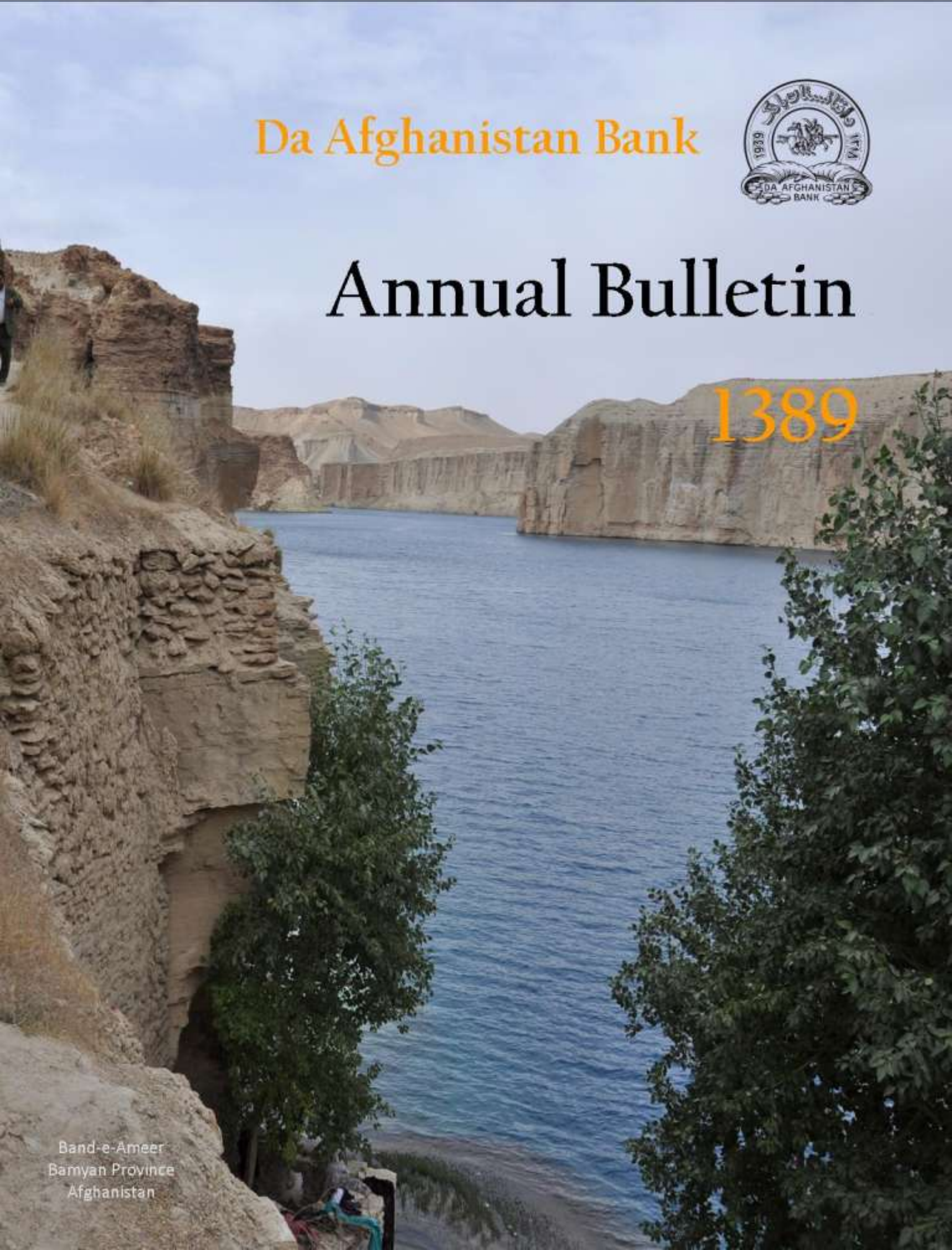
Da Afghanistan Bank

Annual Bulletin

1389



Band-e-Ameer
Bamyan Province
Afghanistan

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Publisher's Statement

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

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Note: Afghanistan fiscal year is Solar year which begins on March 21 each year. This annual bulletin covers developments in the year 1389 which is equivalent to March 22, 2010 to March 21, 2011.

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LIST OF ABBREVIATIONS

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

GOVERNOR'S STATEMENT

Annual Economic and Statistical Bulletin

It is with pleasure that I, on behalf of the Supreme Council, present this release of the Annual Economic and Statistical Bulletin of Da Afghanistan Bank (DAB). This annual bulletin reviews an examines events during the year 1389 (March 22, 2010 to March 20, 2011) and reflects DAB's primary objectives of fostering price stability, developing a sound financial system conducive to macro-economic stability, and encouraging broad-based and sustainable economic growth.

The year 1389 was not an easy year for Afghan economy. On the one hand, economic growth fell short of expectations, dropping to 3.2 percent from 17.2 percent in 1388. Meanwhile, early winter snowfall was light; raising concerns for next year's harvest, and consumer price inflation turnaround and rose sharply at the second half of the year compared to the beginning of the yare when there was actual deflation.

On the other hand, monetary developments point to increased confidence in the national currency. DAB smoothed exchange rate fluctuations while maintaining appropriate control over the money supply. The country's net international reserves increased dramatically by 25.2 percent to USD 5,017.4 million, the banking sector expanded and remained profitable.

The sharp loss of pace in economic growth in 1389 was due to the precipitous drop in rain-fed agriculture as a result of light rainfall through the year. Agriculture, which accounted for 29 percent of GDP in 1389, dominated the economy.

The global economic recovery which began in early 2009 continued its path through 2010 with all economic indicators exhibiting upward trends. According to WEO, the global economy is expected to grow at 4.5 percent per year in both 2011 and 2012, but the growth rate will differ in developed and emerging economies. Advanced economies are expected to grow at 2.5 percent, while emerging and developing economies will grow strongly by 6.5 percent.

The global industrial production recovered in the fourth quarter of 2010, better than preceding quarter of the same year, but a moderate growth in the first quarter of 2011. In developing countries, output growth increased at the end of the first quarter of 2011. Industrial production was expanding in developing countries. In the high-income countries, industrial production growth decreased to 6.4 percent in the first three month of 2011.

Inflation is expected to remain low in advanced economies due to weak domestic consumption as a result of high unemployment and economic recovery below-potential.

In the year under review, monetary aggregates had mixed performances; reserve money, the operational target under ECF program, had an increase of

20.43 percent which is below the PRGF-ECF target of 21 percent.

Currency in circulation “an indicative target under the ECF program”, increased by 34.2 percent in the year under review compared to 29.9 percent ceiling. Da Afghanistan Bank breached the CiC ceiling mainly because of excess demand for local currency as a result of growing people’s confidence on local currency. In the meantime, nominal exchange rate of afghani against US dollars appreciated in the first half of the year and became almost flat in the second half of the year. Afghani appreciated by 6.4 percent from AF 48.48 per USD at the beginning of the year to AF 45.37 per USD at the end of the year under review.

The banking sector performed well in the year under review with a 12.6 percent increase in total assets of the banking system. Gross Loans amounted to AF 80.24 billion (USD 1.77 billion) depicting an increase of 20.7 percent, while deposits stood at AF 156.5 billion (USD 3.44 billion) up by 4.5 percent from the same period last year.

Afghanistan’s merchandize trade deficit widened in the year under review following a substantial expansion in imports compared with the similar period of last year. The trade deficit in terms of GDP also increased to 28 percent in 1389 compared to 20 percent of GDP in 1388. The current account balance recorded a surplus in 1389 compared to a deficit registered in 1388.

The net international reserve (NIR) increased by 25 percent from USD 4,007.1 million in 1388 to USD 5,017.4 million in the year under review.

This report could not have been written without the tireless efforts and generous support of numerous individuals from several departments of the Bank. The work was coordinated by the Monetary Policy Department. Encouragement and support from Jonathan Corning (Deloitte/EGGI Statistics Advisor) is greatly appreciated.

Kabul, September 2011

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank,

(Central Bank of Afghanistan)

EXECUTIVE SUMMARY

This publication constitutes DAB's Annual Economic and Statistical Bulletin for 1389 (2010/11). The content reflects the main results of the Bank's activities aimed at keeping inflation low, maintaining stability of the national currency and developing a robust banking sector in support of sustainable economic growth.

The global economy is on the path of recovery. However, the outlook of the global economy still remains uncertain as some of advanced and emerging economies are still at risk of a double dip recession. According to WEO, the global economy is expected to grow at 4.5 percent per year in both 2011 and 2012, but the growth path will differ for developed and emerging economies. Advanced economies are expected to grow at 2.5 percent, while emerging and developing economies will grow faster at 6.5 percent.

The global industrial production recovered in the fourth quarter of 2010, better than preceding quarter, but a moderate growth in the first quarter of 2011. In developing countries, output growth increased at the end of the first quarter of 2011. Industrial production was expanding at 13.4 percent in developing countries. In the high-income countries, industrial production growth decreased to 6.4 percent in the first three month of 2011.

Inflation will remain low in advanced economies due to weak domestic consumption as a result of high unemployment and economic recovery below-potential. Merchandise trade continued to grow strongly across major economies in the first quarter of 2011. Total imports of G7 and BRICS countries grew by 11 percent in the first quarter of 2011 compared to 8.2 percent in the previous quarter. Total exports grew by 8.5 percent, compared to 8.2 percent in the previous quarter. Global FDI inflows rose five percent to USD 1.24 trillion in 2010, 15 per cent below the pre-crisis average. The recovery of FDI flows will continue in 2011 reaching a total of USD 1.4 to USD 1.6 trillion, making a comeback to the pre-crisis average due to investment opportunities in emerging economies, according to United Nations Conference on Trade and Development (UNCTAD).

In the year under review, monetary aggregates had mixed performances; reserve money, the operational target under PRGF-ECF program, had an increase of 20.43 percent recording AF 151,008.13 million. The actual reserve money was below the PRFG-ECF target of 21 percent. Currency in circulation "an indicative target under the ECF program", increased by 34.2 percent reaching AF 132,407.09 million. Da Afghanistan Bank breached the CiC ceiling of 29.9 percent mainly because of the excess money demand.

Narrow money (M1) grew to AF 261,215 million in the year under review, indicating annual growth rate of 22.8 percent (Y-o-Y) mainly due to increase in demand for afghani as a result of growing people's confidence on local currency. Broad money (M2) demonstrated similar behaviour growing by 22.61percent (Y-o-Y) reaching AF 277,542 million at the end of the year under review.

Capital notes (CNs) auction is one of the instruments used by DAB to control reserve money and withdraw excess liquidity of the banking system.

At the beginning of the year under review, the outstanding amount for 182 day notes noticed a decline, while for 28 day CNs, it has increased. Throughout the mid of the year under review, the outstanding stock remained modestly even, but noticed a sharp increase in the last quarter of 1389. The 28 day CNs amount increased from AF 2.4 billion to AF 3.4 billion and the 182 day CNs it increased from AF 8.4 billion to AF 12.6 billion.

In the meantime, nominal exchange rate of afghani against US dollar appreciated in the first half of the year and became almost flat in the second half. Afghani appreciated by 6.4 percent from AF 48.48 per USD at the beginning of the year to AF 45.37 at the end of the year under review.

Headline inflation turned around and rose sharply in the fourth quarter of 1389 compared to the same period of last year when there was actual deflation. The accelerating trend in headline inflation that began in the first quarter of 1389 continued through the second quarter and finally hit double digit in the third quarter of the year. By all measures, inflation was increasing in the year under review.

The headline consumer price index (CPI), the broadest measure of the general level stood at 181.74 at the end of 1389 representing an inflation rate of 16.6 percent (Year-on-Year) up from -5.2 percent at the end of 1388. The twelve month period average inflation turned positive at the end of the third quarter of the year and rose sharply to 7.7 percent at the end of 1389 compared to -12.24 percent in the same period last year.

The increase in the headline CPI was attributed to the increase in the prices of both food and non-food sub-indexes. The food price index turned around and rose sharply in the year under review. The increase in the food prices was mainly attributed to the increase in the prices of bread and cereals, meat (beef), oil and fats, fruits, vegetables, and tea and beverages. The increase in non-food sub-index was mainly led by rents, construction materials, household goods, transportation, and miscellaneous price indexes.

Core inflation also increased sharply in the year under review. When the effects of significant price changes in bread and cereals, oil and fats, and transportation are excluded from the figures, the year-on-year rate of core inflation in 1389 recorded 13.0 percent increase at the end of the year under review compared to 2.9 percent in the same period of last year. High rate of core inflation remains a matter of concern for policy making side.

When core inflation is measured by 28 percent trimmed mean, the same pattern appears. Core inflation, measured by 28% TM increased by 11.4 percent in 1389 up from 1.8 percent in 1388.

On the fiscal side, government finances remained on track to meet revenues and spending targets. Total domestic revenues observed 25 percent increase in the year 1389 reaching AF 78,683.71 million. The increase in domestic revenues was mainly attributed to custom duties, having an increase of 27 percent to AF 27704.57 million, sales tax increased by 32 percent, and fixed taxes indicated 12 percent increase. Moreover, Income tax revenues stood at AF 10,288.22 million in 1389 which represents a 38 percent increase.

On the other side, core expenditures increased by 29 percent to AF 154,015.86 million in 1389. Core expenditures accounted for 25 percent of GDP. Operating expenditures increased to AF 110,452.78 million in 1389, representing an increase of 25 percent. In addition, the development expenditures also increased to AF 43,563.08 million which shows 40 percent increase. Total core budget was in surplus by about AF 6.1 billion by the end of 1389. This was mainly due to strong revenue collection and large operating budget surplus. The operating budget surplus stood at AF 24.4 billion, while the development budget was in a deficit of AF 18.4 billion. Due to high development budget deficit, the core budget surplus declined by about AF 9.9 billion in 1389. The donor grants for operating budget increased, while grants for development expenditures declined in the year under review. Allotted grants for both operating and development expenditures amounted to AF 4,934.90 million, representing 18 percent decline.

The banking system continued to perform satisfactorily with total asset of the banking system growing by 12.6 percent at the end of the year under review. Total asset of the banking sector stood at AF 203.84 billion at the end of 1389 compared to AF 181.04 billion in the same period last year. Gross Loans amounted to AF 80.24 billion (USD 1.77 billion) depicting an increase of 20.7 percent, while deposits stood at AF 156.54 billion (USD 3.44 billion) up by 4.5 percent from the same period last year. Deposits were largely denominated in USD (62.4 percent) with afghani denominated deposits lagging at 34.54 percent. AF-denominated deposits indicated growth rate of 11.2 percent, while USD denominated deposit were up by 2.6 percent. The entire banking sector was well capitalized, except the crises stricken bank, inclusion of which put a huge pressure on the capital position of the system. With the exclusion of the above mentioned bank, capital adequacy ratio (CAR) of the banking sector remained robust at 30.4 percent.

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

Overall balance of BoP for the year 1389 reveals a surplus of USD 754 million compared to a deficit of USD 797 million in the preceding year. The surplus in the reporting year can be attributed to a large amount of inward grants which are increased by almost 5 percent, and private transfers which are increased by around 7 percent in the reporting year.

The current account balance recorded a surplus of USD 351 million in 1389 compared with a deficit of USD 462 million in 1388.

In the year under review, the capital and financial account recorded an inflow of USD 403 million from an outflow of almost USD 335 million in 1388. This massive increase was mainly led by high amount of foreign direct investment inflow during the year under review.

Earnings from exports slightly decreased by about 4 percent in 1389 to USD 388.37 million compared to USD 403 million in 1388. Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,306.49 million as of March 20, 2011. In bilateral debt perspective, Afghanistan owed USD 1,131.75 million mainly to Russian Federation as a member of Paris Club and other Non-Paris Club creditors. Non-Paris Club debts stood at about USD 132 million at the end of 1389. In respect to multilateral debts, Afghanistan's total debt stood at USD 1,174.73 million at the end of FY 1389.

The Net International Reserves (NIR) of Afghanistan increased by 25 percent from USD 4,007.1 million in 1388 to USD 5,017.4 million in 1389. The reserve assets had a fairly large increase of approximately 26 percent from USD 4,208.5 million in 1388 to approximately USD 5,321.1 million in the reporting year. On the other hand, reserves liabilities increased by 51 percent from USD 201.4 million in 1388 to USD 303.75 million in the reporting year. In compare to 1388 the percentage changes in reserve liabilities however still shows a decline.

On the real sector, the Afghan economy lost momentum in 1389 with growth rate declining to 3.2 percent from 17.1 percent in 1388. The sharp loss of pace in economic activity is attributed to the precipitous drop in rain-fed agriculture as a result of drought. Overall, agriculture continued to dominate the economy; accounting for 27.8 percent of GDP in 1389 down from 31.4 percent in the preceding year. Within the agricultural sector, cereal production suffered the largest drop in output, declining by 23.3 percent in 1389. The main contributor factor for the decrease in cereal production was the output of wheat which has decreased in rain-fed areas as a result of drought.

Despite the sharp decline in overall economic performance, the industrial sector increased in 1389 growing by 6.3 percent, up from 5.5 percent in 1388. Mining and quarrying was the fastest growing sub-sector of industry posting 43 percent growth over the year while the food, beverages, & tobacco sub-sectors increased by 3.8 percent in the year under review.

The services sector continued its upward trajectory increasing its share of the economy from 35 percent of GDP in 1382 to 48 percent in 1389. The performance of the services sector was mainly driven by restaurant & hotels, transport, storage, post and telecommunication sub-sectors.

Private consumptions remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction.

In terms of components of GDP, the major boost to real GDP was a significant increase in real government expenditures. Personal consumption and the trade balance also increased in real terms by significant percentages, but the growth was not as rapid as that in government spending. In contrast, investment spending did not increase substantially.

Global Economic Environment

1

1

GLOBAL ECONOMIC ENVIRONMENT

The global economic recovery which began in early 2009 continued through 2010 with all economic indicators exhibiting upward trend. According to WEO, the global economy is expected to grow at 4.5 percent per year in both 2011 and 2012, but the growth concerns will differ for developed and emerging economies. Advanced economies will grow at 2.5 percent, while emerging and developing economies will grow very strongly at 6.5 percent.

The global industrial production recovered in the fourth quarter of 2010, better than preceding quarter of the same year, but a moderate growth in the first quarter of 2011. In developing countries, output growth increased at the end of the first quarter of 2011. Industrial production was expanding at 13.4 percent in developing countries. In the high-income countries, industrial production growth decreased to 6.4 percent in the first three month of 2011.

Inflation will remain low in advanced economies due to weak domestic consumption as a result of high unemployment and economic recovery below-potential. However, IMF has also raised its average inflation forecasts for emerging and developing economies to 6.9 percent for 2011 and 5.3 percent for 2012, from 6.0 percent and 4.8 percent estimated in January 2011. Rising food and energy prices have driven inflation up significantly in many developing countries due to high weights in total basket of consumer price index in these economies.

Merchandise trade continued to grow strongly across major economies in the first quarter of 2011. Total imports of G7 and BRICS countries grew by 11 percent in the first quarter of 2011 compared to 8.2 percent in the previous quarter. Total exports grew by 8.5 percent, compared to 8.2 percent in the previous quarter. Global FDI inflows rose five percent to USD 1.24 trillion in 2010, 15 per cent below the pre-crisis average. The recovery of FDI flows will continue in 2011 reaching a total of USD 1.4 to USD 1.6 trillion, making a comeback to the pre-crisis average due to investment opportunities in emerging economies, according to United Nations Conference on Trade and Development (UNCTAD).

1. GLOBAL ECONOMY

The world economic recovery which began in early 2009 continued throughout 2010 and all economic indicators exhibited upward trend. According to WEO the global economy is expected to grow at 4.5 percent a year in both 2011 and 2012, but the growth concerns will differ for developed and emerging economies. Advanced economies will grow at 2.5 percent, while emerging and developing economies are expected to grow very strongly at 6.5 percent. The main concern in advanced economies was that after the initial recovery hit by inventory cycle which is almost over and fiscal stimulus policies were changed to fiscal consolidation, commodity prices extremely increased more than expectations reflecting high demand growth and supply shocks. In advanced economies, low share of oil, absence of wage indexation and secure inflation expectations put little effects on economic growth and core inflation. In advanced economies, output is below potential, unemployment is high and growth will be low for many years. In many countries, especially the United States, the housing market is still depressed, leading to a weak housing investment. The fiscal consolidation created market worries about fiscal sustainability after the crisis and in many countries banks are struggling to achieve higher capital ratios in the face of increasing nonperforming loans. Low growth, fiscal depression and financial pressures in the European Union are acute and suffer the union reestablishing financial and fiscal stability in the interaction of low growth and high interest rate is a challenge. In emerging market economies, no long last concerns about the crisis, the strong financial and fiscal positions, high growth and low interest rates reflects fiscal adjustment much easier and will reflect the stable macroeconomic and growth.

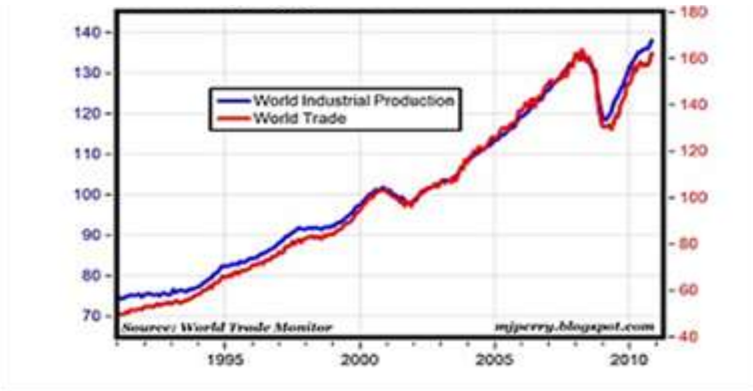
The slowdown in high-income countries (from 2.7 percent in 2010 to 2.2 percent in 2011) mainly attributed to a very weak growth in Japan due to the after-effects of the earthquake and tsunami. Growth in the remaining high-income countries is expected to remain broadly stable at about 2.5 percent through 2013, despite a gradual withdrawal of the substantial fiscal and monetary stimulus introduced following the financial crisis to avoid more serious downturn.

1.1 Global Industrial Production

According to Global Economic Prospects, global industrial production recovered in the fourth quarter of 2010, better than in third quarter of the same year, but a moderate growth in the first quarter of 2011. In developing countries, output growth increased at the end of the first quarter of 2011, industrial production activities in developing countries was expanding at 13.4 percent. High-income countries industrial production growth decreased to 6.4 percent in the three months of 2011, growth of industrial production in developing countries (East Asia Pacific and Europe) reached 9.8 percent in the first quarter of 2011. The good performance in industrial production was supported by cheerful domestic demand in developing countries and a moderate recovery in high-income consumer spending. Slowly improving labor markets in several high-income countries contributed to a return to solid retail sales volume growth. Many economies are now close to their pre-crisis peaks in industrial production, emerging economies showed good performance than high-income countries.

Industrial production in China is now more than 40 percent above its pre-crisis peak, and 36 percent higher for the East Asia region considered as a whole. Production in South Asia continues to grow strongly standing 21.4 percent higher than before the crisis peak, while Latin America and the Caribbean, Europe and Central Asia, and the Middle East and North Africa have yet to exceed earlier peaks levels.

Figure 1.1: World Industrial Production and Trade, (Jan 1999 to Nov. 2011)



Source: Daily Market

1.2 Global Inflation

According to Euro Monitor International, in 2011, inflation will remain inactive in advanced economies due to weak domestic consumption as a result of high unemployment and economic recovery below-potential. However, International Monetary Fund (IMF) also revised its forecasts for average inflation for emerging and developing economies to 6.9 percent for 2011 and 5.3 percent for 2012, from 6.0 percent and 4.8 percent estimated in January 2011. Rising food and energy prices have driven up inflation significantly in many developing countries due to their high weight in the overall consumer price index in these economies. Meanwhile, inflationary pressures have strengthened in several emerging economies, including China and Brazil, as a result of rapid credit expansion and rising capital inflows. In 2012, the average global inflation is expected to ease to 3.4 percent as a result of money tightening policies and a stabilization of commodity prices.

1.3 Global Trade and Investment

Merchandise trade continued to grow strongly across major economies in the first quarter of 2011. Total imports of G7 and BRICS countries increased by 11 percent in the first quarter of 2011 compared to 8.2 percent in the previous quarter. Total exports increased by 8.5 percent compared to 8.2 percent in the previous quarter.

China's trade surplus continued to fall in the first quarter of 2011 as import growth (8.4 percent) outpaced export growth (3.0 percent). At USD 18 billion, China's trade surplus in the first quarter of 2011 was less than half recorded in the fourth quarter of 2010.

In the United States, the trade deficit increased to USD 188 billion as import growth (11.5 percent) outpaced export growth (6.4percent). Import growth also outpaced export growth in Germany, Canada, France, Japan, India, Russia, and South Africa, while exports increased faster than imports in Italy, the United Kingdom, and Brazil.

The global FDI inflows rose five percent to USD 1.24 trillion in 2010, 15 percent below the pre-crisis average. The recovery of FDI flows will continue in 2011 reaching a total of USD 1.4 to USD 1.6 trillion making a comeback to the pre-crisis average due to investment opportunities in emerging economies, according to United Nations Conference on Trade and Development (UNCTAD). The sovereign debt crisis, fiscal and financial imbalances in some developed countries and rising inflation and signs of overheating in major emerging economies could derail the FDI recovery.

Table 1.1: World Merchandize Trade by Region and Selected Economies, Q1-2011 (% Δ)

	Exports		Imports	
	Y-o-Y	Q-o-Q	Y-o-Y	Q-o-Q
World	22	2	22	2
North America	19	1	19	1
United States	18	1	19	1
Canada	17	3	18	3
South and Central America	30	3	27	-2
Brazil	31	-10	25	-3
Europe	18	3	20	4
European Union (27)	19	3	19	4
—intra EU	16	4	16	4
—extra EU	23	1	23	4
Commonwealth of Independent States (CIS)	28	3	39	-14
Russian Federation	24	1	41	-16
Africa and the Middle East	30	14	11	-3
Asia	25	-2	26	4
China	26	-10	33	5
India	42	16	17	16
Japan	13	-5	23	3
Six East Asian traders	25	4	23	5

2. ADVANED ECONOMIES

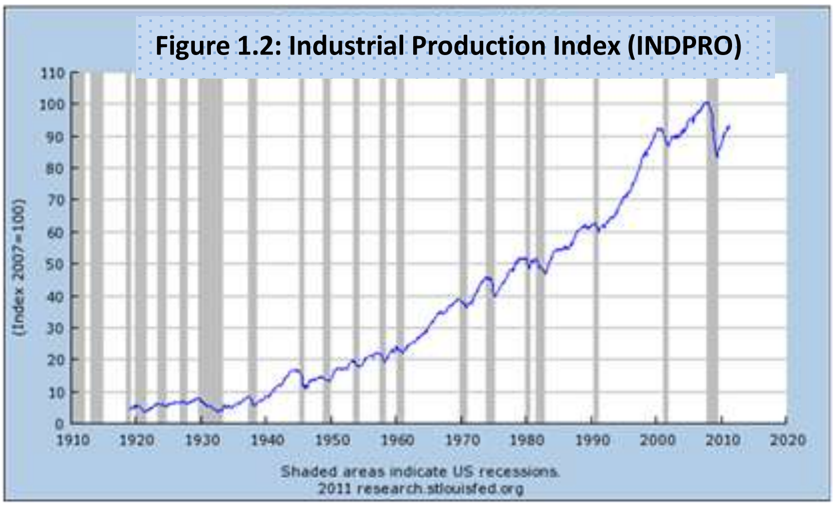
2.1 The United States Economy

The US economy started to follow upward trend at all sectors of the economy. According to the Bureau of Economic Analysis, Real GDP growth increased at an annual rate of 1.9 percent in the first quarter of 2011. . GDP growth in the first quarter of 2011 was led by personal consumption, private inventory investment, exports and nonresidential fixed investment.

According to Reuters, the consumer price index (CPI) in US rose significantly than was expected and continued its upward trend which began in December 2010. Consumer prices climbed by 0.5 percent in February 2011, the highest increase since June 2009 when the monthly price index reached 0.9 percent.

Profits from current production increased to USD 48.7 billion in the first quarter of 2011 compared to an increase of USD 38.2 billion in the fourth quarter of 2010. The internal funds available to corporations for investment increased to USD 16.7 billion in the first quarter compared to an increase of USD 36.9 billion in the fourth quarter of 2010.

Mining and durable-goods manufacturing were the best performing industries in the first quarter of 2011. Overall, mining earnings grew by 5.5 percent and durable goods earnings grew by 2.8 percent. Earnings in all other industries combined grew only by 0.8 percent.



Source: Board of Governors of the Federal Reserve System

2.2 Euro Area Economy

According to the Eurostat, the preliminary estimates of the euro area and EU27, GDP growth in the first quarter of 2011 was 0.8 percent compared to the previous quarter, it was well above the expectations. Seasonally adjusted industrial production in the euro area declined by 0.2 percent compared to February 2011. On the annual basis (compared to March 2010) the industrial production grew by 5.3 percent in the euro area. Industrial production in the euro area declined by 0.7 percent in March after a decline of 0.2 percent in February 2011. Germany and France powered economic growth in the euro area in the first quarter of 2011 as booming exports fueled domestic spending. German GDP jumped by 1.5 percent from the fourth quarter of 2010, while French GDP rose by 1 percent. Spanish economy grew between January and March 2011 by 0.3 percent compared to the previous quarter.

Inflation across the euro zone accelerated to 2.6 percent (year-on-year) in March 2011, up from 2.4 percent in February 2011. According to European Union Data Agency Euro stat, the rate is now significantly above the European Central Bank's expectations for medium-term inflation at below 2 percent across the 17- nation currency area.

According to Reuters, the euro area reported a trade surplus (non seasonally adjusted data) equivalent to € 2.8 billion in March 2011. Current account of the European Union (EU) has accumulated a deficit of € 32,800 million between January and March 2011, up by 15 percent over the same period last year.

Figure 1.3: Euro Area Domestic Product (GDP),
(Billion USD)

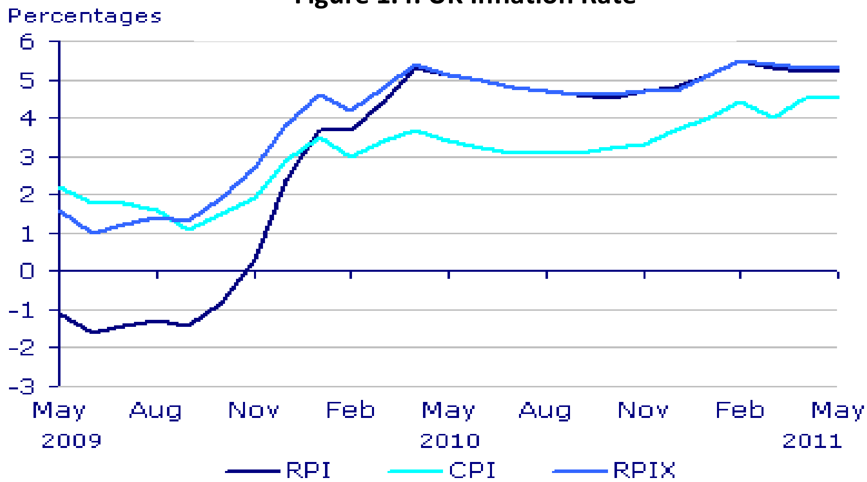
2.3 United Kingdom Economy

According to the National Statistics Office of UK, GDP in the first quarter of 2011 reached 1.6 percent higher compared to the first quarter of 2010. Gross domestic product (GDP) grew by 0.5 percent in the latest quarter, manufacturing output which rose by 0.7 percent, household expenditure fell 0.6 percent in the first quarter of 2011. Government final consumption expenditure rose 0.5 percent in the latest quarter. Gross fixed capital formation fell to 2.0 percent in the first quarter of 2011. Exports of goods and services rose by 2.4 percent, while imports of goods and services fell by 2.4 percent.

According to the National Statistics Office, British industrial output suffered a shock fall in February with a sharp drop in oil and gas supply and flat growth in manufacturing raising concerns for first quarter's growth, while the decline was driven by a 7.8 percent fall in oil and gas extraction, due to maintenance work.

The main downward pressure to the change in CPI inflation came from transportation services.

Figure 1.4: UK Inflation Rate



Source: UK Office of National Statistics

2.4 Germany Economy

According to German Information Center Pretoria, all economic indicators in Germany are in expansion mood and leading to favorable signs. Germany tried to keep the good performance track of GDP in 2011 as experienced in 2010, when the GDP increased to 3.6 percent. Increasing domestic economy was the driving force behind economic growth, together with the ongoing stimulus from foreign trade and investment. Sustained employment growth is improving income prospects for private households and this is a key factor driving the recent increase in consumer confidence. The good performing growth drivers in 2011 will reflect greater balance to overall economic growth in Germany.

The goods producing sector led to a good start in 2011. Output continued to increase in January by 1.8 percent in seasonally adjusted terms. In the construction sector, output rushed forward by 36.3 percent in January. Industrial output continued to increase, rising slightly by 0.2 percent.

Trends in German exports are also pointing upward as 2011 gets underway. Despite a slight decline in the most recent reporting period, exports were up by 0.6 percent in the latest seasonally adjusted three-month comparison of 2011.

The pace of inflation picked up in recent months in Germany. For the first time in the recent two and a half years, the year-on-year increase in consumer prices exceeded 2 percent, with 2.1

percent increase in February 2011, higher than a year ago. High prices for light fuel oil, fuels, and food were the primary factors behind the increase in inflation.

2.5 France Economy

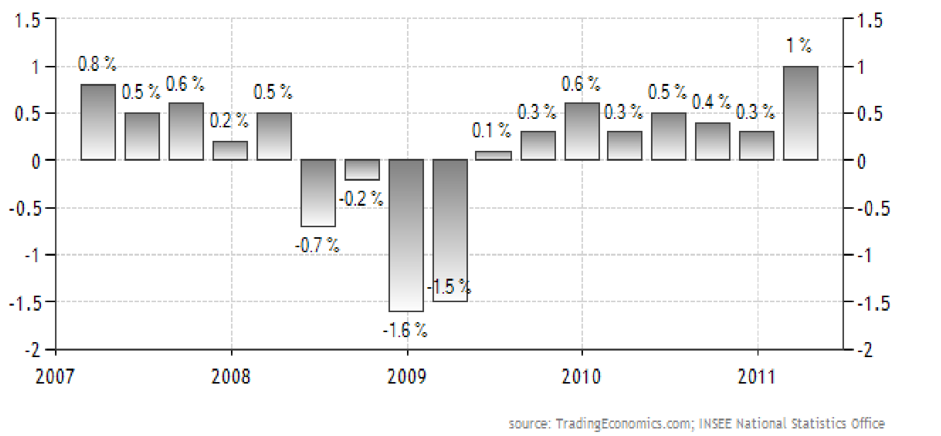
According to Trading Economics, GDP growth in France reached 1 percent in the first quarter of 2011 over the previous quarter. The France economy is confident to achieve the 2 percent growth projected for 2011. France is the second trading nation in Europe. France, as many modern industrialized nations, has a large and diverse industrial base. Economic growth rates in France have been steady for decades due to conservative planning of the economy which in comparison to other western European countries is more centralized by the government.

Industrial production in France expanded to 3.9 percent in April 2011. Industrial production measures changes in output for the industrial sector of the economy which includes manufacturing, mining, and utilities.

According to national statistics office, France's unemployment rate held steady in the first quarter of 2011 at 9.7 percent compared to the final quarter of 2010.

With regard to the purchasing power of households, it would progress only (+0.1percent) in the first quarter of 2011, the likely shock will be on the food.

Figure 1.5: France GDP Growth Rate, (Annual GDP Growth Adjusted by Inflation



2.6 Japan's Economy

According to the data from Trading Economics, the gross domestic product (GDP) in Japan contracted to 0.9 percent in the first quarter of 2011 over the previous quarter. Japan's industrialized free market economy was the second largest in the world. The slowdown as a result of earthquake and tsunami caused decline in consumer spending, business investment, and private-sector inventories. During January to March 2011, weak domestic demand cut 0.8

percentage point off Japan's quarterly growth. Consumer spending dropped by 0.6 percent, business investment also fell 0.9 percent, and falls in spending on cars and services in the quarter contributed to the decline in consumption for the period.

In Japan, industrial production fell by 15.5 percent in March from February 2011 (seasonally adjusted). Shipments fell by 14.6 percent and inventories fell by 4.2 percent. Year-on-year production fell by 13.1 percent, while inventories increased by 3.5 percent.

A mixture of insufficient power, plus earthquake damage to infrastructures caused turmoil for Japan's top-rank exporters such as Toyota, Sony and Panasonic. The world's biggest car company extended its factory shutdowns while electronics companies were increasingly reporting problems at their own plants and that of their supply chains.

The general inflation rate in Japan was last reported at 0.3 percent in April 2011. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power, part of the increase in the cost of living in April stemmed from the advance in global commodities. Foodstuff prices, excluding fresh food, also rose as the cost of flour and other commodities increased due to supply disruptions as a result of March 2011 disaster.

Figure 1.6: Japan's Real GDP Growth Rate

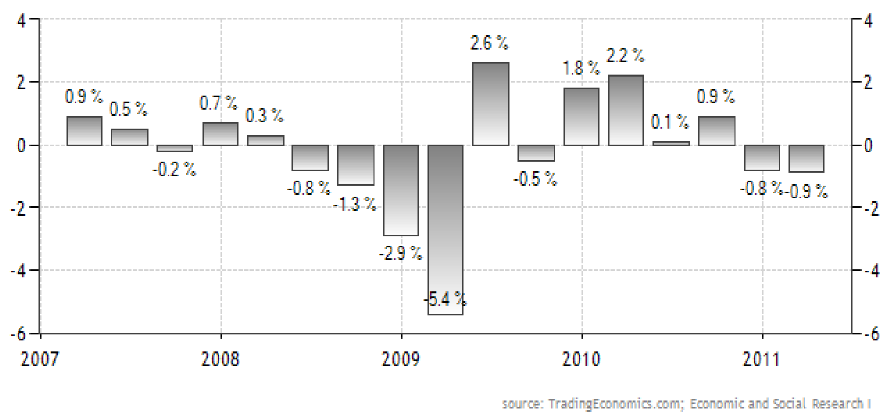


Figure 1.7: Japan Industrial Production

Percentage Changes Y-o-Y

3. EMERGING ECONOMIES

Emerging economies are playing vital role in the global economy. The share of emerging market economies increased from 20 percent in the 1990's to over 30 percent currently.

After the global economic slump of 2008 and 2009, the recovery took divergent paths, with emerging markets powering ahead while advanced economies merely trudged along.

With growth and interest rates remaining unusually low across the developed countries, investors have flocked to emerging markets, bringing much-needed capital but also a risk of inflation.

3.1 China's Economy

China's National Bureau of Statistics reported that the country's gross domestic product (GDP) grew at an annual rate of 9.7 percent in the first quarter of 2011. Investment in fixed assets, industrial production, and agriculture led the strong growth.

In the first quarter of 2011, China faced a volatile international environment and the new emerging challenges in domestic economic development. The Central Party Committee and the State Council firmly carried out the pro-active fiscal policy and prudent monetary policy, strengthened and improved macro- economic control.

Industrial value-added output of Chinese small and medium-size enterprises (SMEs) grew by 16.9 percent year-on-year in the first quarter of 2011, 2.5 percentage points higher than the overall industrial value-added output level, reported by Ministry of Industry and Information Technology (MIIT).

For the first time in seven years, China reported a quarterly trade deficit, as imports raised to an all-time high. Imports offset exports by USD 1.02 billion in the first three months of the year, reported by CNN Money.

However, inflation remains a concern despite raising interest rates four times recently. Consumer prices rose by 5 percent year-on-year in the first quarter of 2011. Food prices were the main driver of inflation, up by 11 percent year-on-year in the first quarter of 2011.

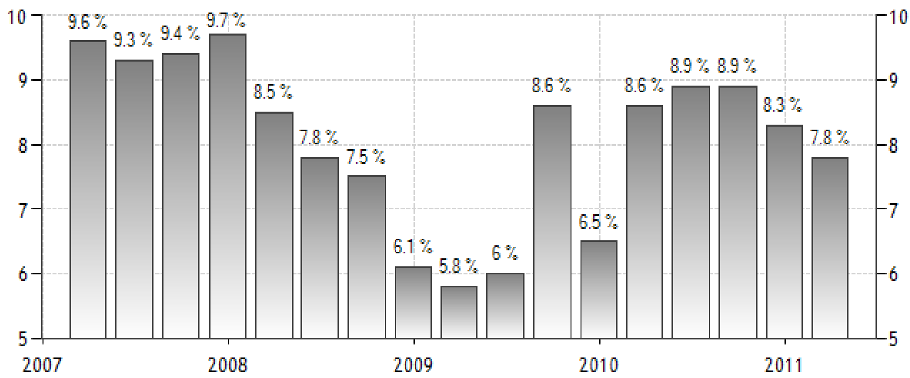
3.2 India's Economy

The gross domestic product (GDP) in India grew by 7.8 percent in the first quarter of 2011 over the same quarter of previous year. India's diverse economy encompasses traditional village farming, modern agriculture, handicrafts, a wide range of modern industries, and a multitude of services. Services are the major source of economic growth.

The Indian economic outlook 2011 indicates that the financial condition of the country became more stable in the recent years, yet inflation has been a significant problem. As per the reports, policy makers have given a significant boost to the financial state of the country. The policy makers brought development in the country's financial state in exchange of the risks related to macro stability which resulted in the inflation.

Forecasters' median estimate of inflation for the first quarter of fiscal year 2011/12 was 8.2 percent, which has been revised from 6.4 percent in the last survey. Over the next five years, inflation is expected to be 6.4 percent, revised from 6.0 percent in last survey. CPI-IW inflation forecast over the next five years remained unchanged at 7 percent.

Figure 1.8: India Real GDP Growth Rate (Y-o-Y)



source: TradingEconomics.com; India Central Statistical Orga

4. Global ASSET AND COMMODITY PRICES

4.1 Financial Markets

Global financial markets remained volatile in the first quarter of 2011 due to continued political unrest in the Middle East and North Africa combined with the fallout from the earthquake in Japan. Volatility in the global financial markets is expected to continue in the second quarter and beyond with the recent run up in the price of oil and rising commodity and food prices posing a threat to the global economic recovery.

According to GuideStone, the first quarter of 2011 was a reminder of the unpredictable nature of world events and how they can dramatically impact capital markets. The terrible earthquake in Japan and political turmoil in the

Middle East were added to a long and growing list of concerns. For investors though, the prospect for future economic growth continues to be the central issue.

The S&P 500® Index was up by 5.92 percent during the reporting period, while many other stock segments, such as small cap stocks, continued to post even better returns. Interest rates increased slightly across the U.S.

4.2 Global Commodity Markets

Global commodity prices have been increasing since 2009, particularly since the fall of 2010. While the strong increase in commodity prices was driven by global economic growth propelled by emerging economies, speculative investment flows into commodity markets amplified the intensity of the price surge.

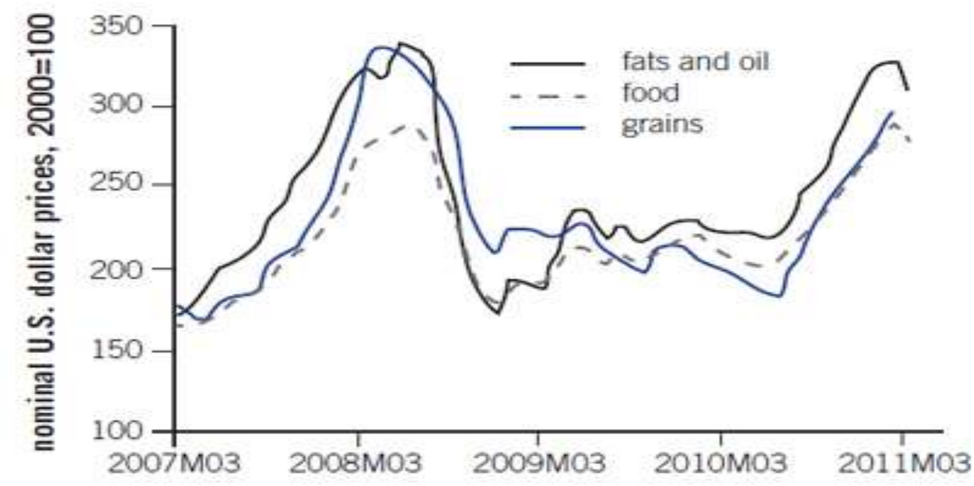
According to Bloomberg, global demand for petroleum-derived fuels rose by 2.9 percent during the first quarter of 2011 led by growth in China, Brazil, and India. Oil futures traded in New York climbed by 20 percent to average of USD 94.60 per barrel amid civil unrest in North Africa and the Middle East that imperiled crude supplies.

. Based on OPEC forecast crude oil production will decline by 370 thousand bbl/d in 2011, followed by an increase of 660 thousand bbl/d in 2012. EIA assumes that almost one-half of Libya's pre-disruption production will resume by the end of 2012. Estimated OPEC crude oil production during the first quarter of 2011 averaged about 30 million bbl/d.

Based on a World Bank report 'Food Price Watch' with global food prices at 36 percent above its 2010 levels, the poor continue to get the larger portion of the impact.

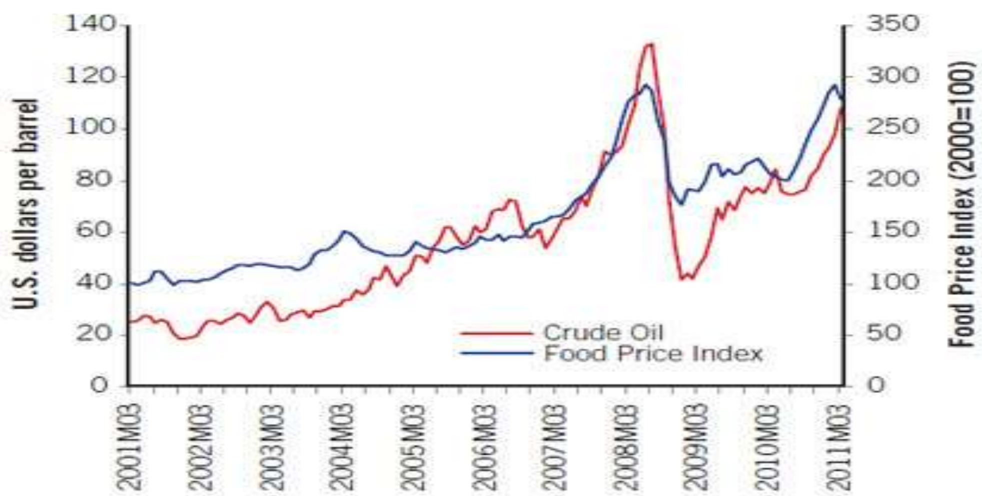
Policy actions that will reduce the pressures on tight global food markets include relaxing bio-fuel mandates when food prices exceed a threshold level, and removing export restrictions on grains. Investments in increasing agricultural yields in an environmentally sustainable manner, efficiency gains in food import supply chains, and greater use of risk-management tools such as hedging products are examples of medium-term policy goals to improve food security.

Figure 1.9: World Bank Global Price Indices
(Nominal US dollar prices, 2000 = 100)



Source: DECPG

Figure 1.10: Food and Fuel Price Trends



Source: World Bank

4.2 Global Commodity Markets

The U.S. dollars continued to depreciate in the first quarter of 2011. The U.S. dollars lost 2.4 percent against G10 currencies, similar to the pace of decline in the fourth quarter of 2010, but more moderate compared to the 8.4 percent QE2-induced drop in the third quarter of 2010.

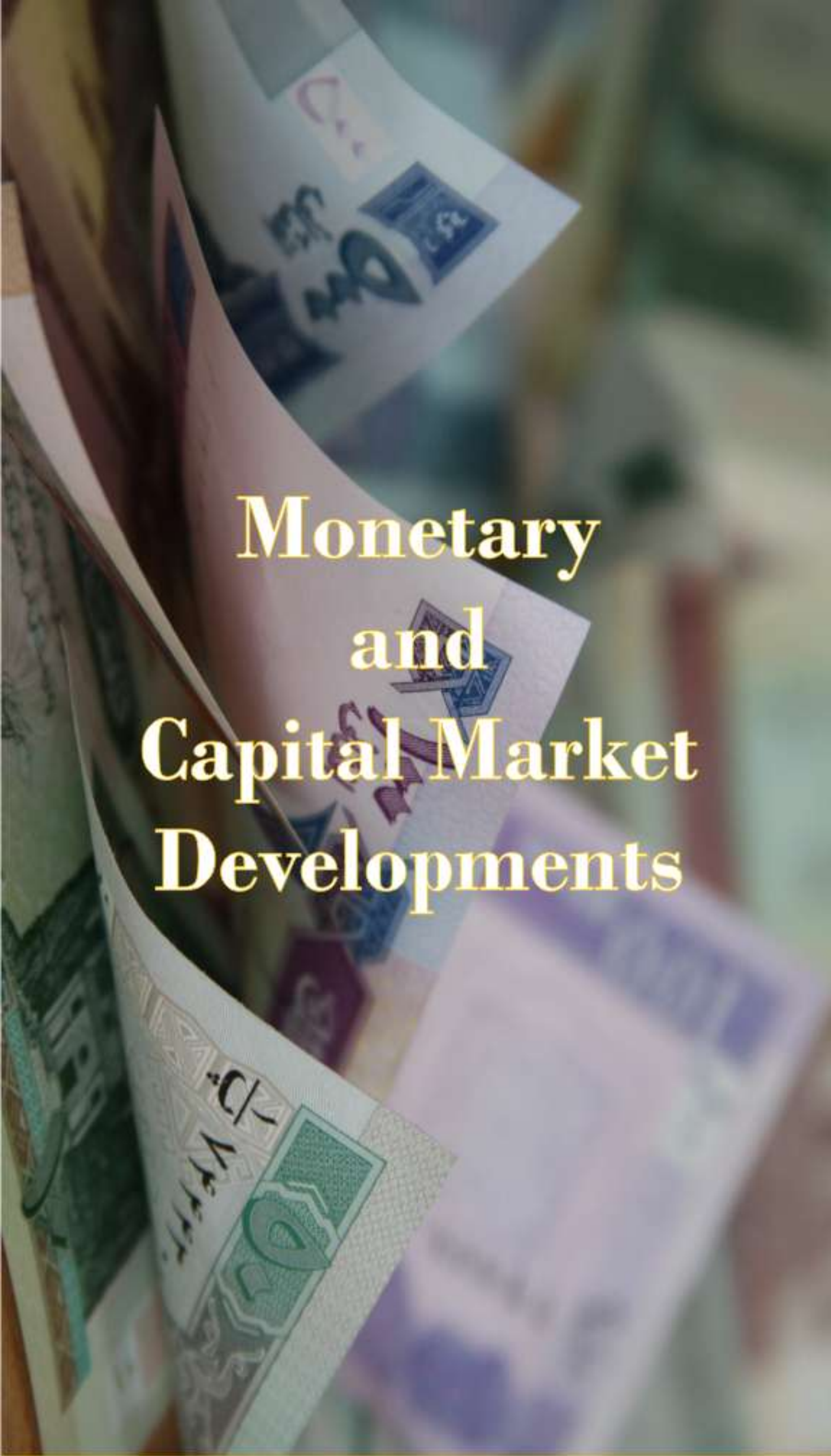
Meanwhile, major currencies appreciated against the U.S. dollars on average. The euro and the pound sterling appreciated mainly because of market's expectations of rising inflation pressures due to global oil prices, which could prompt central banks to increase policy rates. In addition, market's concerns over public debt in periphery countries also lessened. On the other hand, the yen appreciated substantially in the beginning of the earthquakes, hitting the record-low of 76.25 yen per U.S. dollar. This prompted the G7 to stage a concerted intervention aimed to control exchange rate volatility and accommodate Japan's economic recovery.

The Japanese authority also stressed its commitment to monitor the yen closely, which in part caused the currency to depreciate thereafter.

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

Currency	Code	Q1-2010	Q2-2010	Q3-2010	Q4-2010
Euro	EUR	0.743	0.819	0.735	0.755
Swiss Franc	CHF	1.064	1.085	0.976	0.941
British Pound	GBP	0.663	0.664	0.598	0.646
Japanese Yen	JPY	92.670	88.640	83.650	81.540
Chinese Yuan	CNY	6.816	6.789	6.487	6.592

Source: OANDA.COM



Monetary and Capital Market Developments

2

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

Monetary and capital market developments evaluates monetary program under Extended Credit Facility (ECF) program, monetary aggregates, foreign exchange rates, net international reserves, as well as open market operations. In the year under review, monetary aggregates had mixed performances; reserve money, the operational target under ECF program, had an increase of 20.43 percent reaching AF 151,008.13 million. The actual reserve money was below the PRFG-ECF target of 21 percent. Currency in circulation "an indicative target under the ECF program", increased by 34.2 percent in the year under review, reaching AF 132,407.09 million. Da Afghanistan Bank breached the CiC ceiling of 29.9 percent mainly because of the excess money demand.

On the other hand, narrow money (M1) grew to AF 261,215 million in the year under review, indicating annual growth rate of 22.84 percent (Y-o-Y) mainly due to increase in demand for afghani as a result of growing people's confidence on local currency. Broad money (M2) demonstrated similar behaviour growing by 22.61percent (Y-o-Y) reaching AF 277,542 million at the end of the year under review.

Capital notes auction is one of the instruments used by DAB to control reserve money and withdraw excess liquidity of the banking system.

At the beginning of the period under review, the outstanding amount for 182 day notes noticed a decline, while for 28 day CNs, it has increased. Throughout the mid of the year under review, the outstanding stock remained modestly even, but noticed a record increase in the last quarter of 1389. The 28 day CNs amount increased from AF 2.4 billion to AF 3.4 billion and from AF 8.4 billion to AF 12.6 billion for 182 day CNs.

In the meantime, nominal exchange rate of afghani against US dollar appreciated in the first half of the year and became almost flat in the second half. Afghani appreciated by 6.4 percent from AF 48.48 per USD at the beginning of the year to AF 45.37 at the end of the year under review.

1. MONETARY PROGRAM UNDER PRGF-ECF ARRANGEMENTS

Monetary Policy Framework was designed under extended credit facility of poverty eradication and growth facility (PRGF-ECF) program of International Monetary Fund (IMF). For the year 1389, our key operational target (performance criterion) was reserve money (RM), while currency in circulation was set as 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 growing financial sector as well as substantial improvements made by DAB in monetary and financial statistics to analyze and track the changes in financial sector.

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

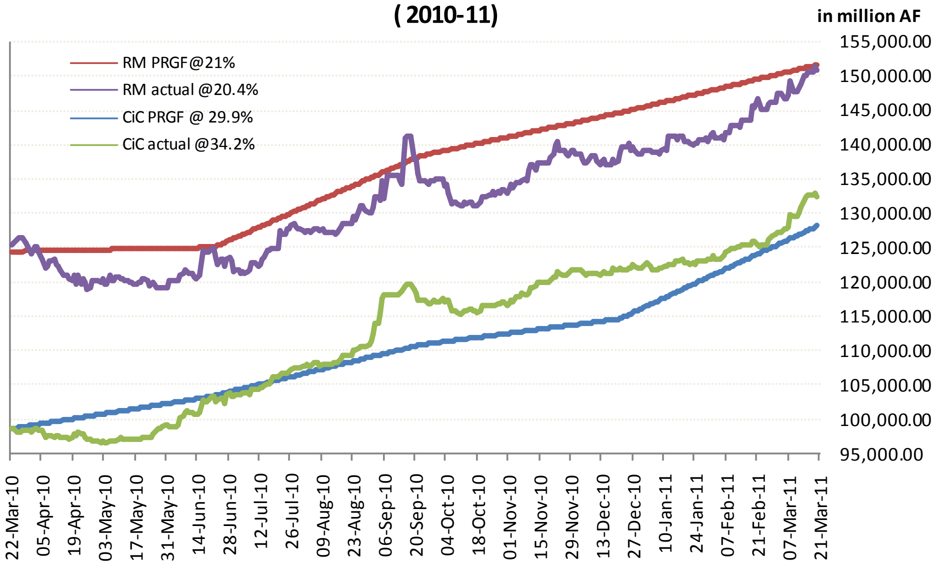
The right amount of reserve money conducive for supporting the domestic price stability is determined using the quantitative theory of money. Hence, the PRGF-ECF target is based on expected economic growth and expected inflation for the current year. For 1389, the target for reserve money has been revised from 22 percent to 21 percent, while the target for CiC growth was revised to 29.9 percent. By implementation of a sound monetary policy; actual reserve money stood at 20.43 percent whereas the target was 21 percent for the year under review.

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

For the year 1389, the CiC ceiling was projected at 29.9 percent growth under PRGF-ECF, while the actual CiC growth stood at 34.2 percent. CiC, the major component of reserve money, had an increase of 34.2 percent in the year under review reaching AF 132,407.09 million breaching the ceiling of AF 128,164.56 million projected growth. The increase in CiC was mainly because of the excess money demand.

Figure 2.1 provides detailed information on reserve money and currency in circulation growth until end of the year under review.

Figure 2.1: Reserve Money and Currency in Circulation : 1389 (2010-11)



Source: Monetary Policy Department/DAB

2. MONETARY AGGREGATES

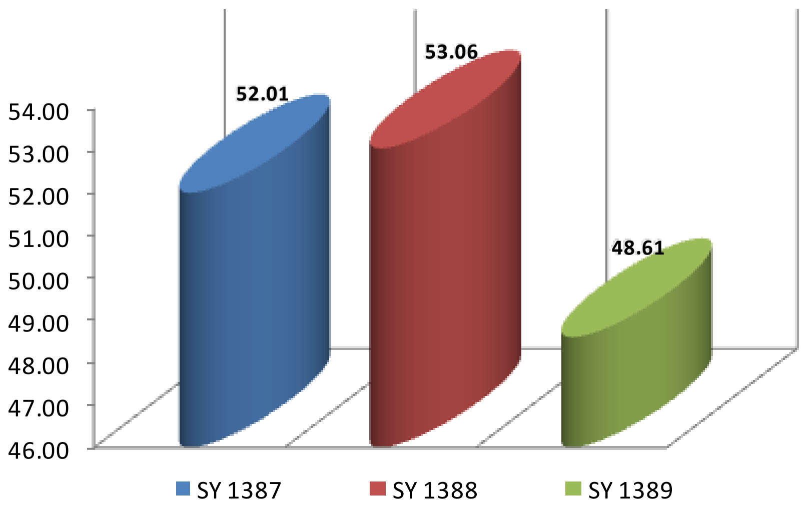
The monetary aggregates -- narrow money (M1) and broad money (M2) -- are compiled following the MFS methodology and definition. Narrow money as referred (M1) grew by 22.84 percent on a year-on-year basis at the end of 1389. The increase in M1 is attributed mainly to the increase in demand for local currency and confidence that people hold afghani and use it as medium of exchange, although the growth in demand deposit was 12.33 compared to the end of 1388.

On the other hand, the stock of broad money (M2) grew to AF 277,542 million; an overall growth of 22.61 percent (Y-o-Y), which is lower than 39.3 percent growth at the end of 1388. M1 is the main contributor to the growth in M2 since M1 constitutes 90 percent of M2.

Quasi money or time deposits of commercial banks which is the other component of M2 decreased by 9 percent at the end of 1389 in compare with the end of 1388. 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 1389 was AF 7,775 million and foreign currency denominated time deposits difference recorded AF 8552 million.

Meanwhile, bank deposits as share of broad money grew by 48.61 percent (Y-o-Y) in the year of 1389 down from 53.06 percent in the previous year. (Figure 2.2)

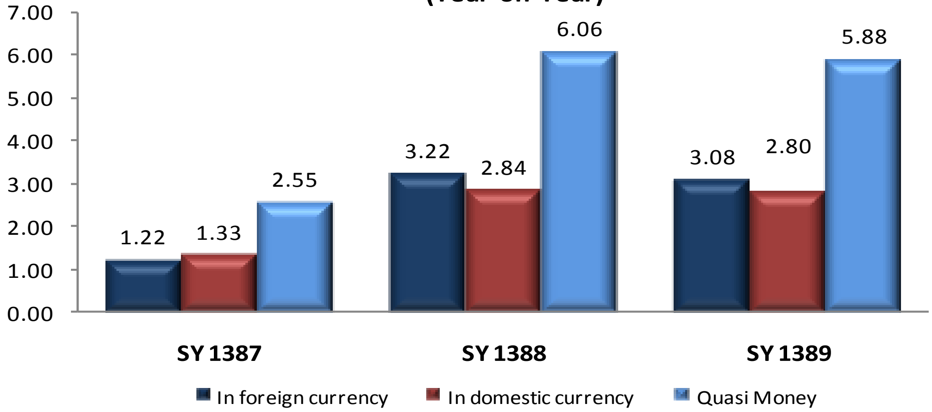
Figure 2.2: Bank Deposits as share of M2 (%)



Source: Monetary Survey Section, Monetary Policy Department DAB

Similarly quasi money as share of broad money was down to 5.88 percent at the end of 1389 down from 6.06 percent at the end of 1388. Afghani-denominated time deposits constitute 2.80 percent of broad money, while foreign currency denominated deposits contributed 3.08 percent of M2. Table 2.1 summarizes monetary aggregates of Depository corporations.

Figure 2.3: Quasi Money as Share of M2 (%) (Year-on-Year)



Source: Monetary Survey Section, Monetary Policy Department DAB

Table 2.1:Monetary Aggregate, 1389 (2010-2011) million AF

	1387	1388			1389		
	Amount	Amount	Y-o-Y Changes	Difference	Amount	Y-o-Y Change (1388 – 1389)	Difference (1389 – 1388)
1- Net Foreign Assets	**183,997**	**232,146**	**26.2%**	**48,148**	**285,116**	**22.82%**	**52,970**
(a) Foreign Assets	219,112	254,679	16.2%	35,567	301,855	18.52%	47,176
DAB Foreign exchange reserves	185,037	206,864	11.8%	21,827	251,790	21.72%	44,926
Gold	34,641	34,641	0.0%	0.000	45,232	30.57%	0.000
Other	150,396	172,223	14.5%	21,827	206,559	19.94%	34,336
Other foreign assets	34,075	47,815	40.3%	13,740	50,065	4.71%	2,250
(b) Foreign Liabilities	35,115	22,533	-35.8%	-12,581	16,739	-25.71%	-5,794
2. Net Domestic Assets	**-21,470**	**-5,791**	**-73.0%**	**15,679**	**-7,575**	**30.81%**	**-1,784**
(a) Net Domestic Credit	6,717	19,572	191.4%	12,856	21,806	11.41%	2,234
Net Credit to Nonfinancial Public Sector	-43,591	-49,527	13.6%	-5,936	-61,308	23.79%	-11,781
Net Credit to Central Government	-44,609	-49,194	10.3%	-4,585	-61,089	24.18%	-11,895
Credit to Central Government	6,659	17,094	156.7%	10,435	16,601	-2.89%	-493
Liabilities to Central Government	51,268	66,288	29.3%	15,020	77,690	17.20%	11,402
Net Credit to State & Local Government	0	0	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Nonfinancial Corporations	1,017	-333	-132.7%	-1,351	-219	-34.23%	114
Credit to Private Sector	49,842	69,652	39.7%	19,810	83,113.9 9	19.33%	13,462
Net Credit to Other Financial Corporations	466	-553	-218.7%	-1,019	0.00	-100.00%	553
(b) Capital Accounts	49,846	57,459	15.3%	7,614	23,683	-58.78%	-33,776
(c)Other Items Net	21,659	32,096	48.2%	10,437	-5,698	-117.75%	-37,794
3- Broad Money(M2)	**162,527**	**226,355**	**39.3%**	**63,828**	**277,542**	**22.61%**	**51,187**
Narrow Money(M1)	158,376	212,648	34.3%	54,272	261,215	22.84%	48,567
CiC (Currency outside depository corporations)	73,842	92,545	25.3%	18,703	126,300	36.47%	33,755
Demand Deposits	84,534	120,103	42.1%	35,569	134,915	12.33%	14,812
Other Deposits (Quasi Money)	4,151	13,707	230.2%	9,556	16,327	19.11%	2,620
In Afghani	2,164	6,417	196.6%	4,254	7,775	21.16%	1,358
In Foreign currency	1,988	7,290	266.8%	5,302	8,552	17.31%	1,262
Securities Other Thank Shares	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Source: Monetary Survey Section, Monetary Policy Department DAB

3. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

3.1 Capital Note Auctions

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

The amount to be auctioned is announced 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.

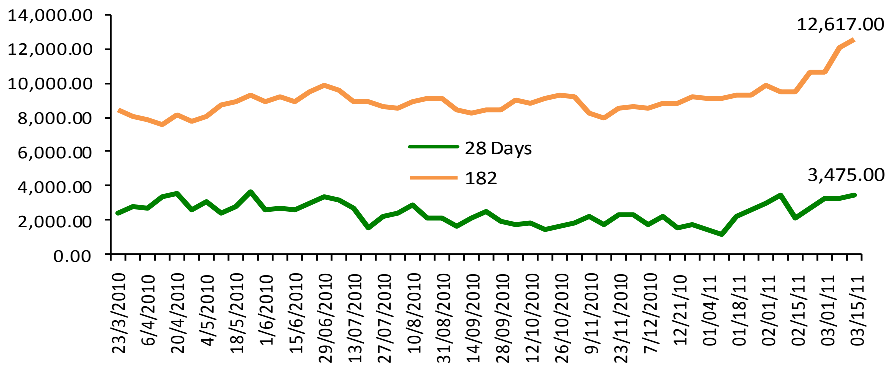
At the beginning of the period under review, the outstanding amount for 182 day notes noticed a decrease while for 28 day CNs, it has increased.

Throughout the mid of year under review, the outstanding stock remained modestly even, but noticed a record increase in the last quarter of 1389. The 28 day CNs amount increased from AF 2.4 billion to AF 3.4 billion and from AF 8.4 billion to AF 12.6 billion for 182 day CNs.

The total outstanding stock of both maturities stood at AF 16.09 billion at the end of the reporting period.

It is worth mentioning that during the year 1389, the announcement amount remained constant for both 28 day and 182 day notes at AF 200 million and AF 100 million respectively.

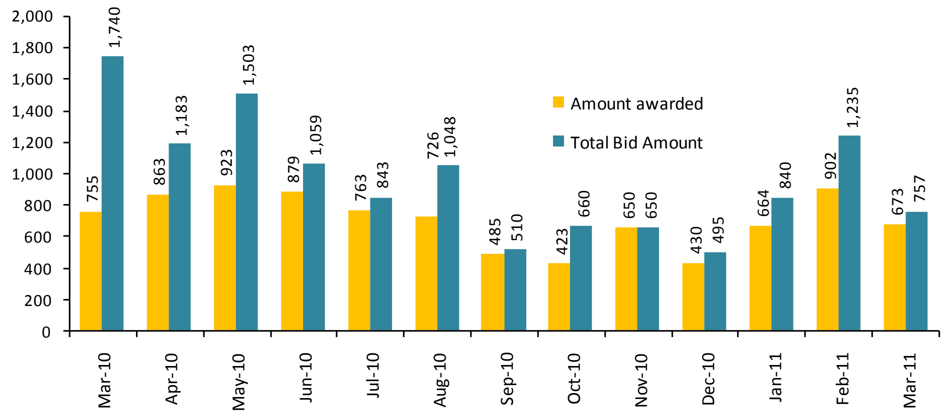
Figur 2.4: Capital Notes Stock Outstanding (million AF)



Source: Market Operations Department, DAB.

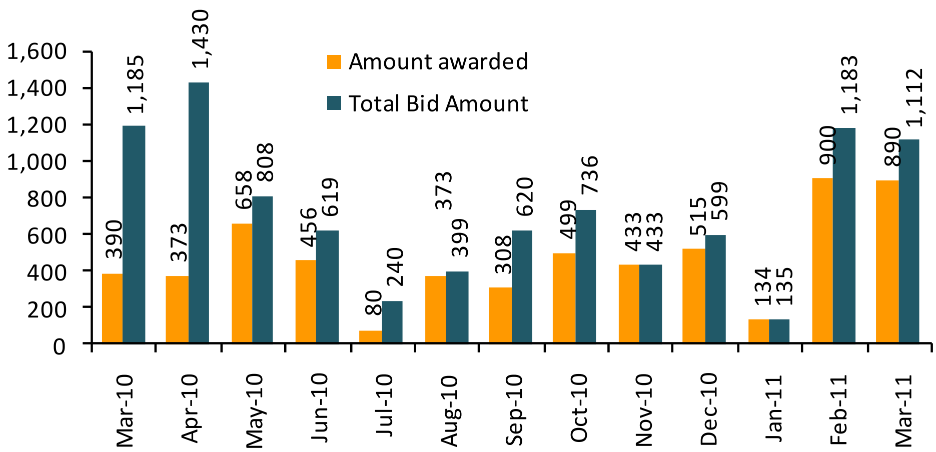
High demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the year under review, the bid amount for 28 day notes was AF 42,721 million and amount awarded was AF 31,960 million for a cover ratio of 1.33. The bid amount for 182 day note was AF 31,309 million and amount awarded was AF 21.417 million for a cover ratio of 1.46. Comparing the cover ratio in the year 1389 to that in the previous year, the cover ratio for 28 day notes was 2.25 and for 182 day notes it was 2.67.

Figure 2.5: 28 Day Capital Notes Demand and Awarded Amount, Monthly Average (million AF)



Source: Market Operations Department, DAB

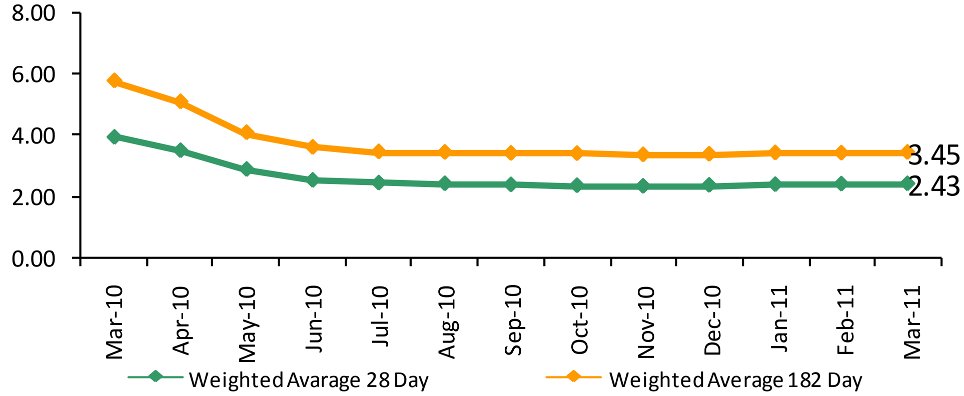
Figure 2.6: 182 Day Capital Notes Demand and Awarded Amount Monthly Average (AF million)



Source: Market Operations Department/ DAB

The weighted average interest rate declined by 150 basis points for 28 day notes and 247 basis points for 182 day notes during the reporting period. The weighted average interest rates ranged between 4.20 percent and 2.43 percent for 28 day notes; and 5.90 percent to 3.43 percent for 182 day maturity. The weighted average interest rates in the previous year were 4.10 percent to 9.17 percent; and 6.06 percent to 10.57 percent respectively.

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



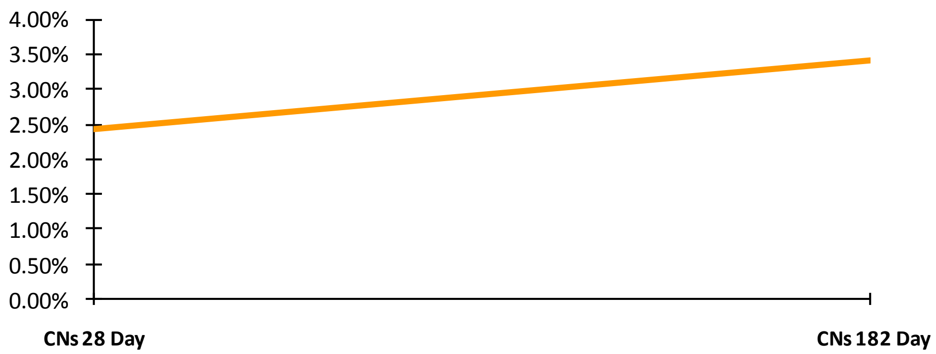
Source: Market Operations Department, DAB

2.1 Term Structure of Interest Rates

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

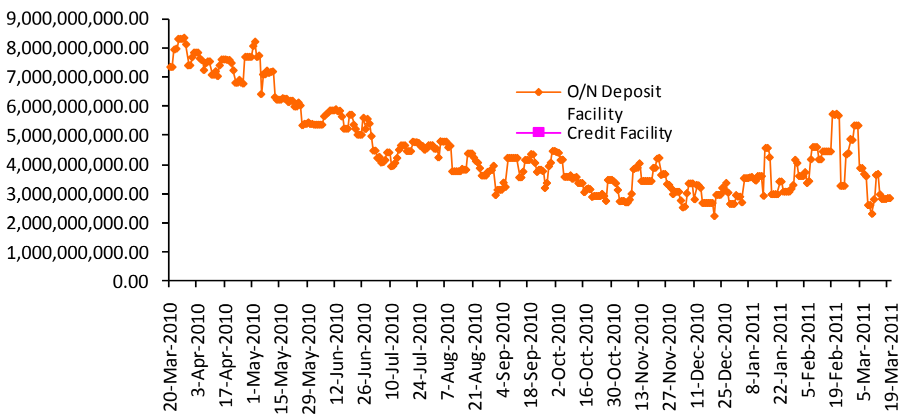
The yield curve for Mar 20th, 2011 was positive.

Figure 2.8: Term Structure of Interest Rates Yield Curve, March 20, 2011



Source: Market Operations Department, DAB

Figur 2.9: Overnight Deposit Balances (in AF)



Source: Market Operations Department, DAB

2.2 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to 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 day notes auction cut-off rate (based on a circular to all banks approved by DAB Executive Board on June 09, 2010). The outstanding amount of deposit facility balances fluctuated between AF 3 to 6 billion during the reporting period.

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

One bank benefited from credit facility for the amount of AF 194 million.

During the year under review, required reserves averaged at AF 580,756,016.66 per bank. This figure was AF 509,323,909.00 during the year 1388.

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

Table 2.3: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount Awarded	Total Bid Amount	Winning Bids	Total Bids	Cut- off Rate	Weighted Avg. Int. Rate
23-Mar-2010	200	480	1,780	3	6	4.05%	4.02
30-Mar-2010	200	1,030	1,700	2	6	3.90%	3.90
06-Apr-2010	200	620	850	2	3	3.80%	3.75
13-Apr-2010	200	1,250	1,370	3	6	3.60%	3.56
20-Apr-2010	200	720	1,330	3	6	3.30%	3.26
05-May-2010	200	1,100	1,430	6	8	3.20%	3.08
11-May-2010	200	620	1,592	4	7	3.05%	2.98
18-May-2010	200	1,100	1,750	2	5	2.88%	2.88
25-May-2010	200	870	1,240	5	7	2.75%	2.68
08-Jun-2010	200	780	780	5	5	2.75%	2.58
15-Jun-2010	200	1,000	1,200	4	5	2.70%	2.54
22-Jun-2010	200	1,205	1,405	4	5	2.61%	2.56
29-Jun-2010	200	530	850	3	4	2.54%	2.50
06-Jul-2010	200	560	650	5	6	2.50%	2.43
13-Jul-2010	200	470	520	3	3	2.55%	2.48
27-Jul-2010	200	1,260	1,360	5	5	2.52%	2.46
03-Aug-2010	200	725	850	4	4	2.48%	2.46
10-Aug-2010	200	930	1,080	5	5	2.45%	2.44
17-Aug-2010	200	Bids rejected	Bids rejected	0	0	0.00%	2.44
24-Aug-2010	200	450	1,360	4	6	2.45%	2.41
31-Aug-2010	200	800	900	5	5	2.43%	2.42
07-Sep-2010	200	430	430	3	3	2.43%	2.42
14-Sep-2010	200	450	450	2	2	2.42%	2.40
21-Sep-2010	200	860	860	5	5	2.42%	2.40
28-Sep-2010	200	200	300	3	4	2.42%	2.37
05-Oct-2010	200	230	630	2	4	2.41%	2.37
12-Oct-2010	200	600	650	3	3	2.40%	2.38
19-Oct-2010	200	485	510	4	4	2.40%	2.37
26-Oct-2010	200	375	850	4	6	2.39%	2.36
02-Nov-2010	200	430	430	3	3	2.39%	2.38
09-Nov-2010	200	1,000	1,000	4	4	2.39%	2.35
16-Nov-2010	No Auction	Eid Days					2.35
23-Nov-2010	200	900	900	5	5	2.38%	2.33
30-Nov-2010	200	400	400	3	3	2.38%	2.37
07-Dec-2010	200	420	420	3	3	2.40%	2.38
14-Dec-2010	200	510	510	3	3	2.40%	2.39
21-Dec-2010	200	220	220	3	3	2.40%	2.36
28-Dec-2010	200	570	830	3	3	2.41%	2.40
04-Jan-2011	200	205	205	2	2	2.41%	2.39
11-Jan-2011	200	190	190	3	3	2.43%	2.39
18-Jan-2011	200	1,320	1,824	6	5	2.43%	2.41
25-Jan-2011	200	940	1,140	4	4	2.43%	2.43
01-Feb-2011	200	530	730	2	2	2.43%	2.43
08-Feb-2011	200	720	1,220	5	6	2.43%	2.42
22-Feb-2011	200	1,455	1,755	5	6	2.43%	2.42
01-Mar-2011	200	1,140	1,290	3	3	2.43%	2.44
08-Mar-2011	200	680	780	4	4	2.43%	2.43
15-Mar-2011	200	200	200	1	1	2.43%	2.43
Total	**9,400**	**31,960**	**42,721**				

Table 2.4: Auction of 182 Day Capital Notes

Start Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total Bids	Cut of Rate	Weighted Avg. Int. Rate
23-Mar-2010	100	400	1,050	2	4	5.90%	5.90
30-Mar-2010	100	80	1,320	1	5	5.70%	5.67
6-Apr-2010	100	20	740	1	4	5.45%	5.45
13-Apr-2010	100	400	2,000	2	7	5.15%	5.15
20-Apr-2010	100	700	1,550	2	6	4.70%	4.70
5-May-2010	100	480	500	3	4	4.50%	4.35
11-May-2010	100	1,030	1,170	4	6	4.30%	4.17
18-May-2010	100	290	340	3	3	4.10%	4.08
25-May-2010	100	830	1,220	3	5	3.89%	3.77
8-Jun-2010	100	540	890	3	3	3.73%	3.71
15-Jun-2010	100	70	170	2	3	3.65%	3.61
22-Jun-2010	100	675	875	2	2	3.62%	3.58
29-Jun-2010	100	540	540	2	2	3.58%	3.55
6-Jul-2010	100	130	150	2	2	3.58%	3.36
13-Jul-2010	100	30	330	1	2	3.58%	3.57
27-07-2010	100	200	200	2	2	3.56%	3.56
3-Aug-2010	100	320	320	2	2	3.48%	3.45
10-Aug-2010	100	580	640	3	3	3.48%	3.45
17-Aug-2010	100	50	70	1	2	3.48%	3.48
24-Aug-2010	100	415	445	4	4	3.48%	3.46
31-Aug-2010	100	500	520	2	3	3.40%	3.40
7-Sep-2010	100	-	Bids Rejected	0	0	0.00%	3.40
14-Sep-2010	100	220	240	2	2	3.45%	3.40
21-Sep-2010	100	590	590	4	4	3.44%	3.43
28-Sep-2010	100	420	1,030	2	3	3.44%	3.43
5-Oct-2010	100	550	700	4	4	3.44%	3.42
12-Oct-2010	100	250	1,050	5	1	3.42%	3.41
19-Oct-2010	100	995	995	4	4	3.42%	3.40
26-Oct-2010	100	200	200	1	1	3.40%	3.40
2-Nov-2010	100	230	230	3	3	3.42%	3.37
9-Nov-2010	100	100	100	1	1	3.39%	3.38
16-Nov-2010	No Auction	Eid Days					3.38
23-Nov-2010	100	1,250	1,250	3	3	3.39%	3.36
30-Nov-2010	100	150	150	2	2	3.40%	3.35
7-Dec-2010	100	440	640	3	4	3.40%	3.37
14-Dec-2010	100	330	330	3	4	3.40%	3.39
21-Dec-2010	100	700	725	3	3	3.40%	3.40
28-Dec-2010	100	590	700	3	3	3.40%	3.39
4-Jan-2011	100	50	50	1	1	3.40%	3.40
11-Jan-2011	100	2	2	1	1	3.42%	3.42
18-Jan-2011	100	200	202	1	2	3.43%	3.43
25-Jan-2011	100	200	200	1	1	3.44%	3.44
1-Feb-2011	100	900	1,100	4	5	3.44%	3.43
8-Feb-2011	100	200	700	1	3	3.43%	3.42
22-Feb-2011	100	1,600	1,750	5	6	3.43%	3.42
1-Mar-2011	100	500	1,115	2	4	3.43%	3.47
8-Mar-2011	100	1,450	1,500	5	5	3.43%	3.44
15-Mar-2011	100	720	720	2	2	3.43%	3.43
Total		**21,417**	**31,309**				

Source: Market Operations Department/DAB

4. FOREIGN EXCHANGE MARKET

4.1 Foreign Exchange Rates

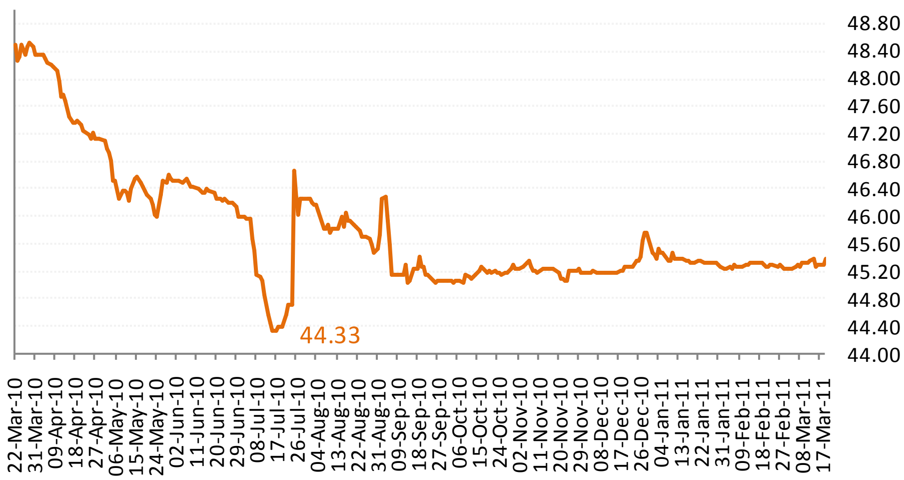
Da Afghanistan Bank's ultimate goal is maintaining price stability in domestic economy, utilizing its instruments effectively with sound policy implementation.

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

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

The daily historic review of the average exchange rate of AF against USD for 1389 is shown in Figure 2.10. As shown in Figure, the exchange rate of afghani against USD was appreciating in the first half of the year, while it became almost flat in the second half of the year. The volatility in exchange rate of AF per USD as calculated by standard deviation was 0.9 for 1389 down from 1.0 in the preceding year. Afghani appreciated by 6.4 percent from AF 48.48 per USD at the beginning of the year to AF 45.37 at the end of the year under review.

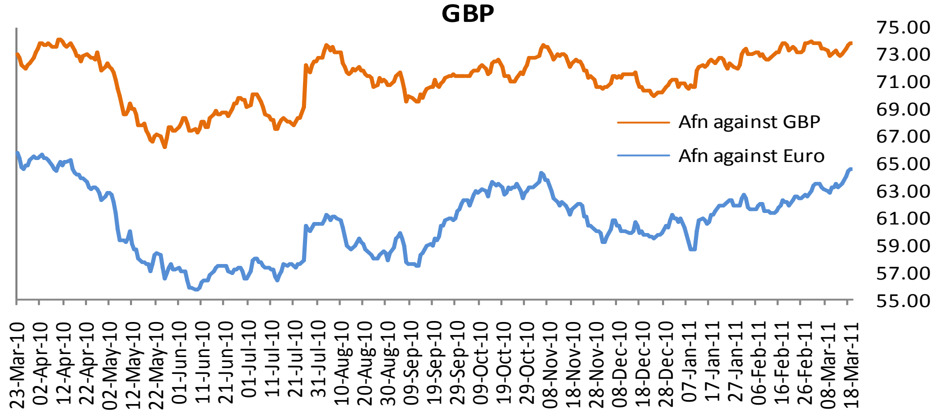
Figure 2.10: Daily Average Nominal Exchange Rate AF/USD 1389



Source: Monetary Policy Department/ Market operations Department/ DAB

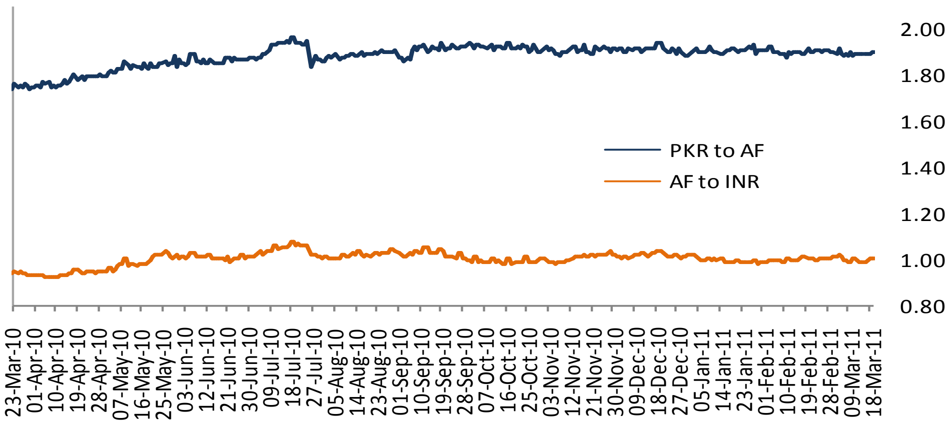
The comparison of historic review of the daily average exchange rate of afghani against some major foreign currencies for the quarter under review is shown in Figures 2.11 and 2.12.

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



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

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



Source: Monetary Survey Section, Monetary Policy Department DAB

4.3 Foreign Exchange Auction

Foreign exchange auction is the other 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 indicative target, DAB has eased the pressure in foreign exchange auction which has resulted actual currency in circulation above the target by a significant margin.

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

DAB's intervention reached a total of USD 1,356.1 million and €188.45 million at the end of the year under review.

Tables 2.5 and 2.6 summarize the result of DAB foreign exchange auctions during the period of March 23, 2010 to March 21, 2011.

Table 2.5: DAB Foreign Exchange Auction Summary (US dollars)

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Ex Rate	Amount Announced (million USD)	Amount Awarded (million USD)	No of Awarded Bidders
23-Mar-10	41	48.250	48.000	48.120	48.270	25.00	18.40	31
27-Mar-10	54	48.362	48.100	48.320	48.340	25.00	23.85	28
30-Mar-10	50	48.430	48.210	48.400	48.450	25.00	29.95	27
03-Apr-10	52	48.310	48.050	48.270	48.340	25.00	26.05	25
06-Apr-10	53	48.220	48.020	48.170	48.240	25.00	20.80	29
10-Apr-10	47	48.090	47.700	48.050	48.100	25.00	21.85	25
13-Apr-10	42	47.725	47.400	47.680	47.760	25.00	23.65	27
17-Apr-10	47	47.350	47.110	47.260	47.370	25.00	21.50	34
20-Apr-10	48	47.320	47.000	47.261	47.360	25.00	24.85	33
24-Apr-10	39	47.130	46.950	47.071	47.170	25.00	21.50	25
27-Apr-10	45	47.040	46.500	47.020	47.130	25.00	15.35	17
01-May-10	54	47.051	46.800	47.020	47.090	25.00	23.35	31
04-May-10	42	46.850	46.500	46.740	46.790	25.00	20.95	29
08-May-10	44	46.220	46.000	46.170	46.260	25.00	13.00	25
11-May-10	46	46.330	46.000	46.300	46.350	25.00	23.15	26
15-May-10	51	46.500	46.000	46.470	46.550	25.00	17.60	26
18-May-10	46	46.405	46.212	46.380	46.440	25.00	15.45	24
22-May-10	38	46.190	46.020	46.140	46.250	25.00	15.00	26
25-May-10	30	45.950	45.710	45.940	46.000	25.00	7.15	7
29-May-10	34	46.500	46.150	46.480	46.480	20.00	1.10	13
01-Jun-10	26	46.500	46.100	46.420	46.500	20.00	9.95	15
05-Jun-10	32	46.460	46.250	46.430	46.480	20.00	14.30	20
08-Jun-10	42	46.481	46.280	46.460	46.490	20.00	13.05	23
12-Jun-10	26	46.380	46.100	46.340	46.390	20.00	11.60	18
15-Jun-10	26	46.310	46.050	46.270	46.340	20.00	8.35	15
19-Jun-10	29	46.291	46.010	46.050	46.340	20.00	12.25	28
22-Jun-10	27	46.210	46.000	46.250	46.060	20.00	16.95	24
26-Jun-10	37	46.180	46.000	46.200	46.110	20.00	17.40	24
29-Jun-10	32	46.070	45.880	46.140	46.010	20.00	15.20	28
03-Jul-10	27	45.930	45.700	45.980	45.880	20.00	9.80	16
06-Jul-10	25	45.660	45.000	45.680	45.600	20.00	7.60	14
10-Jul-10	23	45.080	44.750	45.110	45.030	20.00	7.15	16
13-Jul-10	25	44.610	44.030	44.560	44.550	20.00	3.20	8
17-Jul-10	24	44.330	44.010	44.330	44.200	10.00	6.95	21
24-Jul-10	32	44.700	44.600	44.700	44.510	15.00	10.75	25
27-Jul-10	33	45.950	45.000	46.020	45.800	15.00	11.30	28
31-Jul-10	28	46.240	46.000	46.250	46.200	15.00	14.60	21
03-Aug-10	23	46.140	46.030	46.150	46.100	15.00	15.40	23
07-Aug-10	24	45.750	45.150	45.810	45.600	20.00	8.75	19
10-Aug-10	31	45.720	45.200	45.760	45.650	20.00	11.35	21
14-Aug-10	28	45.780	45.600	45.850	45.750	15.00	13.15	17
17-Aug-10	30	45.990	45.640	46.060	45.950	15.00	14.55	17
22-Jun-10	27	46.210	46.000	46.250	46.060	20.00	16.95	24
26-Jun-10	37	46.180	46.000	46.200	46.110	20.00	17.40	24
29-Jun-10	32	46.070	45.880	46.140	46.010	20.00	15.20	28
03-Jul-10	25	45.930	45.700	45.980	45.880	20.00	9.80	16
21-Aug-10	29	45.850	45.630	45.870	45.770	15.00	12.45	21
24-Aug-10	28	45.680	45.580	45.710	45.640	15.00	14.00	21
28-Aug-10	28	45.660	45.400	45.670	45.610	15.00	17.40	24
31-Aug-10	33	45.480	45.160	45.510	45.460	15.00	13.60	17

02-Oct-10	43	45.050	44.750	45.050	45.010	20.00	23.65	22
05-Oct-10	46	45.010	44.810	45.050	45.000	20.00	19.05	20
09-Oct-10	32	45.000	44.600	45.040	44.981	20.00	3.25	30
12-Oct-10	34	45.070	44.750	45.090	45.050	20.00	9.30	11
16-Oct-10	39	45.220	45.000	45.210	45.191	15.00	9.75	15
19-Oct-10	37	45.220	45.000	45.180	45.195	15.00	8.50	10
23-Oct-10	30	45.180	45.020	45.200	45.150	15.00	11.00	17
26-Oct-10	24	45.120	44.810	45.150	45.100	15.00	8.10	10
30-Oct-10	23	45.230	45.100	45.230	45.223	15.00	3.70	4
02-Nov-10	20	45.260	45.010	45.230	45.224	15.00	7.15	11
06-Nov-10	27	45.350	45.200	45.350	45.311	15.00	12.90	18
09-Nov-10	25	45.180	450.000	45.210	45.100	15.00	8.85	19
13-Nov-10	27	45.180	45.000	45.230	45.070	15.00	11.30	21
20-Nov-10	28	45.140	45.020	45.130	45.071	15.00	10.15	21
23-Nov-10	25	45.040	44.850	45.060	45.000	15.00	10.65	20
27-Nov-10	39	45.175	45.000	45.210	45.151	15.00	17.05	22
30-Nov-10	30	45.180	45.050	45.180	45.100	15.00	15.35	25
04-Dec-10	34	45.172	45.010	45.170	45.120	15.00	18.05	31
07-Dec-10	33	45.173	45.010	45.180	45.130	15.00	17.90	25
12-Dec-10	33	45.121	44.910	45.170	45.060	30.00	20.65	27
19-Dec-10	39	45.120	45.020	45.190	45.090	35.00	25.30	21
10-Dec-26	42	45.3610	45.260	45.350	45.360	30.00	34.80	23
11-Jan-02	43	45.4000	45.110	45.355	45.440	40.00	37.65	36
11-Jan-09	49	45.3100	45.110	45.281	45.340	40.00	26.70	21
11-Jan-16	46	45.3230	45.110	45.305	45.340	40.00	34.80	22
11-Jan-23	49	45.3220	45.150	45.302	45.340	40.00	32.00	26
11-Jan-30	39	45.2850	45.110	45.250	45.310	40.00	30.80	23
11-Feb-06	41	45.2210	45.100	45.211	45.240	35.00	24.60	17
11-Feb-13	33	45.2550	45.030	45.245	45.280	30.00	11.00	6
11-Feb-27	43	45.2900	45.020	45.230	45.280	35.00	33.75	33
11-Mar-13	40	45.3700	45.150	45.350	45.350	35.00	36.90	21
11-Mar-15	47	45.2400	44.850	45.200	45.250	30.00	26.60	21
Total FX announced & awarded						**1,800**	**1,356.1**	

Source: Market Operations Department and Monetary Policy Department staff calculations

Table 2.6: DAB Foreign Exchange Auction (Euro)

Auction Date	No of Bidders	High Price	Low Price	Market Ex Rate	Cut off Price	Amount Announced (million euro)	Amount Awarded (million euro)	No of Awarded Bidders
4-Sep-10	23	58.40	54.50	58.78	56.00	40.00	8.20	20
7-Sep-10	59	58.15	56.20	58.19	57.00	30.00	38.60	53
14-Sep-10	54	57.30	56.25	57.44	57.00	40.00	20.95	25
21-Sep-10	63	58.80	57.60	58.72	58.53	30.00	31.75	31
25-Sep-10	57	60.30	59.10	60.30	60.20	15.00	18.30	23
28-Sep-10	48	60.46	59.50	6.39	6.49	15.00	15.20	15
20-Feb-11	49	61.81	60.10	61.69	61.77	30.00	35.20	24
6-Mar-11	43	63.11	62.00	63.06	63.03	25.00	20.25	20
Total						**225.00**	**188.45**	

3

The Inflation Trend and Outlook

3

THE INFLATION TRENDS AND OUTLOOK

Headline inflation turned around and rose sharply in the fourth quarter of 1389 compared to the same period of last year when there was actual deflation. The accelerating trend in headline inflation that began in the first quarter of 1389 continued throughout the second quarter and finally hit double digit in the third quarter of the year. By all measures, inflation was increasing in the year under review.

The headline consumer price index (CPI), the broadest measure of the general level stood at 181.74 at the end of 1389 representing an inflation rate of 16.6 percent (Year-on-Year) up from -5.2 percent at the end of 1388. The twelve month period average inflation turned positive at the end of the third quarter of the year and rose sharply to 7.7 percent at the end of 1389 compared to -12.24 percent in the same period last year.

The increase in the headline CPI was attributed to the increase in the prices of both food and non-food sub-indexes. The food price index turned around and rose sharply in the year under review. The increase in the food prices was mainly attributed to the increase in the prices of bread and cereals, meat (beef), oil and fats, fruits, vegetables, and tea and beverages. The increase in non-food sub-index was mainly led by rents, construction materials, household goods, transportation, and miscellaneous price indexes.

Core inflation also increased sharply in the year under review. When the effects of significant price changes in bread and cereals, oil and fats, and transportation are excluded from the figures, the year-on-year rate of core inflation in 1389 recorded 13.0 percent increase at the end of the year under review compared to 2.9 percent in the same period of last year. High rate of core inflation remains a matter of concern for policy making side.

When core inflation is measured by 28 percent trimmed mean, the same pattern appears. Core inflation, measured by 28% TM increased by 11.4 percent in 1389 up from 1.8 percent in 1388.

The analysis shows that pattern observed nationwide was similar to the pattern observed in Kabul, with a few exceptions. National headline inflation, which had been negative in 1388 became strongly positive (13.7 percent) in the year under review. Interestingly, however, inflation in rents was increasing slowly nationwide than in Kabul, while inflation in transportation was rising more rapidly.

The situation is different in the quarter-on-quarter changes in inflation. Kabul headline inflation in the fourth quarter of 1389 turned negative recording a deflation rate of 0.2 percent, down from 4.7 percent in the preceding quarter. Prices of bread and cereals, oil and fat, and fuel and electricity fell in the fourth quarter of 1389 leading the headline inflation toward negative territory.

1. INFLATION IN AFGHNISTAN HIT DOUBLE DIGIT AGAIN

1.1 Changes from Same Quarter of Last Year in Kabul CPI

It is important to compare the rate of inflation in the current period (end of 1389) to the rate of inflation in the same period of last year (end of 1388) to eliminate any possible effect of seasonality.

By this measure, the headline rate of inflation in Kabul increased sharply to 16.6 percent (Year – on-Year) compared to the same period of last year where there was actual deflation of 5.2 percent. This sharp turnaround from the previous year was concentrated, both in the food and non-food components. In contrast to 1388, when prices were declining in most food items, 1389 saw increases increase in almost all components. For example, bread and cereals (28% weight) increased dramatically to 24.8 percent from -22.5 percent in 1388, meat (6% weight) increased to 20.1 percent, up from 5.3 percent in 1388, oil & fat (5.3% weight) increased sharply from -0.2 percent in 1388 to 24.4 percent in 1399, fruits (4.9% weight) increased from -2.5 percent to 13.8 percent, vegetables (4.9% weight) increased from 4.8 percent to 13.3 percent, rents (7.1% weight) increased from 6.4 percent to 28.7 percent, transportation (2.3% weight) increased from 5.4 percent to 14.9 percent, education (1.2% weight) increased from -0.4 percent to 11.8 percent, and miscellaneous category (0.9% weight) increased from 0.1 percent in 1388 to 13.3 percent in 1389.

To understand the main factors responsible for increase of 16.6 percent in the rate of inflation in the year under review, it is necessary to look at the individual components of the CPI. Fits we analyze those components that showed the largest unfavorable changes in inflation from t6he previous year.

The food price-index accounts for 61.3 percent of the CPI basket: This price-index increased dramatically in the year under review which pushed headline inflation to increase rapidly. Their prices, which had been fallen sharply in the same period of last year, turned around and rose sharply. The (year-on-year) changes in food prices increased to 18.3 percent at the end of 1389 in contrast to the same period of last year when there was actual deflation of 10.1 percent. Among the different factors responsible for increase in food prices, bad climate situation which caused vast destructive flood in the neighboring counties of Afghanistan, also inside the country affected the agriculture products negatively. The next reason is thought to be the increase in aggregate demand in the international markets due to improvements in the global recession. The main components responsible for the increase in food price-index are as follow:

The Bread and Cereals Sub-index Accounts for 28 percent of the CPI Basket: This price-index rose dramatically to 24.8 percent (Y-o-Y) at the end of 1289, a sharp turnaround from the same period of last year when there was actual deflation of 22.5 percent. The most unfavorable development among all CPI components was the increase in the rate of inflation in bread and cereals as a result of sharp reduction in supply of grains from Pakistan, as well as growing aggregate demand for food items in the international markets. It is worth mentioning that global prices on cereals have soared and are expected to rise further in 2011, to the levels even higher than recorded in 2008.

The Oil & Fat Price-index Accounts for 5.3 percent of the CPI Basket: like other food items, this price-index also surged in the year under review, recording 24.4 percent (Y-o-Y) inflation rate, a sharp turnaround from the same period of last year, where there was actual deflation of 0.2 percent. This 24.6 percentage point increase in the rate of inflation in oil and fats could be attributed to both supply and demand sides. On the supply side, the devastated flood in the neighboring countries, especially Pakistan, the major trade partner of Afghanistan, as well as heavy rainfall and floods in agrarian areas inside the country affected the supply of food items negatively. While on the demand side, the usage of grains for producing ethanol as an alternative for fuel pulled the prices of food items up.

The Meat price-index, Accounts for 6.0 percent of the CPI Basket: This prices-index was increasing steadily at the beginning of the year under review and hit double digit in second quarter of the year. Meat prices increased by 20.1 percent (Y-o-Y) at the end of the year under review compared to 5.3 percent inflation in the same period of last year. One of the main factors responsible for this increase is thought to be the increase in the prices of cereals and grains.

The Fruit price-index, Accounts for 4.9 percent of the CPI Basket: This price-index, another important factor contributing to the increase in headline inflation, also increased rapidly in the year under review. Fruit prices increase sharply by 13.8 percent (Y-o-Y) at the end of the fourth quarter of 1389, a sharp turnaround from -2.5 percent in the same period of last year.

On the other hand, the following food items posted decline in the period under review, which partially offset the unfavorable changes:

The sugar and sweets sub-index, Accounts for 1.8 percent of the CPI Basket: This price-index declined to 7.9 percent (Y-o-Y) at the end of 1389 down from 22.9 percent in the same period of last year.

The Spices sub-index, Accounts for 1.1 percent of the CPI Basket: Prices of spices declined slightly to 5.3 percent, compared to 7.2 percent in 1388.

Table 3.1: Breakdown of Kabul Headline CPI
(Percent changes year on year), Consumer Price Index (March 04=100)

	Weights	1387				1388				1389			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	**100**	**33.3**	**35.7**	**22.7**	**3.2**	**-10.0**	**-14.9**	**-13.2**	**-5.2**	**1.5**	**5.3**	**12.9**	**16.6**
Food and Beverages	**61.3**	**48.6**	**52.7**	**30.3**	**0.9**	**-17.5**	**-21.9**	**-20.7**	**-10.1**	**-0.6**	**4.7**	**15.6**	**18.3**
Bread and Cereal	28.0	91.4	91.9	49.4	-3.6	-30.2	-35.9	-36.0	-22.5	-6.5	3.2	12.5	24.8
Meat	6.0	5.9	11.0	7.0	-0.6	-0.3	-1.4	-1.7	5.3	7.2	21.5	24.2	20.1
Milk and cheese	5.6	8.8	9.6	7.3	9.7	4.7	0.6	1.3	-2.6	1.9	2.0	5.5	3.6
Oil and Fat	5.3	20.2	27.0	-1.7	-14.1	-17.5	-21.2	-5.5	-0.2	5.1	7.6	28.5	24.4
Fresh & dried fruits	4.9	3.9	15.3	12.8	15.0	15.4	9.8	0.3	-2.5	-5.7	-6.3	14.0	13.8
Vegetables	4.9	27.6	28.4	23.3	16.6	-0.1	-1.1	1.2	4.8	14.0	8.0	29.7	13.3
Sugar & Sweets	1.8	-3.2	8.8	7.8	10.4	16.3	18.2	20.8	22.9	14.1	10.4	13.5	7.9
Spices	1.1	11.6	20.7	22.5	18.7	8.4	5.6	2.5	7.2	10.2	5.3	6.1	5.3
Tea & Beverages	2.0	13.3	15.7	17.2	12.6	2.1	0.3	-0.9	1.2	1.8	-0.5	4.9	7.0
Tobacco & Cigarettes	1.7	7.0	8.4	6.6	7.3	3.2	2.1	3.1	4.3	5.6	8.6	10.5	9.5
Non – Food	**38.7**	**10.3**	**10.8**	**10.5**	**7.4**	**5.0**	**-0.8**	**0.9**	**3.0**	**4.8**	**6.3**	**8.8**	**14.2**
Clothing	7.2	5.6	11.0	9.0	8.8	6.8	3.0	1.3	1.3	0.7	-2.1	1.1	3.5
Housing	17.2	10.3	9.9	10.3	7.2	7.1	-2.3	0.4	4.5	6.9	11.6	15.5	15.1
Rents	7.1	6.8	7.6	8.8	9.1	8.6	3.8	4.3	6.4	11.5	19.2	27.5	28.7
Construction materials	3.2	15.6	17.3	11.2	4.2	1.0	-14.1	-11.5	-2.4	3.9	14.4	14.6	9.6
Fuel and Electricity	6.8	11.9	9.5	11.2	6.6	7.7	-3.4	0.7	4.9	3.8	4.5	6.2	4.7
Household goods	7.0	2.7	3.5	2.9	3.7	3.0	2.5	2.6	1.0	0.3	-0.5	2.1	30.1
Health	2.0	7.8	19.2	21.3	23.9	19.3	7.2	4.9	-0.2	-0.5	-0.6	0.6	2.5
Transportation	2.3	40.5	25.9	21.3	1.0	-14.0	-11.9	-2.3	5.4	14.5	10.3	0.2	14.9
Communications	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.2	0.5	1.6	2.1	1.4	0.6	0.1	-0.6	-0.4	-1.7	-0.9	0.5	11.7
Miscellaneous	0.9	15.8	22.6	27.0	17.9	12.6	8.4	4.8	0.1	1.0	-1.3	10.1	13.3
Core inflation (28% TM)		**9.8**	**14.2**	**11.8**	**7.6**	**4.2**	**0.5**	**0.8**	**1.8**	**3.8**	**4.1**	**9.0**	**11.4**
Core infl. (headline excluding bread and cereals, oil and fats, and transportation)			**12.0**	**10.8**	**9.0**	**6.2**	**1.4**	**1.5**	**2.9**	**4.6**	**5.9**	**12.6**	**13.0**

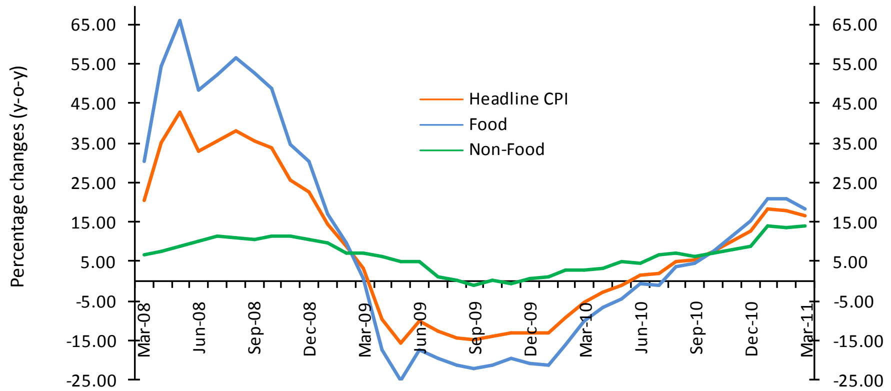
Source: Central Statistics Office and DAB staff calculations.

Non-food price-index, Accounts for 38.7 percent of the CPI Basket: This sub-index which could be a more real representation of inflation due to economic activities turnaround and hit double digit in the fourth quarter of 1389. Rents prices rose sharply to 14.2 percent (Y-o-Y) at the end of 1389 from 3.0 percent in the same period of last year. The impact of non-food on the headline inflation was not as pronounced as the food prices. The main components responsible for the increase in food price-index are as follow:

The Rents sub-index, Accounts for 7.1 percent of the CPI Basket: This sub-index which has the largest weight after clothing in non-food sub-category of the CPI basket rose to 28.7 percent at the end of 1389 compared to 6.4

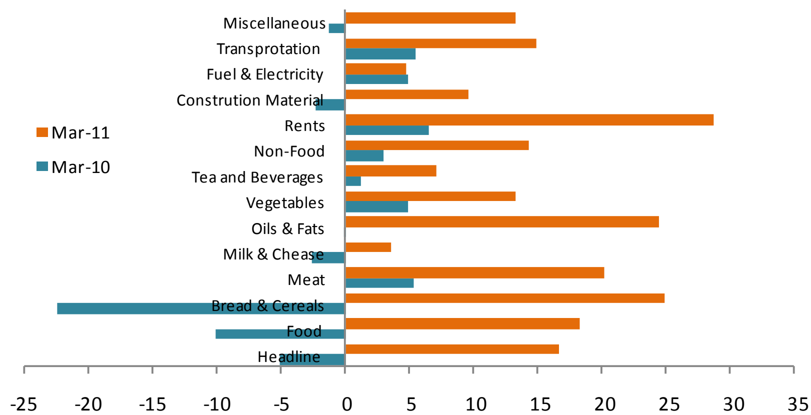
percent in the same period of last year. The main factors pushing this sub-index go up is thought to be attributed to the increasing demand for housing as a result of growing population in Kabul due to large internal displaced people caused by insecurity in some outlying rural areas, as well as repatriation of Afghan refugees from the neighboring countries, especially Iran and Pakistan.

Figure 3.1: Headline inflation, Kabul CPI



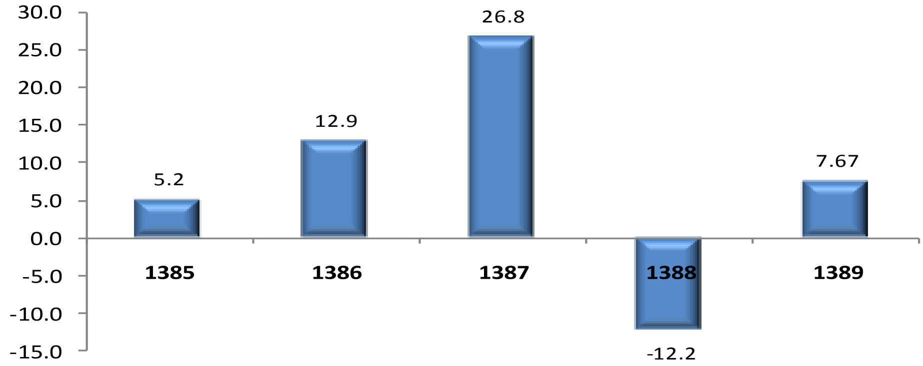
Source: Central Statistics Office and DAB staff calculations.

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



Source: Central Statistics Office/DAB Staff Calculations

Table 3.3: 12 Months Period Average Inflation, Kabul CPI



Source: Central Statistics Office/DAB Staff Calculations

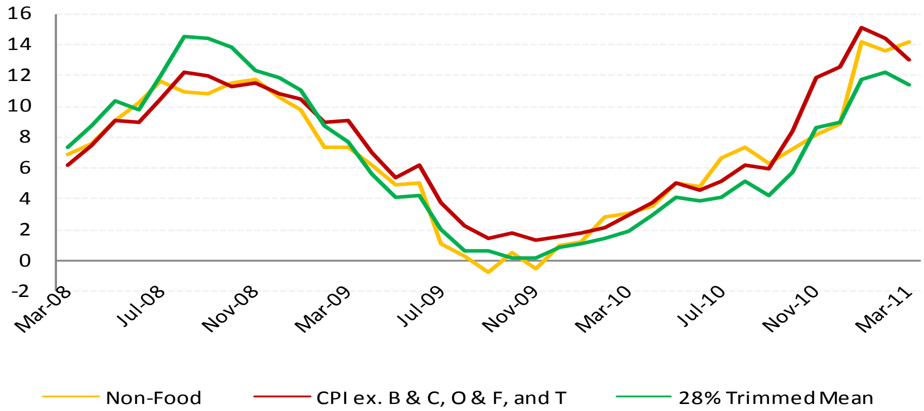
The Household goods sub-index, Accounts 7 percent of the CPI Basket: This sub-index also increased sharply in the reporting period. Prices of household goods rose dramatically by 30.1 percent (Y-o-Y) in the fourth quarter of 1389, compared with 1.0 percent recorded in the same period of previous year.

The volatility in Kabul inflation measured by its standard deviation was 7.9 percent in 1389 up from 3.0 percent in 1388. The high volatility in inflation remains concern for monetary policy.

The analysis of inflation trend includes a measure of core inflation because comparing one period's price statistics with some other period gives a crude measure of inflation (if the general level of prices has risen). But such a measure does not discriminate between relative price changes and inflation, so an increase in price of a single item such as rent may cause a price-index to rise. For this reason, measure of core inflation which removes from overall inflation the components with high volatility rate from the CPI basket. There is no firm theoretical basis, no agreed approach to measure core inflation. Core inflation by all measures increased in the year under review, but the increase in core inflation was less than increase in headline inflation. Core inflation (headline excluding bread & cereals, oil and fats, and transportation) increased by 13 percent in 1389 up from 2.9 percent at the end of 1388. The reason that the increase in the core inflation rate was less than the increase in the headline inflation rate is easy to explain. It is because core inflation excludes the exact two components – bread and cereals, and oils and fats – that showed the largest increase in inflation between the two periods.

When core inflation is measured by the 28 percent trimmed mean, a similar pattern appears. Core inflation increased to 11.4 percent in the fourth quarter of 1389 from 1.8 percent in the same quarter of last year. The trimmed mean excludes the percent changes in prices that rank among the smallest or largest (in numerical terms changes for the month), in this case bread and cereals, rents, household goods, communications, health, and milk & cheese were excluded.

Figure 3.4: Core Inflation (% changes Y-o-Y)

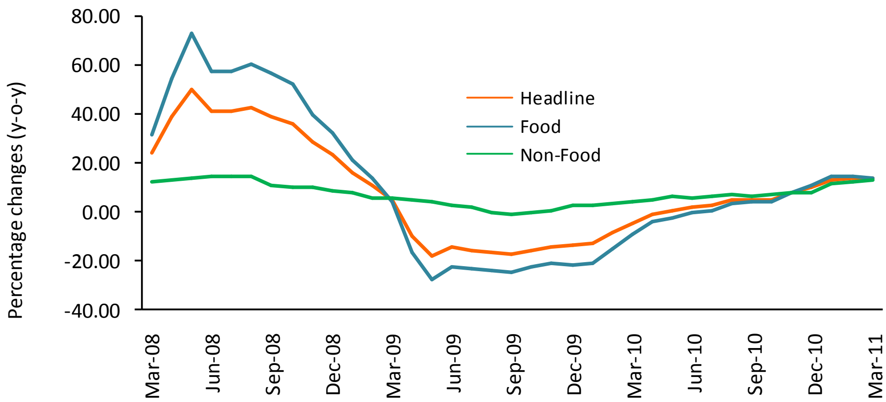


Source: Central Statistics Office and DAB Staff calculations

1.2 Annual Changes in National CPI

The national headline inflation as measured on a year-on-year basis, exhibited similar characteristics to the Kabul inflation. Nationwide headline inflation turnaround and hit double digit in the fourth quarter of 1389, recording inflation rate of 13.7 percent (Y-o-Y) at the end of 1389 compared to the same period of last year when there was actual deflation of 4.5 percent. The main factors responsible for a sharp increase in inflation nationwide were similar to those in Kabul. Again, both food and non-food sub-indexes increased in the reporting period pushing the headline inflation up sharply.

Figure 3.5: Breakdown of Headline Inflation: National CPI



Source: Central Statistics Office/DAB Staff Calculations

Table 3.2: Breakdown of Headline Inflation, National CPI

(Percentage changes year-on-year)

Consumer Price Index, (March 2004=100)

	Weight	1384 (2005 – 06)	1385 (2006 – 07)	1386 (2007 – 08)	1387 (2008 – 09)	1388 (2009 – 10)	1389 (2010 – 11)
Headline	100	9.8	3.8	24.3	4.8	-4.5	13.7
Food and Beverages	61.3	9.1	4.9	31.9	4.3	-9.1	14.0
Bread and Cereal	28	10.9	3	50	3	-19	15.9
Meat	6	3.5	2.7	9.6	-0.5	4.9	17.5
Milk and cheese	5.6	9.5	6.6	15.6	8.8	-3	4.5
Oil and Fat	5.3	2.4	3.2	52.3	-18.8	1.4	21.6
Fresh & dried fruits	4.9	4.9	4.8	12.3	7.7	3.5	10.2
Vegetables	4.9	11.4	19.3	10.5	23.6	-0.1	15.6
Sugar & Sweets	1.8	24.9	2	-4.4	11.6	23.5	7.7
Spices	1.1	12.4	13.4	-8	24.4	0.0	4.3
Tea & Beverages	2	4.4	3.9	4.3	15.5	2.5	6.7
Tobacco & Cigarettes	1.7	5.2	1	6.2	14	5.7	4.0
Non – Food	38.7	10.9	2.2	12.2	5.9	3.8	13.3
Clothing	7.2	3.4	2.6	5.5	12.3	2.5	4.3
Housing	17.2	16.4	-1.5	13.3	3.8	5.9	12.4
Rents	7.1	14.8	-20	11.7	3.3	6.1	13.9
Construction materials	3.2	8.2	-4.5	13.4	6.3	-0.6	11.6
Fuel and Electricity	6.8	22.7	25.3	14.8	3.4	7.8	11.4
Household goods	7	1.7	2.9	8.8	7.6	0.8	26.4
Health	2	13.9	10.7	5.3	16.8	-2.6	2.6
Transportation	2.3	16.6	21.1	27.9	-1.3	4.3	26.3
Communications	0.9	0.1	-0.3	12.3	-0.7	1.7	-3.8
Educations	1.2	-1.1	3.1	4.1	5	-0.8	4.9
Miscellaneous	0.9	13.9	6	30.2	11.5	7.5	9.3
Core (28% Trimmed Mean)			4.7	11.3	7.8	2.3	9.8
Corel (ex. B &C, O & F, and T)		7.6	3.5	10.3	8.5	3.3	11.5

Source: Central Statistics Office/DAB Staff Calculations

The sharp increase in food sub-index was attributed to a sharp increase in bread and cereals, oil and fat, meat, fruits, and vegetables sub-indexes. While the increase in non-food sub-index was due to a sharp increase in rents, household goods, and transportation sub-indexes.

Oils and fats (5.3 percent weight) also experienced a dramatic increase in the year under review compared with the previous year. Oil and fats increased by20.1 percentage points from the previous year, recording inflation rate of 21.6 percent (Y-o-Y) up from 1.4 percent inflation at the same period of last year. The level of inflation in this component was a bit lower than that in Kabul.

In contrast to the situation in Kabul, increases in the rate of inflation in rents were moderate. Rental prices increased nationwide in the fourth quarter of 1389, on a year-on-year basis, recording 13.9 percent increase. This was somewhat higher than the 6.1 percent rate of inflation recorded in the previous year. Although nationwide rental inflation was much lower than in Kabul, but is still high, which may indicate that the migration from the rural areas toward the main cities impact not only Kabul, but also other major cities in Afghanistan.

The milk and cheese price-index (5.6 percent weight) increased modestly nationwide, similar pattern in Kabul. This price-index increased by 4.5 percent (Y-o-Y) at the end of 1389 from a deflation rate of 3.0 percent at the end of 1388.

The non-food sub-index increased sharply at the end of 1389 as a result of increase in prices of rents, construction materials, household goods, transportation.

The rents sub-index (7.1 percent weight) increased sharply to 13.9 percent at the end of 1389 from 6.1 percent in the same period of last year as a result of growing population in the major cities.

The construction materials sub-index (3.2 percent weight) increased to 11.6 percent at the end of 1389 as a result of growing demand for housing.

The household goods (7 percent weight) increased rapidly to 26.4 percent in the year under review from a low inflation rate of 0.8 percent in the previous year.

1.3 Quarterly Changes in Kabul Headline CPI

To see more clearly what was happening to inflation in the most recent time periods, it is necessary to compare the changes in the CPI on a quarter-on-quarter basis. Fortunately, the Kabul headline inflation showed a downward trend in the fourth quarter of 1389 on a quarterly basis. The headline inflation declined to -0.2 percent (q-o-q) in the quarter under review compared to 4.7 percent the preceding quarter. After three consecutive quarters of high inflation in 1389, the decline in headline inflation in the fourth quarter may indicate that inflation has lost momentum.

The main factor responsible for this sharp decline in the fourth quarter of 1389 was a dramatic decline in the prices of bread and cereals. The downward trend in bread and cereals which began in the middle of the third quarter, continued throughout the fourth quarter of the year, recording -2.2 percent (q-o-q) in the fourth quarter compared to -0.5 percent in the previous quarter.

The oil and fat sub-index also dropped in the fourth quarter by -1.5 percent (q-o-q) from 19.9 percent last quarter.

The rents and electricity sub-indexes posted a decline in the fourth quarter representing inflation rate of 3.7 percent and -6.8 percent respectively.

In contrast to the year-on-year changes, the rents price-index declined on quarterly basis recording inflation rate of 3.7 percent in the fourth quarter of the year down from 7.7 percent in the previous quarter.

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

	1387				1388				1389			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	**13.1**	**8.0**	**-4.3**	**-11.6**	-1.5	2.1	-2.3	-3.5	5.4	5.9	4.7	-0.2
Food and Beverages	**19.1**	**8.1**	**-6.6**	**-16.2**	-2.5	2.3	-5.1	-5.0	7.9	7.8	4.7	-2.8
Bread and Cereal	33.3	8.6	-8.6	-27.1	-3.5	-0.3	-8.7	-11.8	16.6	9.9	-0.5	-2.2
Meat	-1.0	0.0	1.4	-1.0	-0.7	-1.1	1.1	6.0	1.1	12.1	3.4	2.4
Milk and Cheese	-1.8	8.0	0.8	2.7	-6.3	-0.1	1.5	-1.2	-2.0	3.9	4.9	-3.0
Oil and Fat	1.8	4.5	-16.2	-3.6	-2.2	-0.1	0.5	1.7	3.0	2.2	19.9	-1.5
Fresh & dried fruits	0.9	15.2	-3.6	2.6	1.3	9.6	-12.0	-0.2	-2.0	8.9	7.1	-0.4
Vegetables	13.5	12.2	-3.7	-4.9	-2.7	11.0	-1.5	0.8	5.8	5.2	18.3	-14.0
Sugar& Sweets	0.3	10.5	-1.2	0.9	5.7	12.2	1.0	2.6	-1.9	8.6	3.8	-2.4
Spices	9.8	7.7	3.0	-2.5	0.2	4.9	0.0	1.9	3.1	0.2	0.7	1.2
Tea and beverages	10.6	4.5	-0.3	-2.2	0.2	2.7	-1.5	-0.2	0.8	0.4	3.8	1.9
Tobacco & Cigarettes	3.4	1.7	1.3	0.7	-0.5	0.7	2.3	1.9	0.7	3.5	4.1	0.9
Non – Food	2.5	7.7	0.5	-3.2	0.2	1.7	2.3	-1.1	1.9	3.1	4.7	3.8
Clothing	1.0	6.9	0.4	0.3	-0.9	3.2	-1.3	0.3	-1.4	0.2	1.9	2.7
Housing	0.6	11.1	1.0	-5.0	0.5	1.4	3.7	-1.1	2.8	6.0	7.3	-1.5
Rents	1.1	6.9	0.2	0.7	0.6	2.2	0.7	2.7	5.4	9.3	7.7	3.7
Construction materials	1.8	13.2	-4.3	-5.5	-1.3	-3.7	-1.4	4.2	5.1	6.0	-1.2	-0.3
Fuel and Electricity	-0.1	13.9	3.3	-9.3	0.9	2.2	7.6	-5.5	-0.2	2.9	9.4	-6.8
Household goods	1.0	1.7	0.0	1.1	0.2	1.2	0.0	-0.5	-0.5	0.4	2.7	26.8
Health	4.5	11.4	1.8	4.7	0.6	0.1	-0.5	-0.4	0.3	-0.1	0.7	1.5
Transportation	18.8	0.3	-2.4	-12.8	0.7	2.7	8.3	-5.9	9.4	-1.0	-1.6	7.9
Communications	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.3	0.2	-0.2	0.1	0.5	-0.3	-1.0	0.3	-0.8	0.6	0.4	11.6
Miscellaneous	3.7	6.2	3.3	3.6	-0.9	2.3	-0.1	-1.1	0.0	0.0	11.3	1.8

Source: Central Statistics Office/DAB Staff Calculations

1.4. Quarterly Changes in National Headline CPI

Quarterly nationwide inflation dropped over the previous quarter, same as it happened to Kabul CPI, but did not enter negative area. The headline rate of inflation stood at 1.4 percent (q-o-q) in the fourth quarter, down from 4.6 percent in the third quarter of 1389. The pattern of changes in the rate of inflation across the CPI basket components, however, was almost the same from what was experienced in Kabul.

For example, the nationwide inflation in bread and cereals dropped to -0.8 percent in the fourth quarter of 1389 compared to 2.2 percent in the preceding quarter indicating that the decline in the prices of bread and cereals was spreading throughout the country.

Table 3.4: Quarter on Quarter Changes in national headline CPI
(Percent changes quarter-on-quarter)
Consumer Price Index, (March 2004 = 100)

	Weights	1387				1388				1389			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	100.0	18.2	5.2	-4.6	-11.6	-3.7	1.4	-0.1	-2.1	2.8	4.3	4.6	1.4
Food and Beverages	61.3	26.7	5.0	-7.0	-15.8	-5.7	1.3	-2.5	-2.4	3.3	5.7	4.2	0.2
Bread and Cereal	28.0	44.7	5.3	-10.4	-24.5	-8.6	-0.8	-4.8	-6.1	5.9	8.0	2.2	-0.8
Meat	6.0	-8.8	2.2	3.0	3.6	-3.2	1.6	3.4	3.0	0.9	7.5	4.4	3.8
Milk and cheese	5.6	3.1	4.4	0.8	0.2	-2.9	1.0	-0.7	-0.5	-0.3	2.2	2.0	0.6
Oil and Fat	5.3	6.4	1.5	-14.6	-12.0	-0.5	-2.7	1.9	2.7	1.1	4.4	15.4	-0.3
Fresh & dried fruits	4.9	2.3	5.4	-1.5	1.5	2.2	8.4	-8.3	1.9	-1.7	2.5	4.8	4.3
Vegetables	4.9	20.9	8.6	2.9	-8.5	-8.1	7.8	0.8	-0.1	4.5	0.9	10.9	-1.3
Sugar & Sweets	1.8	3.1	6.2	1.0	0.9	3.3	10.3	4.8	3.4	-0.8	9.3	0.6	-1.2
Spices	1.1	4.2	11.7	3.9	2.9	-4.1	2.2	0.4	1.6	0.7	1.3	0.1	2.2
Tea & Beverages	2.0	7.8	3.5	1.1	2.4	-0.1	0.4	1.8	0.5	-0.1	0.3	1.9	4.5
Tobacco & Cigarettes	1.7	4.4	-0.7	4.9	4.9	1.0	2.3	1.8	0.4	0.5	1.0	0.0	2.4
Non – Food	38.7	2.8	5.6	0.7	-3.1	-0.1	1.7	3.9	-1.6	2.0	2.2	5.4	3.2
Clothing	7.2	1.6	3.9	4.9	1.5	-1.1	0.4	1.4	1.8	-0.2	0.6	1.5	2.4
Housing	17.2	0.7	8.5	-0.5	-4.6	0.2	3.1	5.8	-3.1	2.1	3.5	8.7	-2.2
Rents	7.1	-0.3	3.2	1.3	-1.0	0.1	5.6	0.4	0.1	5.5	2.3	5.4	0.1
Construction materials	3.2	5.3	5.2	-2.6	-1.5	-0.4	-1.7	0.0	1.5	2.7	3.6	2.7	2.2
Fuel and Electricity	6.8	0.2	14.2	-1.2	-8.5	0.6	2.4	12.5	-6.9	-1.0	4.6	13.4	-5.2
Household goods	7.0	3.7	1.5	1.2	1.0	-0.2	1.1	-0.9	0.8	2.4	1.3	4.7	16.4
Health	2.0	6.2	2.8	2.8	4.1	-1.5	-1.2	-0.1	0.1	0.4	0.4	-0.4	2.3
Transportation	2.3	12.6	4.6	-2.0	-14.5	0.1	-0.7	10.3	-4.9	7.6	0.4	-0.4	17.4
Communications	0.9	0.0	-0.7	0.0	0.0	1.2	0.0	0.0	0.5	-3.6	0.0	0.0	-0.3
Educations	1.2	2.0	-0.4	2.5	0.8	0.9	-0.4	-1.1	-0.1	-0.2	0.8	0.4	3.8
Miscellaneous	0.9	3.4	1.2	4.2	2.3	1.6	2.7	3.5	-0.4	0.6	3.2	5.7	-0.3

Source: Central Statistics Offices and DAB staff calculations

The same pattern was observed in fuel and electricity price-index. Nationwide fuel and electricity sub-index declined in the quarter under review representing a deflation rate of 5.2 percent (q-o-q) down from 13.4 percent in the third quarter of 1389.

Nationwide rental prices also posted a decline in the quarter under review, representing an inflation rate of 0.1 percent (q-o-q) compared to 5.4 percent inflation observed in the preceding quarter.

2. INFLATIONARY OUTLOOK

Inflation turnaround and became positive at the beginning of the second quarter of the 1389 and continued its upward trend throughout the year. Increasing demand conditions, negative developments on the supply side expected to affect prices pressures go up. This indicates the fact that food prices are expected to continue upward trend due to unfavorable winter season with limited snowfall as well as less seasonal rainfalls in the first months of 1388, which will affect domestic wheat production in the rain-fed areas negatively. Based on the upward trend of headline inflation in the second half of 1389, it is expected that year-on-year headline inflation may continue upward trend in the first half of 1390 due to increase in both, food and non-food prices. Increasing supply side pressures, poor domestic wheat production, improving demand lend support o the upward inflation outlook.

Inflation as measured by quarter-to-quarter has been very high so far in 1389 compared to 1388. However, as previously mentioned, the latest quarterly data show a slowdown in inflation. Worldwide, inflation is not expected to diminish. Rising food costs are expected throughout 2011. For example, the United Nations forecasts global food prices to rise by 20 percent in 2011. This global supply shock will undoubtedly affect Afghanistan, where food is already a significant share of national expenditure.

2.1 Supply conditions remained critical

Supply side conditions remain critical with some negative developments on the supply side expected to fuel prices increase. On the supply side, a key source of possible negative developments is the disruption in imports of staples such as wheat, rice, oil and fats, from neighboring countries and other trading partners of Afghanistan. Any interruption in supply either due to poor trade facilities at border points or drought is likely to be passed through to higher prices.

2.2 Demand conditions are improved

Demand side pressures improved as various economic indicators exhibited upward trends. On the one hand, recent data indicate improvements in demand conditions such as increases in property and rental prices. On the other hand, full-year output growth for 1389 was well below the government target. On the wages front, the government increased salary of teachers and other civil servants under the new pay and grade system, prospects for further wage hikes for private sector workers remains uncertain.

4

Fiscal Developments

4

FISCAL DEVELOPMENTS

The fiscal developments analyses implementation of budget, developments in domestic revenues, and donor grants for the financing of both operating and development budgets in 1389. In the past few years, government of the Islamic Republic of Afghanistan (GoIRA) has made significant progress in broadening tax base and improving revenue collection.

Over the course of 1389, GoIRA adopted standard mechanisms and techniques to project revenues on higher frequency in order to allow GoIRA to prioritize development projects across the country, improve budget and expenditure planning, and attain operational efficiency. Domestic revenues observed 25 percent increase recording AF 78,683.71 million in the year 1389. The increase in domestic revenues was mainly ascribed to custom duties, having an increase of 27 percent to AF 27704.57 million, sales tax revenues; representing AF 16,291.24 million. Fixed taxes indicate 12 percent increase. Moreover, income tax revenues stood at AF 10,288.22 million in the year 1389 which represents a 38 percent increase.

On the other hand, sales of land and buildings declined to AF 107.57 million in the year 1389, representing 50 percent decrease. Income from capital property decreased to AF 281.09 million in the period under review, having 9 percent decline.

Core expenditures increased by 29 percent to AF 154,015.86 million in 1389. Core expenditures accounted for 25 percent of GDP. Operating expenditures increased to AF 110,452.78 million in 1389, representing an increase of 25 percent. In addition, the development expenditures also increased to AF 43,563.08 million in 1389 which shows 40 percent increase. Total core budget was in surplus by about AF 6.1 billion by the end of the year 1389. This was mainly due to strong revenue collection and large operating budget surplus. The operating budget surplus stood at AF 24.4 billion, while the development budget was in deficit of AF 18.4 billion. Because of high development budget deficit, the core budget surplus declined by about AF 9.9 billion in the year 1389. However, to compared to the same period in 1388, the core budget surplus increased by AF 5.4 billion.

The donor grants for operating budget increased while grants for development expenditures declined. Allotted grants for both operating and development expenditures amounted to AF 4,934.90 million in 1389, representing 18 percent reduction.

1. REVENUES

Under Poverty Reduction and Growth Facility and Extended Credit Facility PRGF-ECF program of International Monetary Fund (IMF), revenue target was agreed after negotiations between Ministry of Finance (MoF) and IMF. In the year 1389, Ministry of Finance achieved both ECF and budget targets. Customs duties and tax revenues were the main drivers behind significant increase in domestic revenues exceeding the targets. However, non-tax revenues and social contributions were below their targets. Total domestic revenues, classified as tax and non-tax revenues, increased to AF 78,683.71 million in 1389 up from AF 62,678.43 million in 1388, representing 26 percent increase. Tax revenues and custom duties increased to AF 66,391.88 million representing 29 percent increase. Sales taxes mainly business receipt tax, fixed taxes mainly taxes on imports of licensed business, and income taxes imposed on employees' salaries and wages were main contributors to the tax revenues. Tax revenue collections from Large Tax Office (LTO) and Medium Tax Office (MTO) also contributed to the increase in total tax revenues. On the positive side, the non-tax revenues increased to AF 12,291.83 million in the year under review up from AF 11,146.84 million in 1388 which shows 10 percent increase.

Non tax revenues components includes income from capital property, sales of goods and services, administrative fees, royalties and non tax fines and penalties, sale of land and buildings and some other categories as shown in Table 4.1.

Main contributors to the tax revenues in were customs duties, fixed taxes, income taxes, property taxes and sale taxes (See Table 4.3). Customs duties increased to AF 27,704.57 million in 1389 up from AF 21,781.90 million in 1388, this represents a 27 percent increase. Good performance in the collection of customs duties was mainly attributed to the continued structural reforms such as the provision of capacity building programs to customs officials and implementation of customs valuation measures. Fixed tax revenues increased to AF 9,087.31 million up from AF 8,148.73 million in the preceding year, which represents a 12 percent increase. Property taxes increased to AF 245.45 million in the year 1389 up from AF 190.79 million in the year 1388, which depicts 29 percent increase. Sales taxes increased to AF 16,291.24 million up from AF 12,335.96 million in 1388, which shows 32 percent increase. Income taxes increased to AF 10,288.22 million in the year 1389 from AF 7,435.06 million in the previous year, indicating a 38 percent increase.

Table 4.1: Revenue Collections (in million AF)

	1388 Revenue Actual	1389 Revenue Actual	% Δ from 1388 to 1389
Total Domestic Revenues (Tax and Non Tax)	62,678.43	78,683.71	26 %
Tax Revenues	51,531.59	66,391.88	29 %
Non Tax Revenues	11,146.84	12,291.83	10 %
Total Donor Contributions	66,264.02	4,934.90	-93 %

Source: Ministry of Finance website and DAB staff estimation

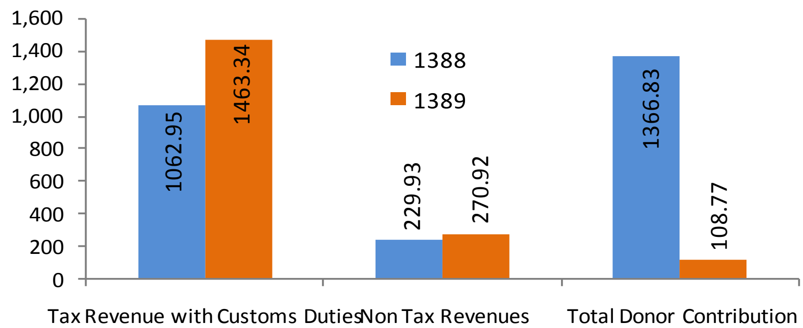
Table 4.2: Revenue Collections (in million USD)

	1388	1389
Total Domestic Revenues (Tax & non- Tax revenue)	1,292.87	1,734.26
Tax Revenue with Customs Duties	1,062.94	1,463.34
Non Tax Rev	2,29.92	270.92
Total Donor Contributions	1,366.77	42.58

Source: Ministry of Finance website and DAB staff estimation

End Period Average exchange rate of FY1389 (ER=45.37) and FY1388 (ER=48.48)

Figure 4.1: Total Domestic Revenues (in million USD)



Source: Ministry of Finance website and DAB staff calculations

Table 4.3: Total Tax and Non-tax Revenues (in million AF)

Tax and non-Tax Revenues	1388	1389	% Δ 1388 to 1389
Taxation & Customs Revenues			
Fixed Taxes	8,149	9,087.31	12%
Income Taxes	7,435	10,288.22	38%
Property Taxes	191	245.45	29%
Sales Taxes	12,336	16,291.24	32%
Excise Taxes	-	-	
Other Taxes	1,224	2,152.21	76%
Tax Penalties and Fines	415	622.88	50%
Customs duties	21,782	27,704.57	27%
Total taxation revenues	**51,532**	**66,391.88**	**29%**
Social contributions			
Retirement contributions	1,066	1,808.14	70%
Total social contributions	**1,066**	**1,808.14**	**70%**
Other revenue			
Income from Capital Property	310	281.09	-9%
Sales of Goods and Services	3,392	4,507.85	33%
Administrative Fees	5,953	6,282.05	6%
Royalties	101	40.37	-60%
Non Tax Fines and Penalties	223	339.32	52%
Miscellaneous Revenue	954	733.58	-23%
Sale of Land and Buildings	214	107.57	-50%
Total other revenue	**11,147**	**12,291.83**	**10%**
Afghanistan Reconstruction Trust Fund (ARTF)	18,918	23,565.31	25%
Law and Order Trust Fund – Afghanistan (LOTFA)	14,297	24,403.57	71%
CSTC - MoD	6,874	14,561.46	112%
Foreign loans	-		
World Bank	742	481.48	-35%
Asian Development Bank	2,152	1,925.47	-11%
Other	514	395.17	-23%
Donor revenue	-	-	
World Bank	12,261	5,272.23	-57%
European Commission	-	-	
ADB	5,833	4,408.98	-24%
CNTF	862	301.51	-65%
Others	3,812	2,596.90	-32%
Total Donor Contributions	**66,264**	**4,934.90**	**-93%**
Loan from IMF	**1,264**	**111,228.23**	**87%**

Source: Ministry of Finance website and DAB staff calculations

2. EXPENDITURES

Total core expenditures, classified as operating expenditures and development expenditures, increased to AF 154,015.85 million in 1389 up from AF 119,168.71 million in 1388, representing a 29 percent increase. Total expenditures accounted for 25 percent of GDP in the year under review. Similarly, development expenditures increased to AF 43,563.08 million in 1389 up from AF 31,096.67 million in 1388, which shows 40 percent increase. Development expenditures accounted for 7 percent of GDP.

The current or operating expenditures increased to AF 110,452.78 million in 1389 up from AF 88,072.03 million in 1388, this represents 25 percent increment and accounts for 18 percent of GDP.

Current expenditures include five categories namely: compensation of employees, goods and services, subsidies and grants, interest payments and acquisition of non-financial assets.

Expenditures on compensation of employees in the year 1389 increased to AF 86,474.03 million from AF 64,257.39 million in 1388, showing a 35 percent increment. The increased expenditures in this category is mainly attributed to rapid implementation of Pay & Grading Reforms, the additional security forces recruited in the first half of the year and the salary disbursements were made to them in the fourth quarter of 1389.

Supplier expenses increased to AF 17,158.49 million in 1389 up from AF 16,888.81 million in 1388, which represents 1.6 percent increase.

Expenditures on interest payments declined to AF 79.50 million in 1389 from AF 103.94 million in 1388, indicating 24 percent decrease. Afghanistan is one of the most aid dependent countries in the world. After the establishment of the transitional government, the international community committed significant resources to the rebuilding of Afghanistan. It is worth mentioning that development projects have been financed by foreign aid since 2001.

GoIRA borrows on highly concessional terms to finance a limited number of discretionary development projects.

Comparatively smaller but rapidly growing parts of the operating budget are subsidies, grants and social transfers. Subsides to state owned enterprises, capital transfers to municipalities, and social expenditures such as pensions are included here. Expenditures on subsidies, grants and contribution decreased to AF 5,151.56 million in 1389 down from AF 5,337.97 million in 1388, which represents a 3 percent decrease.

Table 4.4: Core Expenditures (in million AF)

Particulars	1388 Expenditure Actual	1389 Expenditure Actual	% Changes
Total Expenditures(Development and Operating)	119,169	154,015.86	29%
Development Expenditures	31,097	43,563.08	40%
Operating Expenditures	88,072	110,452.78	25%

Table 4.5: Core Expenditures (in million USD)

	1388	1389
Total Expenditures	2458	3,394.66
Development Expenditures	641	960.17
Operating Expenditures	1817	2,434.49

Source: Ministry of Finance website and DAB staff estimation

End Period Average exchange rate of 1389 (ER=45.37) and 1388 (ER=48.48)

Table 4.6: Total Development Expenditures (in million AF)

Expenditure Splits	1388	1389	% Δ 1388 to 1389
Employees			
Salaries in cash	-	-	
Salaries in kind	-	-	
Salaries and wages advance	-	-	
Social benefits in cash	-	-	
Social benefits - in kind	-	-	
Total employee expenditure	**-**	**-**	
Supplier Expenditure			
Travel	173	170.09	-2%
Communications	71	-	-100%
Contracted services	11,383	12,886.66	13%
Repairs and maintenance	373	188.18	-50%
Utilities	10	97.26	898%
Fuel	36	60.56	69%
Tools and materials	1,093	343.01	-69%
Other	448	519.53	16%
Advances and return of expenditure	1,625	1,508.19	-7%
Total supplier expenses	**15,212**	**15,773.48**	**4%**
Subsidies, grants, contributions and pensions			
Grants	20	16.33	-18%
Grants to foreign government a	-	-	-
Social security benefits cash	-	-	-
Social assist benefit in cash	-	-	-
Advance Subsides Grants	111	400.00	259%
Total subsidies, grants, contributions and pensions expenditure	**131**	**416.33**	**217%**
Buildings and structures	21,102	19,502.08	-8%
Machinery and equip (>50,000)	5,251	3,289.97	-37%
Valuables	4	0.71	-82%
Land	24	9.05	-63%
Capital advance payments	4,584	4,571.46	0%
Total capital expenditure	**30,966**	**27,373.27**	**-12%**

Source: Ministry of Finance website and DAB staff estimation

Table 4.7: Total Operating Expenditures (in million AF)

Expenditure Splits	1388	1389	% Δ 1388 to 1389
Salaries in cash	53,357	73,742.09	38%
Salaries in kind	10,034	12,341.09	23%
Salaries and wages advance	90	127.19	42%
Social benefits in cash	777	263.65	-66%
Social benefits - in kind	-	-	-
Total employee expenditure	**64,257**	**86,474.03**	**35%**
Supplier Expenditure			
Travel	1,147	1,142.26	0%
Communications	582	-	-100%
Contracted services	498	770.29	55%
Repairs and maintenance	2,005	2,038.66	2%
Utilities	829	1,859.32	124%
Fuel	3,230	2,983.32	-8%
Tools and materials	6,101	5,506.80	-10%
Other	1,487	1,846.54	24%
Advances and return of expenditure	1,010	1,011.30	0%
Total supplier expenses	16,889	17,158.49	1.6%
Subsidies, grants, contributions and pensions			
Grants	29	32.05	12%
Grants to foreign government a	10	136.78	2%
Social security benefits cash	4,065	4,731.96	16%
Social assist benefit in cash	354	622.82	76%
Advance Subsides Grants	880	(372.06)	-142%
Total subsidies, grants, contributions and pensions expenditure	5,338	5,151.56	-3%
Buildings and structures	344	458.30	33%
Machinery and equip (>50,000)	711	857.39	21%
Valuables	1.1	1.23	18%
Land	159	260.69	64%
Capital advance payments	269	11.59	-96%
Total capital expenditure	1,484	1,589.20	7%
Interest	104	79.50	-24%
Total interest expenditure	104	79.50	-24%

Source: Ministry of Finance website and DAB staff calculations

3. FINANCING THE CORE BUDGET

Grants finance nearly the entire development budget with the remainder financed through concessional loans. Grants for 1389 declined compared to 1388 due to lower execution of development budget. The operating budget is funded by domestic revenues. However, grants make up a significant proportion of almost 20 percent of total operating budget, in particular for the security sector. Moreover, grants were about 50 percent of total revenues in 1389.

Grants in 1389 amounted to AF 4,934.90 million up from AF 66,264.02 million in 1388, showing 93 percent decrease. Grants received from ARTF scheme increased to AF 23,565.31 million in 1389 from AF 18,918.11 million in 1388, representing a 25 percent increase. Grants received from LOTFA scheme increased to AF 24,403.57 million in 1389 compared to AF 14,297.42 million in 1388, which represents 71 percent increase.

Grants received from CSTC-MoD scheme increased to AF 14,561.46 million in 1389 compared to AF 6,873.80 million in 1388, representing a 112 percent increase.

Although, Afghanistan has significant mineral resources including copper, iron, gold, coal, and semi-precious stones. But, it still represents less than one percent share of GDP. If exploration of untapped mineral resources starts and government privatize state own enterprises, it will enable the government to finance both operating and development expenditures from internal sources

Fiscal management and public administration reform (FMPAR), sponsored by ADB is to develop systems and procedures, supported by increased capacity, aimed at improving budget programming, strengthening revenue mobilization, developing the civil service and enhancing monitoring capabilities of public finances. More specifically, FMPAR will

(i) Strengthen fiscal management;

(ii) Strengthen public administration;

(iii) Strengthen public financial management;

(iv) Develop a framework for public service delivery,

This program will contribute to fiscal management, revenues reforms and budget financing.

Government uses any surplus to increase the cash reserves at Treasury Single Account (TSA), or to repay debts and reduce its liabilities. A budget deficit is financed through cash reserves at TSA, or loans which increases liabilities.

Table 4.8: Donor Contributions, 1389 (in million AF)

Donor contributions	1388	1389	%Δ 1388 to 1389
Afghanistan Reconstruction Trust Fund (ARTF)	18,918.11	23,565.31	25%
Law and order Trust Fund - Afghanistan	14,297.42	24,403.57	71%
CSTC - MoD	6,873.80	14,561.46	112%
Foreign loans	-	-	
World Bank	741.63	481.48	-35%
Asian Development Bank	2,151.60	1,925.47	-11%
Other	513.62	395.17	
Donor revenue	-	-	
World Bank	12,261.13	5,272.23	-57%
European Commission	-	-	
ADB	5,832.50	4,408.98	-24%
CNTF	861.87	301.51	-65%
Others	3,812.34	2,596.90	-32%
Total donor contributions	66,264.02	4,934.90	-93%
Loan from IMF	1,263.77	82,847.00	64%

Source: Ministry of Finance website and DAB staff calculations

Table 4.9: Breakdown of Donor Contributions, 1389 (in million AF)

Donor contributions	Operating Grants	Development Grants
Afghanistan reconstruction trust fund	15,444,749	8,120,559
Law and order trust fund - Afghanistan	24,403,575	
CSTC - MoD	14,513,724	47,740
Foreign loans		
World Bank		481,485
Asian Development Bank		1,925,468
Other		395,167
Donor revenue		
World Bank		5,272,232
European Commission		-
ADB		4,408,982
CNTF		301,514
Others		2,596,900
Total donor contributions	103,719	4,831,186
Loan from IMF	54,465,767	28,381,232

Source: Ministry of Finance website and DAB staff calculations

5

Banking System Performance

5

BANKING SYSTEM PERFORMANCE

Total assets of the banking system registered a year-on-year growth rate of 12.59 percent or AF 22.81 billion at the end of 1389 (March 2011). Total asset of the banking sector stood at AF 203.84 billion at the end of 1389 compared to AF 181.04 billion in the same period last year. Gross Loans amounted to AF 80.24 billion (USD 1.77 billion) depicting an increase of 20.68 percent, while deposits stood at AF 156.54 billion (USD 3.44 billion) up by 4.45 percent from the same period last year. Deposits were largely denominated in USD (62.38 percent) with afghani denominated deposits lagging at 34.54 percent. AF-denominated deposits indicated growth rate of 11.21 percent, while USD denominated deposit were up by 2.56 percent. The entire banking sector was well capitalized, except the crises stricken bank, inclusion of which put a huge pressure on the capital position of the system. With the exclusion of the above mentioned bank, capital adequacy ratio (CAR) of the banking sector remained robust at 30.39 percent. Excluding the crises stricken bank, overall banking sector was profitable earning profit of AF 335 billion, down by 73.31 percent, however the size of losses of the mentioned bank distorts the figure for the whole sector and turns the overall return on assets (ROA) to -20.08. Only branches of foreign banks ended up with profit, while private banks and state-owned banks ended up with losses for the year 1389.

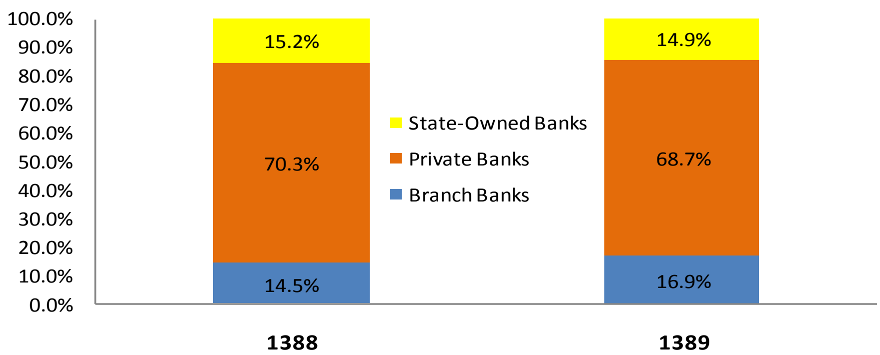
1. ASSETS OF THE BANKING SYSTEM

The banking system continues to grow at a brisk rate. Total assets of the banking system at the end of 1389 stood at AF 203.84 billion (USD 4.49 billion), up by 12.59 percent or AF 22.81 billion since March 2010, Figure 5.1.

All major components of assets experienced increases; the most obvious increase was registered by “loan loss reserves” (up by AF 39.78 billion) mainly due to one big banking institution. The second major increase was posted by “other assets” category of total assets (up by AF 39.19 billion, 418.47 percent) that is attributed to number of banking institutions and mainly to one. The third largest increase was observed in total gross loans, up by AF 13.75 billion followed by cash in vault and claims on DAB (up by AF 9.35 billion), while Claims on Financial Institutions decreased for the period under review. Moreover, the remaining part is made up of, premises and other fixed assets, unconsolidated investments, net due from (NDF), Intangible assets, trading and investment accounts and interest receivables. Comparing to the last quarter (December) the asset base of the system increased by 5.93 percent, this increase was on account of increase in "other assets", cash in vault and claims on DAB, while NDF and investments have depicted nominal increases. Claims on financial institutions, loans, premises and other fixed assets and intangible assets contracted since last quarter.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (33.29 percent), "other assets" (23.82 percent), loan loss reserves (20.18 percent), net loans (19.18 percent), claims on financial institutions (14.75 percent), and NDF (4.60 percent). Other components of total assets were negligible, Table 5.1.

Figure 5.1: Size of the Banking Sector (total assets) Increased by 12.59 percent or AF 22.81 billion



Source: Financial Supervision Department, DAB

Table 5.1: Composition of Assets & Liabilities (in million AF)

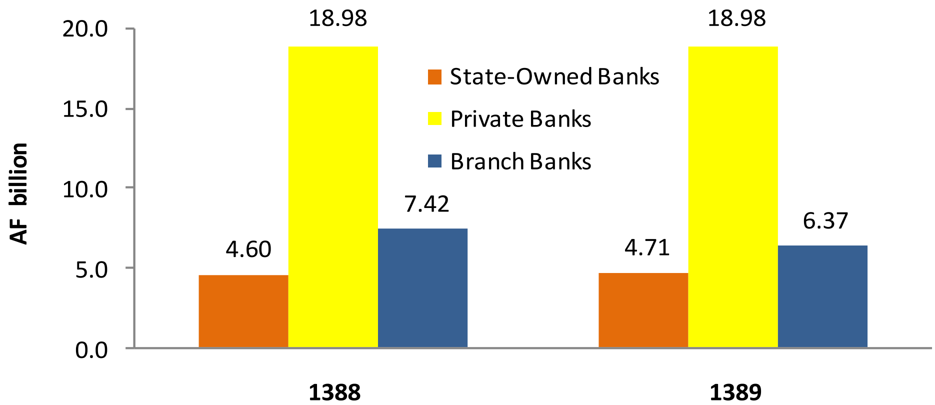
Assets	1388 March 2010	1389 March 2011	% of Total	Growth
Loans (Net)	65,130	39,102	19.18	-39.96
Cash in vault and claims on DAB	58,504	67,855	33.29	15.98
Claims on financial institutions	30,991	30,058	14.75	-3.01
Investments	1,393	2,094	1.03	50.36
NDF	9,254	9,376	4.60	1.31
Others	15,766	55,350	27.15	251.08
Total	181,038	203,836		12.59
Liabilities				
Deposits	149,866	156,537	70.76	4.45
Borrowings	2,180	19,584	8.85	798.34
NDT	565	314	0.14	-44.44
Others	5,924	44,778	20.24	655.89
Total	158,534	221,213		39.54

Source: Financial Supervision Department (FSD)/DAB

1.1 Claims on Financial Institutions

Claims on financial institutions are the fourth largest among various asset categories, currently comprising AF 30.06 billion – 14.75 percent of total assets, 3 percent decrease since March 2010, attributed to number of banking institutions, still indicating that the banking sector has channeled a portion of its attracted funds as deposits in other financial institutions, if credible borrowers were not found. These institutions are both inside the country and outside the country. Later on, if needed for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets Figure 5.2.

Figure 5.2: Claims on Financial Institutions



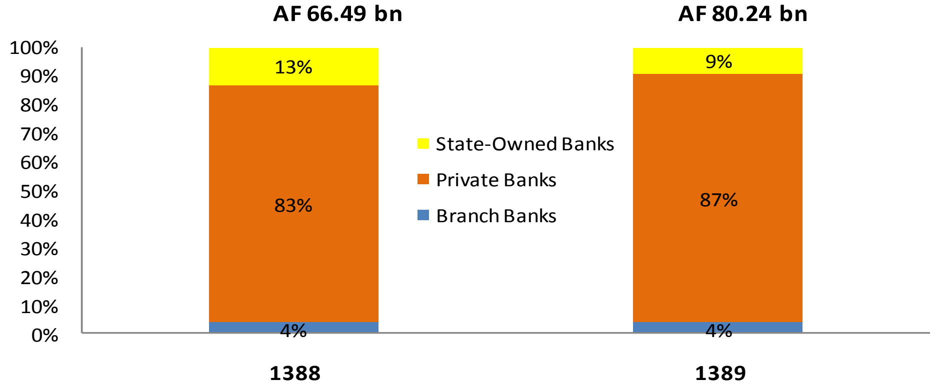
Source: Financial Supervision Department, DAB

Private Banks are the leading creditors, increasing their portfolio both in absolute terms as well as percentage of total loans, currently at AF 70.09 billion or 87.35 percent of total loans. The portfolio of State-owned banks and branches of foreign banks' share and amount were AF 6.86 billion (8.54 percent) and AF 3.29 billion (4.11 percent) respectively.

1.2 Net Loans

The loan portfolio continues to grow, totaling AF 39.10 billion (USD 860.34 billion) as of March 2011 – down by AF 26.03 billion or 39.96 percent since March 2010 or 19.18 percent of total assets; this significant decline in the net loan of the system was due to AF 41.14 billion increase in Loan Loss Reserves mainly attributed to one banking institution. Increases in lending were observed at all but two of the banking organizations, however more than two-third of the growth is still attributable to private bank's group; and more than half to one banking institution.

Figure 5.3: Gross Loans Portfolio Increased by 20.68 percent or AF 13.75 billion



Source: Financial Supervision Department, DAB

1.3 Loan Loss Reserves

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

By the end of 1389 (March 2011), total provision cover of the system was 51.27 percent of the total gross loans in comparison with 2 percent at the end of 1388 (March 2010).

1.4 Distribution of Credit

Segment wise analysis shows that the major portion of the loan portfolio is designated to "other commercial loans" (53.30 percent), mainly in trade sector (34.16 percent). This concentration in other commercial loans, to the exclusion of all other types of lending has been the dominant trend. Loans in SMEs and Micro Credit Loans amounting AF 8.59 billion (USD 188.91 million) by nine banking institutions, was down by AF 1.73 billion since previous period, came from a number of banking institution. But, still lending is picking up, although not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture and mining have not benefited much. About 87 percent of the loans were designate in Kabul with Balkh and Herat provinces in the second and third places respectively. The proportion of loans in other provinces was negligible. The designation of loans sectorally, geographically and institutionally is not properly diversified, but we hope that as time goes over the distribution of loans will become more diversified. It is desirable that all banks take active part in lending, so as to diversify lending services Table 5.4

Table 5.2: Sectoral Distribution of Credit

Ratios	1386 (Mar 2008)	1387 (Mar 2009)	1388 (Mar 2010)	1390 (Mar 2011)
Commercial Real Estate and Construction Loans	9.54	0.19	19.92	25.98
Other Commercial Loans	79.14	-	-	-
Mining	N.A	-	-	0.02
Manufacturing	N.A	0.01	1.22	2.72
Trade	N.A	0.51	32.29	34.16
Communication	N.A	0.00	1.04	1.23
Service	N.A	0.09	4.84	6.72
Utilities	N.A	0.01	2.47	0.03
Others	N.A	0.09	25.00	8.42
Agricultural Loans	0.13	0.00	0.88	0.75
Consumer Loans	2.17	0.02	1.33	1.01
Residential Mortgage Loans to Individuals	2.28	0.01	7.30	8.95
All Other Loans	6.74	0.05	3.69	10.00

Source: Financial Supervision Department/DAB

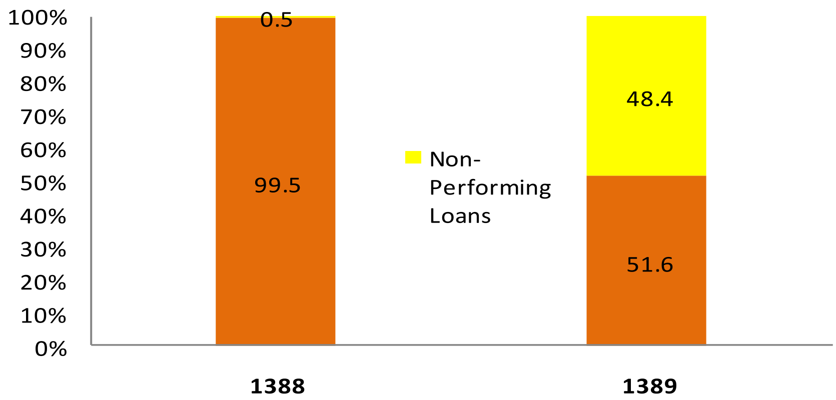
1.5 Non-performing loans

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

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

By the end of 1389 (March 2011) the growth in NPLs which had a decelerated trend during first two quarters of 2010, grew by 3.92 percentage points in September and by 47.36 percentage points in the December, contracted slightly to 48.40 percent or AF 38.83 billion in March 2011, mostly has come from the crises stricken bank Table 5.5

Figure 5.4: Qulity of Loan Portfolio



Source: Financial Supervision Department, DAB

1.6 Adversely-classified loans

Adversely-classified loans (substandard, doubtful) were AF 3.07 billion (USD 67.59 million) increased by AF 2.45 billion at the end of 1389 (March 2011) which was AF 627 million in previous period (March 2010). The percentage share of adversely-classified loans in total gross loans increased to 3.83 percent, from 0.94 percent in the same period last year. Loans under "Watch" category stood at AF 2.17 billion, which was AF 3.88 billion in the previous period. Although, the trend in watch category is decreasing, but still it needs to be monitored to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative.

1.7 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the second largest category, increasing both in absolute as well as in percentage of total assets since previous period (March 2010). The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

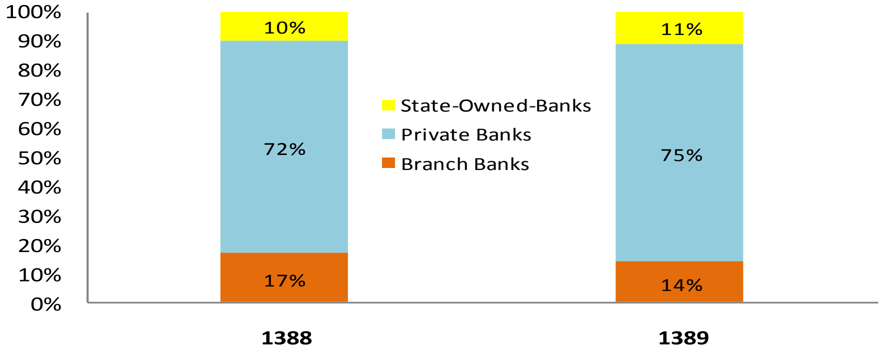
1.8 Investment

The growth in investments accelerated significantly by 56.92 percent or 0.61 percent of total assets by the end of 1389. Major part of the investment took place outside Afghanistan in Euro bonds (Pakistan) and trading companies (USA, UK) by a branch of foreign bank and one state-owned bank.

2. LIABILITIES

Total liabilities of the banking sector were AF 221.21 billion, up by 39.54 percent. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector. Major portion of liabilities are made up of deposits (70.76 percent), with "other liabilities "at second and borrowings at third place. Table 5.2

Figure 5.5: Liabilities Increased by 39.5 percent or AF 62.68 bn



Source: Financial Supervision Department, DAB

2.1 Deposits

Deposits remained the main source of funding in the banking sector, accounting for 70.73 percent of the total liabilities, depicted 4.45 percent growth since last year afghani denominated deposits indicated 11.21 percent growth, accounting for 34.54 percent of the total deposits, whilst the US dollars Denominated deposits registered 2.5 percent growth making 62.38 percent of the total deposits of the system.

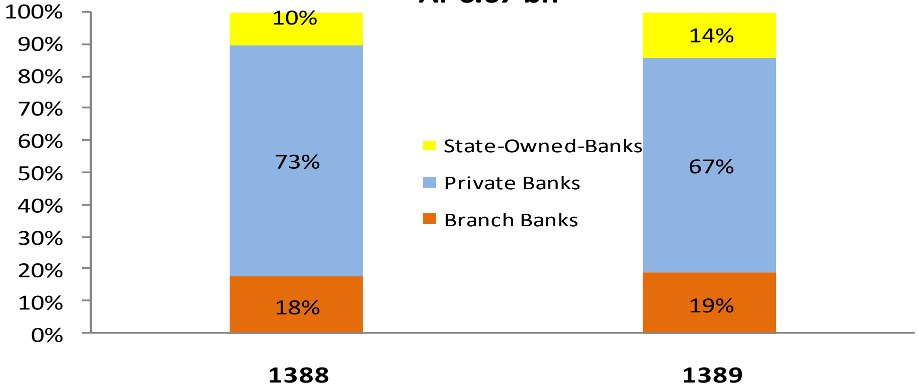
The share of state-owned banks increased to AF 21.79 billion (up by 51.36 percent), which was AF 14.39 billion in March 2010.

Private Banks attracted AF 104.85 billion or 3.97 percent decrease since previous period, when it was AF 109.19 billion.

The share of branches of foreign banks increased to AF 29.90 billion (up by 13.76 percent), which was 26.27 billion in previous period (March 2010).

In terms of types of deposits, demand deposits accounted for 68.72 percent of the total deposit base, up by 12.58 percent, saving deposits with 25.11 percent of total deposits was in the second place, depicting 12.68 percent decrease, and time deposits making 6.18 percent of the deposit portfolio was up by 4.81 percent since March 2010.

Figure 5.6: Deposits Increased by 4.45 percent or AF 6.67 bn



Source: Financial Supervision Department, DAB

Figure 5.7: Currency Composition of Deposits

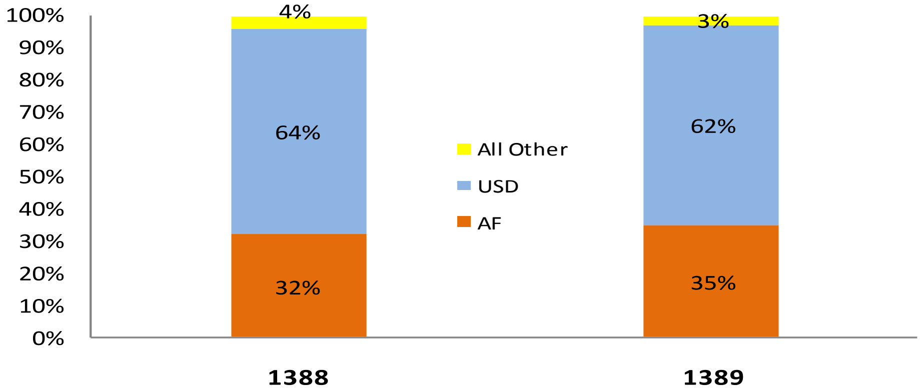


Figure 5.8: Breakdown of Deposits

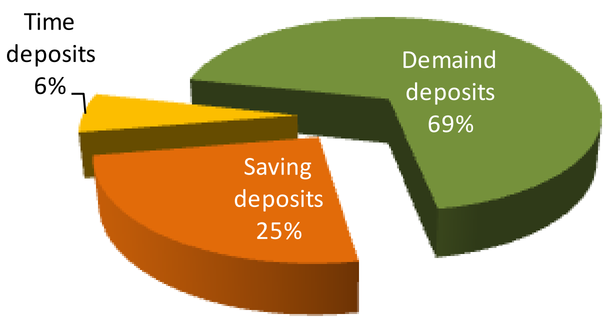
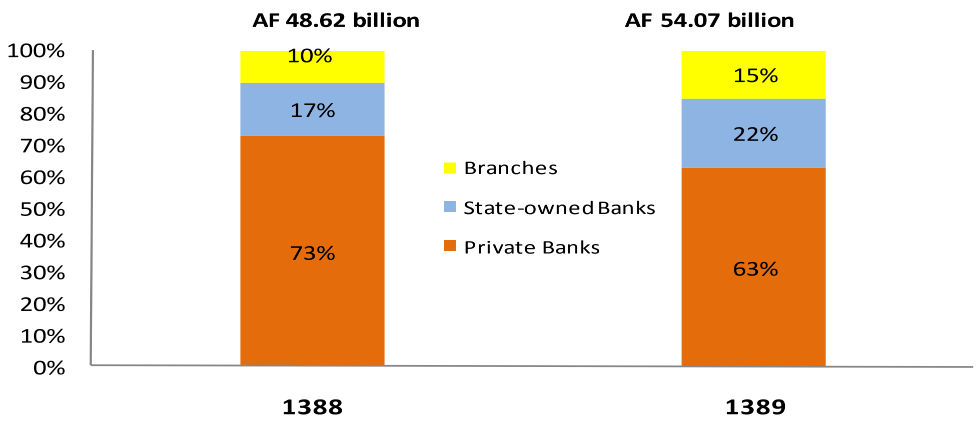


Figure 5.9: Afghani Denominated Deposits



Source: Financial Supervision Department, DAB

2.2 Borrowings

The share of borrowings in total funding structure of the system increased manifold, reaching AF 19.58 billion by the end of the year, up from AF 2.18 billion in March 2010, making 8.85 percent of total liabilities in comparison with 1.38 percent in the same previous period. The major share of this borrowing is attributed to the crises stricken bank.

2.3 Liquidity

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

2.4 Liquidity Ratio (broad measure)

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

Generally, a surplus liquidity position was observed in the banking sector during the year 1389. Analysis show 19.23 percent increase in access liquid assets. 40.58 percent of the total assets comprises of liquid assets. Ratio of the broad liquidity as a median for the all system stood at 63.32 percent. All the banking institutions were well above the minimum required level. Table 5.5

2.5 Capital

In order to strengthen the capital base of the banking system and enhance its stability, DAB increased the minimum financial capital requirement to AF 1.00 billion, and all banking institutions are given two year time period to meet this requirement[1].

A number of the banking institutions already met the requirement; the rest will need to infuse further capital to comply with the new required level. One bank in the system falls far below this requirement.

The entire banking sector was well capitalized, except the crises stricken bank, which put a huge pressure on the capital position of the system. With the exclusion of the said bank, banking sector remained robust at 30.39 percent adequacy ratio. Table 5.5

Excluding crises stricken bank, the system is well capitalized and the capital of the system stood at AF 17.31billion (USD 381 million).

Inclusion of the crises stricken bank puts a huge impact on the financial capital position of the system and takes it to the negative area of the graph (USD -382 million).

If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 17.31 billion makes 11.48 percent of AF 150.68 billion, which is far below the benchmark, while total assets of the full-fledged commercial banks are AF 86.89 billion (excluding crises bank).

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the Net Due to Related Depository Institutions, primarily the home office and other branches of the same bank (NDT), while the closest analogue to negative capital is the net due2 from related depository institutions, primarily the home office and other branches of the same bank (NDF). NDF is probably a normal situation for a foreign branch bank in the first year or so of existence when the branch is establishing itself and seeking loan customers and other investment opportunities. Supervisory action will only be required if the branch persists for another year or two bank's overall worldwide condition and performance is deteriorating.

In the year under review, there was an increase of AF 122 million in NDF standing at AF 9.38 billion as compared to the last period (March 2010), when it was AF 9.25 billion. In the year under review, NDT position decreased by AF 251 million and stood at AF 314 million, when it was AF 565 million in the previous period (March 2010). Only two banks were at favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining three. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted, while the rest are simply sending their acquired funds to their international networks. The NDF positions of two banks have increased, and one bank has a decrease. The largest NDF position by a branch of foreign bank was AF 6.97 billion, decreased by AF 426 million from AF 7.39 billion since last year.

[1] DAB SC resolution dated 16/03/1389

Table 5.3: Key Financial Soundness Indicators of the Banking Sector

Ratio	1386 (Mar 2008)	1387 (Mar 2009)	1388 (Mar 2010)	1390 (Mar 2011)	1390 (Mar 2011)*
Total Capital Adequacy Ratio	31.77	29.81	25.81	-14.46	30.39
Teir 1 Capital Adequacy Ratio	31.16	29.72	24.19	-14.51	30.29
Non-Performing Loans to Total Gross Loans	0.68	0.68	0.50	48.40	3.75
Return on Assets (ROA)	1.80	1.74	1.41	-20.08	0.24
Return on Equity (ROE)	9.89	10.61	10.35	-520.66	1.90
liquidity Ratio (Broad Measure)	40.02	40.02	59.19	63.32	63.83
liquidity Assets to Total Assets	23.80	23.80	0.38	40.58	47.01

*without Crises stricken Bank

Source: Financial Supervision Department/ DAB

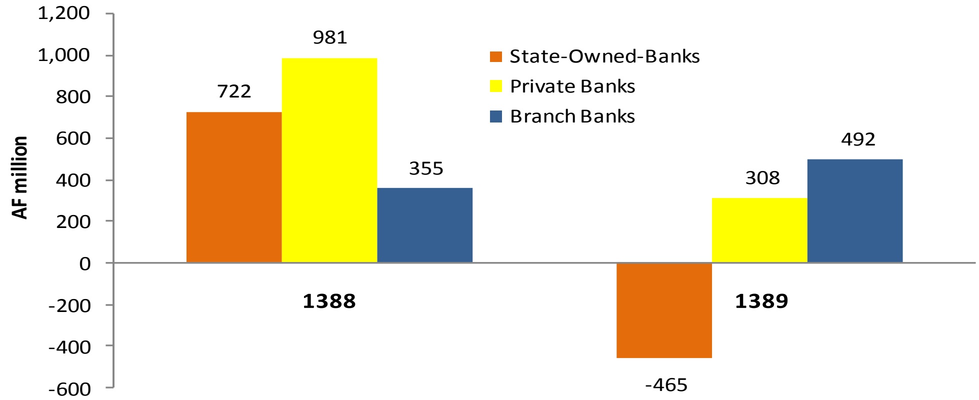
2.6 Profitability

With the exclusion of the crises stricken bank, the banking sector was profitable, but contracted by 73.31 percent amounting to AF 335 million by the end of 1389 (March.2011) Table 5.6. This deterioration was mainly on account of manifold increase in credit provisions, increase in operating cost and decrease in extraordinary items. On the other hand net- interest income, which is the primary source of income increased along with the other non-interest income, but less then to offset the above unfavorable changes.

The return on assets (ROA) of the system decreased by 0.99 percentage points; mainly on account of decrease in total income. Return on equity (ROE) has registered 6 percentage points decrease from 8 percent in the previous period to 2 percent by the end of the year 1389.

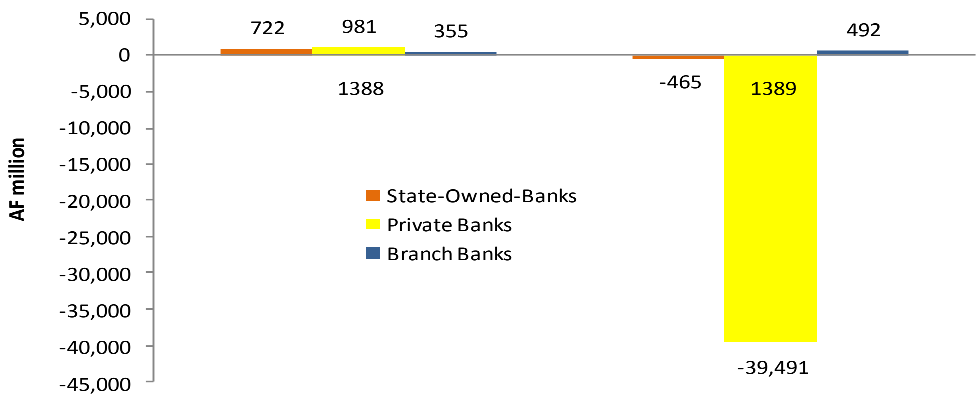
The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a Median stood at 1.54, Eight banking institutions ended up with lower efficiency ratios by the end of 1389.

Figure 5.10: Profitability Excluding Crisses Stricken Bank



Source: Financial Supervision Department/ DAB

Figure 5.11: Profitability Including Crisses Stricken Bank



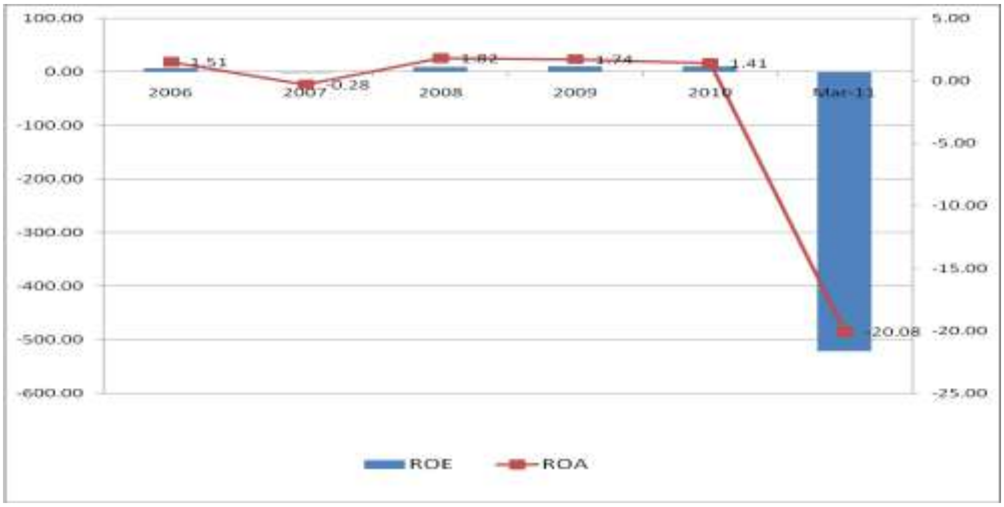
Inclusion of the crises stricken bank on cumulative basis puts a negative impact on the profitability and takes the system to huge losses amounting to AF 39.46 billion, resulting in ROA of -20.08 percent. This deterioration was due to AF 39.12 billion provision by the mentioned bank. On cumulative basis, six banks ended at loss, while it was seven in number last year. On core income basis, four banks were at loss by the end of 1389, the main reason for this poor performance was high operating expenses; this is a kind of permanent situation for these banks.

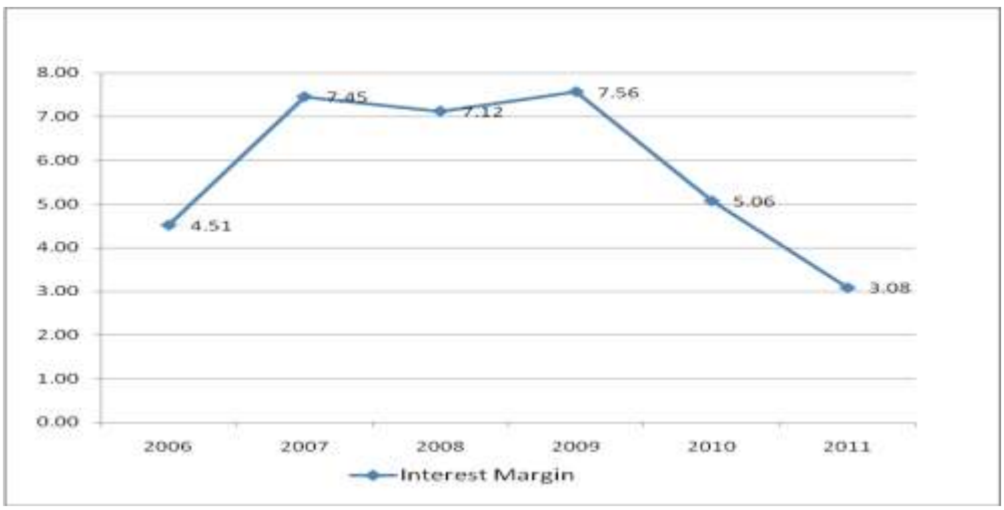
On cumulative basis only branches of foreign banks were profitable, while Private Banks and State-owned banks ended with losses.

Table 5.6: Profit of the banking sector (in million AF)

items	1388 (Mar 2010)	1389 (Mar 2011)	1389* (Mar 2011	Growth
interest income	9,849	8,613	6,344	-13
interest expense	2,295	2,560	1,625	12
Net interest income	7,553	6,053	4,719	-20
Non-interest income	2,917	3,681	3,182	26
Non-interest expenses	4,269	4,462	3,114	5
Salary cost	2,830	3,127	2,018	10
Credit provisions	711	41,365	2,249	5717
P/L before tax	2,661	-39,219	520	-1574
P/L after tax	2,108	-39,463	335	-1972

*without Crises stricken Bank
Source: Financial Supervision Department/DAB





2.7 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for overall open FX position, except four banking institutions holding open FX position on overall and on an individual currency (USD long & short position) basis above the maximum regulatory threshold. In the previous period, only two banking institutions were above the limit on an individual currency basis (USD long position). This indicates that the number of banks in violation of regulatory limits has increased for the year ending 1389. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by AF 4.05 billion and vice versa. Similarly, a 4 percent change would correspond to AF 811.31 million and vice versa.

2.5 Interest Rate Risk

Overall banking institution is in interest-rate sensitive position. If the interest- rate increases by 3 percentage points then there will be increase of AF 1.52 billion in net interest income over the next 12 months. Conversely if the interest-rate decreases by 3 percentage points, the interest income will decline to AF 1.56 billion. For three banking institutions, if the interest-rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is managed on a whole-bank basis).

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

6

External Sector Developments

6

EXTERNAL SECTOR DEVELOPMENTS

The external sector of the economy refers to the international transactions that all residents of the country (private and public sector) conduct with the rest of the world. Such transactions are systematically recorded in detail within a framework that groups them into accounts, where each account represents a separate economic process or phenomenon of the external sector. The Balance of Payments (BoP) is a substantial measure of external sector developments which is a statistical table that records transactions between residents and non-residents, irrespective of the transaction currency, during a specified time period. This chapter compares the developments in the different accounts of BoP for the years of 1388 and 1389.

The overall balance for the year 1389 reveals a surplus of USD 754 million compared to a deficit of USD 797 million in the preceding year. The surplus in the reporting year can be attributed to a large amount of inward grants which are increased by almost 5 percent, and private transfers which are increased by around 7 percent in the reporting year.

The current account balance recorded a surplus of USD 351 million in 1389 compared with a deficit of USD 462 million in 1388.

In the year under review, the capital and financial account recorded an inflow of USD 403 million from an outflow of almost USD 335 million in 1388. This massive increase was mainly led by high amount of foreign direct investment inflow during the year under review.

Earnings from exports slightly decreased by about 4 percent in 1389 to USD 388.37 million compared to USD 403 million in 1388. Based on year-on-year comparisons, the decrease in the exports were dominated by some of the exporting items however, exports of some other items such as leather and wool, and medical seeds showed an increase of almost 118 percent and 22 percent respectively. On the other hand, imports increased significantly by 54 percent to USD 5,154.31 million in 1389 which indicates a growing domestic demand for foreign goods in particular capital goods and industrial supplies. Imports of capital goods and others remarkably increased by around 70 percent to USD 2,725.50 million and imports of industrial supplies increased by almost 62 percent to USD 1,625.14 million which signifies that demand for capital goods in particular machineries and spare parts, and industrial supplies such as construction equipments are growing rapidly in order to fulfill the domestic demand for developments in different sectors of economy. Consequently, the trade deficit expanded to USD 4,765.94 million in 1389 compared to USD 2,933.39 million in 1388, a huge increase of approximately 62 percent. The trade deficit forms about 28 percent of GDP.

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,306.49 million as of March 20, 2011. In bilateral debt perspective, Afghanistan owed USD 1,131.75 million mainly to Russian Federation as a member of Paris Club and other Non-Paris Club creditors. Non-Paris Club debts stood at about USD 132 million at the end of 1389. In respect to multilateral debts, Afghanistan's total debt stood at USD 1,174.73 million at the end of FY 1389.

The Net International Reserves (NIR) of Afghanistan increased by 25 percent from USD 4,007.1 million in 1388 to USD 5,017.4 million in 1389. The reserve assets had a fairly large increase of approximately 26 percent from USD 4,208.5 million in 1388 to approximately USD 5,321.1 million in the reporting year. On the other hand, reserves liabilities increased by 51 percent from USD 201.4 million in 1388 to USD 303.75 million in the reporting year. In compare to 1388 the percentage changes in reserve liabilities however still shows a decline.

1. BALANCE OF PAYMENTS

The statistical statement of BoP shows a surplus in the overall balance amounting to USD 754 million in 1389 up from a deficit of USD 797 million in 1388. This significant increase in the reporting year could be attributed to a sizable boost in the capital and financial account. In 1388, the capital and financial account recorded a deficit of USD 335 million which conversely shows a surplus of USD 403 million in the reporting year. Foreign direct investment had an increment of 18 percent from USD 185 million in 1388 to USD 218 million in 1389 which reveals inflows of capitals to the country. The current account balance (CAB) recorded a surplus of USD 351 million in the year under review compared to a deficit of USD 462 million in 1388. On the other hand, current transfers increased by almost 6 percent from USD 6,838 million in 1388 to USD 7,216 million in 1389, which mainly dominated by public transfers like grants that increased from USD 6,516 million in 1388 to USD 6,871 million in 1389 and private transfers that increased from USD 322 million in 1388 to USD 345 million in 1389, an increase of approximately 5 percent and 7 percent respectively.

According to the BoP statement, exports had a significant increase of 23 percent in 1389 compared to the export data recorded in 1388. A significant part of exports were estimated as transit trade and unofficial exports which increased from USD 1,354 million in 1388 to USD 2,085 million in reporting year.

Based on the BoP statement, import of goods decreased slightly from USD 9,099 million {are the amounts correct?} in 1388 to USD 9,082 million in 1389. Among the import figures, unofficial trade or smuggled imports are also estimated which increased by approximately 14 percent from USD 549 million in 1388 to USD 627 million in the year under review.

Table 6.1: Afghanistan Balance of Payments (in million USD*)*

	2007/08 1386	2008/09 1387	2009/10 1388	% Change	2010/11 1389	% Change
Current account (including grants)	117.0	-105.0	-462.0	340	351.0	-176
Current account (excluding grants)	-5,951.0	-6,441.0	-6,977.0	8	-6,519.0	-7
Trade balance	-5,967.0	-6,720.0	-6,971.0	4	-6,456.0	-7
Exports of goods (f.o.b.) 1/	1,835.0	2,181.0	2,128.0	-2	2,626.0	23
Official exports	482.0	547.0	658.0	20	540.0	-18
Unofficial exports (smuggling and transit trade)	1,352.0	1,633.0	1,354.0	-17	2,085.0	54
Imports of goods (f.o.b.)	-7,802.0	-8,901.0	-9,099.0	2	-9,082.0	0
Official imports	-7,246.0	-8,362.0	-8,550.0	2	-8,455.0	-1
Smuggling	-556.0	-539.0	-549.0	2	-627.0	14
Services and income, net	-425.0	-247.0	-329.0	33	-408.0	24
Of which: Interest due 2/ 3/	-61.0	-61.0	-35.0	-43	-11.0	-69
Current transfers	6,510.0	6,862.0	6,838.0	0	7,216.0	6
Public	6,068.0	6,337.0	6,516.0	3	6,871.0	5
Private (Including through licensed money exchangers)	441.0	525.0	322.0	-39	345.0	7
Capital and financial account	25.0	261.0	-335.0	-228	403.0	-220
Capital Transfer	0.0	0.0	0.0	0	0.0	0
Debt forgiveness 3/	0.0	0.0	-1,061.0	0	0.0	-100
Foreign direct investment	243.0	300.0	185.0	-38	218.0	18
Official loans (net)	129.0	96.0	392.0	308	133.0	-66
Disbursement	133.0	97.0	396.0	308	134.0	-66
Amortization due 2/ 3/	-4.0	-1.0	-4.0	300	-1.0	-75
Other items (net)	-347.0	-134.0	149.0	-211	53.0	-64
Errors and omissions (including short-term capital)	460.0	612.0	0.0	-100	0.0	0
Overall balance	*602.0*	*768.0*	*-797.0*	*-204*	*754.0*	*-195*
Financing	-654.0	-785.0	788.0	-200	-774.0	-198
Changes in reserve assets of the DAB	-745.0	-807.0	-319.0		-794.0	
Use of Fund resources (net)	51.0	17.0	17.0		20.0	
Exceptional financing	40.0	5.0	1,090.0		0.0	
Arrears 5/	-11,007.0	-84.0	0.0		0.0	
Debt rescheduling, of which: 6/	777.0	32.0	29.0		0.0	
Capitalization of interest	47.0	0.0	24.0		0.0	
Multilateral HIPC assistance	3.0	5.0	5.0		0.0	
Debt forgiveness, of which: 3/	10,270.0	56.0	1,061.0		0.0	
HIPC	0.0	0.0	442.0		0.0	
MDRI	0.0	0.0	35.0		0.0	
Financing gap	51.0	17.0	9.0		20.0	
Identified financing (provisional)	51.0	17.0	9.0		20.0	
Of which: IMF ECF	51.0	17.0	9.0		20.0	
Remaining gap	0.0	0.0	0.0		0.0	

Memorandum Items:				
Gross international reserves	2,784.0	3,591.0	3,781.0	5,002.0
(In months of imports) 7/	12.8	13.6	13.2	13.6
(Relative to external debt service due)	42.9	214.6	97.6	410.7
(Relative to commercial bank foreign currency liabilities)	2.2	2.5	3.0	3.4
Current account balance (percent of GDP)				
Including grants	1.2	-0.9	-3.6	2.1
Excluding grants	-61.2	-54.7	-53.7	-38.5
Total debt service (percent of exports) 9/	1.1	1.1	0.9	1.2
Total debt stock (percent of GDP) 8/	20.7	17.5	11.2	8.0

Sources: Afghan authorities; and Fund Staff Estimations and Projections.

1/ Excludes opium exports and, due to limited data availability, flows associated with U.S. Army and most ISAF activities.

2/ Debt service projections are based on the total stock of external debt (including estimates of unverified arrears). Interest on overdue obligations represents estimates by fund staff.

3/ Includes allocation of SDR 128.6 million.

4/ The change in gross international reserves are computed using market exchange rate.

5/ Arrears shown represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations.

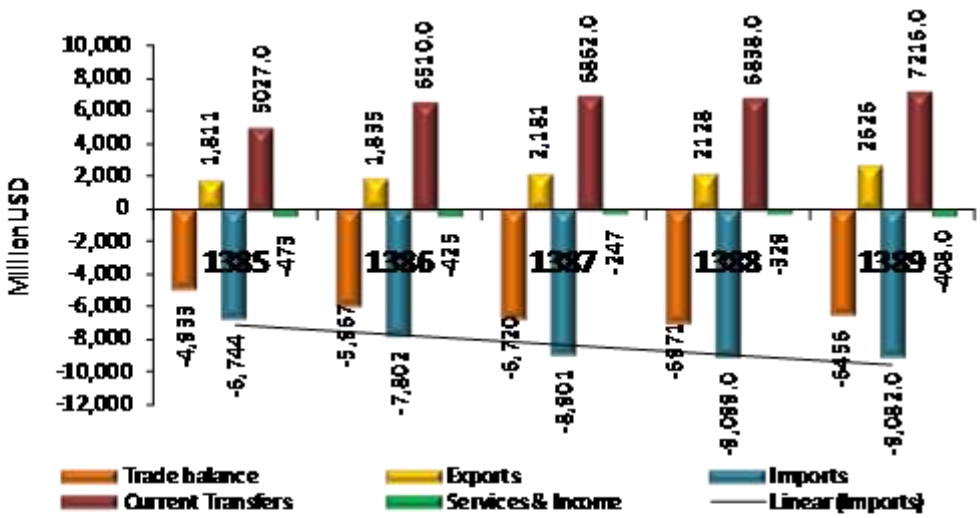
6/ Debt rescheduling includes the capitalization of interest falling due to Paris Club creditors until the completion point, interim assistance from multilateral creditors, and HIPC debt relief from multilateral creditors after the completion point.

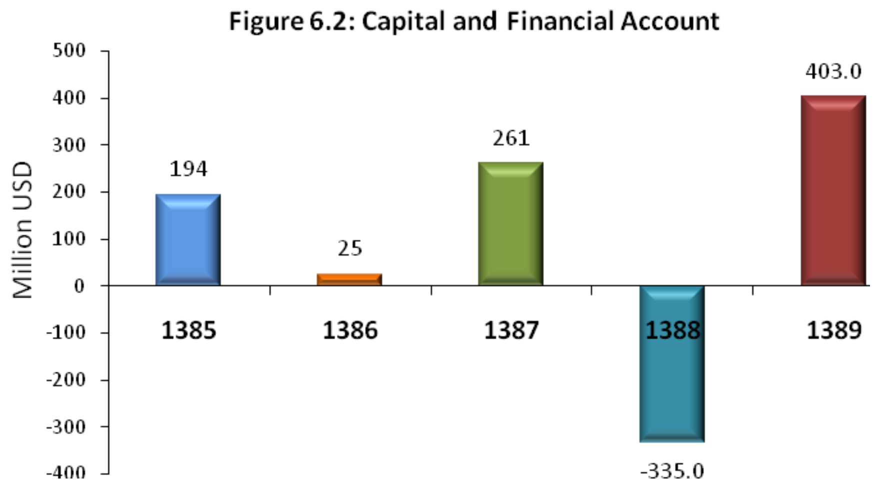
7/ Excluding imports for re-export and duty free imports by donors.

8/ Excluding imports for re-export.

9/ After HIPC and MDRI relief as well as debt relief beyond HIPC from Paris Club creditors. Debt includes obligations to the IMF. The debt stock includes the capitalization of interest to Paris Club creditors until completion point of the enhanced HIPC initiative.

Figure 6.1: Current Account





Source: Central Statistics Office and DAB staff calculations.

1.1 Merchandize Trade

Merchandise trade covers all types of inward and outward movements of goods through a country or territory including movements through customs warehouses and free zones. Based on data provided by the Central Statistics Office, merchandise trade recorded a deficit of USD 4,765.9 million in 1389 compared to a deficit of USD 2,933.4 million in 1388, this represents almost 62 percent increase. The trade deficit constitutes approximately 28 percent of GDP. The main reason behind this is that imports grew much faster than the exports in 1389 compared with the prior year. Imports increased significantly by almost 54 percent, while exports had a decline of about 4 percent in the year under review compared to 1388. According to merchandise trade statistics, total imports for 1389 were recorded at USD 5,154.3 million, where it was USD 3,336.45 million in 1388. This boost in total imports were dominated by almost all importing items in particular capital goods & others categories which increased by 70 percent from USD 1,606.9 million in 1388 to USD 2,725.5 million in the current period. Similarly, import of Industrial supplies, the second largest share in the basket of imports, increased surprisingly by 62 percent from USD 1,001.4 million in 1388 to USD 1,625.1 million in 1389. A significant change in the imports, led by capital goods and industrial supplies has been observed in the year 1389. And finally, imports of other items such as fuel and lubricants and consumer goods increased slightly by 10 percent each. As a result, high imports of capital goods and industrial supplies my relies on the developments in different sectors of economy which called more import of factories, machineries, tools, equipments and spare parts which are used to produce other products for consumption. Conversely, total exports declined slightly by about 4 percent from USD 403 million in 1388 to USD 388.4 million in 1389. Export of food items such as fresh and dry fruits which were thought to be improved in the year under review, declined significantly by 34 percent from USD 202 million in 1388 to USD 134 million in 1389. However, export of other items particularly, leather and wool increased by 118 percent from USD 24.7 million in 1388 to USD 53.9 million in 1389. Likewise, export of medical seeds and others increased remarkably by approximately 22 percent from USD 107.8 million to USD 131.8 million in 1389.

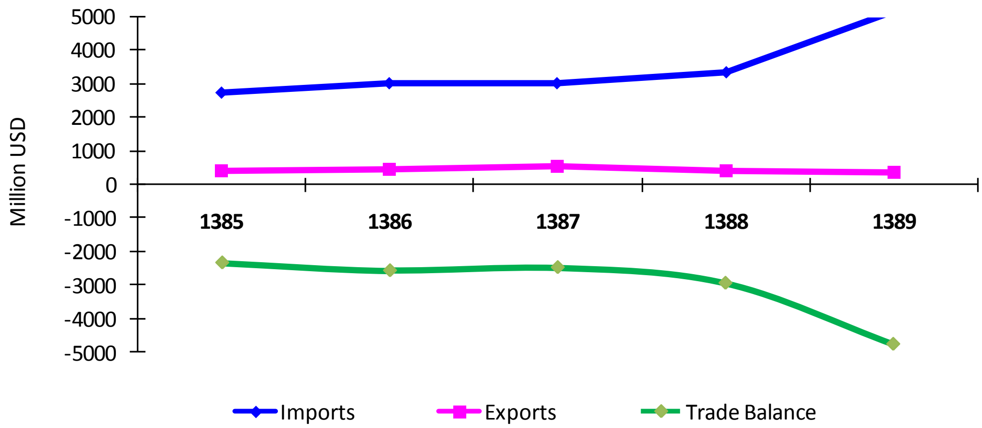
Table 6.2 summarizes merchandise trade including its main categories and trade deficit in absolute terms and as a percentage of GDP from 1385 to 1389.

Table 6.2: Merchandise Trade (In million USD)

Years	1385		1386		1387		1388		1389	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**2,744.19**	**100**	**3,021.86**	**100**	**3,019.86**	**100**	**3,336.45**	**100**	**5,154.31**	**100**
Industrial Supplies	596.69	21.7	692.04	22.9	797.78	26.42	1,001.43	30.01	1,625.14	31.5
Fuels and Lubricants	100.04	3.6	108.49	3.6	101.83	3.37	36.07	1.08	39.68	0.8
Consumer Goods	682.66	24.9	641.86	21.2	689.88	22.84	692.07	20.74	763.99	14.8
Capital Goods and others	1,364.80	49.7	1,579.47	52.3	1,430.37	47.37	1,606.88	48.16	2,725.50	52.9
Exports	**416.46**	**100**	**454.13**	**100**	**544.56**	**100**	**403.06**	**100**	**388.37**	**100**
Carpets & Rugs	186.57	44.8	211.76	46.6	153.05	28.1	68.78	17.1	68.83	17.7
Food items	165.15	39.7	158.86	35.0	283.08	52.0	201.84	50.1	133.91	34.5
Leather & Wool	30.76	7.4	25.77	5.7	29.29	5.4	24.66	6.1	53.84	13.9
Medical seeds & others	33.98	8.2	57.74	12.7	79.14	14.5	107.78	26.7	131.79	33.9
Trade Balance		-2,327.73		-2,567.73		-2,475.30		-2,933.39		-4,765.94
Trade Balance as % of GDP		-30.23		-26.47		-20.98		-22.56		-28.03

Source: Central Statistics Office and DAB staff calculations

Figure 6.3: Imports, Exports and Trade Balance



Source: Central Statistics Office and DAB staff calculations.

Note: Data for 1386 has been revised by CSO.

1.2 Direction of Trade

Direction of trade refers to a particular country or a group of countries which a country's exports are sent to, and from which the imports are brought in, in contrast to the commodity composition of its exports and imports. During the year under review, Pakistan remained Afghanistan's largest export destination. The share of exports to Pakistan accounted for about 40 percent of total exports, however exports to this country declined by approximately 20 percent from USD 194.9 million in 1388 to USD 155 million in 1389. Although, total exports to Pakistan declined in the year under review compared to last year, but export of some items increased incredibly; such as leather and wool (144 percent increase) from USD 11.13 million in 1388 to USD 27.13 million in 1389, and medical plants (54 percent increase) from USD 27.8 million in 1388 to USD 42.9 million in 1389.

Subsequently, exports to India which is the second major trading partner of Afghanistan after Pakistan decreased by 11 percent from USD 74 million in 1388 to USD 65.6 million in 1389. Meanwhile, share of exports to India declined slightly from 18.4 percent in 1388 to 16.7 percent of total exports in the current year. Although, figures indicate a decline in total exports to India, but export of medical seeds has increased remarkably by 127 percent from USD 11.3 million in 1388 to USD 25.7 million in 1389. Afghanistan's exports to Commonwealth of Independent States (CIS) in 1389 compared to 1388 remained unchanged however; exports to China increased extraordinarily by 235 percent from USD 3.5 million to USD 11.7 million.

Direction of exports and imports for 1388 and 1389 are outlined in Tables 6.3 and 6.4.

Table 6.3: Direction of External Trade for 1388, (In million USD)

	Exports		Imports		
Country Name	**Million (USD)**	**Share (%)**	**Million (USD)**	**Share (%)**	**Trade Balance**
Pakistan	194.93	48.4	307.53	9.2	-112.60
India	74.08	18.4	106.11	3.2	-32.03
Iran	38.32	9.5	177.24	5.3	-138.92
China	3.50	0.9	360.05	10.8	-356.55
Common Wealth	36.53	9.1	1,438.74	43.1	-1,402.21
Saudi Arabia	2.31	0.6	-	0.0	2.31
Japan	-	0.0	337.99	10.1	-337.99
Europe	0.89	0.2	161.30	4.8	-160.41
Others	52.50	13.0	447.49	13.4	-394.99
Total	**403.06**	**100**	**3,336.45**	**100**	**-2,933.39**

Source: Central Statistics Office and DAB staff calculations

Table 6.4: Direction of External Trade for 1389 (In million USD)

Country Name	Exports		Imports		
	Million (USD)	Share (%)	Million (USD)	Share (%)	Trade Balance
Pakistan	155.09	39.9	589.16	11.4	-434.07
India	65.62	16.9	120.38	2.3	-54.76
Iran	23.03	5.9	362.35	7.0	-339.32
China	11.71	3.0	659.56	12.8	-647.85
Common Wealth	36.00	9.3	1,661.72	32.2	-1,625.72
Saudi Arabia	2.59	0.7	-	0.0	2.59
Japan	-	0.0	580.31	11.3	-580.31
Europe	1.82	0.5	435.45	8.4	-433.63
United States	-	0.0	65.14	1.3	-65.14
Others	92.51	23.8	680.24	13.2	-587.73
Total	**388.37**	**100**	**5,154.31**	**100**	**-4,765.94**

Source: Central Statistics Office and DAB staff calculation

Figure 6.4: Direction of exports for 1388 (% share)

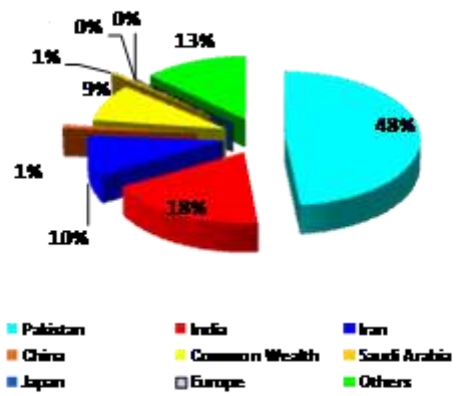
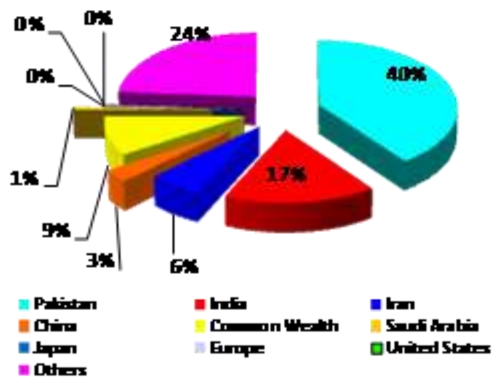


Figure 6.5: Direction of exports for 1389 (% share)



Source: Central Statistics Office and DAB staff calculations

1.3 Composition of trade

In the year under review, the composition of imports presented in Figures 6.6 and 6.7. These figures compare the composition of imports for 1388 and 1389. The composition of imports is presented in percent share of total imports basket. During the year under review, the composition of imports indicates that capital goods are still dominating the largest share in the basket of imports which increased from 48.2 percent in 1388 to 53 percent in 1389. Imports of capital goods and others increased significantly by about 70 percent indicating importance of such commodities in rebuilding, rehabilitation and reconstruction efforts in Afghanistan. Moreover, imports of industrial supplies increased by 62 percent, however; its share in total imports has not changed significantly. As a result, the demand for industrial supplies such as cement, chemical materials, fertilizer, and petroleum is increasing due to implementation of developing projects throughout the country. This indicates that Afghanistan needs to import these materials for economic development and sustainable economic growth in the long-run. Finally, consumer goods' share in total imports reduced from about 21 percent in 1388 to 15 percent in 1389 however; imports of this category increased by 10 percent from USD 692 million to USD 764 million.

Figure 6.6: Composition of imports 1388 (% share)

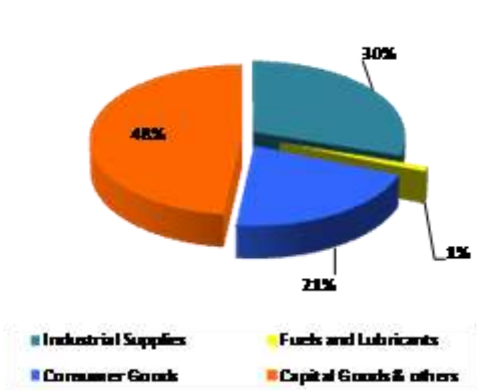
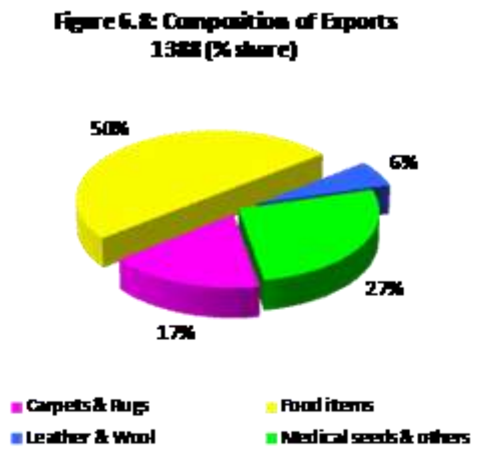


Figure 6.7: Composition of imports 1389 (% share)

Source: Central Statistics Office and DAB staff calculations

On the other side, Figures 6.8 and 6.9 present comparisons of the export compositions for 1388 and 1389. Figure 6.8 shows the composition of exports for 1388 and is broken down by main commodities and products. Share of food items such as fresh and dry fruits in total exports declined significantly to 34.5 percent in 1389, while this category had the largest share of about 50 percent in total exports in 1388. As shown in Figure 6.9, the largest share was recorded for medical seeds and others which constitute about 40 percent of total exports in the year under review. The main item responsible for a sharp increase in exports of medical seeds or plants during 1389 was Saffron. As mentioned above, export of leather and wool grew significantly from USD 24.7 million in 1388 to USD 53.8 million in 1389 and its share in total export stood at about 14 percent in 1389 compared to 6 percent in 1388. Furthermore, the share of carpets and rugs in total exports increased slightly from 17.1 percent in 1388 to 17.7 percent in 1389, however, the export in terms of value remained unchanged.



Source: Central Statistics Office and DAB staff calculations

Considering that the variations in composition of exports and imports are not so large but nevertheless, composition of some items such as import of capital goods and export of leather, wool and medical seeds are significant.

As a result, exports of above mentioned items require more import of capital goods and machineries to replace the traditional manufacturing systems in order to improved and enhanced schemes.

2. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,306.49 million as of March 20, 2011. External debt covers current and non-current loan including bilateral and multilateral loan. The loans reported here are all recognized loans which are verified by creditors and agreed by Afghan authorities. During 1389, repayments and service charges were paid to the Asian Development Bank (ADB) and International Development Association (IDA). In addition, during 1389 a number of creditors made some debt forgiveness, such as ADB made some debt forgiveness of principle amount and service charges and IDA made some debt forgiveness of only service charges. While United States and Germany as members of Paris Club provided with 100 percent debt relief. Based on Ministry of Finance's data, outstanding loan amounts payable to Paris Club creditors at the end of 1389 stood at USD 999.73 million which is only payable to Russian Federation. In other words, Afghanistan's debt from Paris Club members stands at about 43.34 percent of total external debt.

On the other hand, non-Paris Club credits stood at USD 132.02 million at the end of 1389, Saudi Fund for Development (USD 47.15 million), Bulgaria (USD 52.27 million), Kuwait Fund (USD 22.42 million) and Iran (USD 10.16 million). As a result, Afghanistan owed USD 1,131.75 million in bilateral debt which accounts for about 49 percent of the total debt, while in multilateral debt; it was USD 1,174.73 million at the end of

1389 which is the highest share of roughly 51 percent of the total debt. Table 6.5 depicts Afghanistan's external debt for 1389.

Table 6.5: External Debt as of March 20, 2011 (in million USD)

	Amount	Percent of total
Total external debt	2,306.49	100
Bilateral	1,131.75	49.07
Paris Club/1	999.73	43.34
Russian Federation	999.73	43.34
United States	-	0.00
Germany	-	0.00
Non-Paris Club	132.02	5.72
Multilateral	1,174.73	50.93
of which: IDA (World Bank)	416.46	18.06
Asian Development Bank	626.06	27.14
International Monetary Fund	118.61	5.14
Islamic Development Bank	11.62	0.50
OPEC Fund	1.98	0.09

1/ The cancellation of approximately $10.4 billion in external debt amounts to a total 92% reduction of Afghanistan's debt to its three Paris Club creditors, Germany, Russian Federation and the United States on July 19, 2006. Further, United States on Sep 20, 2010 and Germany on Jan 09, 2011 made debt forgiveness amounting to $108.5 and $17.4 respectively. As a result, Afghanistan owed only to Russian Federation as its Paris Club creditor.

Source: Treasury Dept/Ministry of Finance and DAB staff calculations

3. NET INTERNATIONAL RESERVES

Da Afghanistan Bank (DAB) holds international reserves which consist of monetary gold, reserve position and holdings with the IMF and Special Drawing Rights (SDR) 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 currency defense or finance the foreign trade deficit. In 1389, NIR increased by 25.2 percent to USD 5,017.36 million in 1389 from USD 4,007.15 million in 1388. The boost in the NIR was mainly dominated by a significant increase in reserve assets which increased by 26.4 percent from USD 4,208.52 million in 1388 to USD 5,321.1 million in the year under review. On the other hand, reserve liabilities increased considerably by about 51 percent to USD 303.75 million in 1389 from USD 201.37 million in 1388. The reserve liabilities included commercial banks deposits in foreign currency, non-resident deposits in foreign crrency and use of fund resources. Commercial banks deposits in foreign currency increased significantly from USD 85.95 million in 1388 to USD 184.15 million in the year under review. Furthermore, the reserve liabilities on use of fund resources increased slightly from USD 115.16 million in 1388 to USD

119.48 million in 1389, representing almost 4 percent increase. Conversely, the reserve liabilities on non-resident deposits in foreign currency declined significantly by about 51 percent from USD 0.25 million in 1388 to USD 0.11 million in the year under review.

The increase in NIR could be attributed to inflows of foreign exchange particularly from export earnings, current transfers, foreign donations and foreign direct investments. Table 6.6 illustrates the Net International Reserves from 1385 to 1389.

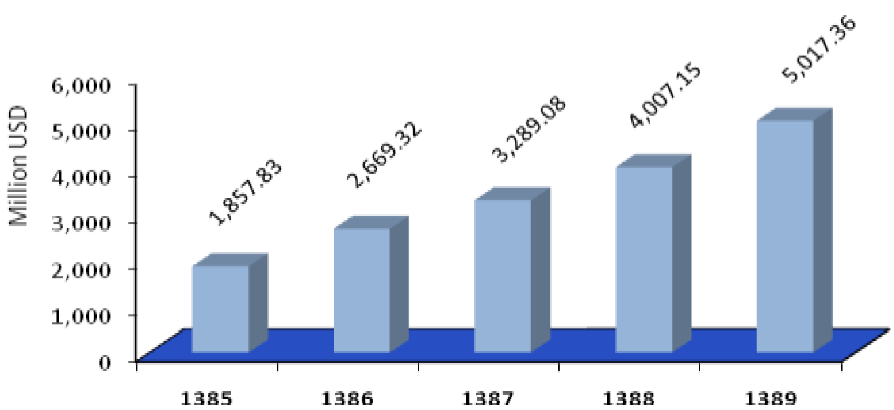
Table 6.6: Net International Reserves, 1389 (in million USD)

	1385	1386	1387	1388	% Changes	1389	% Changes
Net International Reserves	1,857.83	2,669.32	3,289.08	4,007.15	21.8	5,017.36	25.2
Reserves Assets	1,946.22	2,784.33	3,416.63	4,208.52	23.2	5,321.10	26.4
Reserves Liabilities	88.39	115.00	127.55	201.37	57.9	303.75	50.8
Commercial Banks Deposits in Foreign Currency	46.56	35.62	37.05	85.95	132.0	184.15	114.2
Non-residents Deposits in Foreign Currency	6.19	2.61	0.27	0.25	-7.4	0.11	-55.7
Use of Fund Resources:	35.64	76.77	90.23	115.16	27.6	119.48	3.8
Memorandum Items:							
Gross Reserves (in months of imports)	8.5	11.1	13.6	15.1	………	12.4	………
Net International Reserves (in months of imports)	8.1	10.6	13.1	14.4	………	11.7	………

Source: DAB staff calculations

The reserves position of the year under review was considerably strong enough to finance about 11.7 months of imports, while countries with 6 months coverage of imports enjoy a relatively comfortable reserve position.

Figure 6.10: Net International Reserves



7

The Real Economy

7

THE REAL ECONOMY

The Afghan economy lost momentum in 1389 with growth rate declining to 3.2 percent from 17.1 percent in 1388. The sharp loss of pace in economic activity is attributed to the precipitous drop in rain-fed agriculture as a result of drought. Overall, agriculture continues to dominate the economy; accounting for 27.8 percent of GDP in 1389 down from 31.4 percent in the preceding year. Within the agricultural sector, cereal production suffered the largest drop in output, declining by 23.3 percent in 1389. The main contributor factor for the decrease in cereal production was the output of wheat which has decreased in rain-fed areas as a result of drought.

Despite the sharp decline in overall economic performance, the industrial sector increased in 1389 growing by 6.3 percent, up from 5.5 percent in 1388. Mining and quarrying was the fastest growing sub-sector of industry posting 43 percent growth over the year while the food, beverages, & tobacco sub-sectors increased by 3.8 percent in the year under review.

The services sector continued its upward trajectory increasing its share of the economy from 35 percent of GDP in 1382 to 48 percent in 1389. The performance of the services sector was mainly driven by restaurant & hotels, transport, storage, post and telecommunication sub-sectors.

Private consumptions remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction.

In terms of components of GDP, the major boost to real GDP was a significant increase in real government expenditures. Personal consumption and the trade balance also increased in real terms by significant percentages, but the growth was not as rapid as that in government spending. In contrast, investment spending did not increase substantially.

Economic growth in Afghanistan, which was not rapid by some measures, didn't seem to be much affected by continued weak performance of the global economy. As 2010 was worse than 2009, a few major economies showed substantial growth and some continued to contract. In other words, Afghanistan in 1389 did not really reflect global economic trends. Because Afghanistan is not an exporting country, therefore, weak demand for goods overseas is not reflected in a weak manufacturing sector in Afghanistan. In addition, poor economic conditions in donor countries have not made them less generous in supporting the Afghan government budget. Donation and military spending have contributed strongly to increased government spending, which was the major driver of economic growth.

1. GROSS DOMESTIC PRODUCT BY SECTORS OF PRODUCTIONS

The Afghan economy slowed in 1389. According to the Central Statistics Office (CSO), the economy recorded real Gross Domestic Product (GDP) growth of 3.2 percent in 1389 down from 17.1 percent in 1388. Afghanistan continued to be an agricultural country, although the share of agriculture in total economic activity has been declining for a long time. Services, on the other hand, have been increasing its share to GDP. Data for 1389 show that services are now 48 percent of GDP, agriculture 27.76 percent, and industry 20.57percent. The main conclusion from this trend is that crop yields and rainfall still play a pivotal role in determining growth in economic activity, although less so than in the past.

The sharp loss of pace in economic activity is attributed to a drop in rain-fed agriculture as a result of drought. Indeed, a significant drop to real GDP in 1389 over 1388 was the weak performance of the agricultural sector. Overall real GDP growth of 3.2 percent was driven by the 18.1 percent increase in real income from services sector. Even the industrial sector showed a respectable 6.3 percent increase in real income over the previous year. On the other hand, agriculture sector posted a decline of -18.0 percent in real income.

Agricultural production, in turn, was negatively affected in 1389 by continues drought and natural disaster, such as flood and plant disease, the insecurity also impacted the agriculture product negatively. Wheat comprises about 70 percent of the diet for most Afghans. The sharp decrease in cereals production (which contributed to a -18.0 percent decrease in real income from this source) was accompanied by a noticeable increase in the production of fruits and nuts. Income from livestock, however, declined slightly from an increase of 1.2 percent in 1388 to -1.1 percent in 1389.

The strong rebound in the services sector was primarily driven by a sharp increase in incomes from post and telecommunications services which surged by 65.7 percent. Almost as impressive was growth in activity in subsectors like restaurants and hotels, transport and storage, finance. Producers of government services also had a good year, increasing their income by 27 percent. In Afghanistan, the financial sector consists mainly of banks, and the banks showed decrease in loans, and an increase in deposits over the previous year.

Compared with the agriculture sector, the performance of the industrial sector seemed strong, but it was still low, and the increases in incomes were spread across several sources. Incomes from the largest component of the manufacturing sector, (food, beverages, and tobacco) increased by 3.8 percent. More impressive increases were found in sectors that still remain small, relative to total GDP. For example, incomes from mining and quarrying increased significantly by 43 percent, although their share in total GDP still remains small. There were few industrial sub-sectors that declined in 1389 for example, wood & wood production including furniture declined by 9.7 percent and electricity, gas and water decreased by 0.2 percent.

Table 2.3: Real GDP Growth Rate by Sectors of Production (Annual percent changes)

	1386	1387	1388	1389*
Agriculture	**21.2**	**-11.7**	**23.3**	**-18.0**
Cereals and other crops	26.3	-14.3	27.6	-23.3
Fruits and nuts	10	5.9	10.5	22.6
Livestock	-4.7	-2.1	1.2	-1.1
Industries	7.6	5.7	5.5	6.3
Mining and quarrying	64.6	2.7	13.2	43.0
Manufacturing	4.5	2.3	4.0	3.8
Food, beverages, & tobacco	5.1	2.2	3.8	3.8
Textile, wearing apparel & leather	-33.7	2.9	12.1	7.9
Wood & wood prod, incl. furniture	-13.3	-3.0	8.6	-9.7
Paper production, printing, & publishing	30.3	5.4	5.1	7.7
Chemicals, coal, rubber, plastic	10.2	6.7	7.0	6.1
Nonmetallic mineral except petroleum & coal	2.6	-2.0	2.0	0.1
Metal basic	2.1	12.7	12.0	5.3
Electricity, gas and water	9.5	-17.2	12.9	-0.2
Construction	10	10.0	6.7	7.7
Services	7.6	13.8	17.3	18.1
Wholesale & retail trade, restaurants & hotels	64.6	2.3	8.5	5.3
Wholesale & retail trade	4.5	1.8	7.5	3.2
Restaurants & hotels	5.1	7.1	17.8	23.8
Transport, storage and communications	-33.7	21.9	19.0	23.1
Transport, storage	-13.3	12.4	10.2	6.2
Post and telecommunications	30.3	72.0	49.4	65.7
Finance, insurance, real estate and business	10.2	21.3	33.4	14.3
Finance	2.6	21.4	33.5	14.4
Insurance	2.1	16.7	0.0	5.0
Real estate and business services	9.5	8.6	21.1	1.1
Ownership of dwellings	10	6.8	9.1	1.9
Community, social and personal services	-5.1	4.9	15.2	5.5
Producers of Government services	29.1	16.1	23.1	27.0
Other services	-9.6	-3.5	9.0	16.4
Gross Domestic Product	16.1	2.3	17.1	3.2

* Preliminary data
Source: Central Statistics Office
Note: Data for 1386, 1387, and 1388 were recently revised, so some figures may differ from those appearing in previous analyses.

Table: Share of Sectors in Total GDP (Figures in percent, unless otherwise indicated)

	1387 (2008-09)	1388 (2009-10)	1389 (2010-11)
Agriculture	27.75	31.40	27.76
Industries	25.62	21.35	20.57
Services	43.99	43.78	48.02
Nominal GDP (in billion AF)	541,113	627,393	746,859

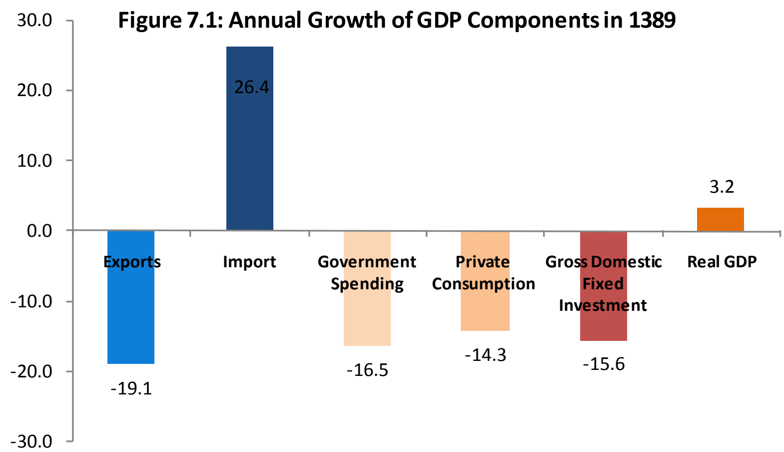
Source: Central Statistics Office

1.1 Gross domestic product by expenditure categories

As is common in all economies, private consumption spending is the most important component of expenditure category in Afghanistan, comprising 97 percent of GDP (based on CSO's data). This large expenditure category contributed substantially to overall growth, increasing by 16.7 percent in real terms, far faster than the previous year's growth rate of 1.8 percent. The faster rate of growth in private consumption, however, was partially offset by a lower rate of growth in government consumption. Government spending in real terms increased still by a substantial 19.8 percent in 1389, an actual decline in growth compared with the previous year's value of 31.4 percent.

The other two expenditure categories, investment and the trade balance, also largely offset each other. Real gross domestic fixed investment grew by 18.5 percent in 1389 compared with 12.3 percent increase in 1388. However, the trade balance got worse for the second year in a row by 50.7 percent, as exports fell and imports increased by -19.1 percent and 26.4 percent respectively. The net effect of all of these changes in the expenditure components is that the rate of growth of GDP in 1389 slightly increased to 18.0 percent from 16.9 percent in 1388.

Figure 7.1: Annual Growth of GDP Components in 1389



Source: Central Statistics Office

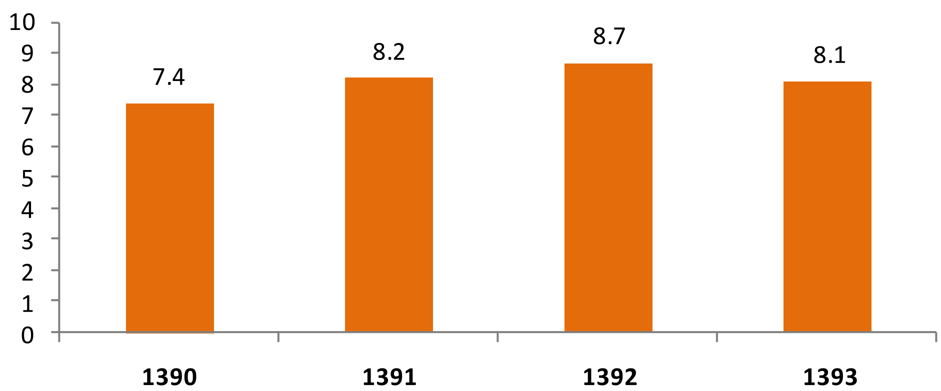
2. OUTLOOK FOR 1390

The economic performance of Afghanistan for 1390 is expected to be favorable. The real GDP growth for 1390 is projected to reach around 7.4 percent. These estimates assume that substantial development-partner funding continues; agriculture and services perform well; the resolution of the Kabul Bank crisis is not disruptive; and industry improves, aided by mining-related construction.

Agriculture's impact on real GDP growth is expected to be positive. If we look at the data trend of the agricultural sector for the last three years, it does not show a positive trend. So at the moment the government of Afghanistan and international community is paying more attention to the agriculture sector to allocate fund for agricultural projects, as the USAID provided a lot of technical assistance to the formers, so hopefully the agriculture sector will recover back in the coming years compared to 1389.

In terms of expenditure categories, the external sector is expected to hold back GDP growth, as exports are forecasted to increase by only 4.6 percent, while imports are expected to rise by 2.6 percent. The faster rate of growth of imports is likely to be influenced by the continuing appreciation of the afghani that was experienced in the first months of 1390.

Title 7.2: Real GDP Growth Projections (1390-1394)



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