Da Afghanistan Bank

Economic & Statistical Bulletin

Semi Annual Bulletin FY1391

(March 21, 2012 to September 20, 2012)

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Note:
Afghanistan's new Fiscal year has been changed effective from 1391 (2012). The fiscal year begins on December 21 each year. This Semi Annual Bulletin describes developments in the first six months of fiscal year 1391 which covers March 21 to September 20, 2012.

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LIST OF ABBREVIATIONS

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

Message of the Governor

Governor's Statement

Semi Annual Economic and Statistical Bulletin

On behalf of the Supreme Council, I am pleased to present this edition of the Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for the first six months of FY1391 (March 21-September 20, 2012). This semiannual bulletin reflects the main results of the Bank's activities aimed at keeping inflation low, maintaining stability of the national currency and developing a more robust banking sector in support of sustainable economic growth.

The fiscal year 1391 is expected to be relatively favorable year for Afghanistan with an expected increase in growth rate compared to the previous year. Based on an estimate done by the Central Statistics Organization and DAB staff, the real GDP growth rate gained momentum and is expected to be about 10 percent in the year under review.

Inflation continued its downward trend through the second quarter of the year under review. The decrease in overall inflation was driven by both, food and non-food price indices.

In Afghanistan, agricultural sector performance was weak in 1389 and 1390, but is expected to rebound in 1391 due to a good winter season and sufficient rainfalls at the beginning of the year, which will lead to a good wheat and grain harvest.

On the other hand, monetary aggregates depicted mixed performance in the first six months of FY1391. Reserve money, the operational target under the ECF program, had a negative growth of 3.2 percent, below the ECF target of 5.6 percent.

Narrow money (M1) increased mainly due to increased demand for afghani as a medium of exchange. Broad money (M2) demonstrated similar behavior at the end of the period under review.

Meanwhile, afghani depreciated against the U.S. dollar by almost 5.5 percent in the period under review.

In the external sector, the merchandise trade deficit widened significantly in the first six months of FY1391 as a result of decrease in aggregate export. The trade deficit, accounts for 22 percent of GDP.

The global economic conditions improved modestly in the third quarter of 2012. The main sources of this acceleration were the emerging market economies, where activity picked up broadly as expected, and the United States, where growth surprised on the upside.

Although, the global economy expanded somewhat in the third quarter of 2012, but the recovery was not strong enough to promote aggregate demand, especially in trading partners of Afghanistan.

The banking system performed satisfactory with the asset base of the banking sector growing by 2.2 percent compared to the preceding quarter. Gross loans grew over the previous quarter as well as compared to the same period of the previous year. Deposits also increased compared to the previous quarter.

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

Kabul, September 2012

Noorullah Delawari

Governor,

Da Afghanistan Bank

EXECUTIVE SUMMARY

The global economic conditions improved modestly in the third quarter of 2012 with global growth increasing to about 3 percent. The main sources of this acceleration were the emerging market economies, where activity picked up broadly as expected, and the United States, where growth surprised on the upside.

Meanwhile, based on estimates, GDP in the G20 area grew by 0.6 percent in the third quarter of 2012 compared with 0.5 percent in the second quarter. However, compared to the same quarter of 2011, G20's GDP contracted by 2.6 percent in the third quarter, down from 2.9 percent in the second quarter of last year. Economic growth accelerated strongly in the third quarter compared to the second quarter in some of the major economies such as United Kingdom, United States, Brazil, France, China and the European Union, while it contracted in Japan and decelerated moderately in Australia, Canada, Germany, Indonesia, Korea and Mexico. China recorded the highest growth rate of 7.4 percent and Italy the largest contraction of minus 2.4 percent in the quarter under review.

The early projected world output growth for 2012 and 2013 was revised to 3.3 percent and 3.6 percent respectively.

The Euro Area periphery has seen a marked decline in activity, driven by financial difficulties evident in a sharp increase in sovereign rate spreads. Activity has disappointed in other economies too, notably the United States and the United Kingdom. Spillovers from advanced economies and homegrown difficulties have held back activity in emerging market and developing economies. These spillovers have lowered commodity prices and weighed on activity in many commodity exporters.

Although, the global economy expanded somewhat in the third quarter of 2012, but the recovery was not strong enough to promote aggregate demand, especially in trading partners of Afghanistan.

Afghanistan's monetary aggregates exhibited mixed performance in the first six months of FY1391; reserve money, the operational target under the ECF program, had a negative growth of 3.2 percent standing at AF 169,762.06 million, which is well below the ECF target of 5.6 percent. Currency in circulation "an indicative target under the ECF program", increased by 0.41 percent in the period under review, reaching AF 148,993.52 million.

Narrow money (M1) grew to AF 312,727 million in the period under review, indicating an annual growth rate of 14 percent (Y-o-Y) mainly due to increase in demand for afghani as a medium of exchange. Broad money (M2) demonstrated similar behavior growing by 13 percent (Y-o-Y) reaching AF 331,422 million at the end of the period under review.

The stock outstanding for both, 182 day and 28 day capital notes (CNs) followed upward trend during the first six months of the year under review, but it started to decline for 28 day CNs from AF 11 billion to AF 9.7 billion the rest of the quarter remained somehow even. On the other hand, the stock outstanding for 182 day notes maintained its upward trend throughout the reporting period, increasing from AFs 22.8 billion to AFs 29.3 billion.

The nominal exchange rate of Afghani against US dollar depreciated in the period under review. Afghani depreciated by 5.55 percent from AF 49.40 per USD at the beginning of the year to AF 52.06 at the end of the period under review.

By most measures, inflation in Afghanistan maintained its downward trend in the first six months of FT1391.

Nationwide headline inflation, measured on a year-on-year basis, stood at 5.4 percent in the second quarter of FY1391; which is lower than the inflation rate of 9.9 percent recorded in the second quarter of 1390. The decrease in the rate of inflation was led by a decline in both, food and non-food price indices. Core inflation, which excludes bread and cereals, oil and fats, and transportation is at a relatively lower level of 8.2 percent (Y-o-Y), lower than the 12.3 percent recorded last year. This suggests that inflation has not persisted in the basic commodities as well as in the other commodities.

When the quarter-on-quarter changes in inflation are observed, however, the situation is somewhat different. National headline inflation increased to 0.71 percent (Q-o-Q) in the second quarter of 1391, up from 0.2 percent recorded in the first quarter. Prices of foodstuff such as milk and cheese, and bread and cereals increased slightly in the quarter under review, which were partially offset by a decrease in prices of oil and fat, vegetables and other components.

In the external sector, merchandise trade deficit widened significantly from US dollar 2,402.65 million in the first six months of 1390 to US dollar 4,379.64 million in the first six months of FY1391, this represents almost 82 percent increase. The trade deficit, as a percentage of GDP, increased to 22 percent in the reporting period, from 13 percent recorded in the same period of last year.

During the period under review, aggregate exports decreased by almost 27 percent, standing at US dollar 144.12 million, down from USD 197.19 million recorded in the same period of last year. The statistics on exports indicated a decrease in all export categories except for leather and wool at the end of the period under review.

Imports of goods increased notably by 74 percent, from US dollar 2,599.84 million in the first six months of 1390 to US dollars 4,523.76 million at the end of the period under review.

At the end of the reporting period, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,502.60 million which shows a decrease of about 5 percent compared with the same period of last year. During the period under review, loan principal repayment made only to the Asian Development Bank (ADB), while service charges paid to the International Development Association (World Bank) and Asian Development Bank (ADB). Moreover, international Development Association (IDA) and Asian Development Bank (ADB) as a major multilateral creditor to Afghanistan made some debt forgiveness on principle and service charges.

Based on available data, Afghanistan net international reserves (NIR) increased by almost 10 percent in the first six months of 1391 compared with the same period of last year.

The overall fiscal performance during the second quarter of 1391 was sluggish due to lower collection in domestic revenues and an increase in operating expenditures. The fiscal sustainability indicator was at 56 percent, which defines that about 56 percent of operating expenses was financed by domestic revenues. In addition, the fiscal sustainability indicator went down from 82 percent in the first quarter to 56 percent in the second quarter FY1391.

During the first six months of FY1391, total revenues including grants increased to AF 123,404.639 million, up from AF 88,027.655 million compared to a year ago.

Total core expenditures during the first six months of FY1391 were AF 102,265.39 million, up from AF 75,641 million in the same period of the previous year. In the quarter under review, total core expenditures increased to AF 63,873.35 million, up from AF 47,195 million in the second quarter of 1390, of which operating expenses were AF 44,529.53 million and development expenses were AF 19,343.819 million. Total expenditures in the quarter under review accounts for 7 percent of GDP.

Donor contributions are used to finance both, development and partly operating expenditures. The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 40,992.47 million in the quarter under review, up from AF 20,192.55 million in the second quarters of FY1390, which shows a 75 percent increase.

The banking sector performance was satisfactory in the reporting period. The asset base of the banking sector grew by 2.24 percent or AF 4.70 billion over the second quarter of 1391 (Sep. 2012) reaching 214.03 billion against AF 209.32 billion in the preceding quarter. While compared to the same previous period, the asset base decreased by 1.86 percent or AF 4.06 billion. Gross loans depicted 2.76 points growth over the quarter and 6.22 percent from the previous year. Deposits stood at AF 187.46 billion, up by 2.23 percent from the previous quarter. The entire banking sector remains well capitalized. The capital of the system stands at AF 15.00billion, increased over the quarter by 4.54 percent, but was down by 3.53 percent since the previous period attributed to losses from a number of banking institutions. The capital adequacy ratio (CAR) of the banking sector of20.88 percent decreased slightly over the previous quarter.

The number of branches of foreign banks declined from five to four during September 2012, due to the withdrawal of Standard Chartered Bank from the local market. This was a decision made by the bank and approved in the normal course of business by DAB. Most of the assets, liabilities, facilities, and staff of SCB transitioned to a private bank already licensed to operate in Afghanistan. Some comparisons below both at the Q-o-Q and Y-o-Y basis will be slightly distorted by this transaction; however, the overall system numbers have not been adversely impacted.

CHAPTER I

GLOBAL ECONOMIC ENVIRONMENT

1

GLOBAL ECONOMIC ENVIRONMENT

The early projected world output growth for 2012 and 2013 was revised to 3.3 percent and 3.6 percent respectively.

However, due to a broad-based slowness of the global economy in the first half of 2012, indicators of activity and unemployment showed increasing trends, while there is no significant sign of improvement in the third quarter. Industrial production has slowed sharply in advanced, emerging market and developing economies and so has world trade. However, unemployment in the advanced economies was noticeably above pre-crisis levels, it has elevated in Eastern Europe, Middle East and North Africa.

The Euro Area periphery has seen a marked decline in activity, driven by financial difficulties evident in a sharp increase in sovereign rate spreads. Activity has disappointed in other economies too, notably the United States and the United Kingdom. Spillovers from advanced economies and homegrown difficulties have held back activity in emerging market and developing economies. These spillovers have lowered commodity prices and weighed on activity in many commodity exporters.

The slowdown in global trade and activity has been accompanied by a marked narrowing of global imbalances, and this is projected to persist. Most of this narrowing reflects weaker domestic demand from crisis-stricken, external deficit economies rather than stronger demand from external-surplus economies.

World manufacturing output growth further slowed during the second quarter of 2012 due to the ongoing second economic recession, which has progressively affected the manufacturing production of developing countries. The growth was lower in the second quarter for industrialized as well as for developing countries. World industrial production in the second quarter of 2012 grew by 3.7 percent, lower than the 4.3 percent in its prior quarter.

The world trade volume slightly increased by 0.8 percent in September 2012 from the previous month, while on quarter-o-quarter basis, it decreased by 0.2 percent following a 0.5% increase in the second quarter.

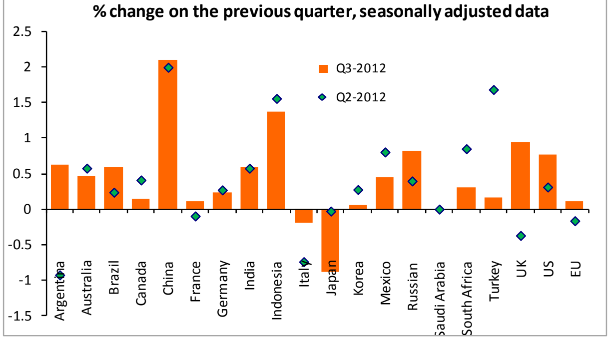
1. THE GLOBAL ECONOMY

1.1 The Global Economic Growth

Economic conditions improved modestly in the third quarter of 2012 with global growth increasing to about 3 percent. The main sources of acceleration were emerging market economies, where activity picked up broadly as expected, and the United States, where growth surprised on the upside.

Meanwhile, based on estimates, GDP in the G20 area grew by 0.6 percent in the third quarter of 2012 compared with 0.5 percent in the second quarter. However, compared to the same quarter of 2011, G20's GDP contracted to 2.6 percent in the third quarter from 2.9 percent in the second quarter. Economic growth accelerated strongly in the third quarter compared to the second quarter in some of the major economies such as United Kingdom, United States, Brazil, France, China and the European Union, while it contracted in Japan and decelerated moderately in Australia, Canada, Germany, Indonesia, Korea and Mexico. China recorded the highest growth rate of 7.4 percent and Italy the largest contraction of minus 2.4 percent in the quarter under review.

Figure 2.1: Quarterly GDP in volume terms for the G20
% change on the previous quarter, seasonally adjusted data



1.2 Global Industrial Production

Global manufacturing output growth further slowed during the second quarter of 2012 due to the ongoing second economic recession, which has progressively affected the manufacturing production of developing countries. The growth was lower in the second quarter for industrialized as well as for developing countries. World industrial production in the second quarter grew by 3.7 percent, lower than the 4.3 percent in the first quarter. The manufacturing sector of developing economies, which largely resisted the financial volatility of the first recession of 2008 – 2009, witnessed lower production growth after 2010 due to a prolonged reduction in external demand and uncertainty in domestic markets.

Industrial growth in industrialized countries has continued to remain low after 2010. The manufacturing output of these countries rose by 1.8 percent in the second quarter of 2012 compared to the same period of the previous year. By contrast, developing countries maintained a relatively higher growth rate. In the second quarter of 2012, the manufacturing output of developing countries grew by 6.9 percent compared to 9.0 percent in the first quarter.

The trend of manufacturing output among industrialized countries has been a mixture of dynamic growth in the countries of North America and East Asia and sustained uncertainty arising from Europe's financial instability. Both Japan and the United States enjoyed strong growth in the second quarter of

2012. Manufacturing output rose by 5.6 percent in the United States and by 7.8 percent in Japan in the second quarter. The production of machinery and equipment and of motor vehicles, especially compared to the low base of the last year, contributed to the higher manufacturing growth in both countries.

A major decline in industrial production was evident in European countries. The production downturn at the beginning of the second recession in 2011 was limited to a few countries of the Eurozone only. However, by the second quarter of 2012, all major economies of the Eurozone are facing a decline in industrial production. The manufacturing output of the Eurozone countries dropped by nearly 3.0 percent in the second quarter compared to the same period of the previous year. The overall decline in industrial production in Europe has been estimated at 1.3 percent for the same period.

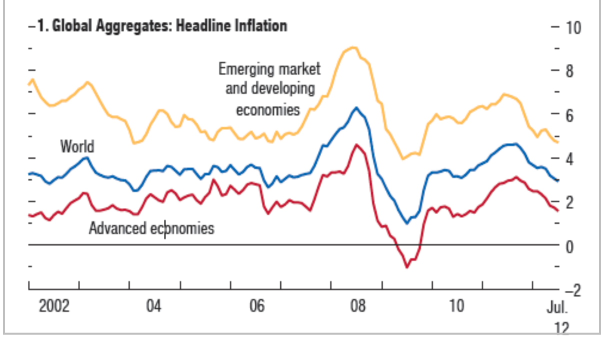
The growth rates of manufacturing output dropped in major developing economies in the second quarter of 2012. China's growth rate decreased to 9.5 percent from 12.7 percent in the first quarter.

1.3 Global Inflation

The slowdown in global activity and ample slack in many advanced economies have meant that inflation has fallen. In advanced economies, lower commodity prices reduced headline inflation to about 1.5 percent as of July 2012, down from more than 3 percent in late 2011. Core inflation has been steady at about 1.5 percent. In emerging market and developing economies, headline inflation has declined by almost 2 percentage points, to slightly under 5.5 percent, in the second quarter of 2012; core inflation has declined too, although to a lesser extent. The forecast is for further easing of inflation pressure in the advanced economies, with headline inflation moving to about 1.75 percent in 2013; in emerging market and developing economies, headline inflation is projected to move broadly sideways.

Figure 1.2: Global Inflation

Twelve-months changes in the CPI



***Source**: IMF/World Economic Outlook, October 2012*

1.4 Global Trade and Investment

The world trade volume increased by 0.8 percent in September 2012 compared to the previous month, following a revised flat reading in August. The increase stems from an upswing in both, export and import growth in emerging Asian economies, a remarkable rebound of import growth in Japan, and a strong export performance in the United States. Nearly all other trade flows contracted, including export and import volumes in the Euro Area.

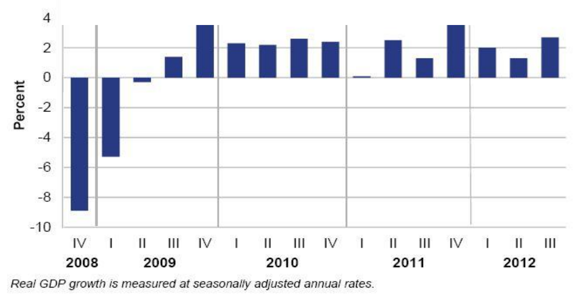
Meanwhile, resurgence in economic uncertainty and the possibility of lower growth rates in major emerging markets risks undercutting this favorable trend in 2012. It has been predicted that the growth rate of FDI will slow in 2012, with flows leveling off at about USD 1.6 trillion, the midpoint of a range. Leading indicators are suggestive of this trend, with the value of both cross-border mergers and acquisitions (M&As) and Greenfield investments retreating in the first five months of 2012. Weak levels of M&A announcements also suggest sluggish FDI flows in the later part of the year. The growth of FDI inflows in 2012 will be moderate in all three groups – developed, developing and transition economies. In developing regions, Africa is noteworthy as inflows are expected to recover. Growth in FDI is expected to be temperate in Asia (including East and South-East Asia, South Asia and West Asia) and Latin America. FDI flows to transition economies are expected to grow further in 2012 and exceed the 2007 peak in 2014.

2. ADVANCED ECONOMIES

2.1 The United States Economy

United States' real GDP grew by 2.7 percent in the third quarter of 2012, (that is, from the second quarter to the third quarter).. In the second quarter, real GDP increased 1.3 percent. The increase in real GDP in the third quarter primarily reflected positive contributions from personal consumption expenditures, private inventory investment, federal government spending, residential fixed investment, and exports that were partly offset by negative contributions from nonresidential fixed investment and state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased slightly.

Figure 1.3: U.S. RGDP Growth (%Δ Q-o-Q)



Source: U.S. Bureau of Economic Analysis

The monthly inflation rate in the United States was reported at 1.7 percent ending September 2012, up from 1.4 percent in August. Inflation rate was recorded at 3.8 percent in September 2011.

Figure 1.4: U.S. Inflation Rate (%Δ Y-o-Y)

Source: tradingeconomics.com

The US unemployment rate declined by 0.3 percentage points, standing at 7.8 percent in September 2012. For the first 8 months of the year, the rate held within a narrow range of 8.1 and 8.3 percent.

At the same time, aggregate exports and imports of the United States in September 2012 were USD 187.0 billion and USD 228.5 billion, respectively. As a result, the trade deficit stood at USD 41.5 billion, down from USD 43.8 billion in August.

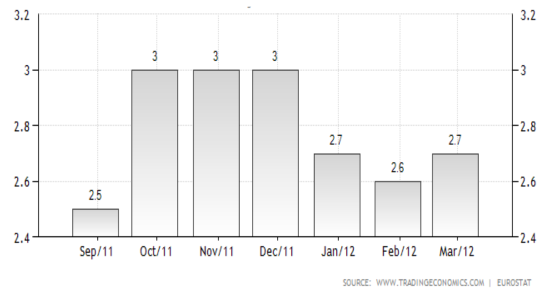
The goods and services deficit decreased USD 2.9 billion from September 2011 to September 2012. Exports were up USD 6.4 billion, or 3.5 percent, and imports were up USD 3.4 billion, or 1.5 percent

2.2 The Euro Area Economy

Euro Area's GDP slightly fell by 0.1 percent during the third quarter of 2012 compared with the previous quarter. In the second quarter of 2012, growth was -0.2 percent. Moreover, seasonally adjusted GDP of Euro Area declined by 0.6 percent in the third quarter of 2012 compared with the same quarter of the previous year, after minus 0.5 percent in the previous quarter.

The inflation rate in the Euro Area was recorded at 2.6 percent in September 2012, up from 2.4 percent in August. This figure was recorded at 2.5 percent in the same month of 2011.

Figure 1.5: Euro Area Inflation (%Δ Y-o-Y)



Source: *tradingeconomics.com*

At the same time, the Euro Area enjoyed a current account surplus of € 41.0 billion in the third quarter of 2012, compared with a surplus of € 14.9 billion in the second quarter of 2012. Euro Area's balance of trade in goods was in surplus of € 30.5 billion in the third quarter of 2012; while, it was € 25.2 billion in the second quarter. Similarly, external balance of trade in services increased from a surplus of € 25.4 billion in the second quarter to € 26.8 billion in the quarter under review.

Euro Area's seasonally-adjusted unemployment rate was 11.6 percent in September 2012, up from 11.5 percent in August.

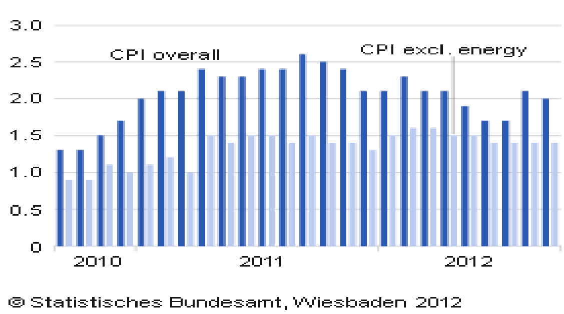
2.3 The German Economy

The German economy expanded by 0.2 percent in the third quarter of 2012 over the previous quarter. While compared to the same quarter of last year, Germany's real GDP increased by 0.9 percent.

Among the member states of the Euro Area, Germany recorded the lowest rate of unemployment after Austria and Luxemburg at 5.4 percent and the lowest youth unemployment rate of 8 percent in September 2012. The unemployment rate of Germany in September of 2011 was 5.8 percent.

In September 2012, the consumer prices in Germany were up 2.0 percent over September 2011. While compare to August 2012, the consumer price index remained unchanged in September 2012. In August 2012, the inflation rate as measured by the consumer price index was 2.1 percent.

Figure 1.6: Inflation Rate for Germany (%Δ Y-o-Y)



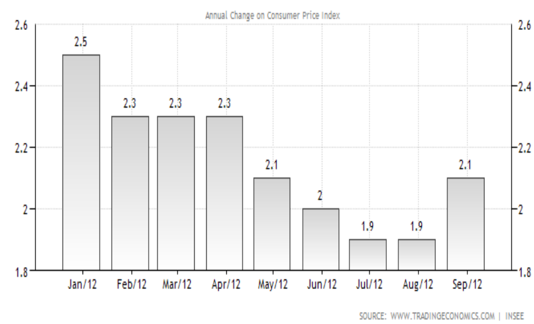
Source: *Federal Statistical Office of Germany*

2.4 The Economy of France

The real GDP of France increased by 0.2 percent in the third quarter of 2012 over the previous quarter. It also indicates that France economy slightly expanded by 0.1 percent compared to the same period of last year. The trading economics website indicates that the unemployment rate in France increased to 10.30 percent in the third quarter of 2012 from 10.20 percent in the second quarter. Historically, from 1996 until 2012, France unemployment rate averaged 9.4 percent reaching an all time high of 11.2 percent in March of 1997 and a record low of 7.5 percent in March of 2008.

The inflation rate in France was recorded at 2.2 percent in September 2012, up from 1.9 percent in August. This was recorded at 2.1 percent in September 2011.

Figure 1.7: Inflation Rate for France (%Δ Y-o-Y)



Source*: tradingeconomics.com*

2.5 The United Kingdom Economy

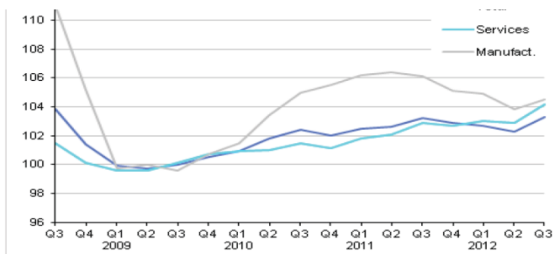
United Kingdom's GDP in volume terms increased by 0.9 percent between the second and third quarter of 2012 compared to minus 0.4 percent in the second quarter. The upward trend in UK's real GDP in the third quarter of 2012 was mainly dominated by services and manufacturing outputs which increased by 1.2 percent and 0.7 percent, respectively.

Meanwhile, the unemployment rate for July to September 2012 was 7.8 percent of the economically active population, down 0.2 percent on April to June 2012 and down 0.4 percent on a year earlier. There were 2.51 million unemployed people in July to September 2012, down by 49,000 from April to

June 2012 and down by 110,000 from a year earlier.

The inflation rate in the United Kingdom slightly declined from 2.6 percent in August 2012 to 2.5 percent in September 2012. This figure was recorded at 4.5 percent in the same month of last year.

Figure 1.8: United Kingdom Output indices, CVMSA



Source: *UK Office for National Statistics*

Figure 1.9: United Kingdom Inflation Rate (%Δ Y-o-Y)

Source: *tradingeconomics.com*

2.6 The Economy of Japan

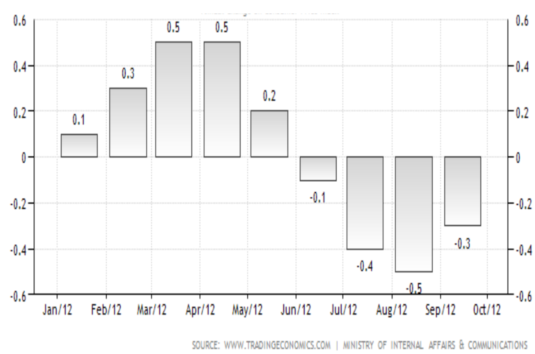
The real GDP in Japan contracted by 0.9 percent in the third quarter of 2012 over the previous quarter; while, compared to the same quarter of last year it has slightly expanded by 0.5 percent.

The unemployment rate in Japan slightly decreased from September 2012 to 4.2 percent from 4.3 percent in August, however, remained unchanged compared to the same period of the previous year.

Japan's trade deficit widened to JPY 756 billion in September 2012, up from JPY 517 billion in August. Japan suffered a trade deficit of JPY 779.6 billion in September 2011. Exports of Japan declined by around 5 percent from JPY 5313 billion in August 2012 to JPY 5045 billion in September. Similarly, imports of this country slightly decreased from JPY 5831 billion in August 2012 to JPY 5801 billion in September.

The inflation rate in Japan rose to minus 0.3 percent in September 2012, compared with minus 0.5 percent in its previous month.

Figure 1.10: Japan Inflation Rate (%Δ Y-o-Y)



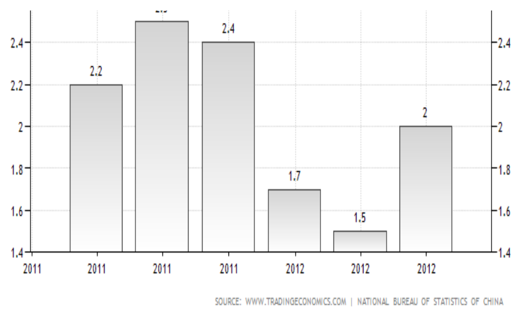
Source: *tradingeconomics.com*

3. EMERGING ECONOMIES

3.1 The Economy of China

China's GDP expanded by 7.7 percent in the third quarter of 2012 over the same period of last year; while it increased by 2.1 percent over the previous quarter. The unemployment rate in China remained unchanged at 4.10 percent in the third quarter of 2012 from 4.10 percent in the second quarter of 2012.

Figure 1.11: China Growth Rate (%Δ Y-o-Y)



Source: www.tradingeconomics.com

The inflation rate in China was recorded at 1.9 percent in September of 2012, lower from the 2 percent in August. Inflation rate in China was 6.1 percent in September 2011.

Figure 1.12: China's Inflation (%Δ Y-o-Y)

Source: www.tradingeconomics.com

Export of China rose by 4.66 percent from USD 1779 hundred million in August 2012 to USD 1861.84 hundred million in September. Similarly, imports increased from USD 1514.68 hundred million in August 2012 to 1587.34 hundred million in September. As a result, China's trade surplus widened to USD 274.5 hundred million in September 2012 from USD 264.32 hundred million in August, approximately 3.85 percent. The trade balance was plus USD 146 hundred million in September 2011.

3.2 The Economy of India

The Gross Domestic Product (GDP) in India expanded 5.3 percent in the third quarter of 2012 over the same period of the previous year. Unemployment Rate in India decreased to 3.80 percent in 2011 from 9.40 percent in 2010. Historically, from 1983 until 2011, India unemployment rate averaged 7.6 percent reaching an all time high of 9.4 percent in December of 2009 and a record low of 3.8 percent in December of 2011.

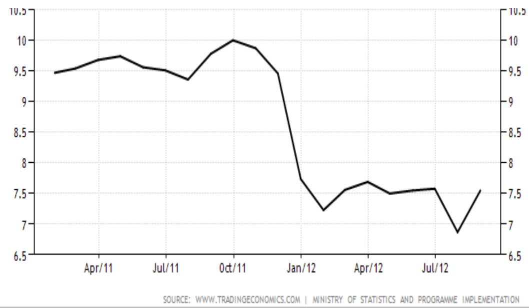
Figure 1.13: India GDP Growth Rate

Source: www.tradingeconomics.com

The inflation rate in India was recorded at 9.78 percent in September 2011 while the inflation rate reached 7.55 percent in September of 2012 indicating a decline in the inflation rate.

Based on available data, India recorded a current account deficit equivalent to USD 22.30 billion in the third quarter of 2012, much higher than USD 16.4 billion in the second quarter. Historically, from 1949 until 2012, India Current Account averaged -1.32 USD Billion reaching an all time high of 7.36 USD Billion in March of 2004 and a record low of -22.30 USD Billion in September of 2012.

Figure 1.14: India Inflation Rate (%Δ Y-o-Y)



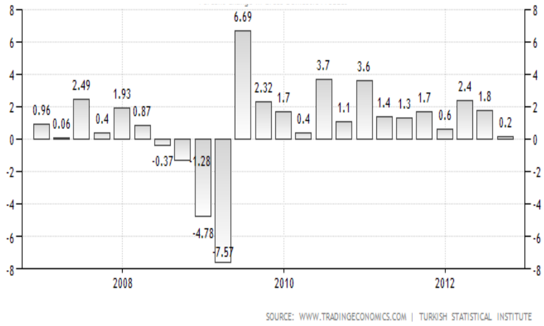
Source: www.tradingeconomics.com

3.3 The Economy of Turkey

The GDP in Turkey expanded 0.20 percent in the third quarter of 2012 over the previous quarter. The GDP growth rate in Turkey was 1.3 percent in the similar period of last year. The unemployment rate in Turkey increased slightly to 9.40 percent in September of 2012 from 9.20 percent in August.

Retail sales in Turkey increased 2.50 percent in the third quarter of 2012 over the previous quarter. In contrast, inflation rate in Turkey a little decreased from 9.07 percent in August 2012 to 8.88 percent in September; however, still it is higher than 6.65 percent in September 2011.

Figure 1.15: Turkey GDP Growth Rate (%Δ Y-o-Y)



Source: *www.tradingeconomics.com*

Retail sales in Turkey increased 2.50 percent in the third quarter of 2012 over the previous quarter. In contrast, inflation rate in Turkey a little decreased from 9.07 percent in August 2012 to 8.88 percent in September; however, still it is higher than 6.65 percent in September 2011.

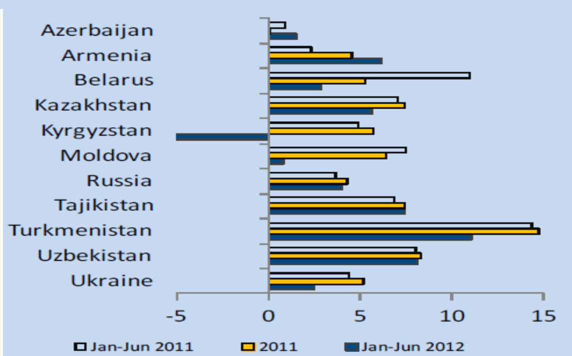
Exports in Turkey increased by 21 percent standing at USD 13,013 million, while imports decreased by 6.4 percent standing at USD 19,838 million in September 2012 compared with September 2011. In the same month, the foreign trade deficit decreased from USD 10,453 million to USD 6,825 million.

4. COMMONWEALTH OF INDEPENDENT STATES (CIS) ECONOMIES

The slowdown in economic activity in the world, affected the growth rate of prices of raw materials. In particular, the price of Brent crude fell by 7 percent in the second quarter of

2012 after a 13 percent year-on-year increase recorded in the first quarter. The decrease in oil prices had an effect on the indicators of the real sector of all CIS economies without exception. A common feature of the economic situation in the region throughout the second quarter was a decline in industrial output. Output growth in the agricultural sector also slowed due to last year's high base effect and this year's drought. The consumer sectors – retail trade and services remained drivers of growth in almost all CIS economies. A rise occurred in construction activity, while the financial sector showed steady lending growth, which indicates some revival of investment activity. As a result, the aggregate real GDP of the CIS member countries rose by 4.4 percent in the first half of 2012 compared with a 4.3 percent increase in the same period in 2011.

Figure 1.16: GDP Growth in CIS Countries (%Δ Y-o-Y)



Source: *Eurasian Development Bank*

4.1 The Economy of Russia

The GDP in Russia increased by 2.90 percent in the third quarter of 2012 over the same quarter of the previous year; while compared to the second quarter which was recorded at 4 percent, it contracted. The unemployment rate in Russia decreased to 5.20 percent in September of 2012 from 5.40 percent in August.

Figure 1.17: Breakdown of Russia's GDP (%Δ Y-o-Y)

Source: *Eurasian Development Bank*

Business confidence in Russia decreased to 1 percent in September 2012 from 2 in its prior month; while compared to the same month of last year of minus 1 percent it increased. On the other hand, the annual inflation rate in Russia was recorded at 8.2 percent in September 2011 while it reached to 5.9 percent in September of 2012 indicating a decline in the inflation rate.

Figure 1.18: Russia's Inflation CPI (%Δ Y-o-Y)

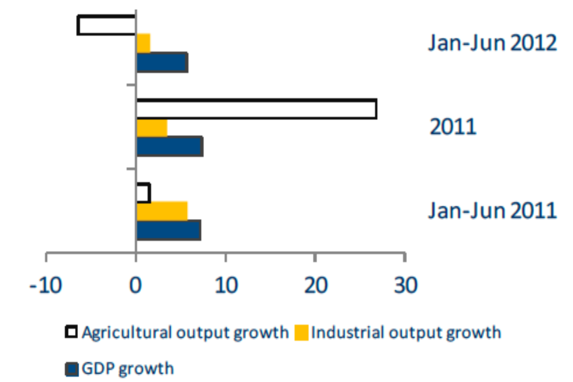
Russia continued to have a current account surplus in the third quarter of 2012, which amounted to USD 13,000 million, down from USD 21,206 million in the second quarter. Meanwhile, Russia recorded a trade surplus of USD 15,597 million in September 2012, up from USD 11,294 million in August. Historically, from 1997 until 2012, Russia's balance of trade averaged USD 8,684.8 million reaching an all time high of USD 20,647.0 million in December 2011 and a record low of USD -185.0 million in February 1998. Russia runs regular trade surpluses primarily due to exports of commodities. Russia's main exports are oil and natural gas (58 percent of total exports), nickel, palladium, iron and chemical products. Others include: cars, military equipments and timber. Russia imports food, ground transports, pharmaceuticals and textile, and footwear.

4.2 Kazakhstan's Economy

Kazakhstan's economic growth rate did not change in the second quarter of 2012. The nation's GDP rose by 5.6 percent (Y-o-Y) in both, Q1 and the first half of 2012. There was a slowdown in the industrial sector – a 1.7 percent increase in annual terms in the first half of 2012 – which was caused by a decline in external demand.

On the other hand, annual inflation rate in Kazakhstan decreased significantly to 4.7 percent in September 2012 from 9 percent in the same period of last year, but remained unchanged compared to August. Similarly, the unemployment rate remained unchanged at 5.2 percent in September 2012 from 5.2 percent in August.

Figure 1.19: Breakdown of Kazakhstan GDP (%Δ Y-o-Y)



***Source**: Eurasian Development Bank*

A decline in international prices of major export commodities led to a 2.9 percent year-on-year decrease in exports of Kazakhstan in the second quarter of 2012. Simultaneously, under the influence of increased internal demand, the import rose by 2.1 percent and the export surplus decreased by 6.8 percent.

4.3 Turkmenistan's Economy

Economic growth in Turkmenistan accelerated to 11 percent in the first half of 2012, but remained below the figure for 2011. Industrial output increased by 32 percent, while the volume of construction grew by 18 percent through the implementation of infrastructure, industrial, and social projects. The Turkmenistan's real GDP is forecasted to continue growing at a high pace, and to have a growth rate of 8 percent in both 2012 and 2013.

Figure 1.20: Breakdown of Turkmenistan GDP (%Δ Y-o-Y)

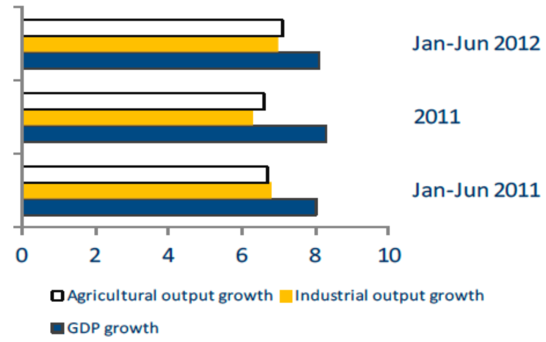
Source: Eurasian Development Bank

The expansion of opportunities for the transportation of gas, coupled with high prices of exported hydrocarbon raw materials, allowed export revenues of Turkmenistan to remain at a high level. The export of natural gas rose by 16.1 percent in annual terms in the first half of 2012, accounting for 90 percent of the total volume of exports. The aggregate nominal volume of exports grew by 47.7 percent. Turkmenistan's imports, 80 percent of which was made up by goods for production and technical purposes, rose by 48.4 percent, mainly through a rise in the export of production equipment.

4.4 Uzbekistan's Economy

The economic growth in Uzbekistan accelerated to 8.1 percent in the first half of 2012. This can be linked to the strengthening of domestic demand, and high prices of the major export items (natural gas, cotton and gold). Internal demand strengthened, offsetting a decline in external demand.

Figure 1.21: Breakdown of Uzbekistan GDP (%Δ Y-o-Y)



Source: Eurasian Development Bank

The inflation rate in Uzbekistan slightly decreased from 3.4 percent in the second quarter to 3.3 percent in the third quarter of 2012. It was 4.5 percent in the third quarter of 2011.

Although Uzbekistan recorded a trade surplus of USD 715.1 million in the third quarter of 2012, however, its exports decreased to USD 3501 million in the third quarter of 2012 from USD 4,031.5 million in the second quarter. Similarly, imports decreased to USD 2,785.90 million in the third quarter of 2012 from USD 3,149.20 million in the second quarter.

5. ASSETS AND COMMODITY PRICES

5.1 Financial Markets[1]

Despite recent favorable developments in financial markets, risks to financial stability have increased, as confidence in the global financial system has become very fragile.

[1] IMF, Global Financial Stability Report, Restoring Confidence and Progressing on Reforms – Oct., 2012.

Although significant new efforts by European policymakers have allayed investors' biggest fears, the euro area crisis remains the principal source of concern. Tail-risk perceptions surrounding currency redenomination have fueled a retrenchment of private financial exposures to the euro area periphery. The resulting capital flight and market fragmentation undermine the very foundations of the union: integrated markets and an effective common monetary policy.

The European Central Bank's (ECB's) exceptional liquidity operations around the beginning of 2012 eased the pressure on banks to shed assets, but that pressure rose again, accompanied by increasing market fragmentation. Subsequently, the statement by the president of the ECB in July, and measures proposed by the ECB in September to increase liquidity support and safeguard an appropriate monetary policy transmission, have been essential in addressing investors' biggest fears and prompted another market recovery. The delays in resolving the crisis have increased the expected amount of asset shrinkage at banks. The largest burden of projected credit supply contractions falls on the euro area periphery, where the combined forces of bank deleverage and sovereign stress are generating very strong headwinds for the corporate sector.

The unfolding euro area crisis has generated safe-haven flows to other jurisdictions, notably the United States and Japan. Although these flows have pushed government funding costs to historic lows, both countries continue to face significant fiscal challenges. In the United States, the looming fiscal cliff, the debt ceiling deadline and the related uncertainty are the main immediate risks. Unsustainable debt dynamics remain the central medium-term concern. Japan faces high deficits and record debt levels, and interdependence between banks and the sovereign is growing. In both countries, necessary steps toward medium-term fiscal adjustment need to be laid out without further delay. The key lesson of the past few years is that imbalances need to be addressed well before markets start flagging credit concerns.

Emerging market economies have adeptly navigated through global shocks so far, but need to guard against potential further shockwaves, while managing a slowdown in growth that could raise domestic financial stability risks. Local bond markets have continued to attract inflows even as the euro area crisis intensified. Overall, many countries in central and Eastern Europe are the most vulnerable because of their direct exposures in the euro area and certain similarities they bear to countries in the euro area periphery. Asia and Latin America generally appear more resilient, but several key regional economies are prone to the risks associated with being in the late phase of a credit cycle that has featured an extended period of rising property prices and debt. Meanwhile, the scope to provide fresh policy stimulus is somewhat constrained in several economies, which underscores the need to deftly manage country-specific challenges.

5.2 Global Commodity Markets[2]

Non-energy prices fell 2.5 percent in May 2012, with declines in most main groups, particularly for industrial commodities. Energy prices declined 7.6 percent. During the month, however, many commodity prices plunged in response to heightened concerns about the Euro Area. Between the beginning and end of May, crude oil prices dropped 15 percent, copper 13 percent and cotton 20 percent, partly reflecting an appreciation of the dollar—up 6.5 percent against a broad group of U.S. trading partners.

Crude oil prices (World Bank average) dropped 8.4 percent in May to USD 104.1/bbl, and fell below USD 92/bbl in early June, on sovereign debt fears, worries about slowing demand, and continued rise in production. There was also an apparent easing of political tensions surrounding Iran's nuclear program. Moscow holds the next round of talks June 18-19 between Iran and officials from six nations, which follow discussions in Baghdad on May 23-24. Iranian exports are expected to fall further in July when sanctions take full effect. Oil demand growth remains weak, and crude stocks are high, especially in the U.S. However, product inventories are low and should begin to build with a seasonal upturn in refining runs. OPEC production continues to rise, with the group nearly 2 mb/d above its 30 mb/d target agreed to in December. OPEC meets June 14th, and is unlikely to change production policy given current economic conditions. The Brent/WTI spread remains at $15/bbl, despite oil now flowing through the reversed Seaway pipeline, as production continues to climb in Canada and the U.S.

Natural gas prices in the U.S. surged 25.2 percent in May to USD 2.44/mmbtu—the first increase in eleven months—on increasing demand in the power sector at the expense of coal, and lower storage injection—although the stock overhang is still large.

Agricultural prices fell 1.7 percent in May, with declines in most commodities partly offset by gains in rice, soymeal, and beverages. Coconut oil and palmkernel oil prices fell 11-14 percent on a 20 percent increase in the Philippines' coconut oil exports. Cotton prices fell 11 percent on weak demand and high stocks, while sugar prices dropped 9 percent following India's decision to allow exports of raw sugar. Palm oil and soybean oil prices fell 7-8 percent on weak demand for food and biodiesel. Rice prices posted the largest increase, up 10 percent, due to a rise in government stocks in Thailand. Soymeal prices rose 7 percent from a shortfall in Latin American soybean supplies that pushed stocks to very low levels. Robusta coffee prices rose 5 percent as producers and traders held back sales in Vietnam.

Metals and mineral prices fell 4.7 percent in May, the third consecutive monthly drop, with declines in all base and precious metals, and iron ore. The fall is due to concerns about global demand, with the focus on Europe and China, and prices are now biting into the cost

[2] World Bank, Commodity Markets Review, Number 125, 11 June 2012

curve for some metals producers. The largest reduction was in tin, down 8 percent, on weak demand from China and rising inventories. Iron ore prices fell 7 percent also due to weak demand and concerns about slowing steel production in China. Nickel prices fell 5 percent on slowing stainless steel demand, rising inventories, and expected new nickel mine capacity. Precious metals fell on lower investment demand and the stronger dollar, with silver prices dropping 8 percent on adding concerns about industrial consumption.

5.3 Global Exchange Rate Movements

In the year 2012 up to the first week of June, the US dollar strengthened from 1.44 to 1.25 per euro, with the bulk of the appreciation occurring post July 2011 as the nominal and real trade weighted US dollar appreciated by 6 percent, largely reflecting the US dollar's safe-haven status at the onset of the Euro Area crisis and the flight to quality that ensued. To a large extent, these developments have also been mirrored in emerging market currencies as developments in the US dollar continue to be a major determinant of both the value and volatility of emerging market currencies. But it is important to realize that in spite of the US dollar's safe haven status, the average real trade weighted emerging market currency has been less volatile than the real US dollar trade weighted exchange rate almost 70 percent of the time over the last 10 years.

Even so, and despite the improvement in developing countries' relative macroeconomic fundamentals vis-à-vis the U.S., some of the larger emerging currencies still came under significant pressure at the onset of the Euro Area debt crisis in the second half of 2011. Likewise, partly because of the liquidity generated by very loose monetary policy in high-income countries several large financially-open emerging market countries experienced a surge in foreign capital in early 2012 when the (partial) relaxation of tensions in high-income Europe and the stabilization of global financial markets resulted in falling investors' risk aversion. As a result, during the first two months of 2012, the trade-weighted real effective exchange rates of Brazil,

Turkey, India and South Africa appreciated by 5 percent or more, while higher international commodity prices boosted the currencies of commodity exporters including Chile, Colombia and Mexico. With the resumption of Euro Area uncertainties since early May and flight of private capital to safer US financial assets — and weakening of commodity prices for commodity exporting developing countries — the US dollar again experienced a generalized appreciation with respect to emerging market currencies.

REFERENCES:

International Monetary Fund (IMF), World Bank, UNIDO, Netherland's Bureau for Economic Policy Analysis, OECS, the U.S. Bureau of Labor Statistics, www.wantchinatimes.com, www.chinafrica.com, Eurostat, Turkish Statistical Institute, and Eurasian Development Bank.

CHAPTER II

MONETARY AND CAPITAL MARKET DEVELOPMENTS

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

MUnitary and capital market developments evaluate monetary program under the Extended Credit Facility (ECF) program, monetary aggregates, foreign exchange rates, net international reserves, as well as open market operations. In the first six months of FY1391, monetary aggregates had mixed performances; reserve money, the operational target under the ECF program, had a negative growth of 3.2 percent reaching AF 169,762.06 million, well below the ECF target of 5.6 percent. Currency in circulation "an indicative target under the ECF program", increased by 0.41 percent in the period under review, reaching AF 148,993.52 million.

On the other hand, narrow money (M1) grew to AF 312,727 million in the period under review, indicating an annual growth rate of 14 percent (Y-o-Y) mainly due to increase in demand for afghani as a medium of exchange. Broad money (M2) demonstrated similar behavior growing by 13 percent (Y-o-Y) reaching AF 331,422 million at the end of the period under review.

Capital note auction is one of the instruments used by Da Afghanistan Bank (DAB) For it monetary policy purposes.

The stock outstanding for both, 182 day and 28 day notes followed upward trend during the first six months of the year under review, but it started to decline for 28 day CNs from AF 11 billion to AF 9.7 billion the rest of the quarter remained somehow even. On the other hand, the stock outstanding for 182 day notes maintained its upward trend throughout the reporting period, increasing from AFs 22.8 billion to AFs 29.3 billion.

The nominal exchange rate of Afghani against US dollar depreciated in the period under review. Afghani depreciated by 5.55 percent from AF 49.40 per USD at the beginning of the year to AF 52.06 at the end of the period under review.

1 – MONETARY PROGRAM UNDER ECF PROGRAM

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

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

The right amount of reserve money conducive for supporting the domestic price stability is determined using the quantitative theory of money. Hence, the ECF target is based on expected economic growth and expected inflation for the current fiscal year (1391).

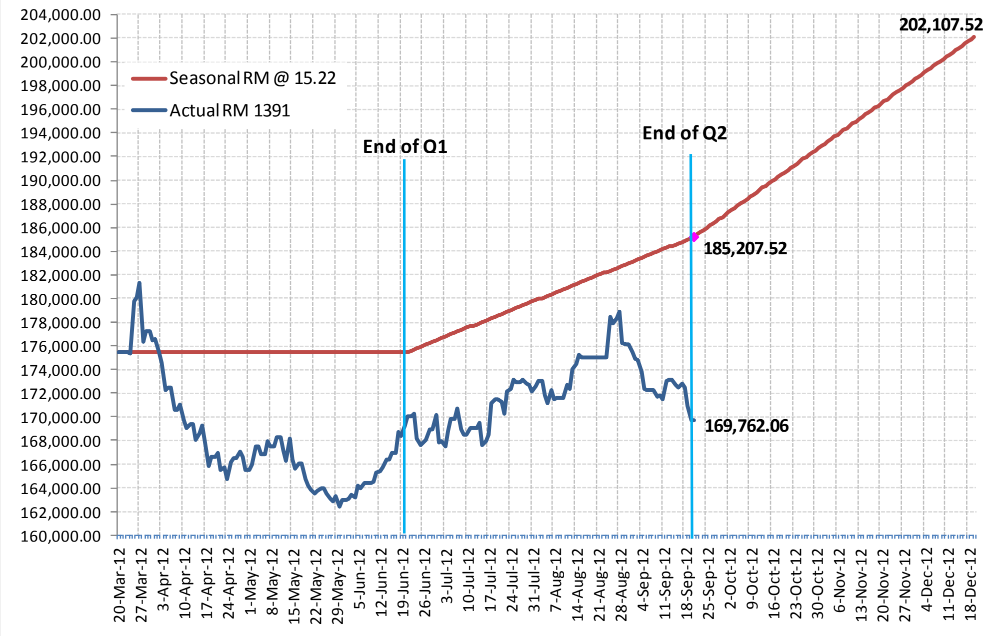
Considering the reserve money as a primary target, DAB has mainly two instruments to control the nominal anchor keeping it below or to the ceiling. DAB has encouraged the secondary market development increasing the interest rate, on the other hand, DAB has eased the FX auction in order to reach the floor on Net International Reserves (NIR)

For the second quarter of FY 1391, the reserve money ceiling was set at 5.6 percent and the currency in circulation was set at 12.5 percent, however the reserve money had negative growth of 3.2 percent and currency in circulation ended at 0.4 percent.

Such decline in the above mentioned variables is due to a slowdown in economic activities driven by uncertainty after 2014 and political instability that has been reflected in the media which has led to such concern in public overall.

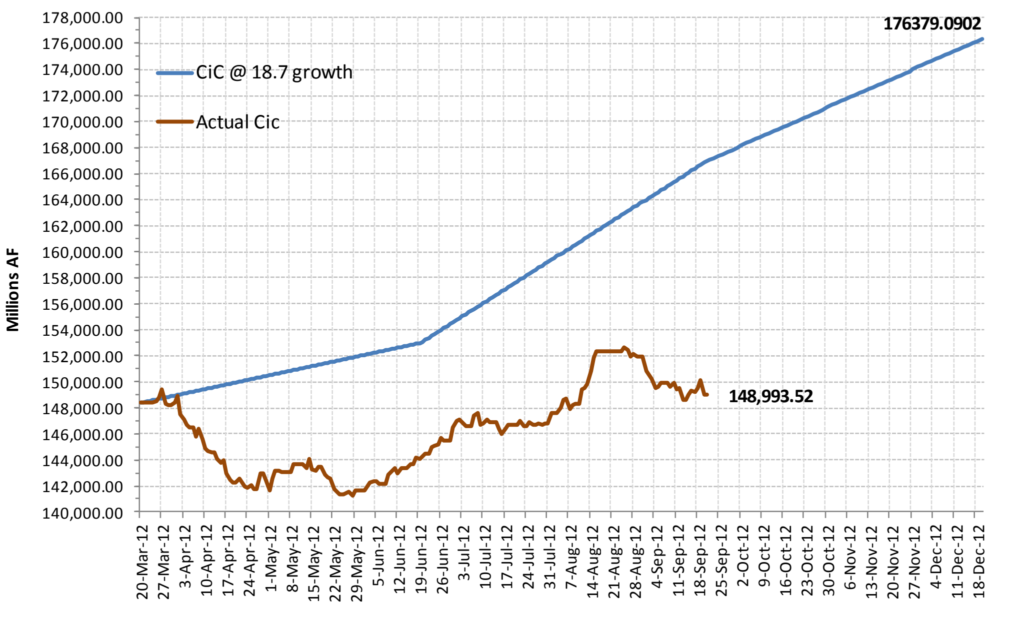
Figure 2.1 provides detailed information on reserve money and currency in circulation growth for the end of the second quarter of FY 1391.

Figure 2.1: Reserve Money for FY1391 (March 21 to Sep 20, 2012)



Source: *Monetary Policy Department/DAB*

Figure 2.2: Currency in Circulation for FY 1391



Source: *Monetary Policy Department/DAB*

2. MONETARY AGGREGATES

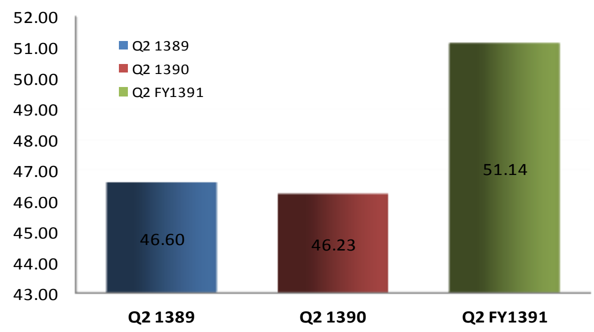
The monetary aggregates -- narrow money (M1) and broad money (M2) -- are compiled following the MFS methodology and definition. Narrow money as referred (M1) grew by 14.23 percent on a year-on-year basis at the end of second quarter 1391 under review. The growth in M1 is attributed mainly to the increase in demand deposits of other depository corporations, 24.54 percent increase in its foreign currency accounts under liability besides an increase of 4 percent in currency in circulation on an annual basis. Overall, the narrow money ended at AF 312,727 million at the end of the second quarter of FY1391.

On the other hand, the stock of broad money (M2) grew to AF 331,422 million; an overall growth of 12.59 percent (Y-o-Y), which is lower than 22.31 percent in the same period of 1390. M1 is the main contributor to the growth in M2 since the M1 constitutes 90 percent of M2.

Quasi money or time deposits of commercial banks which is the other component of M2 decreased by 9.18 percent at the end of the period under review compared with the same period of 1390. However, because quasi money roughly constitutes 7 percent of broad money, therefore, the impact of changes on M2 is negligible. The year-on-year difference of afghani denominated time deposits for the end of 1390 was AF907 million and foreign currency denominated time deposits difference recorded AF 2,688 million.

Meanwhile, bank deposits as a share of broad money increased by 51.14 percent (Y-o-Y) in the period under review, up from 46.23 percent in the previous year. (Figure 2.3)

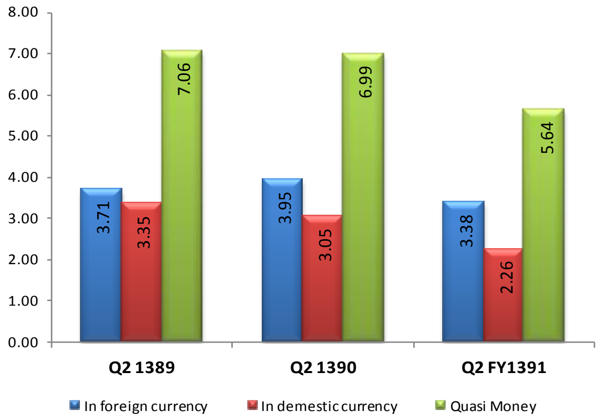
Figure 2.3: Bank Deposits as share of M2(%)



Source: *Monetary Survey, Monetary Policy Department/ DAB*

Similarly, quasi money as a share of broad money was down to 5.64 percent at the end of the first six months of FY1391, down from 6.99 percent at the end of the same period of 1390. Afghani-denominated time deposits constitute 2.26 percent of broad money, while foreign currency denominated deposits constitutes 3.38 percent of M2.

Figure 2.4: Quasi Money as Share of M2 (%)



Source: *Monetary survey Section/ MPD, DAB*

3. FROEIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates

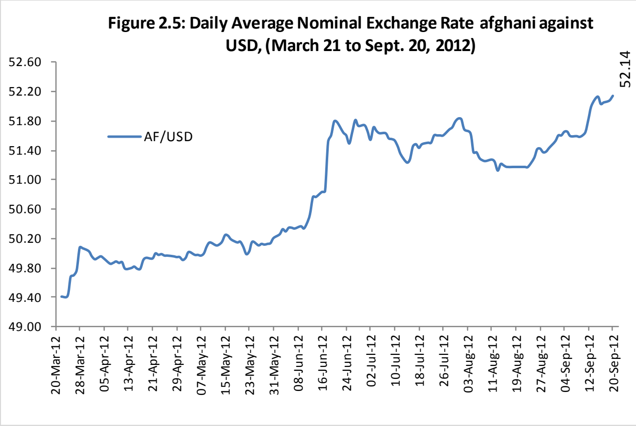
DA Afghanistan Bank's ultimate goal is maintaining price stability in domestic economy, utilizing its instruments effectively with sound policy implementation.

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

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

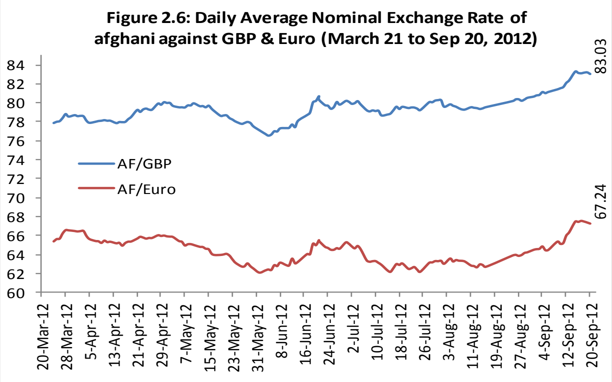
The daily historic review of the average exchange rate of afghani against the USD for the second quarter of FY1391 is shown in Figure 2.5. The afghani continuously weakened against the greenback, pressured by government budget deficit and concerns over country's destination beyond 2014 reflected in local and international media. Afghani depreciated by 5.55 percent from AF 49.40 against the USD at the beginning of the year to AF 52.14 at the end of the period under review. Similarly, it posted significant weakness against GBP, depreciating by 6.69 percent from AF77.2 to 83.03, and exhibiting the same behavior against euro depreciating by 2.86 percent from AF65.37 at the beginning of the year to AF 67.24 at the end of the period under review. However, afghani had an opposite trend against IRR and PKR. Afghani experienced significant gains against IRR, appreciating by 20.83 percent in the period under review, but slightly lost its value against the PKR by 0.86 percent from 1.84 at the beginning of the FY 1391 to 1.82, while it weakened against the INR by 6.34 from 1.03 in the period under review.

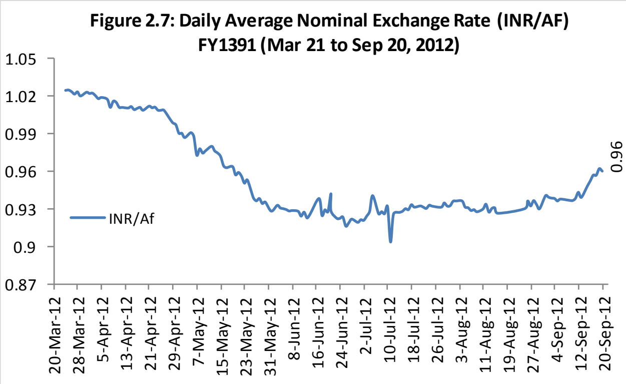
Overall afghani still remains a stable currency in the region against regional currencies in terms of US dollars.



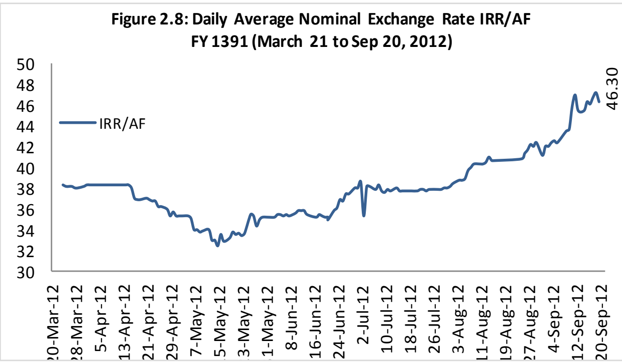
Source: Monetary Policy/Market Operations Departments/DAB

The comparison of historic review of the daily average exchange rate of afghani against some major foreign currencies for the period under review is shown in Figures 2.6, 2.7, 2.8, and 2.9.

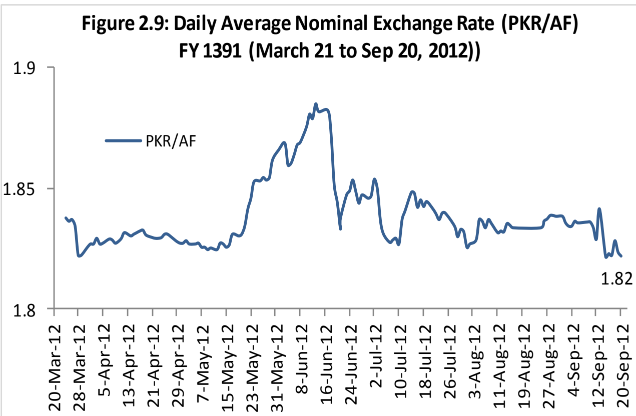




Source: *Monetary Policy Department/ Market operations Department/ DAB*



Source: *Monetary Survey Section, M PD/ DAB*



Source: *Monetary Survey Section, M PD/ DAB*

3.2 Foreign Exchange Auction

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

Since currency in circulation is not the operational target, DAB has eased the pressure in the foreign exchange auction.

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

DAB's intervention reached a total of USD 1,367.7 million and €178.85 million at the end of the period under review.

Table 2.1: DAB USD Auction Summery for the FY 1391 (March 21 to Sep 20, 2012)

Auction Date	No of Bidders	Highest Price	Lowest Price	Market Ex Rate	Cut off Price	Amount Announced	Amount Awarded	No of Awarded Bidders	Total Demand
27-Mar-2012	54	49.75	49.30	49.76	49.70	30	24.40	21	54.10
31-Mar-2012	62	50.03	49.55	50.02	49.90	30	43.10	47	56.30
3-Apr-2012	57	49.93	49.55	49.93	49.91	30	26.15	22	57.00
7-Apr-2012	60	49.86	49.51	49.85	49.82	35	31.40	25	60.00
10-Apr-2012	63	49.88	49.51	49.86	49.85	35	38.50	30	65.40
14-Apr-2012	62	49.78	49.60	49.79	49.75	40	29.30	28	58.10
17-Apr-2012	51	49.78	49.61	49.78	49.78	40	27.40	12	68.00
21-Apr-2012	47	49.93	49.82	49.92	49.92	35	24.55	16	52.40
24-Apr-2012	47	50.00	49.70	49.98	49.98	35	31.00	22	50.00
28-Apr-2012	49	49.97	49.70	49.95	49.94	35	25.00	22	41.50
1-May-2012	49	49.88	49.71	49.90	49.88	35	11.65	9	40.30
5-May-2012	50	50.02	49.71	49.97	49.95	35	31.70	26	55.30
8-May-2012	51	50.20	49.78	49.99	50.01	35	16.85	14	51.60
12-May-2012	47	50.12	49.95	50.10	50.07	35	40.70	29	56.70
15-May-2012	48	50.24	49.88	50.24	50.17	35	41.45	38	50.60
19-May-2012	56	50.17	49.88	50.14	50.08	30	30.70	42	46.60
22-May-2012	48	49.98	49.78	49.98	49.93	30	23.55	27	35.90
26-May-2012	55	50.11	49.97	50.10	50.06	30	28.60	31	42.00
29-May-2012	50	50.12	49.98	50.12	50.10	30	33.85	26	45.30
2-Jun-2012	49	50.25	50.01	50.25	50.21	25	29.20	26	43.80
5-Jun-2012	53	50.36	50.20	50.34	50.32	25	33.35	31	46.10
9-Jun-2012	48	50.37	50.19	50.36	50.33	30	36.90	37	46.00
17-Jun-2012	62	50.83	50.45	50.84	50.76	60	28.25	24	70.70
24-Jun-2012	59	51.59	51.52	51.60	51.00	80	81.95	53	92.30
1-Jul-2012	71	51.65	51.01	51.66	51.45	80	98.95	43	148.30
8-Jul-2012	76	51.53	51.00	51.56	51.35	80	81.15	50	129.35
22-Jul-2012	78	51.52	51.10	51.50	51.45	80	57.85	27	146.00
4-Aug-2012	56	51.66	51.40	51.63	51.40	50	69.05	56	69.05
7-Aug-2012	56	51.31	50.70	51.29	51.21	40	43.20	26	66.05
11-Aug-2012	53	51.28	50.01	51.27	51.21	40	40.25	36	53.80
14-Aug-2012	52	51.17	50.85	51.21	51.12	35	36.90	18	57.45
25-Aug-2012	50	51.29	51.07	51.29	51.22	40	35.65	28	56.05
28-Aug-2012	64	51.43	50.80	51.37	51.35	40	55.80	40	89.30
15-Sep-2012	61	52.23	51.50	52.13	52.00	25	44.85	40	57.15
18-Sep-2012	63	52.05	51.50	52.06	52.00	25	34.55	29	55.90
Total						**1395**	**1367.7**		**2214.40**

Source: Market Operations Department and Monetary Policy Department staff calculations

3.3 Net International Reserve

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

In the past few years, Afghanistan's NIR had a substantial steady growth which is an important indicator of ability to repay the external debts and financing the foreign trade deficit. NIR increased by 13.41 percent to USD 5,783.07 million in 1390, up from USD 5099.46 million in 1389. The boost in NIR was mainly dominated by a significant increase in reserve assets which increased by 13.46 percent from USD 5,403.21 million in 1389 to USD 6,130.38 million in the year under review. On the other hand, reserve liabilities increased considerably by 14.34 percent to USD 347.31 million in 1390 from USD 303.75 million in 1389. The reserve liabilities included commercial bank deposits in foreign currency, non-resident deposits in foreign currency and use of fund resources. Commercial bank deposits in foreign currency increased significantly from USD 184.15 million in 1389 to USD 227.72 million in the year under review. Furthermore, the reserve liabilities on use of fund resources remained fixed at USD 119.48 million in 1390. Similarly, the reserve liabilities on non-resident deposits in foreign currency remained fixed throughout the year around USD 0.11 million in 1390.

Increase in NIR could be attributed to inflows of foreign exchange, particularly from export earnings, current transfers, foreign donations and foreign direct investments.

4. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

4.1 Capital Note Auctions

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

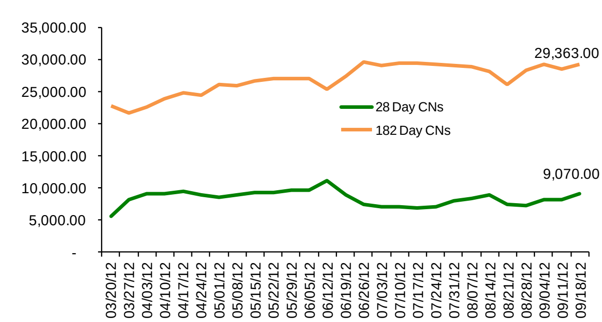
The amount to be auctioned is announced every Monday to the banks electronically. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase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

The stock outstanding for both 182 day and 28 day notes followed an upward trend during the first six months of the year under review, but it started to decline for 28 day CNs from AF 11 billion to AF 9.7 billion the rest of the quarter remained somehow even. On the other hand, the stock outstanding for 182 day notes maintained its upward trend throughout the reporting period, increasing from AFs 22.8 billion to AFs 29.3 billion. More accumulation of 182 day stock outstanding is due to the fact that the interest rates are following a downward pattern and investors are better off investing in longer maturity. The period under review ended with 28 day CNs stock of AF 9.0 billion and AF 29.4 billion for 182 day CNs, while these figures were AF 8.3 billion and AF 22.8 billion respectively at the end of the last year.

The total outstanding stock of both maturities stood at AF 38.4 billion at the end of the reporting period and AF 31.1 billion at the end of last year(Figure 2.10).

It is worth mentioning that during the period under review, the announced amount remained unchanged for both, 28 day and 182 day CNs standing at AF 200 million and AF 100 million respectively.

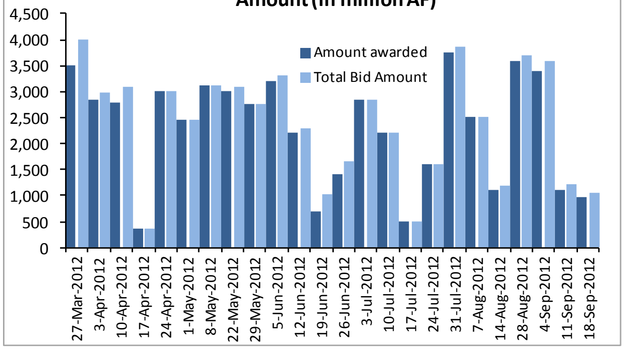
Figur 2.10: Capital Notes Stock outstanding (million AF)



Source: *Market Operations Department, DAB.*

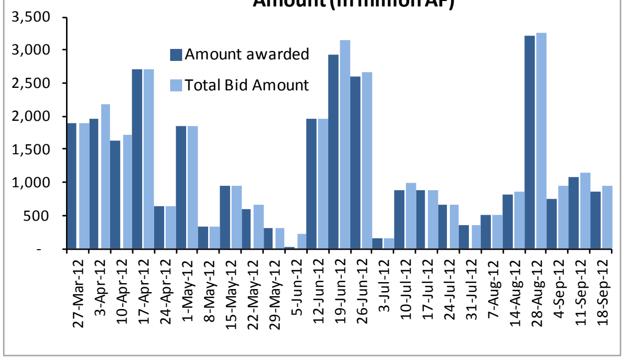
High demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the bid amount for 28 day notes was AF 58 billion while the awarded amount stood at AF 56 billion for a cover ratio of 1.05. The bid amount for 182 day note was AF 32 billion and the amount awarded was AF 31 billion for a cover ratio of 1.04. Comparing the cover ratio in the mid year 1391 to that in the year 1390, the cover ratio for the 28 day note was 1.12, while for 182 day note it was 1.09 (Figure 2.11 for 28 day CNs and Figure 2.12 for 182 day CNs).

Figure 2.11: 28 Day CNs Demand and Awarded Amount (in million AF)



Source: *Market Operations Department, DAB.*

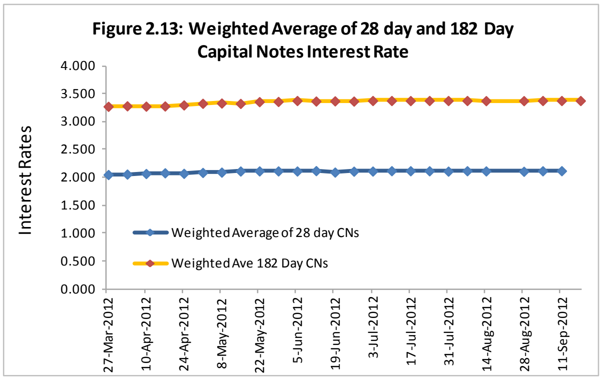
Figure 2.12: 182 Days CNs Demand and Awarded Amount (in million AF)



Source: Market Operations Department, DAB.

The weighted average interest rates ranged between 2.05 percent and 2.12 percent 28 day notes; and between 3.27 percent and 3.38

percent for 182 day maturity for the six months reporting period. The weighted average interest rates in the previous year ranged between 2.03 percent and 2.41 percent; and between 3.22 and 3.42 percent respectively (Figure2.13).



***Source:** Market Operations Department, DAB*

4.2 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to 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 cutoff rate (based on a circular to all banks approved by the DAB Executive Board on June 09, 2010).

The outstanding amount of deposit facility balances followed an uneven trend during the reporting period. It fluctuated between 2.94 and 7.60 billion AF during the period.

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

During the period under review, only one bank benefited from the facility amounting AF 700 million.

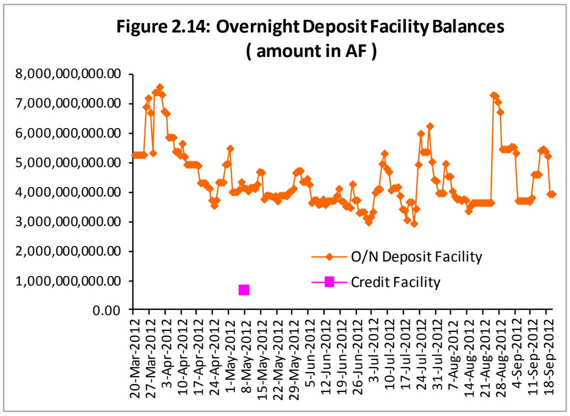
During the period under review, required reserves averaged AF 790,297,589.47 per bank. This figure was 674,527,899.81 during the year 1390.

Required reserves were remunerated at 1 basis points below the cutoff rate of last 28 day capital notes auction rate or equal to the deposit facility rate.

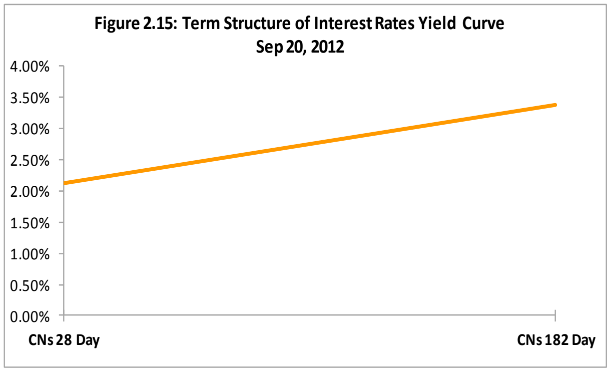
4.3 Term Structure of Interest Rates

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

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



Source: *Market Operations Department, DAB*



Source: *Market Operations Department, DAB*

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

Start Date	Auction Amount	Amount awarded	Total Bid Amount	No. of Winning Bids	No. of total bids	Cut off Rate	Low Bid	Weighted Average
27-Mar-2012	200	3,502	4,002	5	6	2.090%	2.037	2.052
3-Apr-2012	200	2,850	2,975	6	7	2.090%	2.020	2.060
10-Apr-2012	200	2,800	3,100	5	6	2.090%	2.040	2.070
17-Apr-2012	200	360	360	2	2	2.090%	2.080	2.083
24-Apr-2012	200	3,000	3,000	3	3	2.100%	2.060	2.073
1-May-2012	200	2,450	2,455	4	5	2.110%	2.080	2.089
8-May-2012	200	3,125	3,125	6	6	2.130%	2.050	2.095
22-May-2012	200	3,000	3,100	4	4	2.130%	2.100	2.115
29-May-2012	200	2,750	2,750	3	3	2.130%	2.110	2.117
5-Jun-2012	200	3,200	3,300	4	5	2.130%	2.090	2.117
12-Jun-2012	200	2,200	2,300	3	4	2.123%	2.090	2.115
19-Jun-2012	200	700	1,030	3	3	2.123%	2.120	2.122
26-Jun-2012	200	1,400	1,658	3	5	2.123%	2.050	2.096
3-Jul-2012	200	2,850	2,850	4	4	2.123%	2.050	2.112
10-Jul-2012	200	2,200	2,200	3	3	2.123%	2.080	2.114
17-Jul-2012	200	500	500	1	1	2.121%	2.121	2.121
24-Jul-2012	200	1,600	1,600	3	3	2.121%	2.120	2.120
31-Jul-2012	200	3,750	3,850	5	5	2.121%	2.100	2.119
7-Aug-2012	200	2,500	2,500	3	3	2.122%	2.100	2.113
14-Aug-2012	200	1,100	1,200	3	3	2.122%	2.120	2.120
28-Aug-2012	200	3,600	3,700	5	5	2.122%	2.100	2.117
4-Sep-2012	200	3,400	3,600	4	4	2.122%	2.110	2.110
11-Sep-2012	200	1,110	1,210	4	4	2.122%	2.090	2.119
18-Sep-2012	200	960	1,060	4	4	2.122%	2.120	2.121
Total		**55,707**	**58,315**					

Source: *Market Operations Department, DAB*

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

Start Date	Auction Amount	Amount awarded	Total Bid Amount	No. of Winning Bids	No. of total bids	Cut off Rate	Low Bid	Weighted Average
27-Mar-12	100	1,900	1,900	5	5	0.033	3.230	3.276
3-Apr-12	100	1,950	2,174	4	6	0.033	3.280	3.285
10-Apr-12	100	1,637	1,721	5	6	0.033	3.250	3.279
17-Apr-12	100	2,700	2,700	5	5	0.033	3.270	3.282
24-Apr-12	100	630	630	2	2	0.033	3.300	3.301
1-May-12	100	1,856	1,856	6	6	0.033	3.280	3.330
8-May-12	100	330	330	2	2	0.034	3.330	3.335
15-May-12	100	950	950	4	4	0.034	2.370	3.328
22-May-12	100	600	650	2	2	0.024	2.360	3.360
29-May-12	100	300	300	1	1	0.034	2.360	3.363
5-Jun-12	100	30	210	1	3	0.034	3.380	3.380
12-Jun-12	100	1,950	1,950	4	4	0.034	3.350	3.371
19-Jun-12	100	2,937	3,137	5	6	0.034	3.360	3.374
26-Jun-12	100	2,600	2,655	5	5	0.034	3.370	3.370
3-Jul-12	100	150	150	1	1	0.034	3.380	3.380
10-Jul-12	100	890	990	1	4	0.034	3.380	3.380
17-Jul-12	100	870	870	4	4	0.034	3.370	3.379
24-Jul-12	100	670	670	3	3	0.034	3.380	3.380
31-Jul-12	100	350	350	4	4	0.034	3.380	3.380
7-Aug-12	100	500	500	4	4	0.034	3.380	3.380
14-Aug-12	100	817	867	6	6	0.038	3.370	3.378
28-Aug-12	100	3,210	3,260	5	5	0.034	3.370	3.378
4-Sep-12	100	759	951	5	6	0.034	3.380	3.380
11-Sep-12	100	1,087	1,137	5	5	0.034	3.380	3.380
18-Sep-12	100	850	950	4	4	0.034	3.380	3.380
Total		**30,523**	**31,858**					

Source: *Market Operations Department, DAB*

CHAPTER III

THE INFLATION TREND AND OUTLOOK

3

THE INFLATION TREND AND OUTLOOK

The trend toward decelerating inflation in Afghanistan that began in the first quarter of 1391, fortunately, seemed to maintain its way in the second quarter as well. By most measures, inflation has decreased in the first six months of 1391, which could create less hardship for the population and lesser challenges for policymakers.

For example, nationwide headline inflation, measured on a year-on-year basis, stood at 5.40 percent in the second quarter of 1391; which is lower than the inflation rate of 9.90 percent recorded in the second quarter of 1390. The decrease in the rate of inflation was led by a decline in both, food and non-food price indices. Also, core inflation, which excludes bread and cereals, oil and fats, and transportation from headline CPI, is currently at a relatively lower level of 8.20 percent (Y-o-Y), lower than the rate of 12.30 percent last year. This suggests that inflation has not persisted in the basic commodities as well as in the other commodities.

The Kabul headline inflation in the second quarter of 1391 was 7.40 percent (Y-o-Y), which is lower than the inflation rate of 10.30 percent in the same period of the previous year. Here, a fall in the rate of inflation in food and non-food price indices is responsible for a decline in the overall index.

When the quarter-on-quarter changes in inflation are observed, however, the situation is somewhat different. National headline inflation in the second quarter of 1391 increased to 0.71 percent (Q-o-Q), up from 0.2 percent recorded in the first quarter. Prices of foodstuff such as milk and cheese, and bread and cereals increased slightly in the quarter under review, which were partially offset by a decrease in inflation rate of oil and fat, vegetables and some other components.

The (Q-o-Q) changes in Kabul CPI showed almost similar pattern to nationwide inflation. Kabul inflation increased by 1.8 percent (Q-o-Q) in the second quarter compared to zero percent inflation recorded in the previous quarter.

1. INFLATION EASED IN THE SECOND QUARTER OF FY1391

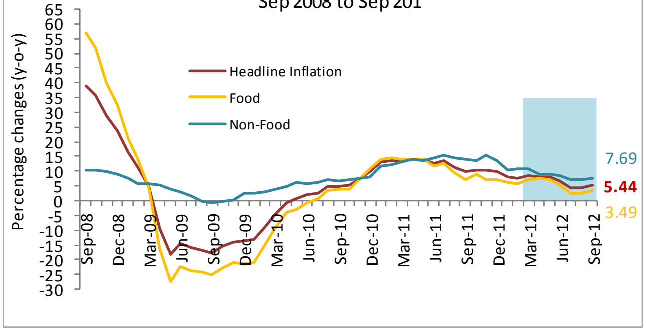
1.1 Annual Changes in National Headline Inflation

In the second quarter of 1391, inflation, when measured by year-on-year percentage changes, was somewhat better than was recorded in the same quarter of 1390. The national headline inflation was 5.40 percent (Y-o-Y) at the end of the second quarter of 1391, compared to 9.9 percent inflation observed in the same period of the previous year.

The CPI measures the average price of a fixed set (or basket) of goods and services. The basket is intended to reflect all of the items a typical family buys to achieve a minimum standard of living in a base period (currently March 2011). The CPI does not count the price of each item equally, but weights each according to its share of total household expenditures in the base period. The Central Statistics Organization (CSO) launched new Consumer Price Index (CPI) which is a major step toward improving the quality of price statistics in Afghanistan. The total number of items in the CPI basket increased to 290 items, up from 202 items in the old basket. The nationwide CPI basket witnessed significant changes with a total number of provinces being surveyed expanded to 10 provinces, up from 6 provinces in the old basket. The CPI baskets were re-weighted and re-based from March 2004 to March 2011. In the new CPI basket, the share of food price-index decreased to 52 percent compared to 63.2 percent in the old basket, while non-food constitutes 48 percent of total basket, this indicates positive changes in the household's cost of living.

To analyze the contributing factors responsible for the decrease in inflation, it is necessary to discuss the behavior of inflation in those components that have the most significant weights in the CPI basket. First, we will analyze those components that showed the largest favorable changes and then we will look at the components with unfavorable changes in the reporting period.

Figure 3.1: Breakdown of National Headline CPI
Sep 2008 to Sep 201



Source: Central Statistics Office and DAB staff calculations

Unsurprisingly, the main cause of 4.5 percentage-point decrease in the rate of inflation was due to the decrease observed in most components of food and non-food price indices. Food prices (52 percent of the CPI), actually decreased by 3.5 percent (Y-o-Y) in the second quarter of 1391, compared to 7.2 percent in the second quarter of 1390. After declining from its peak experienced in 1387, food prices again rose rapidly in 1389, following world trends. In Afghanistan, agricultural production has been lower in 1390 and 1389 compared with 1388, but is expected to rebound in 1391 due to a good winter season and sufficient rainfalls at the beginning of the year, which will lead to a good wheat and grain harvest.

Inflation in non-food prices decreased significantly to 7.7 percent (Y-o-Y) from 14.2 percent recorded in the previous year – and the effect on overall inflation was as pronounced as the food prices. Other characteristics of the current quarter's data are that, compared with previous quarters, there are significant decreases – that are the major components of the CPI where inflation decreased significantly from the previous year.

The most favorable development in the second quarter of 1391 was a significant decline in the prices of vegetables, which represented a negative growth of 4.4 percent. The other components of food that posted decline were milk and cheese (4.8 percent of the CPI) decreased by 7.9 percent (Y-o-Y) compared to 9.4 percent over the same period a year ago. Prices of oil and fat (4 percent of CPI) also showed sharp decreases. Oil and fat, another important component of food sub-index (representing 4 percent of the CPI), displayed similar behavior standing at 0.3 percent (Y-o-Y), down from 24.2 percent in the same period of last year. This decrease of 23.9 percentage points in the rate of inflation in oil and fat can be attributed to supply side.

Fresh and dried Fruits prices have been falling; an important factor contributed to the decline in headline inflation. This price index fell by 6.3 percent (Y-o-Y) in the second quarter of 1391, a sharp decrease from 18.9 percent inflation observed in the second quarter of 1390.

Vegetable prices also contributed to the drop in headline inflation; the prices of vegetables (7.9 percent of the CPI), declined in the second quarter of 1391 to -4.40 percent (Y-o-Y), compared to 2.2 percent in the second quarter of 1391.

The non-food prices has fallen as well; clothing, an important component in the non-food sub-category, (comprises 7 percent of the whole index) fell to 8.3 percent in the second quarter of 1391 compared to 15.4 percent in the same quarter of last year, this decrease in the prices was due to increased supply of clothing.

Transportation prices also fell; this is another important component in the non-food sub-category which comprises 4.7 percent of the whole index, fell to 6.6 percent in the second quarter of 1391 compared to 19.6 percent observed in the second quarter of 1390.

The unfavorable development was the increase observed in the rate of inflation in bread and cereals; based on expectations about the decrease in grain supply from Pakistan, the prices of bread and cereals rose on a year-on-year basis in the second quarter of 1391. Bread and cereals rose by 4.6 percent, compared to 2.9 percent increase observed in the same period of last year. Bread and cereals comprise 17.7 percent of the new CPI basket, still the largest individual component of the CPI.

In the second quarter of 1391, meat prices (7.2 percent of the CPI), increased by 12.9 percent (Y-o-Y), compared to the same period of last year when it was 8.9 percent, due to increase in the prices of cereals and grains.

Core inflation exhibited similar behavior as headline inflation; It is clear from the above statements that inflation has lost momentum by all measures. A measure of core inflation, which removes from overall CPI inflation the components with the high volatility rate, also declined during the reporting period. Core inflation is also often interpreted as measuring the long-run of persistent inflation. For example, core inflation measured as headline inflation excluding bread and cereals, oil and fat, and transport, was 8.2 percent (Y-o-Y) in the second quarter of 1391, higher than the headline inflation rate of 5.4 percent, but below the last year's core inflation rate of 12.3 percent.

Another way of measuring core inflation is the trimmed mean; which excludes components that rank among the smallest or largest (in numerical term changes for the month). Considering the total number of components in the CPI basket, 28 percent (6 items) should be trimmed, 3 items from the bottom and 3 items from the top. Trimmed mean CPI decreased to 5.7 percent in the second quarter of 1391, down from 11.8 percent in the same quarter last year. However, the level of the core inflation, measured by TM, was almost the same as the headline inflation.

Figure 3.2: Core Inflatin
Mar 2012 to Sep 2012

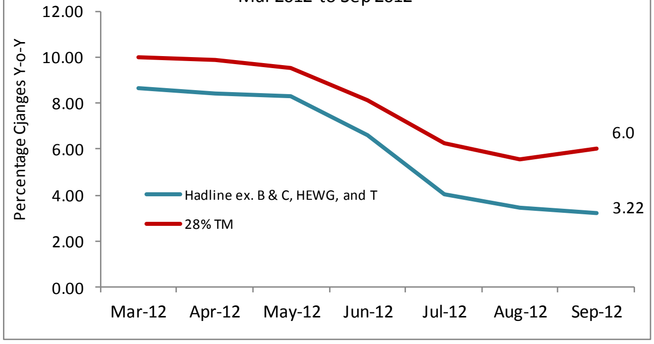


Table 3.1: Major Components of National Headline CPI

(Percent change y-o-y)

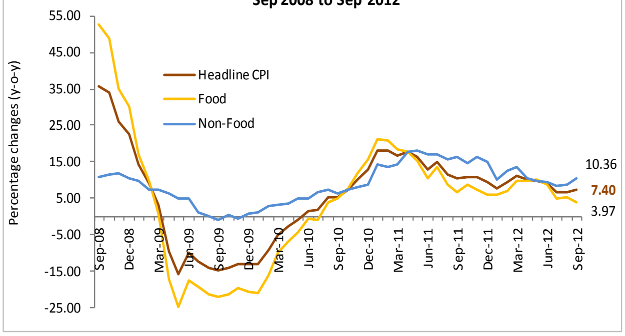
	Weight	1388 Sep-09	1389 Sep-10	1390 Sep-11	1391 Sep-12
Headline	**100.0**	**-17.7**	**4.9**	**9.9**	**5.4**
Food	**52.0**	**-25.2**	**3.9**	**7.2**	**3.5**
Bread & Cereals	17.7	-38.7	2.1	2.9	4.6
Meat	7.2	5.0	15.6	8.9	12.9
Milk & Cheese	4.8	-0.9	0.7	9.4	7.9
Oils & Fats	4.0	-27.1	10.5	24.2	0.3
Fresh & Dried Fruits	4.8	10.8	-5.9	18.9	6.3
Vegetables	7.9	-6.8	6.3	2.2	-4.4
Sugar and Sweets	2.9	16.1	17.5	6.3	-2.8
Spices	0.9	4.7	4.1	27.2	11.8
Non-Food	**48.0**	**-0.8**	**6.5**	**14.2**	**7.7**
Clothing	7.0	5.6	3.7	15.4	8.3
Health	3.3	4.1	0.8	3.0	4.4
Transportation	4.7	-16.7	13.3	19.6	6.6
Communications	1.1	1.2	-3.1	2.6	-2.7
Educations	0.1	3.8	-0.6	11.2	1.9
Miscellaneous	1.8	11.1	7.0	9.9	17.7
Core inflation (28% TM)		2.0	2.1	11.8	5.7
CPI ex. B &C		-1.6	6.2	13.1	5.6
CPI ex. B& C, O & F		0.6	6.9	12.3	8.2

Source: *Central Statistics Office and DAB staff calculations*

1.2 Annual Changes in Kabul Headline Inflation

The Kabul headline inflation as measured on a year-on-year basis, showed similar characteristics to the nationwide CPI inflation. Headline inflation decreased in the second quarter of 1391 to 7.4 percent, compared to 10.3 percent experienced in the same quarter of 1390. The causes of the decrease in headline inflation in Kabul CPI were also similar to those affecting nationwide inflation.

Figure 3.3: Breakdown of Kabul Headline inflation, Sep 2008 to Sep 2012



Source: *Central Statistics Office and DAB staff calculations*

The favorable developments in Kabul CPI were the fall in the rate of inflation in milk and cheese, the decline in milk and cheese prices was another significant factor responsible for the decrease in Kabul CPI. Throughout Afghanistan, milk and cheese prices fell in the second quarter of 1391 at a year-on-year rate of 6.1 percent, compared with 10.8 percent in the same quarter a year ago.

Prices of oil and fat also exhibited a sharp decline; oil and fat also experienced rapidly decline in the reporting period, compared with the same period of the previous year. Oil and fat prices decreased significantly by 35.8 percentage points in the reporting period, and ended up at -0.7 percent (Y-o-Y). Both, the level of inflation in this component, and the decrease in inflation from the previous period, were quite lower than what was observed nationwide.

Prices of fresh and dried fruits (4.8 percent of CPI) also decreased during the reporting period, but the decrease was not as significant as what was observed nationwide. The prices of fruits decreased by 11.9 percent (Y-o-Y), a decrease from an inflation rate of 16.2 percent in the same quarter of last year.

Vegetable prices also contributed to the decline in Kabul headline inflation; vegetables, which comprise 7.9 percent of the whole index, after showing a negative growth in the first quarter of 1391 (-2.7 percent), fell further in the second quarter of 1391 standing at -3.5 percent (Y-o-Y).

The transportation sub - index fell rapidly; transportation with a significant share of 4.7 percent in total basket, exhibited a similar trend to the nationwide CPI. Throughout country, transport costs fell rapidly in the second quarter of 1391, when measured on a year-on-year basis, compared with the second quarter of 1390. The 10.6 percentage-point decrease in transportation,

Although, most of the significant components of Kabul CPI showed favorable changes in the second quarter of 1391 over the previous period, some components posted increase which partially offset these favorable changes.

For example:

The bread and cereals (17.7 percent of CPI) increased rapidly; prices of bread and cereal rose by 7.2 percent (Y-o-Y) in the second quarter of 1391 compared to 0.9 percent increase recorded in the same quarter of the previous year. The increases were quiet higher than what was observed in nationwide CPI. The possible factor responsible for the increase in this sub-index could be due to decrease in supply of grains coming in from neighboring countries.

Meat prices (7.2 percent of the CPI; the other component that posted increase; this price-index rose by 15.5 percent (Y-o-Y), a sharp increase compared to 7.9 percent increase recorded in the same period a year ago. This significant 7.6 percentage-point increase in the rate of inflation in meat could be due to increased prices of cereals and grains.

The health prices also increased; health prices rose rapidly in the second quarter of FY1391 throughout the country, but the growth was more significant in Kabul compared to the nationwide CPI. Health prices increased by 10.8 percentage-point compared with the previous year.

Table 3.2: Breakdown of Kabul Headline CPI

(Percent change y-o-y)

Consumer Price Index

	Weight	1388 Sep-09	1389 Sep-10	1390 Sep-11	1391 Sep-12
Headline	**100**	-14.9	5.3	10.3	7.4
Food	**52.0**	-21.9	4.7	6.5	4.0
Bread & Cereals	17.7	-35.9	3.2	0.9	7.2
Meat	7.2	-1.4	21.5	7.9	15.5
Milk & Cheese	4.8	0.6	2.0	10.8	6.1
Oils & Fats	4.0	-21.2	7.6	35.1	-0.7
Fresh & Dried Fruits	4.8	9.8	-6.3	16.3	11.9
Vegetables	7.9	-1.1	8.0	-2.7	-3.5
Sugar and Sweets	2.9	18.2	10.4	11.5	-4.7
Spices	0.9	5.6	5.3	2.9	35.6
Non-Food	**48.0**	-0.8	6.3	16.2	10.3
Clothing	7.0	3.0	-2.1	9.7	3.8
Health	3.3	7.2	-0.6	5.1	15.9
Transportation	4.7	-12.0	10.3	12.4	1.8
Communications	1.1	0.0	0.0	0.0	-0.4
Educations	0.1	0.1	-0.9	12.5	1.2
Miscellaneous	1.8	8.4	-1.3	16.0	19.5
Core inflation (28% TM)		0.5	4.1	10.0	6.6
CPI ex. B &C		-1.0	6.2	14.2	7.4
CPI ex. B& C, O & F		0.7	6.2	12.8	12.2

Source: Central Statistics Office/DAB staff calculations

1.3 Current Quarter Changes in National Headline CPI

To see more clearly what is happening to inflation in the most recent time periods, we may compare the quarter-on-quarter changes in the overall CPI and its various components in the second quarter of FY1391. Nationwide headline inflation increased slightly when quarterly changes are observed. Headline inflation increased by 0.7 percent (q-o-q) in the second quarter of FY1391, compared to 0.2 percent increase recorded in the preceding quarter.

The pace of growth across the CPI components was uneven in the quarter under review. For example, bread and cereals, milk and cheese, clothing, housing, electricity, water & gas, and health price indices experienced higher rates of inflation in the second quarter compared to those in the previous quarter.

Nationwide inflation in bread and cereals was significantly higher in the second quarter, representing an inflation rate of 2.2 percent (q-o-q) compared with a 1.6 percent increase in the first quarter of FY1391. Inflation in milk and cheese was significantly higher in the second quarter, reaching an inflation rate of 1.2

percent, compared with a deflation of 0.6 percent in the first quarter. Nationwide, clothing prices were slightly higher in the second quarter, standing at 1.2 percent (q-o-q) compared with a 1 percent increase in the first quarter of FY1391. Housing, electricity, water & gas price-index rose sharply in the second quarter, representing an inflation rate of 3.7 percent, compared with a 1 percent increase in the preceding quarter.

Some favorable developments were also observed in the quarter under review, for example meat prices declined from 0.7 percent in the first quarter to 0.50 percent in the quarter under review. Prices of oil and fat dropped to -1.2 percent, down from 1.7 percent experienced in the first quarter of FY1391.

Table 3.3: Breakdown of National Headline CPI

(Percent changes Q-to-Q)

Consumer Price Index

	Weight	1391	
		Q1	Q2
Overall Index	**100**	**0.2**	**0.7**
Food and beverages	**52.0**	**-0.3**	**-0.4**
Bread and Cereals	17.7	1.6	2.2
Meat	7.2	0.7	0.5
Milk, cheese and eggs	4.8	-0.6	1.2
Oils and fats	4.0	1.7	-1.2
Fresh and dried fruits	4.8	0.7	-2.9
Vegetables	7.9	-7.5	-8.8
Sugar and sweets	2.9	0.1	3.8
Spices	0.9	3.5	1.2
Non-alcoholic beverages	1.8	2.1	3.2
Non-Food	**48.0**	**0.6**	**1.9**
Tobacco	0.4	0.4	-1.9
Clothing	7.0	1.0	1.2
Housing, electricity, water and gas	20.7	1.0	3.7
Furnishing and household goods	7.0	0.8	0.7
Health	3.3	0.2	3.0
Transportation	4.7	-0.8	-2.1
Communication	1.1	-1.7	-2.7
Recreation and Culture	0.7	-0.2	5.6
Education	0.1	-0.3	0.9
Restaurants and Hotels	1.0	0.2	0.2
Miscellaneous	1.8	0.6	0.5

1.2 Current Quarter Changes in Kabul Headline Inflation

In this chapter, we may compare the quarter-on-quarter changes in Kabul CPI and its various components in the second quarter of FY1391 with those experienced in the first quarter of FY1391. The quarterly headline inflation in the second quarter was higher, 1.8 percent (q-o-q), up from 0.0 percent in the previous quarter.

The reason that inflation increased slightly from the previous quarter could be attributed to an increase in the prices of bread and cereals, milk, cheese and eggs, clothing, housing and health. The prices of these important commodities actually increased in the second quarter by 4 percent, 2.4 percent, 2.6 percent, 4.6 percent and 12 percent respectively. These unfavorable changes, however, were somehow offset by a decrease in the prices of oil and fat, fresh and dried fruits, transportations, and some others.

Table 3.4: Breakdown of Kabul Headline CPI

(Percent changes Q-to-Q)

Consumer Price Index

Period	Weight	1391	
		Q1	Q2
Overall Index	100	0.0	1.8
Food and beverages	52.0	-0.4	-0.2
Bread and Cereals	17.7	3.4	4.0
Meat	7.2	1.2	1.1
Milk, cheese and eggs	4.8	-2.5	2.4
Oils and fats	4.0	1.2	-2.4
Fresh and dried fruits	4.8	0.4	-5.3
Vegetables	7.9	-9.7	-6.5
Sugar and sweets	2.9	1.8	4.5
Spices	0.9	7.1	4.5
Non-alcoholic beverages	1.8	0.3	2.1
Non-Food	48.0	0.4	3.3
Tobacco	0.4	1.5	0.7
Clothing	7.0	-1.8	2.6
Housing, electricity, water and gas	20.7	0.8	4.6
Furnishing and household goods	7.0	1.4	0.4
Health	3.3	2.5	12.0
Transportation	4.7	-2.0	-2.5
Communication	1.1	0.1	-0.6
Recreation and Culture	0.7	-1.1	0.7
Education	0.1	-0.1	0.8
Restaurants and Hotels	1.0	0.8	0.0
Miscellaneous	1.8	1.3	0.1

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

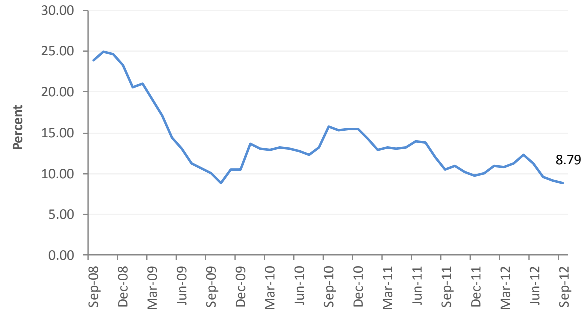
2. REGIONAL INFLATION

2.1 Inflations in Pakistan

Inflation in Afghanistan has clearly lost momentum in the second quarter of FY1391, on a year-on-year basis and is, in fact; now lower than Pakistan inflation. In September 2012, headline inflation in Pakistan was 8.8 percent (Y-o-Y), which was slightly lower than 10.5 percent recorded in September 2011, and somehow lower than the rate of 11.30 percent observed in June 2012. Pakistan's food inflation was 7.6 percent in September 2012, compared with non-food inflation of 9.70 percent. The rate of inflation in food was lower than the 9.9 percent rate observed in September 2011, while the non-food inflation rate was slightly lower than the 10.9 percent rate observed a year ago. Inflation in Pakistan is still higher than what is observed in Afghanistan, but appears to be stabilizing at some level. In Afghanistan, the decrease in overall inflation was due to decrease in both, food and non-food sub-indices, the decline in food items was almost similar to what was observed in Pakistan, also the rate of inflation in non-food items decreased to the levels that is almost similar to those observed in Pakistan, but the decrease in the rate of inflation in Afghanistan was more than the decline which was observed in Pakistan.

Core inflation, which excludes the food and energy components, is still higher, but is similar to what was observed last year. In September 2012, core inflation was 10.5 percent (Y-o-Y), slightly down from 10.6 percent in September 2011, and down from 11.5 percent recorded in June 2011.

Figure 3.5: Pakistan CPI Inflation (% Δ Y-o-Y)

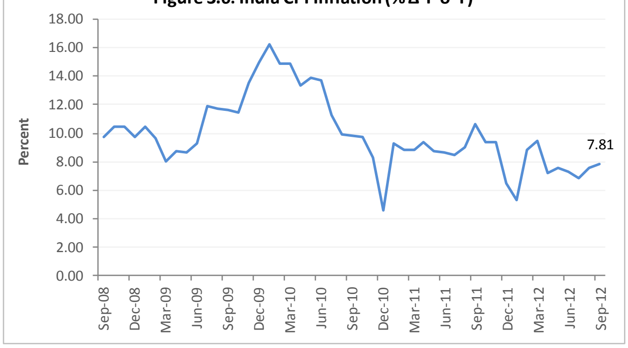


	CPI			Core Inflation		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Sep-11	10.50	9.90	10.90	10.60	11.70	17.00
Oct-11	11.00	11.70	10.40	10.50	11.70	15.40
Nov-11	10.20	10.00	10.30	10.40	11.50	12.00
Dec-11	9.70	9.50	9.90	10.20	10.60	8.30
Jan-12	10.10	9.20	10.70	10.30	10.40	8.70
Feb-12	11.00	10.50	11.50	10.70	10.70	7.20
Mar-12	10.80	9.80	11.50	10.90	10.50	4.50
Apr-12	11.30	10.70	11.60	10.90	11.00	3.80
May-12	12.30	11.30	13.00	11.20	11.70	7.10
Jun-12	11.30	10.30	12.00	11.50	11.10	6.40
Jul-12	9.60	9.10	10.00	11.30	10.70	7.20
Aug-12	9.10	8.50	9.40	10.80	10.60	7.70
Sep-12	8.80	7.60	9.70	10.50	10.40	7.80

2.2. Inflation in India

India is experiencing similar inflationary trends compared to Pakistan, but slightly higher compared to Afghanistan. In September 2012, the overall CPI rose slightly by 7.8 percent (Y-o-Y), slightly up from the 7.25 percent increase recorded in June 2012, while clearly down from 10.6 percent observed in September 2011. The Indian inflation accelerated to a 10 month high in September after an increase in diesel prices, it comes after the government raised state-set prices of diesel by 14 percent to help rein in India's gaping fiscal deficit, limiting room for an interest-rate cut to revive the economy and also limiting the central bank's ability to cut rates to help support the slowing economy.

Figure 3.6: India CPI Inflation (% Δ Y-o-Y)



CHAPTER IV

EXTERNAL SECTOR DEVELOPMENSTS

4

EXTERNAL SECTOR DEVELOPMENTS

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

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

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

Merchandise trade statistics which present exports and imports comparison for the first six months of 1390 and FY1391 indicates that the trade deficit has widened significantly from US dollar 2,402.65 million in the first six months of 1390 to US dollar 4,379.64 million in the first six months of FY1391, this represents almost 82 percent increase. The trade deficit, as a percentage of GDP, increased to 22 percent in the first six months of FY1391, from 13 percent in the same period last year.

During the period under review, aggregate exports decreased by almost 27 percent, standing at US dollar 144.12 million, down from 197.19 million recorded in the same period of last year. The statistics on exports indicated a decrease in all export categories except for leather and wool at the end of the period under review.

Exports are mainly dominated by carpets and rugs which has decreased by almost 89 percent, food items such as fresh and dry fruits decreased by 27 percent, and medical seeds decreased by 19 percent. On the other hand, leather and wool categories increased slightly by about 3 percent in the first six months of FY1391 compared with the similar period last year.

Imports of goods increased notably by 74 percent, from US dollar 2,599.84 million in the first six months of 1390 to US dollars 4,523.76 million at the end of the period under review.

As the statistics show, imports of almost all importing categories increased except for fuel and lubricants, which decreased by about 23 percent in the first six months of FY1391. The other import categories, such as consumer goods, industrial supplies, and capital goods increased by 199 percent, 144 percent and 87 percent respectively, compared with the corresponding quarter last year.

At the end of the reporting period, Afghanistan's public and publicly guaranteed external debt stock stood at US dollars 2,502.60 million which shows a decrease of about 5 percent compared with the same period of last year. During the period under review, loan principal repayment made only to the Asian Development Bank (ADB), while service charges paid to the International Development Association (World Bank) and Asian Development Bank (ADB). Moreover, international Development Association (IDA) and Asian Development Bank (ADB) as a major multilateral creditor to Afghanistan made some debt forgiveness on principle and service charges.

According to the available data, the net international reserves (NIR) increased by almost 10 percent in the first six months of 1391 compared with the same period of last year. This figure was USD 5,618.89 million in the first six months of 1390, which increased to US dollars 6,178.55 million in the period under review.

1. MERCHADISE TRADE

Based on data provided by the Central Statistics Office, Afghanistan's merchandise trade deficit widened in the first six months of FY1391 following a substantial expansion in imports compared with the same period of last year. Merchandise trade statistics show that the trade deficit widened 82 percent, from USD 2,402.65 million in the first six months of 1390 to USD 4,379.64 million in the period under review. The trade deficit stood at approximately 22 percent of GDP.

The deficit in the trade balance was mainly attributed to an increase in imports in the first six months of FY1391, compared with the same period a year ago. Aggregate imports increased significantly by almost 74 percent, while exports declined by around 27 percent compared to the first six months of 1390. According to merchandise trade statistics, total imports for the period under review was recorded at US dollars 4,523.76 million, where this figure was recorded at US dollars 2,599.84 million in the same period last year. The boost in expenditure of total imports was dominated by almost all importing items, in particular consumer goods which increased by 199 percent from US dollars 296.85 million in the first six months of 1390 to US dollars 886.99 million in the period under review. Industrial supply increased by almost 144 percent, from US dollars 303.55 million in the first six months of 1390 to US dollars 741.53 million in the period under review, and capital goods increased by 87 percent from US dollars 1,229.25 million to US dollars 2298.41 million in the first six months of FY1391. On the contrary, imports of fuel and lubricants decreased by almost 23 percent, from US dollar 770.19 million to US dollars 596.83 million in the period under review.

On the other hand, total exports declined notably by 27 percent, from US dollar 197.19 million to US dollar 144.12 million in the period under review.

Trade statistics indicate a decline in the export items driven almost by all export categories, such as carpet and rugs which decreased significantly by 89 percent from US dollars 21.04 million to US dollars 2.39 million in the first six months of FY1391. Food items such as fresh and dry fruits declined by almost 27 percent from US dollars 59.01 million in the first six months of 1390 to US dollars 43.28 million in the first six months of FY1391, while medical seeds declined by about 19 percent from US dollars 101.63 million to 82.49 million in the period under review, and finally, exports of leather and wool which was recorded at US dollars 15.51 million in the first six months of 1390, increased slightly to US dollars 15.96 million in the period under review.

As a result, a significant change in the import structure in favor of capital goods and others has been observed during the first six months of FY1391.

The share of capital goods and others in total imports increased from 47.3 percent in the first six months of 1390 to 50.8 percent in the first six months of 1391. Imports of capital goods mainly comprise spare parts, machineries and unspecified items.

The second largest share in total imports was recorded for consumer goods, which increased from 11.4 percent to 19.6 percent in the first six months of FY1391. The third largest share in total imports was recorded for industrial supplies during the first six months of FY1391, the share of industrial supplies in total imports increased from 11.7 percent in the first six months of 1390 to 16.4 percent in the period under review. Imports of industrial supplies mainly cover; petroleum oil, metals, fertilizer and cement which are essentials for economic development. Higher imports of capital goods and industrial supplies are a proof of developments in industrial and construction sectors. At the same time, share of fuel and lubricants declined from 29.6 percent to about 13.2 percent in the first six months of FY1391. Finally, the trade balance deficit as percent of GDP increased from 13 percent in the first six months of 1390 to 22 percent in the period under review.

Table 1.1 illustrates main categories of the merchandise trade, the percentage share of main categories of exports and imports from 1387 up to end of the first six months of 1391.

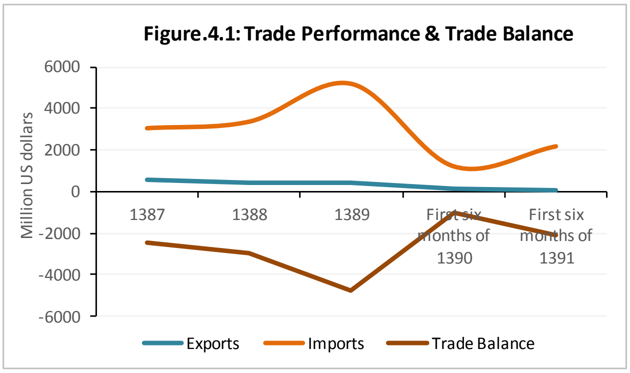


Table 4.1: Merchandise Trade (in million USD)

Years	FY 1387		FY 1388		FY 1389		First 6 months of FY 1390		First 6 months of FY 1391	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**3,019.86**	**100%**	**3,336.45**	**100%**	**5,154.31**	**100%**	**2,599.84**	**100%**	**4,523.76**	**100%**
Industrial supplies	313.36	10.4%	294.24	8.8%	602.48	11.7%	303.55	11.7%	741.53	16.4%
Fuel and Lubricants	484.42	16.0%	707.19	21.2%	1022.66	19.8%	770.19	29.6%	596.83	13.2%
Consumer goods	791.71	26.2%	728.14	21.8%	803.67	15.6%	296.85	11.4%	886.99	19.6%
Capital goods and other	1,430.37	47.4%	1,607	48.2%	2725.50	52.9%	1229.25	47.3%	2298.41	50.8%
Exports	**544.56**	**100.0%**	**403.07**	**100%**	**388.37**	**100%**	**197.19**	**100%**	**144.12**	**100%**
Carpets & Rugs	153.05	28.1%	68.8	17.1%	68.83	17.7%	21.04	10.7%	2.39	1.7%
Food Items	290.38	53.3%	224.80	55.8%	156.35	40.3%	59.01	29.9%	43.28	30.0%
Leather & Wool	29.29	5.4%	24.67	6.1%	53.84	13.9%	15.51	7.9%	15.96	11.1%
Medical seeds & others	71.84	13.2%	84.82	21.0%	109.35	28.2%	101.63	51.5%	82.49	57.2%
Trade Balance	**-2,475.30**		**-2,933.38**		**-4,765.94**		**-2,402.65**		**-4,379.64**	
Trade Balance as % of GDP	**-21%**		**-23%**		**-28%**		**-13%**		**-22%**	

Source: CSO and DAB staff calculations

2. DIRECTION OF TRADE

Tables 4.2 and 4.3 show Afghanistan's direction of trade with its trading-partners in the first six months of 1391. Principally, Afghanistan's major trading-partners' are Pakistan, India, China, Iran and Commonwealth of Independent States (CIS). The merchandise trade statistics show that Afghanistan's total exports decreased by 27 percent from US dollars 197.19 million to US dollars 144.12 million in the reporting period. Such a decrease in the value of exports is due to relatively low foreign demand for Afghanistan's exports and slow recovery in most of the export destinations of Afghanistan.

During the period under review, Pakistan remained on top among the export destinations, despite its exports decreased from 60 percent to 35.88 percent of total exports.

Afghanistan's exports to Pakistan were US dollars 51.71 million in the first six months of

FY1391 compared to US dollars 118.31 million in the same period of last year, which has significantly declined by about 35 percent in the first six months of FY1391. Major export items to Pakistan were carpets and rugs and food items such as fresh and dry fruits. During the period under review, based on available data, exports of all items to Pakistan registered a decline as a result of lower demand. Export of carpets and rugs surprisingly decreased by 89 percent, from US dollars 21.04 million in the first six months of 1390 to US dollars 2.39 million in the period under review. The export of food items to Pakistan declined by about 27 percent, from US dollar 59.01 million to US dollar 43.28 million, which was mainly dominated by the export of dry fruits that decreased by 93 percent from US dollar 10.67 million in the first six months of 1390 to US dollar 0.75 million in the current period. Similarly, export of medical seeds and others to Pakistan decreased by almost 19 percent, from US dollar 101.63 million in the first six months of 1390 to US dollar 82.49 million in the period under review. While export of leather and wool to Pakistan, slightly increased from US dollars 15.51 million to US dollar 15.96 million approximately, 3 percent in the current period.

India was the second largest destination among others in the first six months of 1391. Afghanistan's exports to India increased by almost 69 percent, from US dollars 20.19 million to US dollars 34.19 million during the current period compared to the same period last year. Such increases in total exports to India; were mainly denominated by medical seeds, carpets and dry fruits which have increased by approximately 90 percent, 33 percent and 17 percent respectively, during the first six months of FY1391.

Commonwealth of Independent States (CIS) remained the third largest export destination with 15 percent share in total exports among others during the first six months of FY1391.

Afghanistan's exports to CIS countries during the current period compared to the same period of last year increased by almost 30 percent, from US dollar 17.55 million to US dollars 22.74 million. The increase in total exports to CIS, was mainly for unspecified items that bound to US dollars 18.53 million from US dollars 0.64 million in the period under review.

However, Iran still remains the forth export destination with a share of almost 5.16 percent among others. Afghanistan's exports to Iran decreased from US dollars 10.39 million to USD 7.44 million during the period under review. The decrease in total exports to Iran was mainly from unspecified and seeds oil categories that has declined by 69 percent and 5 percent respectively.

The export of Afghan commodities to China increased by about 67 percent. Exports to China which was recorded at US dollar 4.28 million in the first six months of 1390; moderately went up to USD 7.15 million in the period under review.

Table 4.2: Direction of External Trade: First Half of FY 1391 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	51.71	35.88%	1064.36	23.53%	-1012.65
India	34.19	23.72%	119.61	2.64%	-85.42
Iran	7.44	5.16%	531.31	11.74%	-523.87
Germany	0.45	0.31%	135.84	3.00%	-135.39
China	7.15	4.96%	337.22	7.45%	-330.07
England		0.00%	76.24	1.69%	-76.24
Saudi Arabia	0.54	0.37%		0.00%	0.54
USA		0.00%	65.08	1.44%	-65.08
Common Wealth of Independent States (CIS)	22.74	15.78%	1028.81	22.74%	-1006.07
Japan		0.00%	104.64	2.31%	-104.64
Other Countries	19.90	13.81%	1060.65	23.45%	-1040.75
Total	**144.124**	**100%**	**4,523.76**	**100%**	**(4,379.64)**

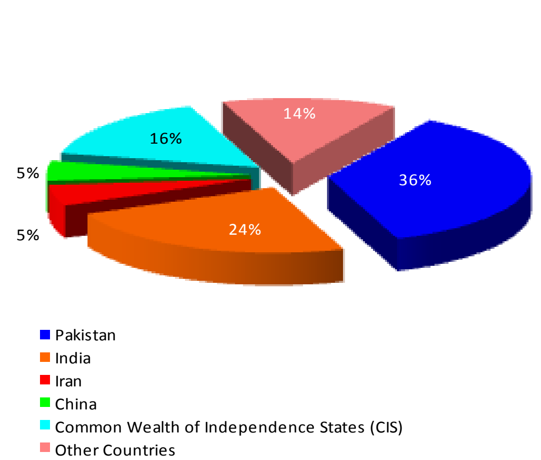
Source: *CSO and DAB staff calculations*

Table 4.3: Direction of External Trade: First Half of FY1390 (In million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	118.31	60.00%	406.28	15.63%	-287.97
India	20.19	10.24%	45.67	1.76%	-25.48
Iran	10.39	5.27%	201.91	7.77%	-191.52
Germany	1.40	0.71%	111.82	4.30%	-110.42
Common Wealth of Independence States (CIS)	17.55	8.90%	869.48	33.44%	-851.93
China	4.28	2.17%	300.96	11.58%	-296.68
Saudi Arabia	0.56	0.28%		0.00%	0.56
Japan		0.00%	237.92	9.15%	-237.92
England		0.00%	8.92	0.34%	-8.92
United States		0.00%	42.09	1.62%	-42.09
Other Countries	24.51	12.43%	374.79	14.42%	-350.29
Total	**197.19**	**100.00%**	**2599.84**	**100.00%**	**-2402.65**

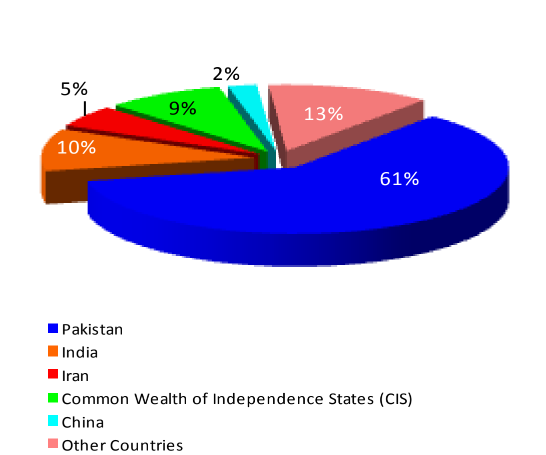
Source: *CSO and DAB staff calculations*

Figure. 4.2: Direction of Exports (% share) First Six Months of FY1391



Source: CSO and DAB Staff calculations

Figure. 4.3: Direction of Exports (% share), First Six Months of FY1390



Source: CSO and DAB Staff calculations

2.1 Composition of Trade

The composition of total Imports is illustrated in Figures 4.4 and 4.5. These figures compare the composition of imports in the first six months of FY1391, with the similar period of last year.

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

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

The composition of imports for the first six months of FY1391 indicates that imports of capital goods and others had the largest share in the total basket of imports, which has increased to 51 percent from 47 percent recorded a year ago. Imports of capital goods and others that were recorded at US dollar 1,229.25 million in the first six months of 1390, has remarkably increased to US dollar 2,298.41 million (almost 87 percent) in the period under review.

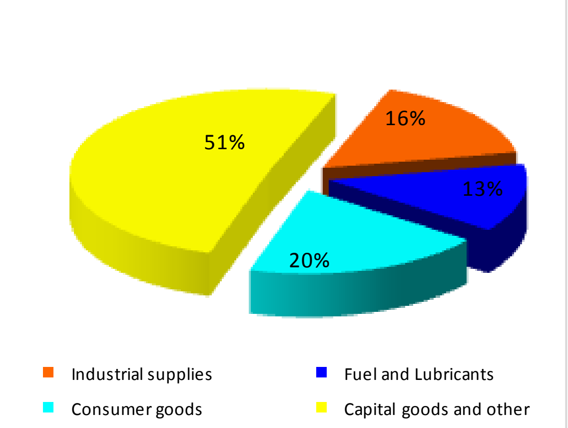
The second largest share was recorded for consumer goods which has increased notably by about 20 percent in the current period, from 11 percent recorded in the same period last year.

According to available data, expenditure on imports of consumer goods increased considerably by 199 percent, from US dollar 296.85 million in the first six months of 1390 to US dollar 886.99 million in the period under review. This increase in the consumer goods is mainly due to higher domestic demand for foreign goods, which incurred expenditure on certain food items in the quarter under review.

Similarly, industrial supplies had the third largest share in total of imports, which has increased by about 16 percent in the reporting period, from 12 percent in the corresponding period last year. Likewise, expenditure on imports of industrial supplies remarkably increased by about 144 percent, from US dollar 303.55 million to US dollar 741.53 million in the period under review. Industrial supplies normally cover metals, fertilizer, chemical, and cements, so the demand for these items has been increasing due to the implementation of development projects all over the country and shows the country's need to import these materials for economic development and sustained economic growth in the long-run.

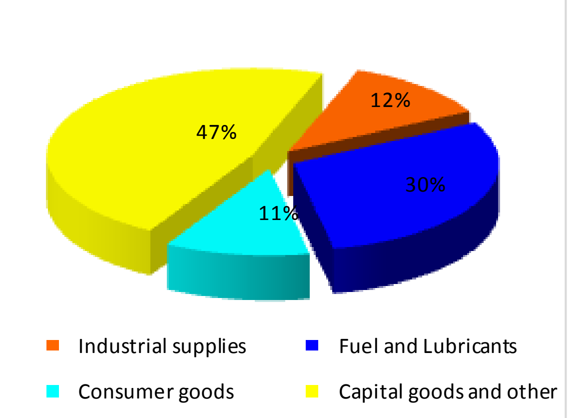
Conversely, expenditure on imports of fuel and lubricants (petroleum oil) in total imports reduced by about 23 percent, from US dollar 770.19 million with a share of 30 percent in the first six months of 1390 to US dollar 596.83 million with a share of 13 percent in the current period.

Figure 4.4: Composition of Imports (share%) First Six Months of FY1391



Source: *Central Statistics Office and DAB staff calculations*

Figure 4.5: Composition of Imports (share%) First Six Months of FY1390



Source: *Central Statistics Office and DAB staff calculations*

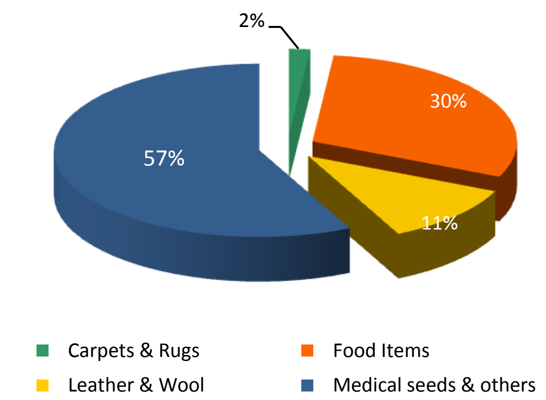
On the other hand, Figures 4.6 and 4.7 compare the composition of total exports in the first six months of FY1390, with that in the corresponding period of FY1391.

According to merchandise trade statistics, medical seeds and others which had the largest share of total exports, calculated at 51 percent in the first six months of 1390, still remains the largest share, 57 percent of total exports, although the value of exports indicates a decline of almost 19 percent, based on six month comparison of merchandise trade statistics.

The second largest share recorded for food items, which remained unchanged at 30 percent in the period under review. However, in terms of value, it shows a notable decline of 27 percent, from US dollars 59 million in the first six months of 1390 to US dollars 43.28 million in the period under review. In addition, leather and wool has the third largest share of total exports in the first six months of FY1391. Exports of such items increased from US dollars 15.51 million with a share of 8 percent in the first six months of 1390 to US dollar 15.96 million with a share of 11 percent in the current period.

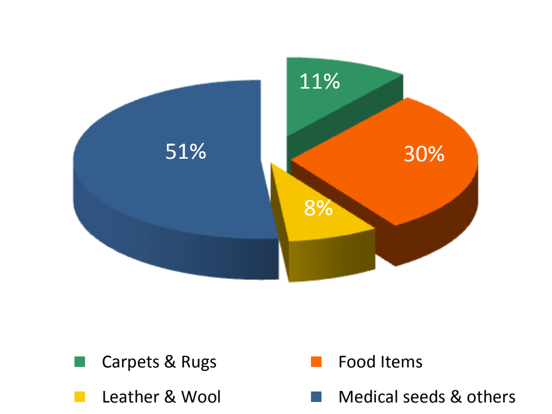
Finally, carpets and rugs which are considered the main component of Afghan exports in the past decades, significantly posted a decrease of 89 percent, from US dollar 21.04 million, with a share of 11 percent to US dollar 2.39 million, with a share of 2 percent in the period under review.

Figure 4.6: Composition of Exports (share%) First Six Months of FY1391



Source: Central Statistics Organization/DAB staff calculation

Figure 4.7: Composition of Exports (share%) First Six Months of FY1390



Source: Central Statistics Organization/DAB staff calculation

3. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt stock stood at US dollar 2,502.60 million as of Sep 21, 2012. During the period under review, 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 some significant debt forgiveness on principal amount and service charges during the first six months of FY1391.

Based on MoF's data, Afghanistan's total loans amounts payable to the Paris-Club creditors at the end of the first six months of FY1391 stood at US dollar 1,100.05 million which is only payable to the Russian Federation.

In other words, Afghanistan's total debt from Paris Club members stands at about 43.96 percent of the total current external debt which decreased by about 5 percent in comparison with the similar period of last year.

The following table illustrates the overall picture of current external debt of Afghanistan until the end of the first six months of FY1391.

Table 4.4: External Debt: Second Quarter of FY1391 (in units indicated)

	In million USD	Percent of total
Total external debt	2,502.60	100.00
Bilateral	1,229.21	49.12
Paris Club	1,100.05	43.96
Russian Federation	1,100.05	43.96
United States	-	0.00
Germany	-	0.00
Non-Paris Club	129.15	5.16
Multilateral	1,273.40	50.88
of which: IDA (World Bank)	420.68	16.81
Asian Development Bank	690.35	27.59
International Monetary Fund	135.51	5.41
Islamic Development Bank	24.86	0.99
OPEC Fund	2.00	0.08

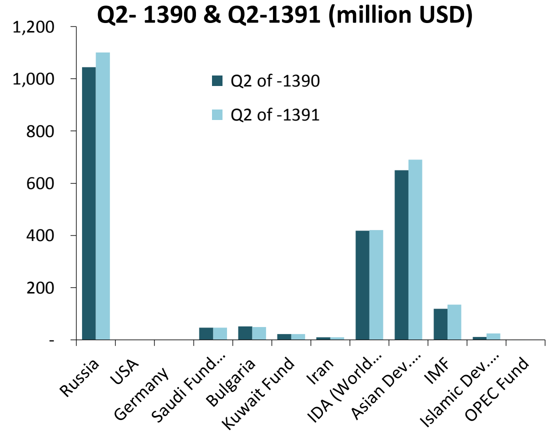
***Source**: Debt Asset Management Unit, Ministry of Finance, Afghanistan*

Furthermore, Non-Paris Club creditors which include the Saudi Fund for Development, Bulgaria, Kuwait Fund and Iran stood at USD 129.15 million in the first six months of 1391.

On the other hand, multilateral credit stood at US dollar 1,273.40 million compared to US dollar 1,200.1 million at the end of the similar period of last year, which shows an increase of about 6 percent.

Figure 4.8 compares Afghanistan's external debt stock for the first six months of 1390 and FY1391.

Figure 4.8: External debt comparisons: Q2- 1390 & Q2-1391 (million USD)



***Source:** Treasury Department/MoF/DAB staff calculation*

3. NET INTERNATIONAL RESERVES

The Net International Reserves (NIR) held by the Da Afghanistan Bank, consist of monetary gold, reserve position and holdings with the

IMF and special drawing rights (SDR), as well as holdings of foreign exchange in Afghanistan and abroad such as US dollars, euro, GBP and other major currencies. The NIR communicated in US dollars, are defined as reserve assets minus reserve liabilities.

During the period under review, the NIR increased by almost 10 percent to US dollar 6,178.55 million, up from US dollar 5,618.89 million recorded in the same period of last year. The increase in the NIR was mainly dominated in a substantial increase in the reserve assets, which increased by 11 percent from US dollar 5925.35 million in the first six months of 1390 to US dollars 6,580.06 million in the period under review.

At the same time, reserve liabilities increased substantially by about 31 percent, from US dollars 306.46 million to US dollars 401.50 million in the reporting period, which shows that the reserve assets are noticeably higher than the reserve liabilities. The increases in reserve liabilities mostly attributed to the commercial bank deposits in foreign currency. It increased by about 50.86 percent from US dollars 186.87 million in the first six months of 1390, to US dollars 281.91 million in the period under review.

The reserve liability of non-resident deposits in foreign currency and use of fund resources remaining unchanged during the six months of FY1391, compared with the similar period of last year.

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

Table 4.5 illustrates the overall picture of Net International Reserves of Afghanistan from 1388 up to end of the first six months of FY 1391.

Table 4.5: Net International Reserves, 1390 (million of USD)

Changes in the previous quarter	1388	% Changes	1389	% Change	First 6 months of 1390	% change	First 6 months of 1391	% change
Net International Reserves (million US Dollar)	4,007.15	23.22	5,099.46	27.26	**5,618.89**	10.19	**6,178.55**	9.96
Reserve Assets	4,208.52	22.71	5,403.21	28.39	**5,925.35**	9.66	**6,580.06**	11.05
Reserve Liabilities	201.37	10.91	303.75	50.84	**306.46**	0.89	**401.50**	31.01
Commercial bank deposits in foreign currency	85.95	4.00	184.15	114.24	**186.87**	1.48	**281.91**	50.86
Non-resident deposits in foreign currency	0.25	-89.57	0.11	-55.72	**0.11**	0.00	**0.11**	0.00
Use of Fund resources	115.16	17.53	119.48	3.75	**119.48**	0.00	**119.48**	0.00
Gross Intl. Reserves (in months of import)	15.14		12.58		**13.67**		**8.73**	
Net Intl. Reserves (in months of import)	14.41		11.87		**12.97**		**8.19**	

The increase in NIR could be attributed to considerable inflows of foreign exchange, particularly from foreign donations and personal remittances. The current position of NIR is considerably strong enough to finance around 10.86 months of imports, while countries with 6 months coverage of imports enjoy a relatively comfortable reserve position.

Figure 5.11 represents the net international reserves of Afghanistan for the past few years.

CHAPTER V

FISCAL SECTOR DEVELOPMENTS

5

FISCAL DEVELOPMENTS

The overall fiscal performance during the second quarter of 1391 was sluggish due to lower collection in domestic revenues and rise in operating expenditures. The fiscal sustainability indicator was at 56 percent, which defines that about 56 percent of operating expenses was financed by domestic revenues. In addition, the fiscal sustainability indicator went down from 82 percent in the first quarter to 56 percent in the second quarter 1391.

The fiscal policy in Afghanistan under the government and the IMF's new economic program, the Extended Credit Facility, is defined as the government's inter-temporal budget constraint that requires it to raise enough revenue in the future to cover all its non-interest spending and also to service and eventually to pay off its outstanding debt. The fiscal sustainability has remained one of the government's objectives to meet the future obligation of fiscal growth, price stability, full employment and economic growth.

Like other emerging and less developing economies around the world, a budget imbalance exists in Afghanistan. Total core budget in the second quarter of 1391 was in surplus according to the report by the Ministry of Finance. Total revenues including donor grants exceeded core expenditures in the quarter under review, leading to a budget surplus of AF 2,967.24 million, showing only 5 percent surplus.

During the first six months of FY1391, total revenues including grants increased to AF 123,404.639 million, up from AF 88,027.655 million compared to a year ago. However, for the second quarter of FY 1391 total revenue was AF 66,840.589 million. Total domestic revenues excluding grants were AF 25,848.116 million, up from AF 24,464.073 million, showing a 11 percent increase in the second quarter of 1391. Total domestic revenues in the quarter under review account for 3 percent of GDP.

Total core expenditures during the first six months of FY1391 were AF 102,265.39 million, up from AF 75,641 million in the same period of the previous year. In the quarter under review, total core expenditure increased to AF 63,873.35 million, up from AF 47,195 million in the second quarter of 1390, of which operating expenses were AF 44,529.53 million and development expenses were AF 19,343.819 million. Total expenditures in the quarter under review account for 7 percent of GDP.

Donor contributions are used to finance both, development and partly operating expenditures. The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 40,992.47 million in the quarter under review, up from AF 20,192.55 million in the second quarters of FY1390, which shows a 75 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

For the second quarter-ended Sunbula 30, FY1391, the Government recorded domestic revenues of AF 51.307.453 million, an increase of 10 percent on a constant currency basis compared to the prior-year period of six months. Total domestic revenues excluding grants, for the quarter under review was AF 25,848.12 million, up from AF 24,464.07 million, showing a 6 percent increase over the prior-year (1390). However, the collected revenues missed the quarterly target of AF 29 million, agreed with IMF under the Extended Credit Facility (ECF) program.

During the first six months, total consolidated revenues including revenues from donor loans grew to AF 123,404.639 million, which increased by 40 percent, compared to the total revenue collection of AF 88,027.655 million during the same period of 1390. Domestic revenue contribution to consolidated revenues totaled AF 51,307.453 million, representing an increase of 10 percent compared to the amount of AF 46,737.901 million in the year 1390, despite the fact of a missing target collection of AF 57,141.4 million. Regardless to the sluggish performance of revenue collection and not receiving the Kandahar custom office's revenue, most of the increase in domestic revenues was mainly due to the tax revenue collection.

Total revenues during the first six months of FY1391 comprise AF 37,071.896 million of tax revenues and custom duties, AF 1,441.865 million of social contribution, AF 12,793.693 million of the other revenues and donor contributions of AF 72,097.186 million, compared to amounts of AF 33,348.140 million, AF 1,071.324 million, AF 12,318.438 million and AF 41,289.754 million respectively during the same period last year. Total revenues including donor grants accounted for 7 Percent of GDP.

Total revenues in the second quarter of FY1391 comprise AF 18,573.18 million of tax revenues and custom duties, AF 845.48 million of social contribution, AF 6,429.46 million of the other revenues and donor contributions of AF 40,992.47 million respectively. Total domestic revenues accounted for 3 Percent of GDP.

The sluggish performances in domestic revenue collection in the second quarter were driven primarily by a disruption in Afghan imports in the Pakistan borders. In addition, lower investment levels were reported in the quarter under review, compared to the same period of the previous year.

Total tax collections showed an increase in the period under review. In accordance to receipts, overall tax revenue increased from AF 17,620.22 million to AF 18,573.18 million, showing a 5 percent increase in the quarter under review. On a constant currency basis, total consolidated tax revenues excluding custom duties grew to a record AF 12,146.35 million for the second quarter, an increase of 25 percent, or AF 2,442.89 million, compared to the prior-year period which amounted AF 9,703.46 million. However in most of tax categories the revenue collection performances were lethargic.

Total fixed tax revenues increased in AF 4,959.453 million, up from AF 4,505.297 million, representing an increase of AF 454.16 million, or 10 percent compared to the prior-year period. Although, total fixed revenue collection decreased to AF 2,410.36 million down from AF 2,482.75 million showing a 3 percent decline during the quarter under review compared to the same quarter of the previous year.

Total income tax revenues grew to AF 7,593.444 million in the first six months, representing an increase of AF 2,646.03 million, or 53 percent from amount of AF 4,947.417 million in the prior-year period. For the quarter under review, total revenues from income tax amounted to AF 3,992.33 million, up from AF 2,223.27 million, showing 80 percent increment compared to the same period of 1390.

Total custom duties decreased to AF 6,426.83 million for the second three months ended Sunbula, 30, 1391, representing a decrease of 19 percent or AF 1,489.93 million from AF 7,916.76 million in the prior-year period. However, this is important to mention that total amount of custom duties do not include amounts collected from the custom offices of Kandahar province.

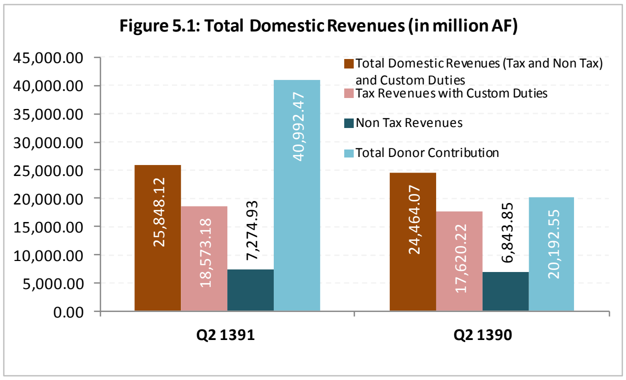
Sales tax collections made up from AF 7,551.743 million to AF 9,470.261 million with 25 percent increment for the first six months of the FY 1391, nonetheless, there was 23 percent of increase in the second quarter with a total collection of AF 5,192.58 million, up from AF 4,206.52

million in the same period of previous years. Total revenues from property taxes decreased by 10 percent, down from AF 176.263 million recorded in the first six months of FY1390 to AF 159.192 million during six months of FY1391. In the quarter under review, property tax collection totaled AF 59.64 million, down from AF 93.15 million, representing a 36 percent decline from the same quarter of last year. According to receipts for other taxes, total amount for the first six months of FY1391 revenues were higher by 10 percent with the collection of AF 1,080.896 million from AF 894.207 million, although, other tax collection for the quarter under review represented 27 percent decrease from amount of AF 541.88 million to AF 393.43 million compared to the same quarter of 1390 and also remained below the YTD target of AF 8,542.00 million.

The overall performances of the domestic revenue collection were sluggish. Regardless to the fact that the total collection of custom duties does not include duties from custom offices of Kandahar for the second quarter of FY1391.

During the quarter under review, the overall performance of other taxes which constitutes the largest source of revenues in Afghanistan, was sluggish compared to the same period of the previous year. Despite the fact that new routes were introduced recently this had to add in the total collection of domestic revenue.

Collections in the major revenue categories are shown in summary form in Table 5.1. Detailed information is presented in the appendix 1:



Source: *Ministry of Finance website and DAB staff calculation.*

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.

Table 5.1: Revenue Collection, (in million AF)

Tax and Non- Tax Revenues	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY 1390 Actual	1390 YTD Actual	Quarterly % Change	YTD % Change
Total Domestic Revenues (Tax and Non Tax) and Custom Duties	**25,848.12**	**123,404.64**	**24,464.07**	**88,027.66**	11%	40%
Tax Revenues with Custom Duties	18,573.18	37,071.90	17,620.22	33,348.14	5%	11%
Non Tax Revenues	7,274.93	14,235.56	6,843.85	13,389.76	4%	6%
Total Donor Contribution	40,992.47	72,097.19	20,192.55	41,289.75	75%	75%

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

Table 5.2: Revenue Collection (in million USD)

Tax and Non- Tax Revenues	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change
Total Domestic Revenues (Tax and Non Tax) and Custom Duties	**501.22**	**2,600.18**	**515.47**	**1,843.13**	-3%
Tax Revenue with Custom Duties	391.34	718.87	371.26	698.24	5%
Non Tax Rev	152.32	299.95	144.20	280.36	6%
Total Donor Contribution	794.89	1,519.11	425.46	864.53	87%

Source: MoF website and DAB staff estimation (End period average exchange rate of Q2 FY1391 (51,57) and Q2 FY 1390 (47.76)

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

Tax and Non- Tax Revenues	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change	YTD % Change
Fixed Taxes	2,410.36	4,959.453	2,482.75	4,505.297	-3%	10%
Income Taxes	3,992.33	7,593.444	2,223.27	4,947.417	80%	53%
Property Taxes	59.64	159.192	93.15	176.263	-36%	-10%
Sales Taxes	5,192.58	9,470.261	4,206.52	7,551.743	23%	25%
Excise Taxes	-	-	-	-	-	-
Other Taxes	393.43	1,080.896	541.88	894.207	-27%	21%
Tax Penalties and Fines	98.01	188.823	155.90	275.658	-37%	-32%
Customs duties	6,426.83	13,619.826	7,916.76	14,997.554	-19%	-9%
Total taxation revenues	**18,573.18**	**37,071.896**	**17,620.22**	**33,348.140**	**5%**	**11%**
Retirement contributions	845.48	1,441.865	609.13	1,071.324	39%	35%
Total social contributions	**845.48**	**1,441.865**	**609.13**	**1,071.324**	**39%**	**35%**
Income from Capital Property	48.82	2,632.042	86.95	2,523.885	-44%	4%
Sales of Goods and Services	1,557.45	2,746.989	1,297.35	2,276.657	20%	21%
Administrative Fees	1,706.22	3,922.403	2,615.21	3,917.650	-35%	0%
Royalties	49.74	125.810	65.19	105.737	-24%	19%
Non Tax Fines and Penalties	118.56	252.618	148.86	297.170	-20%	-15%
Extractive Industry	38.08	96.540	19.04	31.340	100%	208%
Miscellaneous Revenue	2,853.76	2,862.228	1,995.72	3,137.176	43%	-9%
Sale of Land and Buildings	56.84	155.062	6.40	28.823	788%	438%
Total other revenue	**6,429.46**	**12,793.693**	**6,234.72**	**12,318.438**	**3%**	**4%**
ARTF	8,670.81	5,826.480	2,280.71	5,826.481	280%	158%
LOTFA	9,435.54	12,010.790	5,943.96	12,010.789	59%	8%
CSTC - MoD		18,102.110		18,102.111	91%	77%

	14,539.34		7,622.19			
Foreign loans						
World Bank	2.47	63.170	63.17	63.166	-96%	-96%
ADB	464.68	473.330	396.67	473.327	17%	64%
Other	122.39	151.330	149.29	151.334	-18%	-19%
Donor revenue						
World Bank	1,221.87	2,001.630	1,538.99	2,001.632	-21%	-8%
EC	-	-	-	-	-	-
ADB	3,197.49	1,041.740	622.02	1,041.743	414%	465%
DFID	-	12.140	12.14	12.137	0%	0%
US & USAID	2,831.31	1,068.540	1,052.66	1,068.541	169%	165%
Others	506.58	538.490	510.74	538.493	-1%	-5%
Total Donor Contributions	**40,992.47**	**41,289.75**	**20,192.55**	**41,289.754**	**103%**	**75%**

Source: *MoF website and DAB staff calculations.*

2. EXPENDITURES

Core expenditures rose by AF 26,624.17 million presenting 21 percent increment, reaching AF 102,265.39 million during the first six months of FY1391 versus AF 75,641 million recorded during the same period of FY1390. Core expenditures in the quarter under review accounted for 7 percent of GDP.

Total core expenditures classified into development and operating expenditures. Development expenditures increased to AF 26,901.71 million in the first six months of FY1391, up from AF 16,852.310 million in the same period of 1390, showing a 60 percent increase. During the second quarter of FY1391, total development expenditures were AF 19,343.819 million, which shows 68 percent increase over the amount of AF 11,510.748 million recorded in the same period of last year. Development expenditures accounted for 2 percent of GDP.

The current or operating expenditures increased to AF 75,363.68 million in the first six months of FY1391, up from AF 58,788.91 million in the same period of 1390, this represents 28 percent increase and accounts for 5 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 MRRD where their budget execution process was 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 consist of following 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 59,900.388 million during six months of FY1391, up from AF 48,077.280 million in the same period of 1390, which represents a 25 percent increase. Current expenditure increased from AF 44,529.53 million in the second quarter of FY1391, up from AF 35,684.65 million in the same period of FY1390, showing a 25 percent rise. According to FPU/MoF, the increase in operating expenditures was due to higher wage bill for the civil servants, and rise in security forces strengths, both Afghan National Army and Afghan National Police and implementation of reforms in the public sector. 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.

During the first six months of FY1391, expenditures on interest payments increased to AF 46.747 million, up from AF 44.733 million, representing 5 percent increment. However, in the second quarter of FY1391, total interest payments were AF 6.30 million, down from AF 7.22 million recorded in the same period of last year, which indicates 13 percent decrease.

According to the MoF's Fiscal Bulletin, 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 a concessional basis to help it to finance its development projects.

Subsidies, grants, and social transfers are the third largest components of the recurrent expenditures, this includes subsidies to state-owned enterprises, capital transfers to municipalities and pensions to retired public servants. About 4 percent of the expenditures in this category is spent on social transfers, principally pensions. Expenditures on subsidies, grants and contribution increased to AF 5,490.537 million in the first six months of FY1391, up from AF 3,398.421 million, presenting 62 percent increment. While on the quarterly basis, expenditures on subsidies was up from AF 2,386.59 million in the second quarter of 1390, to AF 2,946.64 million in the quarter under review, this represents a 23 percent increase.

Consolidated adjusted development expenditures was AF 26,901.71 million for the first six months ended Sunbula 30, 1391, representing an increase of AF 10,049.40 million, or 60 percent, up from AF 16,852.310 million in the prior-year period. On a constant currency basis, consolidated adjusted development expenditures increased by AF 7,833.071 million or 68 percent with amount of AF 19,343.819 million, up from AF 11,510.748 million in the prior-year period.

The total finances includes significant expenditures incurred during fiscal year 1391 to support future period expansion and growth, as well as additional operating expenses related to a large number of recent additions to 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.

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

Particulars	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change	YTD % Change
Total Expenditures(Development and Operating)	**63,873.35**	**102,265.39**	**47,195.40**	**75,641.21**	35%	35%
Development Expenditures	19,343.82	26,901.71	11,510.75	16,852.31	68%	60%
Operating Expenditures	44,529.53	75,363.68	35,684.65	58,788.91	25%	28%

Source: Ministry of Finance website and DAB staff calculation

Table 5.5: Core Expenditures as of Second Quarter of 1390 (in million USD)

Particulars	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change	YTD % Change
Total Expenditures(Development and Operating)	**1,238.58**	**1,982.66**	**994.42**	**1,583.78**	25%	25%
Development Expenditures	375.10	521.55	242.54	352.85	55%	48%
Operating Expenditures	938.25	1,461.10	751.89	1,230.92	25%	19%

Source: MoF website and DAB staff estimation (End period average exchange rate of Q2 Year 1391 (51,57) and Q2 Year 1390 (47.76)

Table 5.6: Total Development Expenditures (in million AF)

Particulars	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change	YTD % Change
Travel	106.78	151.160	54.43	75.027	96%	101%
Communications	-	-	-	-		-
Contracted services	7,477.10	9,181.082	3,380.65	4,434.227	121%	107%
Repairs and maintenance	36.72	44.433	49.87	66.744	-26%	-33%
Utilities	90.55	101.168	35.08	49.293	158%	105%
Fuel	20.37	24.393	14.88	18.375	37%	33%
Tools and materials	177.94	218.285	89.39	123.177	99%	77%
Other	68.87	107.171	118.96	164.910	-42%	-35%
Advances and return of expenditure	1,465.05	2,787.135	986.16	1,163.626	49%	140%
Total supplier expenses	**9,443.39**	**12,614.827**	**4,729.41**	**6,095.379**	**100%**	**107%**
Grants	-	-	-	-	-	-
Grants to foreign governments	-	-	-	-	-	-
Social Security cash benefits	-	-	-	-	-	-
Social assist benefit in cash	-	-	-	-	-	-
Advance Subsides Grants	-	-	-	-	-	-
Total subsidies, grants, contributions and pensions exp.	-	-	-	-	-	-
Buildings and structures	5,987.74	10,089.824	3,347.55	5,067.935	79%	99%
Machinery and equip (>50,000)	467.83	645.710	1,193.11	1,377.316	-61%	-53%
Valuables	1.14	1.136	3.00	3.002	-62%	-62%
Land	-	0.000	9.63	9.625	0%	0%
Capital advance payments	3,443.72	3,550.214	2,228.05	4,299.052	55%	-17%
Total capital expenditure	**9,900.43**	**14,286.88**	**6,781.33**	**10,756.93**	**46%**	**33%**
Interest	-	-	-	-	-	-
Total interest expenditure	-	-	-	-	-	-

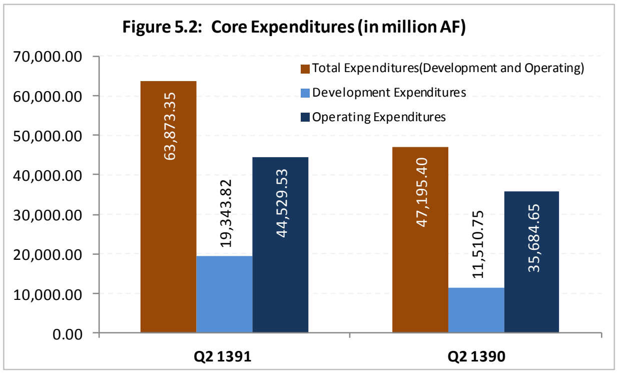
Source: Ministry of Finance website and DAB staff calculation

Source: *MoF website and DAB staff calculations*

Table 5.7: Total Operating Expenditures (in million AF)

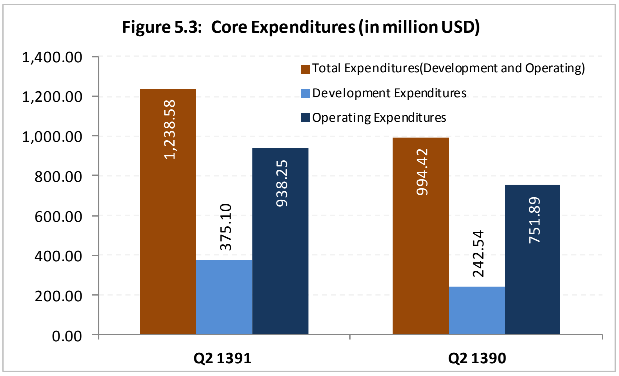
Particulars	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	Qtr % Change	YTD % Change
Salaries in cash	28,082.76	50,320.606	23,565.85	41,119.833	19%	22%
Salaries in kind	6,030.89	9,083.184	4,509.94	6,384.615	34%	42%
Salaries and wages advance	113.30	199.252	61.10	320.823	85%	-38%
Social benefits in cash	164.04	297.347	151.46	252.008	8%	18%
Social benefits - in kind	-	0.000	-	0.000	0%	0%
Total employee expenditure	**34,390.99**	**59,900.388**	**28,288.35**	**48,077.280**	**22%**	**25%**
Travel	530.79	760.453	301.44	546.590	76%	39%
Communications	-	-	-	-		
Contracted services	188.54	295.932	62.42	106.571	202%	178%
Repairs and maintenance	253.00	373.737	531.55	651.685	-52%	-43%
Utilities	2,191.74	2,951.414	440.20	621.131	398%	375%
Fuel	1,098.97	1,533.788	1,101.35	1,499.848	0%	2%
Tools and materials	1,516.22	2,030.754	1,374.34	1,890.889	10%	7%
Other	485.14	789.685	420.53	517.633	15%	53%
Advances and return of expenditure	89.82	175.278	415.35	906.905	-78%	-81%
Total supplier expenses	**6,354.23**	**8,911.041**	**4,647.18**	**6,741.252**	**37%**	**32%**
Grants	1,013.80	1,014.900	22.70	28.600	4366%	3449%
Grants to foreign government	-	0.000	-	0.000	0%	0%
Social security cash benefits	1,910.39	4,146.787	1,937.00	2,927.331	-1%	42%
Social assist benefit in cash	24.69	131.094	16.89	32.490	46%	303%
Advance Subsides Grants	(2.24)	197.756	410.00	410.000	-101%	-52%
Total subsidies, grants, contributions and pensions expenditure	**2,946.64**	**5,490.537**	**2,386.59**	**3,398.421**	**23%**	**62%**
Buildings and structures	163.48	195.558	97.18	169.384	68%	15%
Machinery and equipment (>50,000)	647.60	773.682	104.28	142.787	521%	442%
Valuables	11.11	11.110	-	0.107		
Land	4.15	25.776	106.12	119.580	-96%	-78%
Capital advance payments	5.02	8.839	47.72	95.363	-89%	-91%
Total capital expenditure	**831.36**	**1,014.965**	**355.30**	**527.220**	**134%**	**93%**
Interest	6.30	46.747	7.22	44.733	-13%	5%
Total interest expenditure	**6.30**	**46.747**	**7.22**	**44.733**	**-13%**	**5%**

Source: *MoF website and DAB staff calculations*



Source: Ministry of Finance website and DAB staff calculation

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



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 72,097.186 million in the first six months of FY1391, up from AF41,289.754 million in the same period of fiscal year 1390, which represents a 75 percent increase.

According to Fiscal Policy Unit/MoF, donor contributions comprised an important part of the national budget. Donor grants finance major expenditure items in the operating budget, especially security related expenditures. The grants finance bulk 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.

During the first six months of FY1391 total donor grants for development expenditures were AF 55,333.64 million, up from AF 31,275.42 million, showing a 77 percent increase compared to the same period last year. In the quarter under review, development expenditure reached AF 29,173.63 million, up from AF 13,611.57 million, showing a 114 percent increase. While, grants for operating expenditures in the first six months of FY1391 was AF 16,763.55 million, up from AF 10,014.34 million recorded a year ago. During the second quarter of FY1391, grants for current expenditures increased from AF 6,580.97 million to AF 11,818.84 million, showing 80 percent increment compared to the same period of the previous year.

Table: 5.8: Total Donor Contribution, Q2 1391 and Q2 1390 (in million AF)

Donor Contribution	Q2 FY1391 Actual	1391 YTD Actual	Q2 FY1390 Actual	1390 YTD Actual	% Change	YTD % Change
Afghanistan Reconstruction Trust Fund	8,670.81	15,057.186	2,280.71	5,826.481	280%	158%
Law and Order Trust Fund - Afghanistan	9,435.54	12,993.619	5,943.96	12,010.789	59%	8%
CSTC - MoD	14,539.34	32,074.328	7,622.19	18,102.111	91%	77%
Foreign loans						
World Bank	2.47	2.468	63.17	63.166	-96%	-96%
Asian Development Bank	464.68	774.087	396.67	473.327	17%	64%
Other	122.39	122.388	149.29	151.334	-18%	-19%
Donor revenue						
World Bank	1,221.87	1,850.560	1,538.99	2,001.632	-21%	-8%
European Commission						
ADB	3,197.49	5,880.867	622.02	1,041.743	414%	465%
DFID			12.14	12.137	-100%	-100%
US and USAID	2,831.31	2,831.313	1,052.66	1,068.541	169%	165%
Others	506.58	510.371	510.74	538.493	-1%	-5%
Total donor contributions	40,992.47	72,097.186	20,192.55	41,289.75	103%	75%

Source: Ministry of Finance website and DAB staff calculation

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

Donor contributions	Operating Grants	Development Grants
Afghanistan Reconstruction Trust Fund	10,244.16	4,813.03
Law and Order Trust Fund - Afghanistan	12,993.62	
CSTC - MoD	32,074.33	
Foreign loans		
World Bank		2.47
Asian Development Bank		774.09
Other		122.39
Donor revenue		
World Bank		1,850.56
European Commission		
ADB		5,880.87
DFID		
US and USAID		2,831.31
Others	21.53	488.84
Total donor contributions	55,333.64	16,763.55

Source: *Ministry of Finance website and DAB staff calculations.*

The main donor contributors to the development expenditures are as follows: ARTF, LOTFA, ADB, DFID, EC, World Bank, CSTC, US and USAID (See Table 5.8).

CHAPTER VI

BANKING SYSTEM PERFORMANCE

6

BANKING SYSTEM PERFORMANCE

Asset base of the banking sector grew by 2.24 percent or AF 4.70 billion over the second quarter of 1391 (Sep. 2012) reaching 214.03 billion against AF 209.32 billion in the preceding quarter. While compared to the same previous period the asset base decreased by 1.86 percent or AF 4.06 billion. Gross loans depicted 2.76 points growth over the quarter and 6.22 percent from the previous year. Deposits stood at AF 187.46 billion, up by 2.23 percent from the previous quarter. Deposits were largely denominated in USD (65.40 percent) with Afghani denominated deposits lagging at 31.63 percent. AF-denominated deposits indicated a decrease of 0.99 percent, while USD denominated deposit were up by 2.79 percent. Deposits showed a 15.09 percent increase from the same period of previous year (Sep. 2011). The entire banking sector remains well capitalized. The capital of the system stands at AF 15.00billion, increased over the quarter by 4.54 percent, but was down by 3.53 percent since the previous period attributed to losses from a number of banking institutions. The capital adequacy ratio (CAR) of the banking sector of20.88 percent decreased slightly over the previous quarter.

On a cumulative basis in the second quarter of 1391 (Sep. 2012) the banking sector incurred losses amounting to AF 79 million against AF 1.43 billion of the previous periods or reduced by AF 1.35 billion since June, 2012 mainly on account of a significant decrease in credit provisions. The return on Assets (ROA) reached -0.08 percent while return on equity (ROE) was -1.03 percent against last quarter's -2.80 percent and -36.65 percent, respectively. Comparing to the previous year losses were down by AF 390 million. Private Banks and branches of foreign banks finished with profits, while state-owned banks ended up with losses for the quarter under analysis.

The number of branches of foreign banks declined from five to four during September 2012, due to the withdrawal of Standard Chartered Bank from the local market. This was a decision made by the bank and approved in the normal course of business by DAB. Most of the assets, liabilities, facilities, and staff of SCB transitioned to a private bank already licensed to operate in Afghanistan. Some comparisons below both at the Q-o-Q and Y-o-Y basis will be slightly distorted by this transaction; however, the overall system numbers have not been adversely impacted.

1. ASSET OF THE BANKING SYSTEM

The asset size of the banking sector grew by 2.24 percent, standing at AF 214.03 billion by the end of September, 2012, against the 0.44 percent growth at the end of June, 2012. Figure 6.1

The break-up of total assets reveals that the most obvious increase was registered by “inter-bank claims” (up by AF 10.44 billion or 26.26 percent) The second major increase was posted by cash in vault and claims on DAB(AF 5.27Billion or 5.35 percent);while other components of total assets evidenced decreases.

As Compared to previous year (September, 2011) the asset base of the system decreased by 1.86 percentage points.

The most important components of the system’s total asset portfolio were cash in vault/claims on DAB (48.43percent), inter-bank claims (23.46 percent),net lo05ans (17.98 percent) and “other assets” (6.74percent).While the share of other components of total assets were negligible, Table 6.1.

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

Assets	Sunbula 1390 Sep. 2011	Jawza 1390 March 2012	Sunbula1391 Sep. 2012	% of Total	Q-o-Q
Cash in vault and claims on DAB	83,688	98,374	103,646	48.43	5.35
Inter-bank claims	35,139	39,763	50,208	23.46	26.26
Investments	4,509	6,582	6,150	2.87	-6.56
Loans (Net)	35,833	37,599	38,486	17.98	2.35
NDF	10,381	7,174	1,107	0.52	-84.56
Others	48,540	19,832	14,432	6.74	-27.22
Total	218,090	209,324	214,029		2.24
Liabilities					
Deposits	162,873	183,363	187,459	94.19	2.23
Borrowings	1,690	2,584	2,413	1.21	-6.50
NDT	327	1,002	1,399	0.70	39.62
Others	37,649	8,025	7,756	3.89	-3.35
Total	202,539	194,974	199,027		2.08

Source: *Financial Supervision Department (FSD)/DABhe*

Figure 6.1: Share of the Banking Sector (Total assets) across the banking group

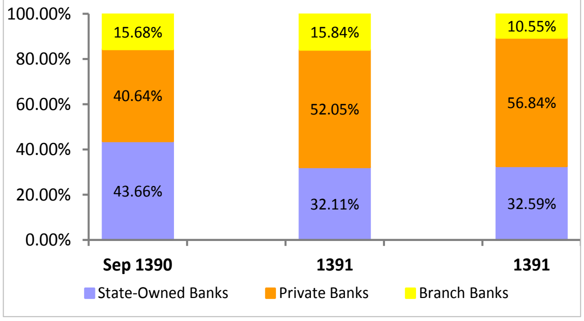
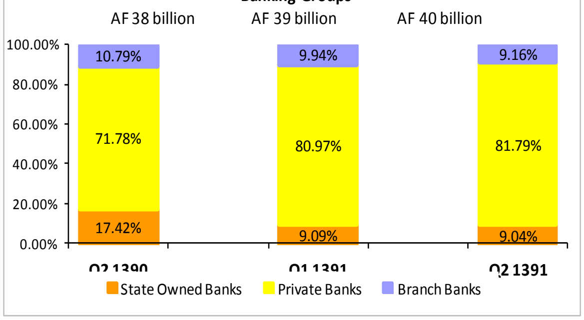


Figure 6.2: Share of Gross Loans Portfolio among Banking Groups



Source: *Financial Supervision Department, DAB*

1.1 Gross Loans

Total gross loans indicated AF 1.08 billion increases over the quarter, constituting 18.82 percent of the total assets. Increases in lending were observed at five banking institutions, whereas in nine, decreases were observed. One branch of the foreign bank did not participate. However, more than two-thirds of the growth in loans is attributable to the private bank group.

Compared to the preceding year total gross loans posted a 6.22 percent increase.

Private Banks are the leading lenders, compared to the previous quarter their portfolios both in absolute term as well as percentage of total loans has increased, currently standing at AF 32.94 billion or 81.79 percent of total loans. The portfolio of branches of foreign banks and that of State-owned banks were AF 3.69billion (9.16 percent) and AF 3.64 billion (9.04 percent) in shares and amount respectively.

Private Banks are the leading lenders, but compared to the previous period, their portfolios, both in absolute terms as well as percentage of total loans has decreased, currently standing at AF 29.44 billion or 73.52 percent of total loans. This decrease in private bank portfolios was mainly due to the splitting of the crisis stricken bank into New Kabul Bank and Receivership, where good assets passed to the New Kabul Bank and non-performing assets (mainly loans) remained with the receivership. The portfolio of State-owned banks and that of branches of foreign banks were AF 6.04 billion (15.08 percent) and AF 4.56 billion (11.39 percent) in shares and amount respectively.

1.2 Loan Loss Reserves

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

By the end of September, 2012 (Sunbula, 1391), a total provision cover of the system was 4.43 percent of total gross loans in comparison with4.06 percent previous quarter and5.49 percent last year September, 2011.

1.4 Distribution of Credit

Sector wise analysis shows that the major portion of the loan portfolio is classified as “other commercial loans” (67.44 percent against 65.63 percent last quarter and 63.80 percent last year), mainly in the trade sector (27.62 percent against 28.01 percent last quarter). Increases in credit in manufacturing, services and agriculture sectors have been observed during the quarter, while communication, residential and mortgage loans to individuals, trade and in all other loan sectors posted declines. Compared to last year increases have been observed both in absolute and percentage of the total loans in Services, Manufacturing, and Agriculture sectors. Concentration in other commercial loans and mortgage loans to the exclusion of all other types of lending has been the dominant trend. Lending in the Commercial Real Estate and Construction Loans, Trade, consumer loans, Residential Mortgage Loans to Individuals and “all other loans” categories of total loans have witnessed decreases during this period (Table 6.4). Loans to SMEs and Micro Credit standing at AF 6.02 billion provided by seven banking institutionsdepictedAF223 million and an AF2.90billion decrease in the SME sector since previous quarter and year. Still, lending is picking up, although not significant in some loan categories related to important sectors of the economy, e.g. agriculture, mining and communication sectors. About 79.29 percent of the loans was designated in Kabul with Herat and Balkh provinces in the second and third places respectively. The proportion of loans in other provinces was negligible. The designation of loans by sector, geography and institution are not adequately diversified, but we hope that as time goes on the distribution of loans will become more extensive. It is desirable that all banks take active part in lending, so as to diversify lending services and properly perform their role in financial intermediation.

Table 6.2: Sectoral Distribution of Credit

Ratios	1386 (Mar 2008)	1387 (Mar 2009)	1388 (Mar 2010)	1389 (Mar 2011)	1390 (Mar 2012)	1391 (Sep. 2012)
Commercial Real Estate and Construction Loans	9.54	0.19	19.92	25.98	2.85	2.80
Other Commercial Loans	79.14	-	-	-	-	-
Mining	N.A	-	-	0.02	0.72	0.14
Manufacturing	N.A	0.01	1.22	2.72	13.32	10.41
Trade	N.A	0.51	32.29	34.16	27.84	27.62
Communication	N.A	0	1.04	1.23	0.94	1.93
Service	N.A	0.09	4.84	6.72	11.95	17.73
Utilities	N.A	0.01	2.47	0.03	0.3	0.07
Others	N.A	0.09	25	8.42	10.89	9.55
Agricultural Loans	0.13	0	0.88	0.75	2.06	2.56
Consumer Loans	2.17	0.02	1.33	1.01	0.82	0.80
Residential Mortgage Loans to Individuals	2.28	0.01	7.3	8.95	15.65	15.66
All Other Loans	6.74	0.05	3.69	10	12.65	10.73

Source: *Financial Supervision Department/DAB*

1.5 Non-performing loans

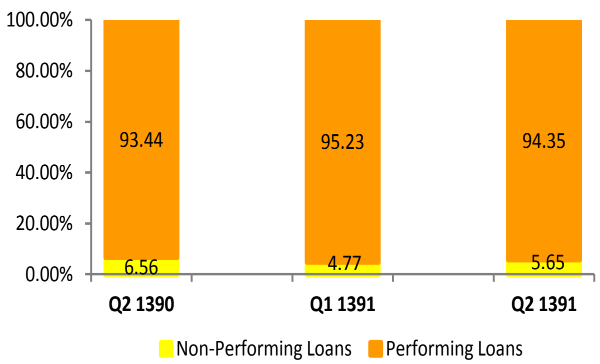
Banks should try to strengthen credit risk management measures to curtail the level of NPLs. It is essential for banks to evaluate credit applications carefully and closely monitor the financial condition of their borrowers, to ensure that credit expansion will not pose a threat to the stability of the financial system.

Compared to the last quarter June, 2012 Non-performing loans showed an AF 404 million increase in the current quarter (September, 2012), mainly attributed to four banking institutions. Table 6.5

By the end of the quarter September, 2012 the growth in non-performing loans decelerated by AF 214 million reaching to AF2.27 billion or 5.65 percent of gross loans, with 77 percent of the NPLs related to three of the commercial banks, as compared to the previous period (September, 2011) when NPL were AF 2.48 billion, with 81 percent of the NPLs related to two banking institutions.

The sector wise distribution of NPL reveals that a major portion originates from commercial loans and residential and mortgage loans to individuals and consumer loans. Credit quality in residential mortgage loans to individuals, consumer loans and all other loan categories of the total loans except commercial loans showed improvement during the current quarter September, 2012.

Figure 6.3: Quality of Loan Portfolio



1.6 Adversely-classified loans

Adversely classified loans (substandard, doubtful)[3] amounting to AF 3.01 billion, as of September 2012, show an AF 413 million increase during the quarter comprising7.47 percent of total gross loans attributed to a number of banking institutions. While compared to the preceding year, an AF 804 million decrease is observed where adversely classified Loans were AF 3.81 billion or 10.05 percent of the total gross loans.

1.7 Loans classified Watch

Loans classified in the "watch" category are AF 2.41 billion, which makes 5.97 percent of total gross loans down shown AF 1.32billion increases over the previous quarter, attributed mainly to three banking institutions. Compared to last year, watch loans were upby11 points. This category of loans requires close monitoring, as it may lead to more adversely classified loans (Substandard, Doubtful) in the future.

1.8 Loans classified loss

Loans classified loss amount to AF 34 million 0.09 percent of total gross loans increased by AF 3 million over the quarter, while down by AF 274 million (came from four banking institutions) since previous period(September, 2012).

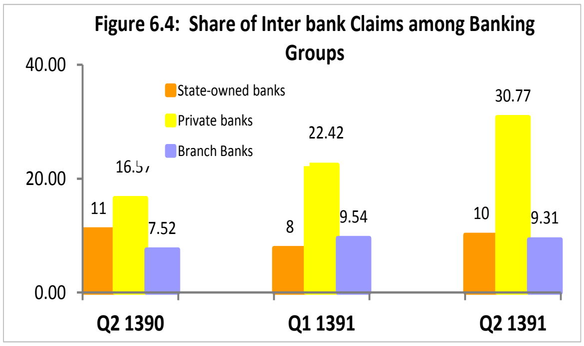
1.9 Inter-Bank Claims

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

AF 50.21 billion–23.46percent of total assets registered AF 10.44 billion increases over the quarter and Posting AF 15.07 billion increase since September 2011, attributed to a number of banking institutions, still indicating that the banking sector has channeled a portion of its attracted funds to deposits in other financial institutions, if creditable borrowers were not found. These institutions are both inside and outside the country. Later on, if needed for liquidity purposes or after receiving applications from low-risk borrowers, these assets can be substituted to higher income earning assets Figure 6.2.

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

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



Source: Financial Supervision Department/DAB

1.10 Investment

The investment portfolio of the banking sector decreased by 6.56 percent standing at AF 6.15 billion or 2.87percent of total assets over the quarter mostly came from three banking institutions. Compared to last year investments shown AF 1.64 billion increase in comparison with AF 4.51 billion or 2.07 percent in (September, 2011).A major part of the system's investment took place outside Afghanistan in First Gulf Bank and TAQA bonds (UAE), Euro bonds (Pakistan) and trading companies (USA, UK) by two commercial banks and a branch of a foreign bank.

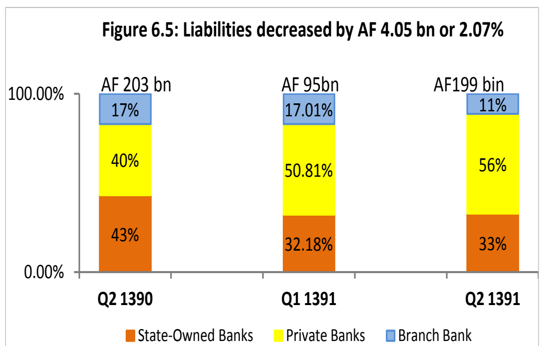
1.11 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remain the largest category, increasing both in absolute as well as in percentage of total assets since the previous quarter posting an AF 5.27 billion or 5.35 percent increase; while compared to the preceding period indicated AF 19.77 billion or 23.63 percent increase. The banking sector is fully compliant with required reserve regulations and is deploying slowly and prudently the attracted funds into other types of assets. This appears to be the sector's conservative response to the Kabul Bank crisis

2. LIABILITIES

The total liabilities of the banking sector increased by AF 4.05 billion or2. 08 percent standing at AF199.03billionagainst AF 194.97 billion in the preceding quarter while decreasing by 1.73 percent against AF 202.54 billion in the previous period (September, 2011).The drop in total liabilities was due to decreases in NDT and "other liabilities".

The majority of liabilities is made up of deposits (94.19 percent). This is an indication of public confidence, and good public relations and marketing policies of the banking sector, with "other liabilities "at second and borrowings in third place.



Source: *Financial Supervision Department, DAB*

2.1 Deposits

Deposits being the main funding source, increased by 2.23 percent during the quarter, witnessing a steady growth of 15.09 percent, this is an indication of the strength of the economy and the appositive outlook for the future. Despite negative media reporting turmoil in the banking sector depositors retained their trust in the system. Afghani denominated deposits indicated a 0.99 percent increase over the quarter, although it is only a5.62 percent growth against that of 16.82 percent last year, accounting for an overall 31.63 percent of total deposits, while US dollar Denominated deposits registered2.79 percent increase during the quarter, composing an19.95 percent increase over the7.79 percent increase in the preceding period making up 65.40 percent of the total deposits of the system.

Private Banks attracted AF 104.17 billion, increasing by 14.23 percent on a quarterly basis and 40.47percent against AF 2.56 percent last year making 55.57 percent of the system's deposits.

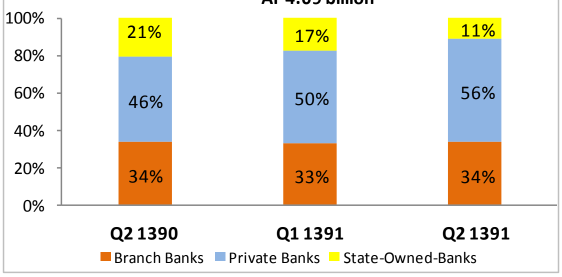
The share of state-owned banks increased to AF 62.83 billion (up by 3.15 percent Q-O-Q) and 14.10 since the preceding year accounting for 33.52 percent of the system's deposits, when it was AF 55.06 billion in the preceding period. State owned banks appear to be losing market share to Private Banks in this regard.

The share of branches of foreign banks decreased by 34.57 percent over the quarter, and 39.22 percent since last year standing at AF 20.45 billion making up 10.90 percent of total deposits of the system.

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

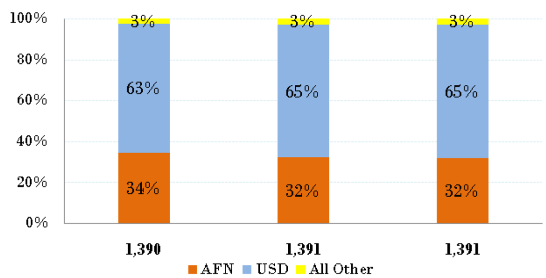
In terms of types of deposits, demand deposits accounted for 71.94 percent of the total deposit base, up by6.89 percent Q-o-Q and 22.31 percent Y-o-Y basis, saving deposits with 24.44 percent of total deposits was in the second place, depicting 34.38 percent decrease on Q-o-Q, and51.76 percent decrease on Y-o-Y basis, and time deposits making up3.61 percent of the total deposit portfolio, was down by 2.27 percent on quarterly basis while increased by 18.76 percent since September, 2011.

Figure 6.6: Deposits Increased by 2.23 percent or AF 4.09 billion



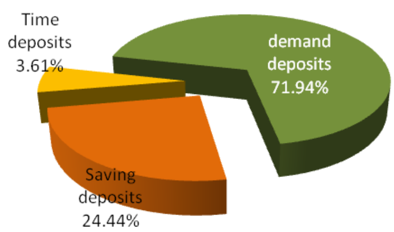
Source: *Financial Supervision Department, DAB*

Figure 6.7: Currency Composition of Deposits



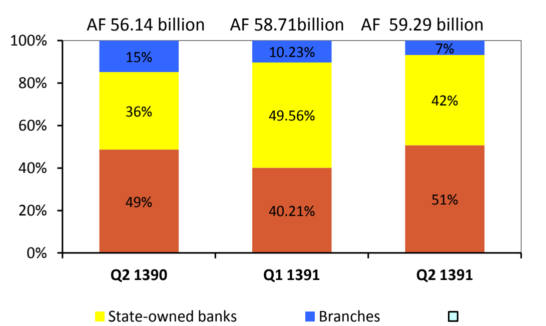
Source: *Financial Supervision Department, DAB*

Figure 6.8: Breakdown of Deposits



Source: *Financial Supervision Department, DAB*

Figure 6.9: Afghani Denominated Deposits



2.2 Borrowings

The share of borrowings in the total funding structure of the system decreasedby7 percent on Q-o-Q and increased by 43 percent on Y-o-Y basis, standing at AF 2.41 billion at the end of the September 2012, down from AF 2.58 billion in the previous quarter and AF1.69 billion in the preceding year, making 1.21 percent of total liabilities in comparison with 1.33 percent in the last quarter. The current borrowing position is attributed to two banks.

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 banks are required to maintain a reasonable level, in order to avoid any liquidity problem. For this reason, banks have an asset liability committee (ALCO); one of its tasks is the liquidity management of the bank through gap analysis, stress testing, scenario analysis, cash flow analysis, etc. according to the policies of the bank.

2.3.1 Liquidity Ratio (the broadest measure)

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

Generally, a surplus liquidity position was observed in the banking sector during this period. Analysis show 15.92 percent 35.85 percent increase in the excess liquid assets, against 2.82 percent growth in the last quarter and 47.36 percent growth in the previous year respectively.64.14percent of the sector's total assets are comprised of liquid assets. Ratio of the broad liquidity as a median for the whole system stood at 70.60 percent. All banking institutions were well above the minimum required level. Table 6.5

2.4 Capital

In order to strengthen the capital base of the banking system and enhance its stability, DAB increased the minimum Paid in capital requirement to AF 1.00 billion, and all banking institutions was given two year time period to meet this requirement[4].Currently the deadline for this capital increase is over, three banking institutions are still falling short of the requirement as of 30 September 2012.

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

Otherwise the system is well capitalized. The capital fund of the banking sector stands at AF 15.00 billion, although increased by 4.54 points since last quarter. Compared to last year (September, 2011), the capital was down by 3.53percent due to losses from a number of banking institutions.

On an aggregate basis the Capital Adequacy ratio of the banking sector stands at 22.75 percent. Table 6.5 show that all banks in the system registered capital adequacy ratio above the minimum threshold (12 percent of risk-weighted assets), except one bank (under regulatory forbearance).The Basel benchmark for capital to risk weighted is 8 percent.

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

During the period under review, the NDF position decreased by AF 6.07 billion standing at AF 1.11 billion since last quarter, and shows a decrease of AF 9.27 billion compared to the last period (September, 2011), when it was AF 10.38 billion.

In the period under review, NDT position increased by a significant 39.62 percent on Q-o-Q basis, while by 328 percent from the previous period, the NDT position for two previously holding branches of the foreign banks has increased, while one branch of the foreign bank switched to NDF position. Two branches of the foreign banks were in favorable NDT position, greater than the unfavorable NDF positions for the remaining two. Put differently,

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

two banks are actively seeking domestic investment outlets for the funds they have attracted, while the rest two are simply sending their acquired funds to their international networks. The NDF position of one branch of the foreign bank has increased, the largest NDF position holding branch of a foreign bank has left Afghanistan.

2.5 Profitability

On a cumulative basis for the first quarter of 1391(June,2012) the losses of the banking sector were realized as AF 1.43 billion, against AF 692 million losses in the last quarter indicating AF 741 million increase, this increase in the losses of the system mostly came from credit provisions. Compared to June 2011 the losses decreased by AF 61 million. The decrease in losses was mostly attributable to increases in net interest income (which is the main source of income) and decrease in non-interest expenses, while salary

Expenses, credit provisions and taxes show increases. The return on assets (ROA) of the system deteriorated and reached-2.80 percent against -1.02 percent in March, 2012; while return on equity (ROE) became –36.65 percent from -12.59percent in the previous quarter. On a cumulative basis five banks have incurred losses of AF 1.99 billion, against that of AF 1.12 billion in the preceding quarter with five banks at loss, while AF 1.96 billion in previous periods with seven banks at loss. On a core income basis four banks ended with losses mainly on account of a decrease in total income.

The efficiency ratio[5] of the system as a median stood at 1.73. Seven banking institutions ended up with lower efficiency ratios by the end of June, 2012.

On an aggregate basis Private Banks and branches of foreign banks were profitable, while State-owned banks ended with lossesFigure6.10The efficiency ratio[6] of the system as a median stood at 1.46. Eight banking institutions ended up with lower efficiency ratios by year -end 1390 (March, 2012).

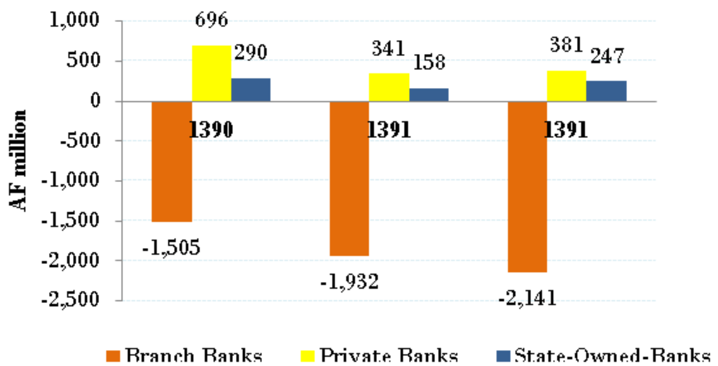
[5] net interest income + trading account gain/loss + other non-interest income divided by operating expenses

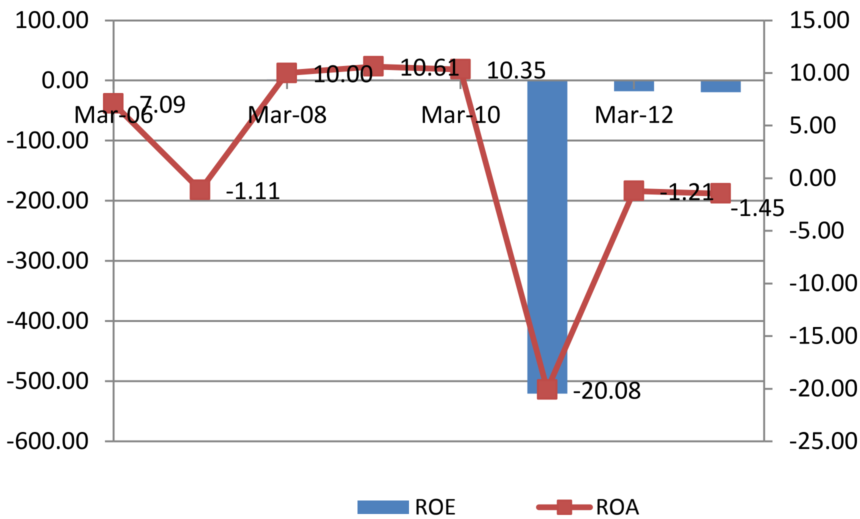
[6] net interest income + trading account gain/loss + other non-interest income divided by operating expenses

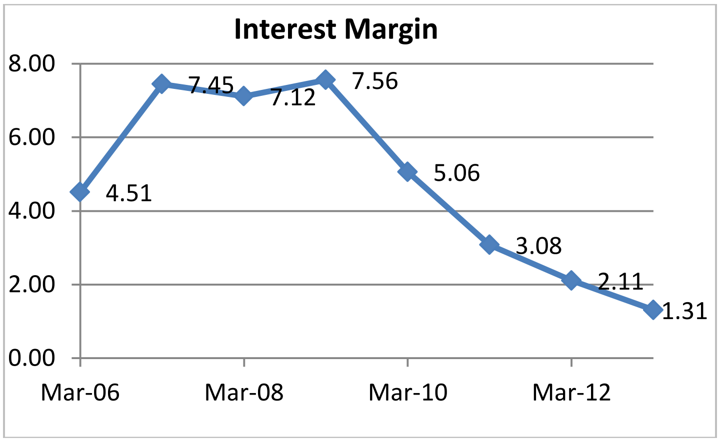
Table 6.3: Profit of the banking sector (in million AF)

items	1390 (Sep. 11)	1391 (Jun. 12)	1391 (Sep. 12)	Q-O-Q Changes
interest income	3,179	1,789	1,889	11.11
interest expense	1,074	524	437	(13.82)
Net interest income	2,105	1,265	1,451	26.24
Non-interest income	1,659	852	1,044	(8.66)
Non-interest expenses	2,054	907	1,153	(15.40)
Salary cost	1,539	876	820	12.17
Credit provisions	1,945	1,673	522	147.59
P/L before tax	-1,775	-1,338	-1,336	125.28
P/L after tax	-1,910	-1,433	-1,512	107.11

Figure 6.10: Profitability







2.6 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for the overall open FX position, except for banking institutions holding open FX positions on the overall and on an individual currency (USD and EURO short& long positions) basis crossed the set limits. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is theoretically 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 4.74billion and vice versa. Similarly, a 4 percent change would correspond to AF 949 million

2.7 Interest Rate Risk

Overall the banking system is in an interest-rate sensitive position. However, calculations made from the Interest Rate Sensitivity Schedules of all banks reveal that, the net-interest income of the system over the next 12 months may increase by AF 210 million in an event of an increase in the market interest-rate (upward interest rate shock) by 3 percentage points. Conversely if the interest rate decreases by 3 percentage points (downward interest rate shock) interest income will decline by AF 210 million. For four banking institutions, if the interest-rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is theoretically managed on a whole-bank basis).

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

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