Collection as of Second Quarter of 1390 (in million AF)

	Q2 1390 Revenue Actual	Q2 1389 Revenue Actual	% Δ from Q2 1389 to Q2 1390
Total Domestic Revenues (Tax and Non Tax)	44,047.49	19,648	124%
Tax Revenues	17,620.22	14,956	18%
Non Tax Revenues	6,234.72	4,692	33%
Total Donor Contribution	20,192.55	23,923	-16%

Source: Ministry of Finance website and DAB staff calculation

Table 5.2: Revenue Collection as of Second Quarter of 1390 (in million USD)

	Q2 1390	Q2 1389
Total Revenue (Tax & Non-tax Revenues)	964	414
Tax Revenues	386	315
Non Tax Revenues	136	99
Total Donor Contribution	442	504

Source: Ministry of Finance website and DAB staff estimation

End Period Average Exchange Rate according to DAB was for Q2, 1390 was AF 47.46 per USD, while it was AF 45.69 per USD in Q2 1389

Figure 5.1: Revenue Collection (in million USD)

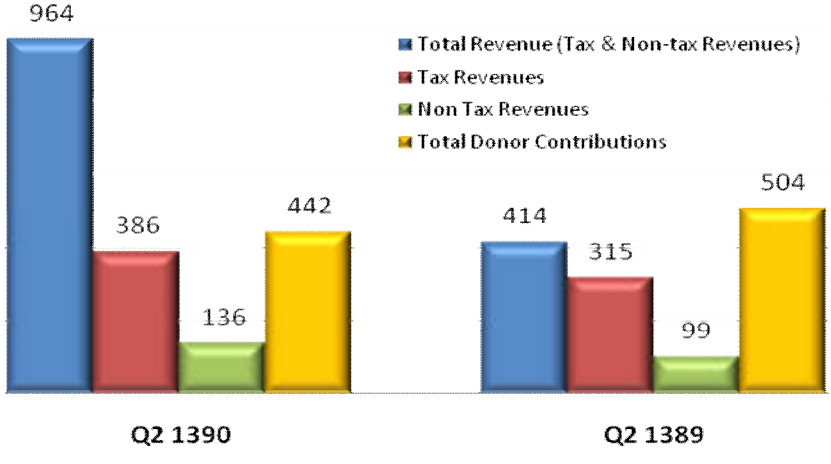


Table 5.3: Breakdown of Total Domestic Tax and Non-tax Revenues (in million AF)

Tax and non-Tax Revenues	Q2 1389	Q2 1390	% Changes
Taxation & Customs Revenues			
Fixed Taxes	2,482.75	2,065	20%
Income Taxes	2,223.27	2,033	9%
Property Taxes	93.15	41	126%
Sales Taxes	4,206.52	3,665	15%
Excise Taxes	-	-	-
Other Taxes	541.88	456	19%
Tax Penalties and Fines	155.90	102	52%
Customs duties	7,916.76	6,593	20%
Total taxation revenues	17,620.22	14,956	18%
Social contributions			
Retirement contributions	609.13	434	40%
Total social contributions	609.13	434	40%
Other revenue			
Income from Capital Property	86.95	67	29%
Sales of Goods and Services	1,297.35	953	36%
Administrative Fees	2,615.21	1,405	86%
Royalties	65.19	10	543%
Non Tax Fines and Penalties	148.86	63	134%
Miscellaneous Revenue	19.04		
Sale of Land and Buildings	6.40	12	-49%
Total other revenue	6,234.72	4,258	46%
ARTF	2,280.71	9,362	-76%
LOTFA	5,943.96	5,579	7%
CSTC - MoD	7,622.19	2,990	155%
Foreign loans	-	-	-
World Bank	63.17	200	-68%
ADB	396.67	698	-43%
Other	149.29	67	124%
Donor revenue	-	-	-
World Bank	1,538.99	1,424	8%
EC	-	-	-
ADB	622.02	2,148	-71%
DFID		-	-
US & USAID	1,052.66	796	32%
Others	510.74	660	-23%
Total Donor Contributions	20,192.55	23,923	-16%

Source: Ministry of Finance website and DAB staff estimation

2. EXPENDITURES

Total core expenditures rose by AF 13,164 million or 21 percent in the first six month of 1390. Total core expenditures stood at AF 75,641 million during the first six months of 1390 versus AF 62,477 million during the same period of 1389. Total core expenditures in the first six months of the year under review accounted for 10 percent of GDP.

Total core expenditures are classified into development and operating expenditures. Development expenditures increased to AF 16,852.31 million in the quarter under review up from AF 16,196.46 million in the second quarter of 1389, which shows 4 percent increase. Total development expenditures accounted for 2 percent of GDP.

The current or operating expenditures increased to AF 58,788.91 million in the quarter under review up from AF 46,280.51 million in the second quarter of 1389, representing 27 percent increase. The current expenditures accounted for8 percent of GDP.

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

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

Expenditures on compensation of employees increased to AF 48,077.28 million in the quarter under review up from AF 37,710.55 million in the second quarter of 1389, which represents 27 percent increase. According to FPU/MoF, the increased spending on wages and salaries was mainly paid to the additional security forces (Afghan National Army and Afghan National Police). It is expected that almost all of the budgeted amount on employee compensation will be expended by the end of the year, as the recruitment process of ANP and ANA accelerates, together with the relatively faster implementation of Pay and Grading Reform in the second half of the year.

Expenditures on interest payments increased in the quarter under review reaching AF 10,801.66 million up from AF 9,574.39 million in the second quarter of 1389, this indicates 13 percent increase.

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

Subsidies, grants and social transfers are the third largest components of the recurrent expenditures, this includes subsides to state-owned enterprises, capital transfers to municipalities and pensions to retired public servants. About 4 percent of the expenditures on this item are spent on social transfers, and principally pensions. Expenditures on subsidies, grants and contribution increased to AF 3,398.42 million in the quarter under review up from AF 2,950.18 million in the second quarter of 1389, this represents 15 percent increase. According to the FPU/MoF, operating expenditures on social security are likely to increase in future as relatively strong

growth is expected in the registration and number of retired civil servants as well as army officials (see Tables 5.3 and 5.4).

Table 5.4: Core Expenditures as of Second Quarter of 1390 (in million AF)

Particulars	Q2 1390 Expenditure Actual	Q2 1389 Expenditure Actual	% Changes
Total Expenditures(Development and Operating)	47,195.40	40,842	16%
Development Expenditures	11,510.75	13,338	-14%
Operating Expenditures	35,684.65	27,504	30%

Source: Ministry of Finance website and DAB staff calculation

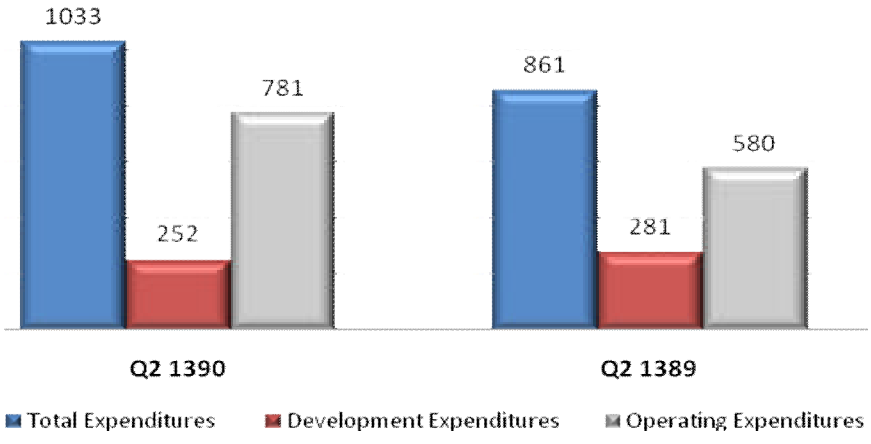
Table 5.5: Core Expenditures (in million USD)

	Q2 1390	Q2 1389
Total Expenditures	1033	861
Development Expenditures	252	281
Operating Expenditures	781	580

Source: Ministry of Finance website and DAB staff estimation

End Period Average Exchange Rate for Q2 1390 was AF 47.46/USD, and for Q2 1389 it was AF 45.69/USD

Figure 5.2: Core Expenditures (in million USD)



Source: Ministry of Finance website and DAB staff estimation

Table 5.6: Total Operating Expenditures (in million AF)

Expenditure Splits	Q2 1390	Q2 1389	% Changes
Employees			
Salaries in cash	23,565.85	18,804	25%
Salaries in kind	4,509.94	2,994	51%
Salaries and wages advance	61.10	58	6%
Social benefits in cash	151.46	112	35%
Social benefits - in kind	0.00	-	0%
Total employee expenditure	28,288.35	21,968	29%
Supplier Expenditure			
Travel	301.44	256	18%
Communications	0.00	-	
Contracted services	62.42	61	2%
Repairs and maintenance	531.55	358	48%
Utilities	440.20	339	30%
Fuel	1,101.35	587	88%
Tools and materials	1,374.34	1,376	0%
Other	420.53	642	-34%
Advances and return of expenditure	415.35	49	752%
Total supplier expenses	4,647.18	3,669	27%
Subsidies, grants, contributions and pensions			
Grants	22.70	11	108%
Grants to foreign government	0.00	91	0%
Social security benefits cash	1,937.00	1,469	32%
Social assist benefit in cash	16.89	61	-72%
Advance Subsides Grants	410.00	(27)	-1621%
Total subsidies, grants, contributions and pensions expenditure	2,386.59	1,605	49%
Capital expenditure			
Buildings and structures	97.18	19	407%
Machinery and equip (>50,000)	104.28	125	-17%
Valuables	-	-	-
Land	106.12	100	6%
Capital advance payments	47.72	14	241%
Total capital expenditure	355.30	258	38%
Interest			
Interest	7.22	4	71%
Total interest expenditure	7.22	4	71%

Source: Ministry of Finance website and DAB staff estimation

Table 5.7: Total Development Expenditures (in million AF)

Particulars	Q2 1390	Q2 1389	% Changes
Travel	54.43	28	93%
Communications		-	
Contracted services	3,380.65	3,501	-3%
Repairs and maintenance	49.87	39	28%
Utilities	35.08	19	89%
Fuel	14.88	10	56%
Tools and materials	89.39	79	13%
Other	118.96	240	-51%
Advances and return of expenditure	986.16	781	26%
Total supplier expenses	4,729.41	4,697	1%
Grants	-	16.33	-100 %
Grants to foreign governments	-	-	-
Social security benefits cash	-	-	-
Social assist benefit in cash	-	-	-
Advance Subsides Grants	-	400.00	-100%
Total subsidies, grants, contributions and pensions exp.	-	416.33	-100 %
Buildings and structures	3,347.55	5,971	-44%
Machinery and equip (>50,000)	1,193.11	353	238%
Valuables	3.00	1	321%
Land	9.63	-	0%
Capital advance payments	2,228.05	1,900	17%
Total capital expenditure	6,781.33	8,225	-18%
Interest	-	-	-
Total interest expenditure	-	-	-

Source: Ministry of Finance website and DAB staff calculation

3. FINANCING THE CORE BUDGET

The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 41,289.75 million in the second quarter of 1390 up from AF 39,706.50 million in the second quarter of 1389, which represents 4 percent increase.

According to FPU/MoF, donor contribution constitutes 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 10,014,335 million, while for the operating expenditures it was AF 31,275,419 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 5.8).

Table: 5.8: Total Donor Contribution, Q2 1390 and Q2 1389 (in million AF)

Donor contributions	Q2 1390	Q2 1389	% Changes
Afghanistan Reconstruction Trust Fund	5,826.48	14,028.79	-58%
Law and Order Trust Fund - Afghanistan	12,010.79	10,934.00	10%
CSTC - MoD	18,102.11	5,628.64	222%
Foreign loans	-	-	-
World Bank	63.17	200.26	-68%
Asian Development Bank	473.33	861.93	-45%
Other	151.33	130.82	16%
Donor revenue	-	-	
World Bank	2,001.63	2,361.72	-15%
European Commission	-	-	-
ADB	1,041.74	2,190.81	-52%
DFID	12.14	487.02	-98%
US and USAID	1,068.54	1,131.24	-6%
Others	538.49	1,751.26	-69%
Total donor contributions	41,289.75	39,706.50	4%

Table 5.9: Breakdown of Donor Contribution for Q2 1390 (in million AF)

Donor contributions	Operating Grants	Development Grants
Afghanistan Reconstruction Trust Fund	1,117,097	4,709,383
Law and Order Trust Fund - Afghanistan	12,010,789	
CSTC - MoD	18,102,111	-
Foreign loans		
World Bank		63,166
Asian Development Bank		473,327
Other		151,334
Donor revenue		
World Bank		2,001,632
European Commission		-
ADB		1,041,743
DFID		12,137
US and USAID		1,068,541
Others	45,422	493,071
Total donor contributions	31,275,419	10,014,335

Source: Ministry of Finance website and DAB staff estimation

CHAPTER VI

BANKING SYSTEM PERFORMANCE

6

BANKING SYSTEM PERFORMANCE

Total assets of the banking system registered a decrease of 2.94 percent (year-on-year) or AF 6,603 million at the end of the second quarter of 1390 (September 2011). Total asset of the banking sector stood at AF 218.09 billion (USD 4.57 billion) at the end of September 2011 compared to AF 224.69 billion (USD 4.99 billion) in the same period last year. Gross loans amounted to AF 37.92 billion (USD 795 million) depicting a decrease of 51 percent, which has come from a number of financial institutions, but mainly from the splitting of crises stricken bank into New Kabul Bank and receiver. Good assets came under the New Kabul Bank and bad assets (mainly loans) gone to receiver, While deposits stood at AF 162.87 billion (USD 3.42 billion) up by 10.43 percent from the same period of last year. Deposits were largely denominated in USD (62.75 percent) with afghani denominated deposits lagging at 34.5 percent. AF-denominated deposits indicated growth rate of 16.8 percent, while USD denominated deposit were up by 7.8 percent. The entire banking sector was well capitalized, and the capital of the system stood at AF 15.55 billion (USD 326 million), although down by 33.05 percent since previous period where it was AF 23.23 billion. This significant dropdown was due to splitting of crises stricken bank in to New Kabul Bank and Receiver, which caused the decrease in capital comparing to last year.

The capital adequacy ratio (CAR) of the banking sector was at 16.3 percent. On cumulative basis the banking sector has registered losses of AF 1.91 billion (USD 40.04 million), where it was profitable (AF 1.82 billion) in the previous period (September 2010), resulting in an ROA of -1.87 percent annualized which was 1.91 percent in the same period of last year. Only branches of foreign banks ended up with profit, while private banks and state-owned banks ended up with losses for the quarter ending September 2011.

1. ASSET OF ASSET OF THE BANKING SYSTEM

The banking system continues to grow at a brisk rate. Total assets of the banking system at the end of the second quarter of

1390 stood at AF 218.09 billion (USD 4.57 billion), down by 2.9 percent or AF 6.60 billion since September 2010. The main components responsible for this decrease were total gross loans, intangible assets and premises and other fixed assets.

On the other hand, some other components of assets experienced increase; the most obvious increase was registered by "trading and investment accounts" (up by AF 2.92 billion or 390.75 percent) mainly due to two financial institutions. The second major increase was posted by unconsolidated investments category of total assets (up by AF 243 million, 40.17 percent). The third largest increase was observed in cash in vault and claims on DAB categories (up by AF 2.26 billion or 37.10 percent) followed by loan loss reserves (up by AF 496 million or 31.27 percent), NDF up by AF 1.41 billion or 15.77 and other assets up by 5.6 billion or 15.33 percent. Comparing to the last quarter (June, 2011), the asset base of the system increased by 0.62 percent, this increase was due to increase in interbank claims, NDF and premises, and other fixed assets has depicted nominal increases, while loan loss reserves, other assets, cash in vault and claims on DAB, intangible assets and gross loans contracted since last quarter.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (38.37 percent), "other assets" (19.32 percent), net loans (16.43 percent), interbank claims (16.11 percent), and NDF (4.76 percent). Other components of total assets were negligible. Table 6.1

Figure 6.1: Size of Banking Sector (Total assets) decreased by 2.94 percent or AF 6.60 billion

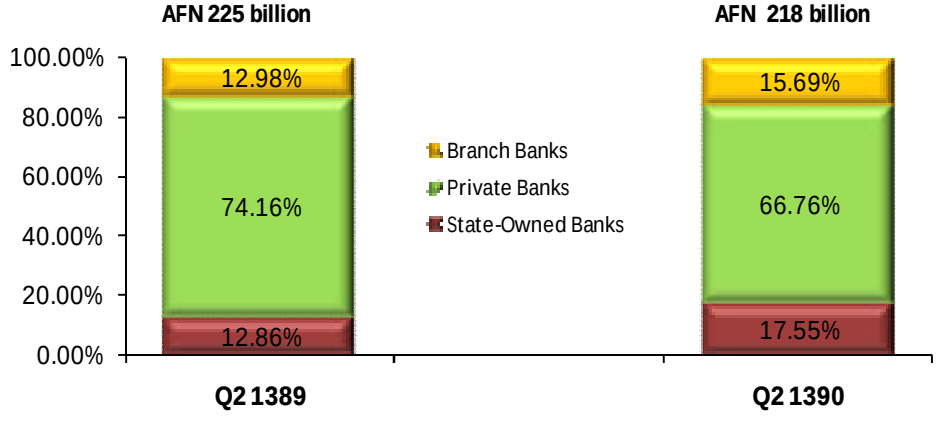


Table 6.1: Composition of Assets & Liabilities (in million AF)

Assets	1389 September 2010	1390 September 2011	% of Total	Growth
Loans (Net)	76,419	35,833	16.43	-51.39
Cash in vault and claims on DAB	61,041	83,688	38.37	37.10
Interbank claims	33,607	35,139	16.11	4.56
Investments	1,351	4,509	2.07	233.75
NDF	8,967	10,381	4.76	15.77
Others	43,308	48,540	22.26	12.08
Total	224,693	218,090		-2.94
Liabilities				
Deposits	147,485	162,873	80.42	10.43
Borrowings	20,929	1,690	0.83	-91.93
NDT	5	327	0.16	6440
Others	33,044	37,649	18.59	13.94
Total	201,463	202,539		0.53

Source: Financial Supervision Department (FSD)/DAB

1. Interbank Claims

Interbank Claims are the fourth largest among various asset categories, currently comprising AF 35.14 billion or 16.11 percent of total assets; this represents 4.56 percent increase since September 2010. The increase is attributed to a number of banking institutions, indicating that the banking sector has channeled a portion of its attracted funds as deposits in other financial institutions, if credible borrowers were not found. These institutions are both inside the country and outside the country. Later on, if needed for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets Figure 6.2.

Private Banks are the leading creditors, but compared to the previous period, their portfolio both in absolute terms as well as percentage of total loans depicted a decrease, currently standing at AF 27.22 billion or 71.79 percent of total loans. The decrease in private banks portfolio was mainly due to splitting of the crises stricken bank into New Kabul Bank and Receiver. Good assets came under the New Kabul Bank and bad assets (mainly loans) gone to receiver. The portfolio of State-owned banks and branches of foreign banks' share and amount stood at AF 6.61 billion (17.42 percent) and AF 4.09 billion (10.79 percent) respectively.

Source: Financial Supervision Department, DAB

1.2 Net Loans

The loans/ advances portfolio of the system stood at AF 35.83 billion (USD 751 billion) as of September 2011 – down by AF 40.59 billion or 53.1 percent since September 2010 or 16.4 percent of total assets; this significant decline in the net loan of the system came from a number of financial institutions, but mainly from the splitting of crises stricken bank into New Kabul Bank and Receiver. Increase in lending was observed at nine banking institutions, where as in six banking institutions decreases were observed, while two of the banking organizations did not participate, however more than two-third of the growth is still attributable to private bank's group.

Source: Financial Supervision Department, DAB

1.3 Loan Loss Reserves

While assessing the level of credit risk, banks have to give due attention to credit risk mitigation tools within its risk mitigation framework. Banks are required to make both, general provisions (on standard assets) and specific provisions (on non-standard assets) in order to mitigate their credit risk.

By the end of Sunbula 1390 (September 2011), total provision cover of the system was 5.5 percent of the total gross loans in comparison to 2 Percent in the same period of last year (September 2010).

1.4 Distribution of Credit

Segment wise analysis shows that the major portion of the loan portfolio is designated to "other commercial loans" (63.8 percent), mainly in trade sector (28.7 percent). A significant increase has been observed in Residential Mortgage Loans to Individuals and all other loans being 17.49 percent and 12.32 percent of the total portfolio respectively. This concentration in other commercial loans, mortgage loans and all other loans to the exclusion of all other types of lending has been the dominant trend. Moreover the lending in manufacturing and services sectors has improved, while the loans in the "Commercial and Real Estate and Construction Loans" and "other commercial loans" have witnessed a decrease during this period. Loans in SMEs and Micro Credit Loans amounting AF 8.03 billion (USD 168 million) by eight banking institutions, was down by AF 1.92 billion since previous period, came from a number of banking institutions, the decrease was obvious in SME sector. But, still lending is picking up, although not sufficient enough in some loan categories related to important sectors of the economy, e.g. agriculture and mining have not benefited much. About 77.6 percent of the loans were designated in Kabul with Balkh and Herat provinces in the second and third places respectively. The proportion of loans in other provinces was negligible. The designation of loans sectorally, geographically and institutionally is not properly diversified, but we hope that as time goes over the distribution of loans will become more diversified. It is desirable that all banks take active part in lending.

Table 6.2: Sectoral Distribution of Credit

Ratios	1386 (Mar 2008)	1387 (Mar 2009)	1388 (Mar 2010)	1389 (Mar 2011)	1390 (Sep.2011)
Commercial Real Estate and Construction Loans	9.54	0.19	19.92	25.98	3.46
Other Commercial Loans	79.14	-	-	-	-
Mining	N.A	-	-	0.02	0.91
Manufacturing	N.A	0.01	1.22	2.72	8.77
Trade	N.A	0.51	32.29	34.16	28.73
Communication	N.A	0	1.04	1.23	2.52
Service	N.A	0.09	4.84	6.72	11.83
Utilities	N.A	0.01	2.47	0.03	0.08
Others	N.A	0.09	25	8.42	10.96
Agricultural Loans	0.13	0	0.88	0.75	1.95
Consumer Loans	2.17	0.02	1.33	1.01	0.99
Residential Mortgage Loans to Individuals	2.28	0.01	7.3	8.95	17.49
All Other Loans	6.74	0.05	3.69	10	12.32

Source: Financial Supervision Department/DAB

1.5 Non-performing loans (NPLs)

The NPLs ratio for the last five years ranged between 1.13 percent and 0.50 percent, but increased to 51.88 percent in December 2010. The significant increase in NPLs by the end of Dec.2010 was more pronounced in the crises stricken bank.

Banks should try to strengthen credit risk management measures to curtail the level of NPLs. This is essential for banks to evaluate credit application carefully and closely monitor financial condition of their borrowers, to ensure that credit expansion will not pose a threat to the stability of the financial system By the end of the second quarter of 1390 (September 2011) the growth in NPLs has decelerated to AF 2.49 billion (USD 52 million) or 6.56 percent of gross loans up by AF 1.03 billion compared to the previous period (September 2010), where non-performing loans were AF 3.52 billion. Comparing to the last quarter June 2011, non-performing loans indicated AF 706 million increase during this quarter, mainly attributed to three banking institutions.

Source: Financial Supervision Department, DAB

1.6 Adversely-Classified Loans

Adversely-classified loans (substandard, doubtful) stood at AF 3.81 billion (USD 80 million) posting a decrease of AF 1.56 billion at the end of Sunbula 1390 (September 2011) which was AF 5.37 billion in the previous period (September 2010). The percentage share of adversely-classified loans in total gross loans increased to 10.05 percent, from 6.88 percent in the same period last year, the increase in percentage was due to increase in denominator of the ratio.

1.7 Loans Classified Watch

Loans under "Watch" category stood at AF 2.17 billion (USD 45 million) or 5.7 percent of total gross loans which was AF 19.31 billion or 24.75 percent of the gross loans in the previous period. The loan category has an upward trend which needs close monitoring to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative.

1.8 Loans classified Loss

Loans classified loss amounts to AF 308 million (USD 6 million) up by AF 165 million or 0.81 percent of total gross loans since previous period, mostly came from one banking institution.

1.9 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the largest category, increasing both in absolute as well as in percentage of total assets since previous period (September 2010), registering AF 22.65 billion or 37.10 percent increase during this period. The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

1.10 Investment

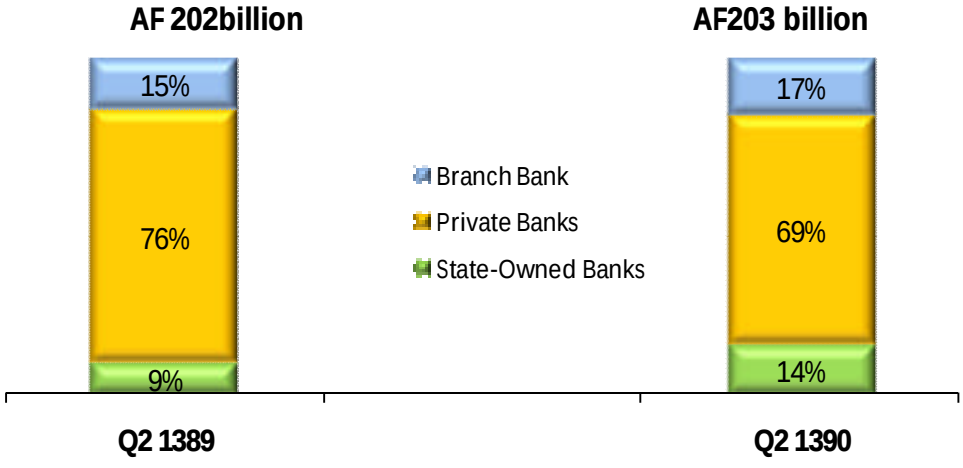
The growth in investments accelerated significantly by 233.75 percent or 2.07 percent of total assets, amounting to AF 4.51 billion by the end of Sunbula 1390 (September 2011). Major part of the investment took place outside Afghanistan in First Gulf Bank and TAQA bonds (UAE), Euro bonds (Pakistan) and trading companies (USA, UK) by two commercial banks and a branch of foreign bank.

2. LIABILITIES

Total liabilities of the banking sector were AF 202.54 billion (USD 4.25 billion), up by 0.53 percent. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Major portion of liabilities are made up of deposits (80.42 percent), with "other liabilities "at second and borrowings at third place. Table 6.2

Figure 6.5: Liabilities Increased by AF 1.08 billion or 0.53 percent



Source: Financial Supervision Department, DAB

2.1 Deposits

Deposits remained the main source of funding in the banking sector, accounting for 80.4 percent of the total liabilities, depicted 10.43 percent growth since last year (September 2010). Afghani denominated deposits indicated 16.82 percent growth, accounting for 34.47 percent of the total deposits, whilst the US dollars denominated deposits registered 7.8 percent increase making 62.8 percent of total deposits of the system.

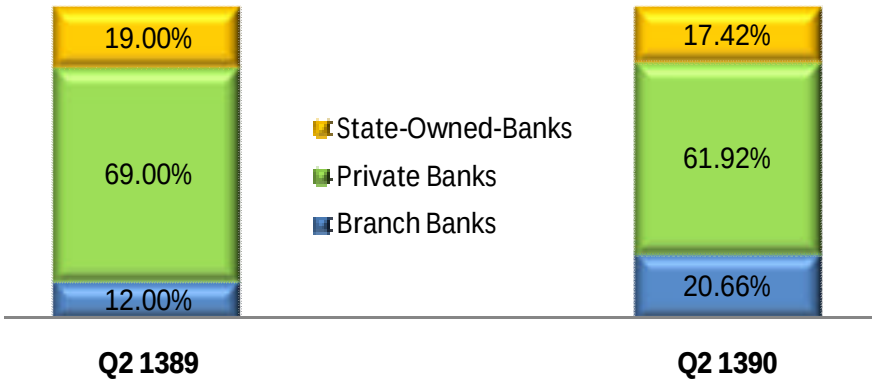
The share of state-owned banks increased to AF 28.37 billion (up by 66.51 percent), which was AF 17.04 billion in September 2010.

Private Banks attracted AF 100.84 billion, which decreased by 0.72 percent since previous period, where it was AF 101.57 billion.

The share of branches of foreign banks increased to AF 33.65 billion (up by 16.56 percent), which was 28.87 billion in previous period (September 2010).

In terms of types of deposits, demand deposits accounted for 67.7 percent of the total deposit base, up by 8.04 percent, saving deposits with 23.7 percent of total deposits was in the second place, depicting 23.5 percent increase, and time deposits making 8.6 percent of the total deposit portfolio, was down by 1.1 percent since September 2010.

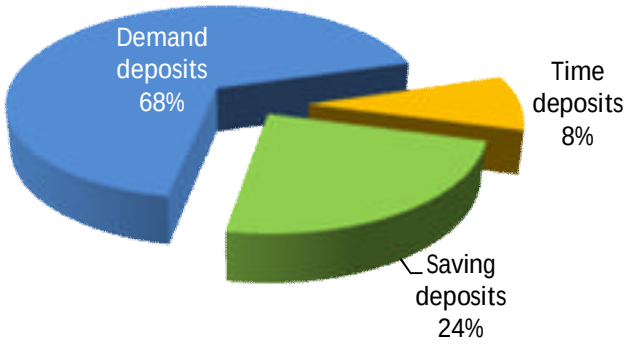
Figure 6.6: Deposits increased by 0.53 percent or AF 1.08 billion



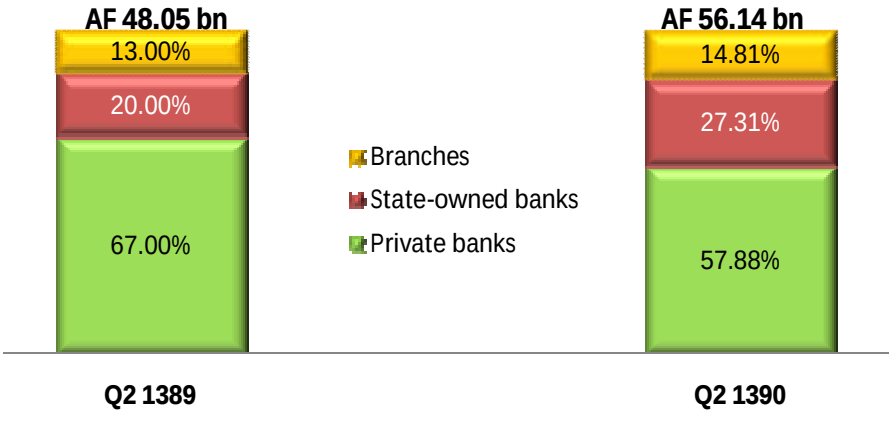
Source: Financial Supervision Department

Figure 6.7: Currency Composition of Deposits

Figure 6.8: Breakdown of Deposits



Fiugre 6.9: Afghani Denominated Deposits



Source: Financial Supervision Department, DAB

2.2 Borrowings

The share of borrowings in total funding structure of the system decreased significantly, standing at AF 1.69 billion (USD 35.43 billion) by the end of the September 2011, down from AF 20.93 billion in September 2010, making 0.85 percent of total liabilities in comparison with 10.4 percent in the same previous period. The significant decrease in borrowing has come from three banking institutions.

2.3 Liquidity

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

2.4 Liquidity Ratio (broad measure)

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

Generally, a surplus liquidity position was observed in the banking sector during this period. Analysis show a 47.36 percent increase in access liquid assets. 47.1 percent of the total assets comprises of liquid assets. Ratio of the broad liquidity as a median for the all system stood at 51.66 percent. All the banking institutions were well above the minimum required level.

2.5 Capital

In order to strengthen the capital base of the banking system and enhance its stability, DAB has increased the minimum financial capital requirement to AF 1.00 billion, and all banking institutions are given two year time period to meet this requirement1.

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

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

The system is well capitalized and the capital of the system stands at AF 15.55 billion (USD 326 million), although down by 33.05 percent since previous period where it was AF 23.23 billion. This significant dropdown is due to splitting of crises stricken bank in to New Kabul Bank and Receiver, which caused the decrease in capital comparing to last year.

On aggregate basis, capital adequacy ratio of the banking sector was 16.30 percent. Table 6.5

If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 15.55 billion makes 7.13 percent of AF 218.09 billion, which is far below the benchmark, while total assets of the full-fledged commercial banks are AF 183.88 billion .

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

In the period under review, there was an increase of AF 1.41 billion in NDF standing at AF 10.38 billion as compared to the last period (September 2010), when it was AF 8.97 billion.

In the period under review, NDT position amplified manifold and increased by AF 322 million and stood at AF 327 million, when it was AF 5 million in the previous period (September 2010). Only two banks were at favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining three. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted, while the rest are simply sending their acquired funds to their international networks. The NDF positions of two banks have increased, and one bank has a decrease, while one bank has switched to NDT position during this period. The largest NDF position by a branch of foreign bank was AF 9.26 billion, increased by AF 1.91 billion from AF 7.34 billion in previous period September 2010.

Table 6.3: Key Financial Soundness Indicators of the Banking Sector

Ratio	1386 (Mar 08)	1387 (Mar 09)	1388 (Mar 10)	1390 (Mar 11)	1390 (Mar 11)*	1390 (Sep. 11)
Total Capital Adequacy Ratio	31.77	29.81	25.81	-14.46	30.39	16.3
Teir 1 Capital Adequacy Ratio	31.16	29.72	24.19	-14.51	30.29	16.09
Non-Performing Loans to Total Gross Loans	0.68	1.15	0.5	48.4	3.75	6.56
Return on Assets (ROA)	1.8	1.74	1.41	-20.08	0.24	-1.87
Return on Equity (ROE)	9.89	10.61	10.35	-520.66	1.9	-33.62
liquidity Ratio (Broad Measure Median)	40.02	40.02	59.19	63.32	63.83	60.44
liquidity Assets to Total Assets	23.8	23.8	0.38	40.58	47.01	47.07

*without Crises stricken Bank

Source: Financial Supervision Department/ DAB

2.6 Profitability

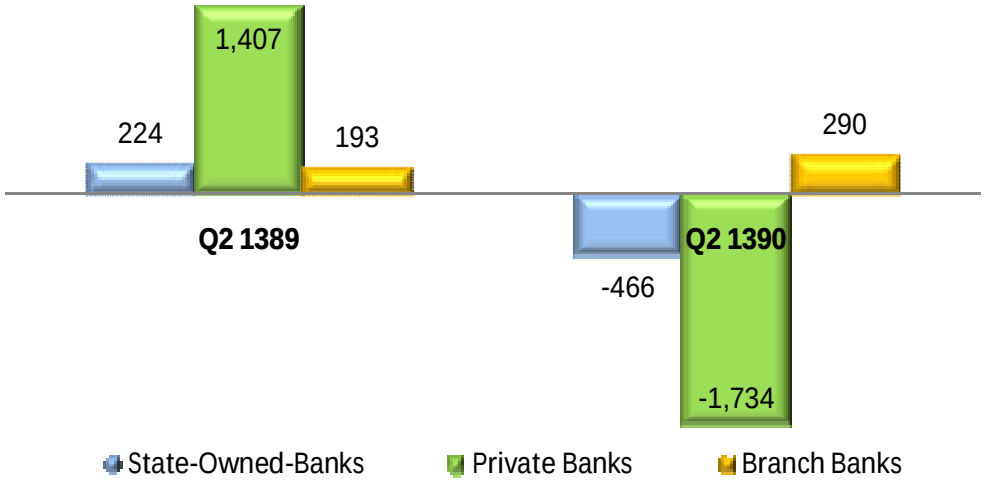
The banking sector has been registering losses in the first two quarters of 1390 (April to September2011) except for the month of July, 2011. On cumulative basis, the banking sector has registered losses of AF 1.91 billion (USD 40.40 million), where it was profitable (AF 1.82 billion) in the previous period (September 2010), this deterioration was mainly on account of manifold increase in credit provisions (by AF 1.38 billion), decrease in net interest income (by AF 2.02 billion) and FX losses (by AF 106 million), on the other hand, non-interest income has increased by AF 339 million, and operation cost has decreased by AF 298 million, but less than amount to offset the above unfavorable changes.

The return on assets (ROA) of the system decreased to -1.87 percent; where it was 1.91 percent in the previous period (September 2010), the return on equity (ROE) has decreased to –33.62 percent from 15.96 percent in the previous period. On a cumulative basis, seven banks have incurred loss of AF 1.98 billion, where it was AF 102 million in the previous period with six banks at loss. On core income basis, two banks ended with losses mainly on account of decrease in total income.

The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a Median stood at 1.65, Eight banking institutions ended up with lower efficiency ratios by the end of Sunbula 1390 (September 2011).

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

Figure 6.10: Profitability of the Banking Sector (in AF million)

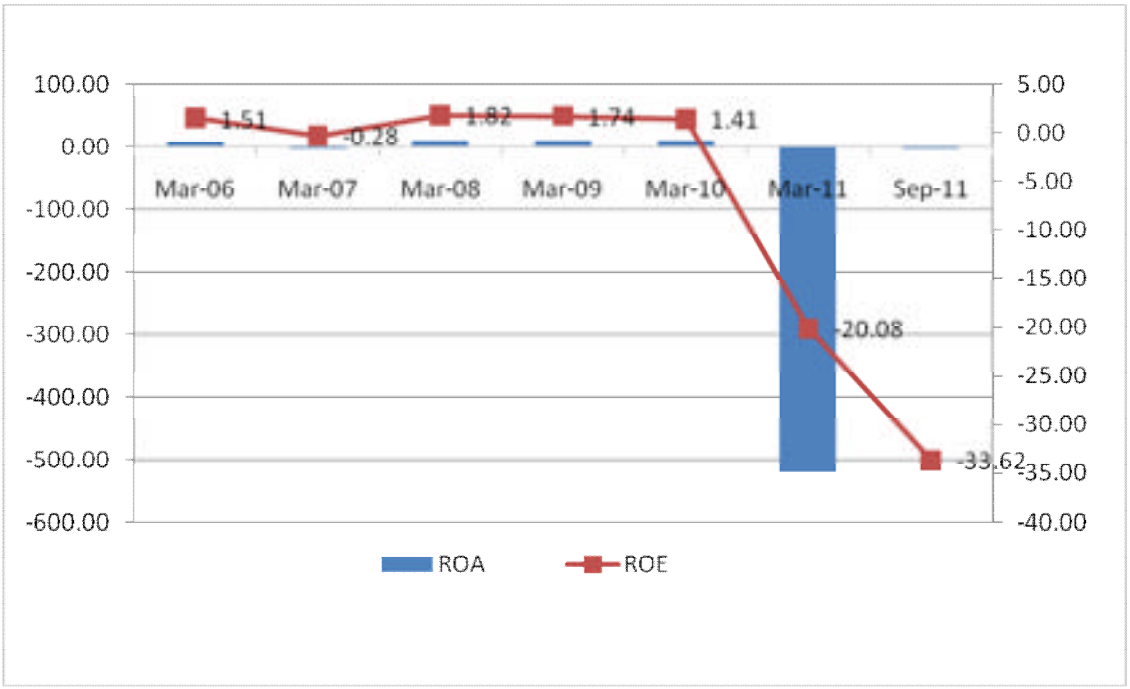


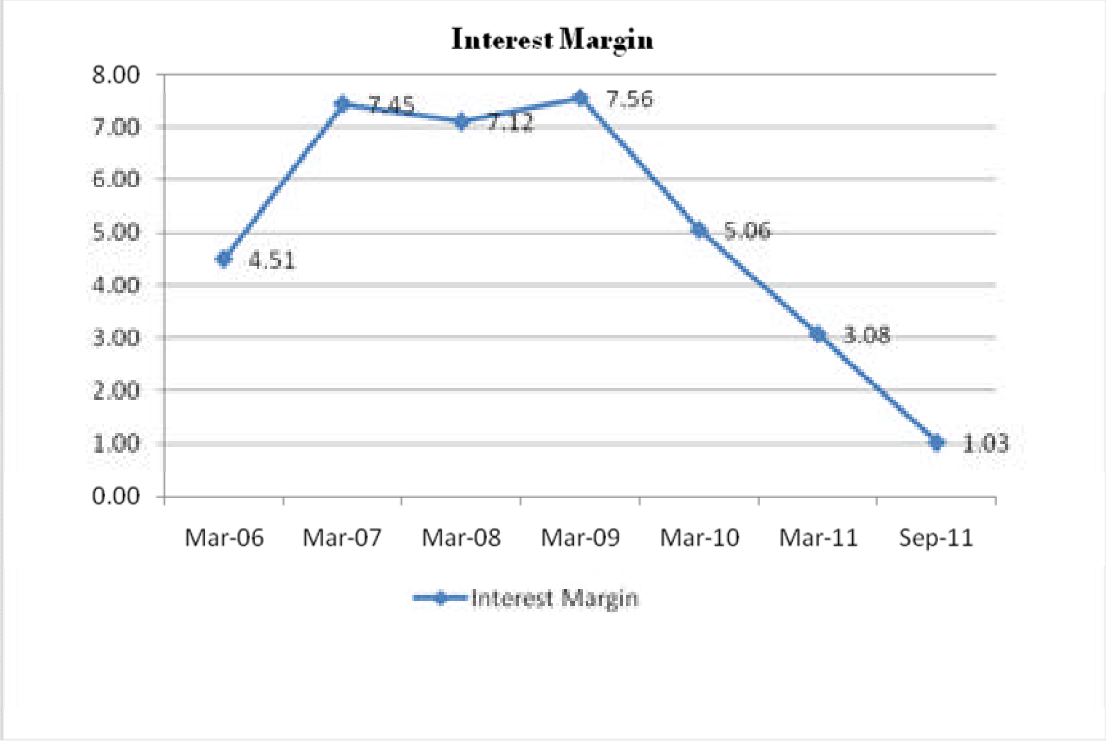
Source: Financial Supervision Department/ DAB

Table 6.4: Profit of the Banking Sector (in million AF)

items	1389 (Sep. 2010)	1390 (Sep. 2011)	Growth
interest income	5,551	3,179	-43
interest expense	1,422	1,074	-24
Net interest income	4,129	2,105	-49
Non-interest income	2,181	1,659	-24
Non-interest expenses	2,235	2,055	-8
Salary cost	1,551	1,539	-1
Credit provisions	561	1,945	247
P/L before tax	1,963	-1,775	-190
P/L after tax	1,823	-1,910	-205

Source: Financial Supervision Department/DAB





Source: Financial Supervision Department/DAB

2.7 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for overall open FX position, except four banking institutions holding open FX position on overall and on an individual currency (USD short & long position) basis above the maximum regulatory threshold. In the previous period, only one banking institution was above the limit on overall and on an individual currency basis (USD long position). This indicates that the number of banks in violation of regulatory limits has increased for the quarter ending September, 2011. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by AF 5,212 million and vice versa. Similarly, a 4 percent change would correspond to AF 1,041 million and vice versa.

2.8 Interest Rate Risk

Overall banking institution is in interest-rate sensitive position. If the interest- rate increases by 3 percentage points there will be an increase of AF 42 million in net interest income over the next 12 months. Conversely, if the interest-rate decreases by 3 percentage points, the interest income will decline to AF 42 million. For five banking institutions, if the interest-rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is managed on a whole-bank basis).

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

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