



# **Da Afghanistan Bank**

## **Economic and Statistical Bulletin**

**Quarterly Bulletin, Q3 FY1393**

(June 21 to September 20, 2014)

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**Note:**

Afghanistan's new Fiscal year has been changed from 1391 (2012). The new fiscal year begins on December 21 each year. This Quarterly Bulletin describes developments in the third quarter of fiscal year 1393 which covers June 21 to September 20, 2014.

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## LIST OF ABBREVIATIONS

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

# MESSAGE OF THE GOVERNOR



# GOVERNOR'S STATEMENT

## Quarterly Economic and Statistical Bulletin

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On behalf of the Supreme Council, I am pleased to present this edition of the Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for the third quarter of FY1393 (June 21-September 20, 2014). This quarterly bulletin reflects the outcomes of the Bank's activities aimed at keeping inflation low, maintaining stability of the national currency, and developing a more robust banking sector in support of sustainable economic growth.

The fiscal year 1393 appear a challenging year for the Afghan economy. The political and securing uncertainties overshadowed the economic growth. The downward trend in economic growth in FY1392 kept on to the FY1393. The real GDP growth is expected to slow down further, remaining below 3 percent. Non-agricultural sectors are suffering from a weak business confidence, emanating from the uncertainties, while agriculture and livestock sector had a desirable performance as a result of favorable weather conditions and the adequate seasonal rainfalls.

In the light of the prevailing global economic situation, a significant fall in oil prices and deterioration of aggregate demand, global inflation has declined over the third quarter of 2014. Similar to the developed nations, emerging economies of Asia have also experienced a downward inflation trend over the last quarter.

In response to the benign international inflation environment, annual inflation in Afghanistan has also declined to its lowest rate of 4.21 percent in the month of September 2014. Besides the lower global food and oil prices, subdued global economic growth, and a weak global aggregate demand conducive to lower inflation levels internationally, the subdued level of inflation in Afghanistan can be attributed to a range of internal factors including political and economic situation of the country.

On the other hand, monetary aggregates depicted mixed performance during the third quarter of FY1393. Reserve money (RM), the operational target, has grown slightly above the target at the end of the third quarter.

Broad money (M2) grew at a relatively moderate rate compared to the previous quarter.

Narrow Money (M1) experienced a lower growth rate compared to a year ago. Meanwhile, quasi money or time deposits of the banking sector, the other component of M2, had a decline of 7 percent, compared to the same quarter of last year.

Despite of increases in the value of the U.S. dollars during Q3 2014 in the international markets, DAB was able to maintain a stable exchange rate of afghani against the U.S. dollar.

In the third quarter of FY1393, the banking sector performance weakened as a result of the political and security uncertainties. The asset base of the banking sector declined in the quarter under review. Total deposits decreased by 1.99 percent, while the gross loan portfolio of the banking sector witnessed a decrease of 4.57 percent.

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

Noorullah Delawari

Governor,

Da Afghanistan Bank

## EXECUTIVE SUMMARY

The global economy continued to expand at a moderate pace in the third quarter of 2014. However, the growth performances were uneven across different economies. At the same time as the U.S. economy continued to show broader signs of improvements, growth in the euro area hold-back among persistent structural constraints and weakening stance. Economic activities in Asia also continued to expand, but in a more moderate fashion across several economies.

Following a decline in the first quarter, and picking up in the second, the U.S. economy moderated in the third quarter of 2014.

The U.K. economy grew moderately in the third quarter of 2014. According to the preliminary estimates released by the Office for National Statistics (ONS), the economy registered a 0.7 percent growth in the quarter under review, compared to 0.9 percent in the previous quarter, but higher from the same quarter of previous year by 3 percent.

The German economy valued to be 739.60 billion euro at the end of the third quarter 2014, representing a 0.1 percent (Q-o-Q) growth after a slight contraction recorded in the previous quarter. However the GDP growth in the third quarter was down from the same period of the previous year, when it was 0.3 percent.

After recording slight contraction in the second quarter, the economy of Germany

turned to have a positive growth of 0.1 percent over the previous quarter

Household final consumption, government consumption, and exports showed a positive effect, while total capital formation and inventories decreased in the period under review.

Economy of France witnessed a recovery in the third quarter of 2014. According to the first results of the quarterly national account, released on 14 Nov 2014, the economy of France had a 0.3 percent growth in the third quarter.

The recovery in the economy was mainly driven by the household consumption expenditure, general government expenditure, and a bouncing in the production of goods and services by 5 percent after a decline of 8 percent in Q2 2014.

The economy of Japan experienced a deeper recession in the third quarter, followed by a severe contraction in the preceding quarter of 2014. According to the second preliminary estimates made by the Cabinet Office of Japan, the economy further contracted in the third quarter by 0.48 percent, standing at 523.76 billion Yen, mainly driven by 8 percent tax hike on April, to curb public debt.

Based on the *World Bank*, the Russian economic growth in the third quarter of 2014 was 0.7 percent (Y-o-Y), down from 0.8 and 0.9 percent recorded in the second and

first quarters of the year respectively. A series of sanction over the Ukraine crisis and fall in oil prices are the major causes of slower growth.

In the year 2014, as of end September, China experienced its weakest growth rate. The annual growth rate was recorded at 7.3 percent, down from 7.5 and 7.4 percent recorded in the second and first quarters, respectively. Similarly, the growth rate in the third quarter was lower than the same quarter of last year when it was 7.8 percent.

Turkey's GDP growth rate was 1.7 percent in the third quarter of 2014, down compared both to the previous quarter, and the same quarter of the previous year. The growth was mainly driven by the financial, insurance, and manufacturing industry.

Indian economy recorded an annual growth of 3.2 percent in the third quarter of 2014. The growth was lower than the previous quarter by 6 percentage points.

Electricity, gas, water supply, construction, social and personal service, insurance & real states and others were the main factors of this growth.

Afghanistan's monetary aggregates exhibited mixed performance in the third quarter of FY1393; the actual reserve money grew by 11.1 percent at the end of the third quarter of FY1393 (Sept. 2014), compared to the beginning of the year. The actual reserve money stood at AF 198.757 billion at the beginning of the year; however, it increased

to AF 203.673 billion at the end of the third quarter, surpassing the ceiling by AF 22.098 billion. The main reasons behind a sharp increase in actual reserve money were thought to be the uncertain political and economic environment in the country, which led US dollars and other foreign currencies to be used as the store of value. Secondly, the increased government spending on security and defense sectors during the period under review could be the other factor causing an increase in the currency in circulation.

Broad money (M2) grew at a relatively moderate rate compared to the previous quarter. In the third quarter of FY1393, M2 stood at AF 384,856 million, representing an increase of 3.82 percent compared to 6.53 percent growth recorded in the same quarter of FY1392. The growth in M2 was mainly driven by an increase in narrow money (M1), which constitutes a major portion of M2. The other component of M2 had a negative growth of 7 percent. M1 registered a growth rate of 4.45 percent, down from 6.6 percent in the same quarter of 1392.

Meanwhile, quasi money or time deposits, the other component of M2, had a decline of 7 percent, compared to 4.3 percent increase recorded in the same quarter of last year.

Inflation in Afghanistan maintained its downward trend in the third quarter of FY1393.

The national headline inflation experienced a considerable decline over the period started from August 2013 up to Sept. 2014. The broadest measure of the general price level (National Headline Inflation) in the country was recorded at 4.2 percent by the end of the third quarter of FY2014, which is way below its level of 8 percent in the same period of the previous year.

The inflation rate of Food and Beverages considerably fallen from 9.1 percent in the third quarter of 2013 to 6.8 percent (Y-o-Y) in the third quarter of FY2014. Bread & cereals, meat, milk, and vegetables are the key and the highest weighted subcomponents of the Food sub-index; therefore, to analyze the developments in the food section, these items are important to be focused on.

Bread and Cereal, registered a decline of 3.6 percent over one year period, reaching 11 percent (Y-o-Y) in the current quarter. Similar to Bread & Cereals, other subcomponents including Meat, Milk & Cheese & Eggs, and Vegetables have also experienced a downward trend over the period of September 2013 to September 2014.

Such a decline in food inflation can partly be explained by an overall fall in global food prices over the last year. For instance, owing to a bumper cereal production in the US, the

prices of wheat and corn experienced a drop of 27 percent and 25 percent respectively. Similarly, palm oil index shows a drop in the price of this product over the same period.

The most favorable developments in national CPI inflation have been observed in the non-food section of the CPI. The overall annual inflation in the non-food section has declined from 6.8 percent (Y-o-Y) in September 2013 to 1.4 percent at the end the reporting period. Among all items in non-food section, the housing subcomponent of the CPI, which carries the greatest weight, declined remarkably from an inflation rate of 6.8 percent (Y-o-Y) in the third quarter of 2013 to a deflation rate of 8.8 percent in the quarter under review.

The external sector performance weakened in the quarter under review, the current account deficit improved, while the capital flows witnessed a downward trend in the third quarter of the FY 1393. The trade balance position worsened as the total imports exceeded far the total exports. On the other hand, the Net International Reserves (NIR) increased slightly by only one percent in the quarter under review. However, the external debt stock decreased by 15 percent. The external debt policy pursued by the government helped the external debt position to stay within the manageable limits.

Most importantly, the debt service payments should be monitored in order, not to restrict the financing of key development programs.

The Merchandise trade statistics shows that trade deficit narrowed to 32 percent, from USD 2,214.12 million in the third quarter of the FY 1392 to a deficit of USD 1,512.20 million in the third quarter of the FY 1393. The trade deficit makes up approximately 7 percent of GDP.

Aggregate imports decreased significantly by 29 percent, while total exports boosted by almost 26 percent in the third quarter of the FY 1393.

According to merchandise trade statistics, total imports for the period under review was recorded USD 1665.98 million, where this figure was USD 2336.48 million in the similar period last year. The decrease in expenditure on total imports were due to three importing categories, in particular fuel and lubricants, which decreased by 65 percent, from USD 677.37 million in the third quarter of the FY 1392, to USD 249.64 million in the third quarter of the FY 1393. Capital goods and others declined by 28 percent from USD 923.79 million in the third quarter of the FY 1392, to USD 666.83 million in the quarter under review, industrial supplies diminished by 41 percent, from USD 305.22 million to USD 179.72 million.

On the other hand, imports of consumer goods rose by almost 32 percent, from USD 430.10 million in the third quarter of the FY 1392, to USD 569.79 million in the third quarter of the FY 1393.

Total Exports increased by 26 percent, from USD 122.36 million, to USD 153.78 million in the third quarter of the FY 1393.

Based on the trade statistics, all export categories exhibited upward trend in the period under review. Carpets and rugs rose significantly by 96 percent, from USD 15.90 million in the third quarter of the FY 1392 to USD 31.14 million in the third quarter of the FY 1393. Food items such as the fresh and dry fruits, medical seeds and others category, remained the leading categories driven the overall exports up.

The overall fiscal performance during the third quarter of 1393 was weak due to lower collection in domestic revenues. As a result of a shortfall in government revenues and donor's contribution, the national budget deficit increased over the first three quarters of the FY1393. The budget deficit increased to AF 32.4 billion by the end of the third quarter (September 2014), from a budget surplus of AF 34.3 billion recorded in the same period of last year. Out of total national budget deficit of AF 32.4 billion, AF 22.2 billion was the deficit in the operating budget and the remainder AF 8.9 billion was

the deficit observed in the development budget.

In the banking sector, the asset base of the banking sector dropped by 1.64 percent or AF 4.00 billion during the quarter under analysis compared to 1.79 percent growth in the month of June 2014, registering 1.86 percent decrease since the preceding period (Sep. 2013). The decline in banking system assets was mainly due to decrease in deposits.

Gross loan portfolio of the banking sector witnessed a decrease of 4.57 percent or AF 2.14 billion (3.14 percent increase in June 2014) over a quarter standing at AF 44.76 billion. Compared to the Sep.2013, gross loans depicted 5.14 percent decrease. The decrease in the loan portfolio is mainly on account of repayment, settlement and charge-off of loans, besides new loans have been disbursed as well.

Deposits the main funding source in the banking sector stood at AF 200.54 billion, comprising 96.09 percent of the total liabilities of the sector decreased by 1.99 percent against the 2.82 percent increase in the previous quarter (June, 2014), mainly attributed to prolonged election process and prevailed uncertainty in the economy. The Deposits were largely denominated in USD (60.44 percent) with Afghani denominated deposits lagging at 35.84 percent. AF-denominated deposits indicated an increase of 2.97 points against the 7.57 percent increase in June, 2014 while USD

denominated deposits was down by 5.03 points against 0.26 percent decline in June, 2014.

The capital base of the banking sector remained strong at AF30.12 billion, although decreased slightly on account of a decrease in profitability of the banking sector. Capital adequacy ratio (CAR) of the banking sector recorded at 26.26 percent. All the banking institutions are above the set limits for CAR.

Banking sector profit declined over a quarter, resulting in 0.37 percent Return on Assets (ROA) against 0.56 percent and 2.97 percent Return on Equity (ROE) against 4.57 percent in June, 2014. Profits amounted to AF 297 million compared to AF 457 million recorded in June, 2014. State-owned Banks, Private Banks and Branches of Foreign banks ended up with profits during the quarter under analysis.





# GLOBAL ECONOMIC ENVIRONMENT

1



## 1

## GLOBAL ECONOMIC ENVIRONMENT

The global economy continued to expand at a moderate pace in the third quarter of 2014. However, the growth performances were uneven across different economies. At the same time as the U.S. economy continued to show broader signs of improvements, growth in the euro area hold-back among persistent structural constraints and weakening stance. Economic activities in Asia also continued to expand, but in a more moderate fashion across several economies.

### 1. ADVANCED ECONOMIES

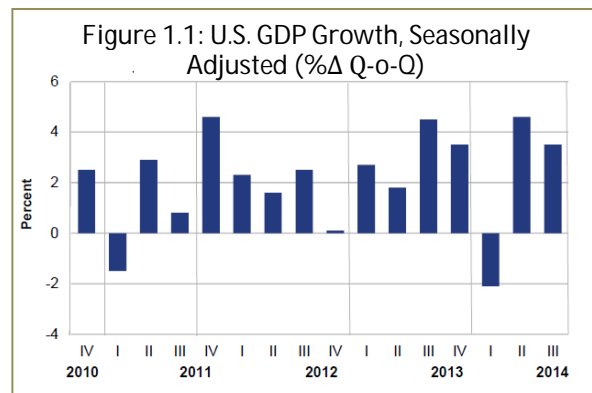
#### 1.1 The United States Economy

Following a decline in the first quarter, and picking up in the second, the U.S. economy moderated in the third quarter of 2014. According to the advanced estimate released by the *Bureau of Economic Analysis/ U.S department of commerce* on 30-Oct-2014, the U.S economic growth was 3.5 percent in the third quarter, down from the previous quarter.

Moderation in the growth was mainly driven by the investment. In addition, consumer spending, spending on durable goods and

business investment increased in the third quarter, slower than that in the previous quarter.

**Inflation Rate:** Inflation in the U.S. was recorded 1.7 percent at the end of the third quarter 2014, down from 2.1 percent recorded at the end of the preceding quarter. On the annual basis, before seasonal adjustment, all items index increased by 1.7 percent. Price increase of shelter and food outweighed price decrease of energy. Both, food and shelter prices increased by 3 percent each, while energy price decreased by 6 percentage points.



Source: Bureau of Economic Analysis, U.S. Department of Commerce

#### Unemployment Rate:

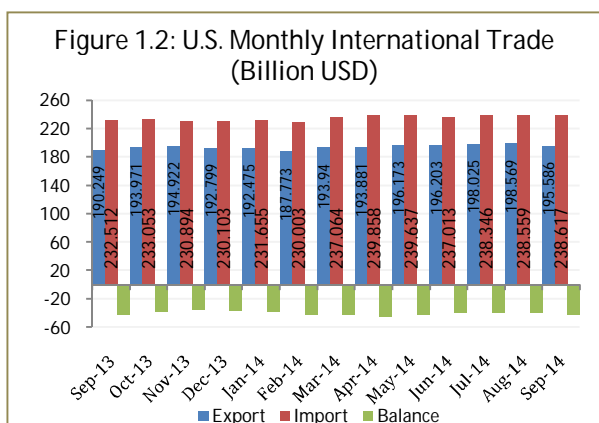
The U.S unemployment rate continued its downward trend for the past two years (on

average) and was recorded 5.9 percent at the end of the third quarter, down from the previous quarter, as well as from the same quarter of last year when the unemployment rates were 6.1 and 7.2 percent respectively.

The decrease in unemployment rate was driven by an increase in the rate of employment in professional and business services in addition to the retail trade and health care.

**International Trade:** the U.S trade gap widened at the end of the third quarter 2014, compared to the previous one as well as the same quarter of last year. According to the data released by the *U.S. department of commerce*, total exports was USD 195.6 billion, while its total import was USD 238.6 billion USD, indicating a deficit of USD 43 billion, up from the previous quarter by 5.44 percent as well as from the same quarter of last year by 1.82 percent.

China was on the top of trade partners followed by Germany and Japan, while Afghanistan was ranked as 99<sup>th</sup> partner.



Source: U.S. Bureau of Economic Analysis / U.S. Department of Commerce

## Public Debt

According to the data released by the *Bureau of fiscal service*, total outstanding debt of U.S at the end of the third quarter of 2014 was recorded at USD 17,824,071 million, indicating a 6.5 percent increase over the end of the previous quarter.

## 1.2 The United Kingdom Economy

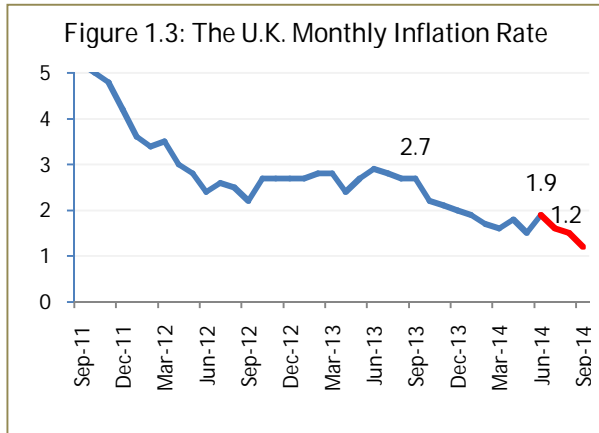
The U.K economy grew moderately in the third quarter of 2014. According to the preliminary estimates released by the Office for National Statistics (ONS), the economy registered a 0.7 percent growth in the quarter under review, compared to 0.9 percent in the previous quarter, but higher from the same quarter of previous year by 3 percent.

The growth in the third quarter of 2014 was mainly driven by four industrial groupings. Construction and output experienced the highest growth rates of 0.8 and 0.7 percent, respectively, followed by production and agriculture, growing by 0.5 percent and 0.3 percent respectively.

**Inflation Rate:** Inflation rate in the U.K was recorded 1.2 percent at the end of the third quarter 2014, down from the second quarter, when the inflation rate was 1.9 percent. A decline in the cost of transportation and ranges of recreational goods was the main drivers responsible for the fall in the overall inflation rate.

In the year 2014, up to September, prices of food and motor fuel decreased by 1.5

percent and 6.0 percent respectively. Increase in supermarket competition, GBP appreciation; fall in crude oil and petroleum prices could be other factors behind the low inflation rate.

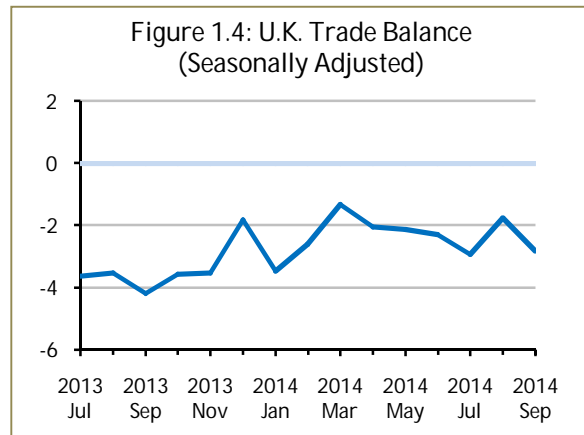


Source: Office for National Statistics (ONS)

**Unemployment rate:** The unemployment rate of the UK was 6.0 percent in the third quarter of 2014, down from 6.3 percent and 7.6 percent recorded in the previous quarter and in the same quarter of last year respectively.

**International Trade:** The U.K trade deficit is estimated at BP 2.8 billion in the third quarter of 2014, up from 2.286 billion at the end of the previous quarter, but considerably down from BP 4.2 billion deficit in the same period of last year.

Germany remained the largest trade partner of the UK, having the largest deficit from it, while its surplus reached to its 8 year lowest level with the U.S; however its deficit with the china and Hon Kong got considerable decrease.



Source: Office for National Statistics (ONS)

### 1.3 The German Economy

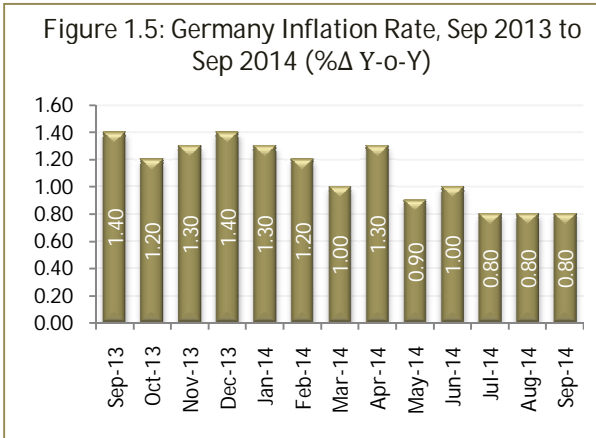
**GDP growth:** The German economy valued to be 739.60 billion euro at the end of the third quarter 2014, representing a 0.1 percent (Q-o-Q) growth after a slight contraction recorded in the previous quarter. However the GDP growth in the third quarter was down from the same period of the previous year, which was 0.3 percent.

After recording slight contraction in the second quarter, the economy of Germany turned to have a positive growth of 0.1 percent over the previous quarter

Household final consumption, government consumption, and exports showed a positive effect, while total capital formation and inventories decreased in the period under review.

**Inflation rate:** Consumer price index (Y-o-Y) was estimated to be 0.8 percent at the end of the third quarter of 2014, lower than that in the previous quarter by 2 percentage points, but considerably down from 1.4

percent in the same quarter of the previous year. During the current year, the highest inflation rate was recorded at 1.3 percent, while the lowest rate was 0.8 percent.



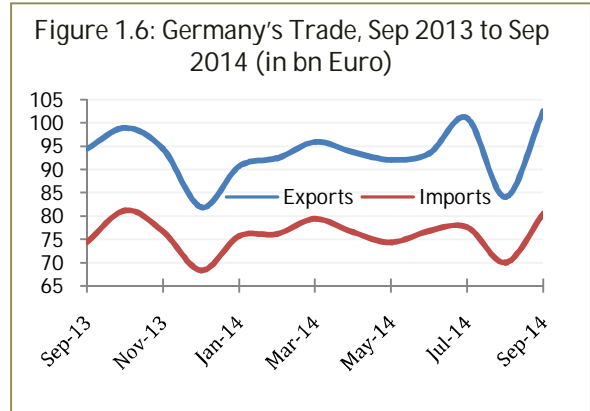
Source: Federal Statistics Office (Destatis)

**Unemployment rate:** Unemployment in Germany remained unchanged at the end of Q3 2014, over the previous quarter. According to the data released by the *Federal Statistics Office (Destatis)*, the unemployment rate in Germany was 5 percent in Q3 2014, same as that in the Q2, however it was down from the same quarter of last year by 3 percentage points.

**International Trade:** Germany enjoyed a continued trade surplus of € 21.9 billion at the end of Q3 2014, up from € 16.6 and 20 billion recorded at the end of Q2 2014 and at the end of the same period of the previous year, respectively.

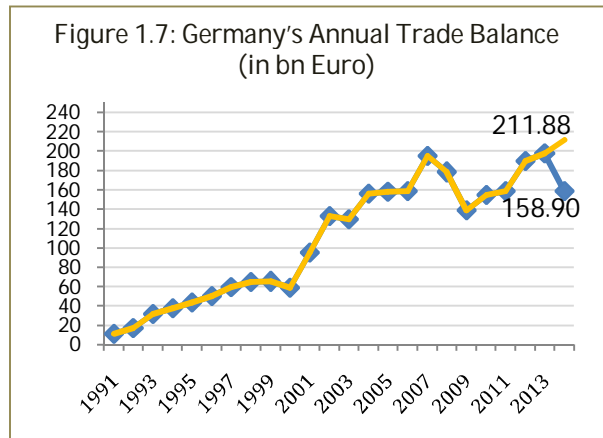
At the end of Q3 2014, Germany exported goods to the members of European Union States (EU) valued € 58.6 billion, to the Euro area countries € 36.5 billion, € 22.2 billion to

EU countries not belonging to Euro area, and € 43.8 billion to other countries.



Source: Federal Statistics Office (Destatis)

It is worth mentioning that Germany had a two decade trade surplus, averaging around € 8.5 billion. The total trade surplus in 2014, as of September, reached € 158.90 billion, and is expected to exceed € 200 billion at the end of the year.



Source: Federal Statistics Office (Destatis)

### 1.4 The Economy of France

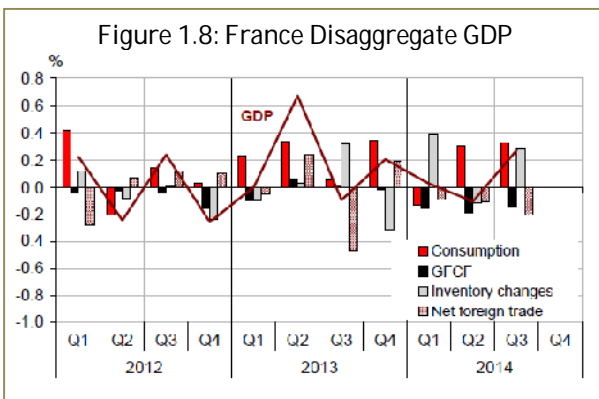
Economy of France started recovery in the third quarter of 2014. According to the first

result of the quarterly national account, released on 14 Nov, 2014, economy of France had a 0.3 percent growth in the third quarter.

The recovery in the economy was mainly driven by the household consumption expenditure, general government expenditure, and a bouncing in the production of goods and services by 5 percent after a decline of 8 percent in Q2 2014.

**Inflation Rate:** France experienced a deflation rate of 0.4 percent at the end Q3 2014, compared to 0.3 percent inflation recorded in the same period of the previous year.

**Unemployment Rate:** Unemployment rate was 10.5 percent at the end of Q3 2014, slightly up compared to that in Q2, as well as compared to the same period of the previous year, when it was 1 percent and 2 percent respectively.



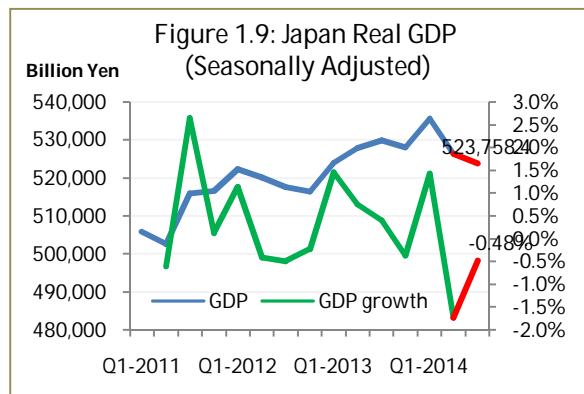
Source: National Institute of Statistics and Economic Studies (INSEE)

**International Trade:** After experiencing a negative growth of 1 percent in the second

quarter, exports of France recovered in the third quarter of 2014, representing a 5 percent growth rate mainly driven by pharmacy, coke and petroleum. Similarly, imports increased by 1.1 percent in the third quarter of 2014, compared to 3 percent in the previous quarter. Foreign trade in the third quarter had a negative contribution of 2 percent in total GDP.

### 1.5 The Economy of Japan

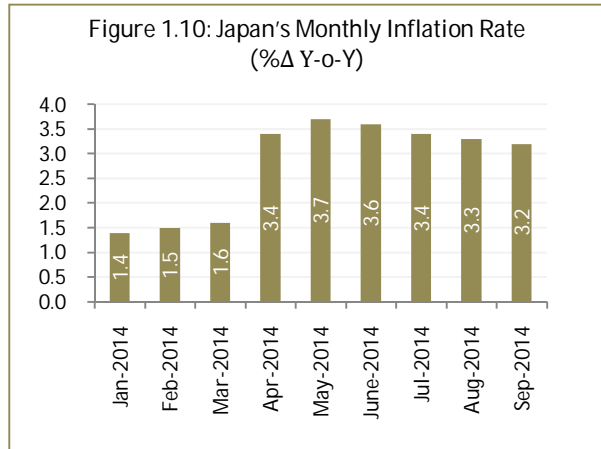
The economy of Japan experienced a deeper recession than the expected in the third quarter, followed by a severe contraction in the preceding quarter of 2014. According to the second preliminary estimates made by the *Cabinet Office of Japan*, the economy further contracted in the third quarter by 0.48 percent, standing at 523.76 Billion Yen, mainly driven by the 8 percent tax hike on April, to curb public debt.



Source: Cabinet Office, Japan

**Inflation rate:** Inflation rate in Japan was 3.28 percent (Y-o-Y) in the third quarter of 2014, down from the preceding quarter, as

well as from the same quarter of the previous year.



Source: Japan's Ministry of Internal Affairs & Communications

**Unemployment rate:** Unemployment rate in Japan was 3.6 percent at the end of Q3 2014, slightly up from the previous quarter, however, it is below by 4 percentage points, compared to the same quarter of the last year.

**International Trade:** In the third quarter of 2014, total export of goods and services stood at 22,491 billion Yen, while total import of goods and services stood at 19,892.8 billion Yen, indicating a net export of 2598.7 billion Yen, down by 4.6 percent in the previous quarter, however it is up by 30 percent compared to the same quarter of last year when it was 1,992 billion Yen.

## 2. EMERGING ECONOMIES

### 2.1 The Economy of Russia

Based on the *World Bank*, the Russian economic growth in the third quarter of 2014 was 0.7 percent (Y-o-Y), down from 0.8

and 0.9 percent recorded in the second and first quarters of the year respectively. A series of sanctions over the Ukraine crisis and fall in oil prices are the major causes of slower growth.

**Inflation Rate:** After experiencing a stable inflation rate in the past two consecutive quarters (first and second), the overall price level increased in the third quarter 2014. According to the data released by the *Federal Statistics Service*, inflation rate (Y-o-Y) in the third quarter was 1.5 percent. Depreciation of Russian Ruble against the greenback, as well as the sanctions against Russia, may have resulted in the price hike.

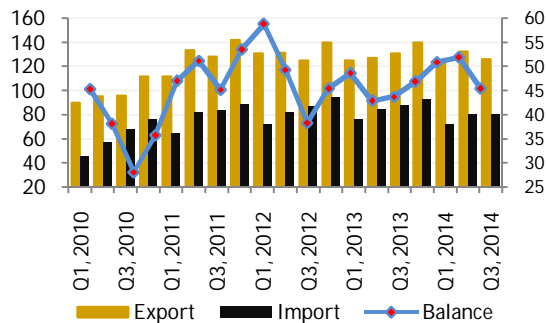
**Unemployment rate:** Unemployment in the Russia was slightly lower in the third quarter 2014, compared to the previous quarter.

According to the *Federal State Statistics Service*, the unemployment rate was averaged at 4.9 percent in the Q3 2104, down by 1 percentage point from the previous quarter, but notably down from 5.2 percent in the same quarter a year ago.

**International Trade:** Trade surplus increased over the same period of last year by 3.8 percent, standing at USD 45 billion, lower than the previous quarter. Russia enjoys a trade surplus for a long time. Considering the last five year data, the highest surplus (Q-o-Q) was recorded in Q1 2012, standing at USD 58.7 billion, while the lowest surplus was recorded in Q3 2010, standing at USD 28 million.

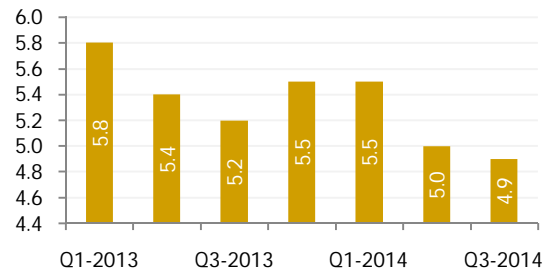


Figure 1.11: Russia Quarterly Trade Balance (USD bn)



Source: Central Bank of Russia

Figure 1.12: China Growth Rate (%Δ Y-o-Y)



Source: Department of Labor, Employment and Science Statistics, Federal State Statistics Service

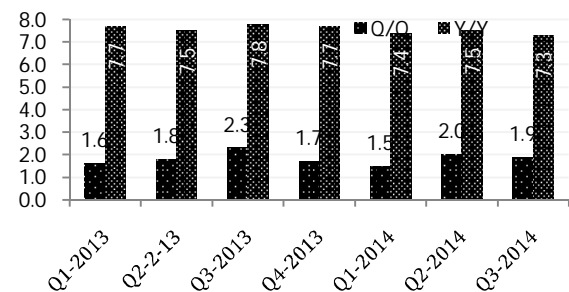
## 2.2 The Economy of China

In the year 2014, as of the end September, China experienced its weakest growth rate. The annual growth rate was recorded at 7.3 percent, down from 7.5 and 7.4 percent recorded in the second and first quarters, respectively.

Similarly the growth rate in the third quarter was lower than the same quarter of last year when it was 7.8 percent.

According to preliminary accounting results of GDP released by the *National Bureau of Statistics of China*, the expansion in the third quarter was driven by the favorable performance of wholesale and retail trade having 9.7 percent growth followed by financial intermediation and construction having 9.1 and 9.0 percent growth respectively. In addition to that, agricultural products and industrial production had good momentum contributing positively in the expansion of the economy.

Figure 1.13: China GDP Growth Rate

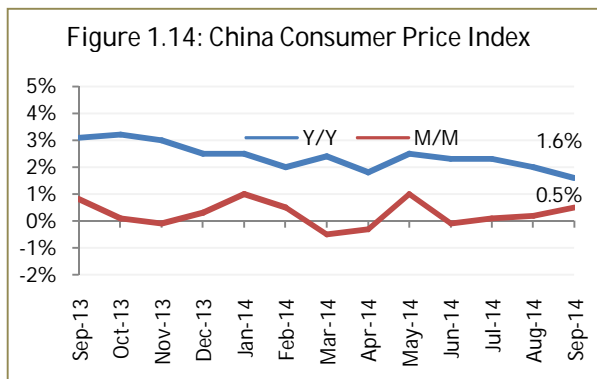


Source: National Bureau of Statistics of China

**Inflation rate:** The annual price levels were recorded 1.6 percent at the end of the third quarter of 2014, down from 2.3 and 2.4 percent in the second and in the first quarters.

Prices in the urban areas increased by 1.7 percent, while in the rural areas, the pace was slower at 1.4 percent. Food and services increased by 2.3 percent each, while non-food prices increased by 1.3 percent. From January to September, the overall CPI went up by 2.1 percent over the same period of last year.

**Unemployment rate:** Unemployment rate in china remained unchanged at 4.1 percent, similar to that recorded in the previous quarter.

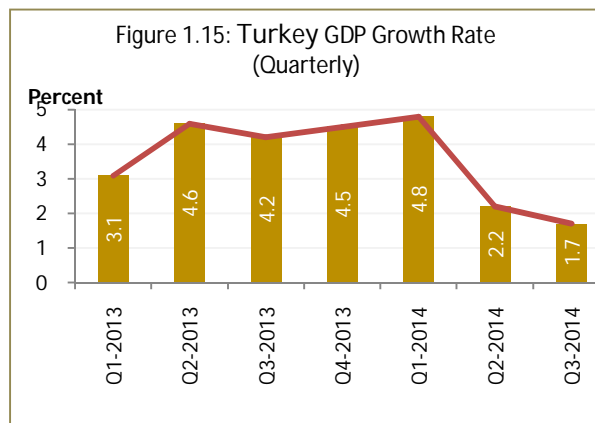


**International Trade:** At the end of the third quarter 2014, the total exports of china stood at 1.32 trillion Yuan, while total imports were 1.12 trillion Yuan indicating a surplus of 190.1 billion Yuan.

In the first three quarters of 2014, total exports of china reached USD 1.7 trillion, while total imports were USD 1.46 billion. Compared to the previous year, exports increased by 5.1 percent, while imports increased by 1.3 percent and surplus had an increase of 37.8 percent.

## 2.3 The Economy of Turkey

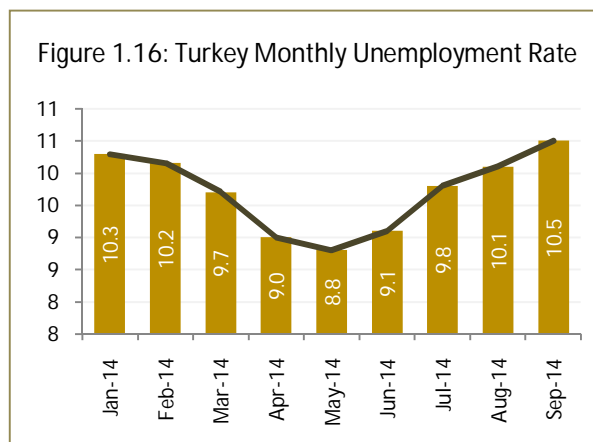
Turkey's GDP growth rate was 1.7 percent in the third quarter of 2014, down from the past two quarters, and the same quarter of the previous year. The growth was mainly driven by the financial, insurance, and manufacturing industry.



Source: Turkish Statistical Institute

**Inflation Rate:** The annual Inflation rate was 8.86 percent at the end of third quarter 2014, down from 9.16 percent in the previous quarter, but up from 6.43 percent in the same quarter of previous year.

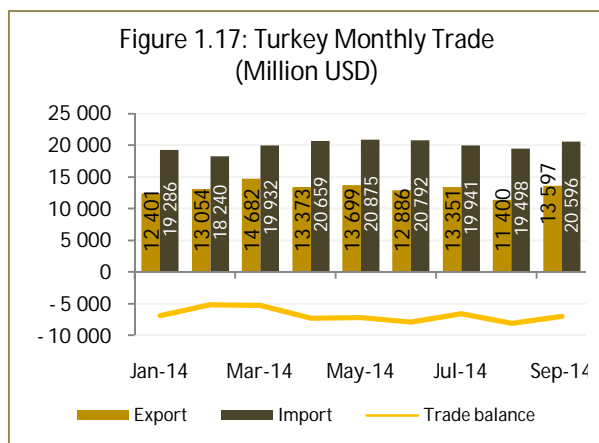
**Unemployment Rate:** The unemployment rate of Turkey was 10.5 at the end of the third quarter of 2014, down from 9.1 percent recorded in the previous quarter and 9.2 percent in the same quarter of the previous year.



Source: Turkish Statistical Institute

## International Trade:

Turkey's economy has been suffering from a trade deficit for many years. At the end of the third quarter 2014, the trade deficit stood USD 7 billion, down from USD 7.9 billion in the previous quarter and similarly down from the same quarter of previous year by almost USD 500 million.



Source: Turkish Statistical Institute

## 2.4 The Economy of India

Indian economy recorded an annual growth of 3.2 percent in the third quarter of 2014. The growth was lower than the previous quarter by 6 percentage points.

Electricity, gas, water supply, construction, social and personal service, insurance & real states and others were the main factors of this growth.

**Inflation Rate:** Inflation rate was 4.64 percent (y-o-y) in the third quarter of 2014, down from 7.73 percent in the preceding quarter, and 9.84 percent in the same quarter of the previous year, respectively.

**International Trade:** India's exports in merchandise trade reached USD 163.7 billion at the end of third quarter 2014, while its imports stood at USD 234.1 billion indicating deficit of USD 70.4 billion. Compared to the same period of last year, exports increased by 6.44 percent, while imports increased by 1.56 percent and the trade gap lowered by 8.2 percent.

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**MONETARY  
AND CAPITAL  
MARKET  
DEVELOPMENTS**

**2**



# 2

## MONETARY AND CAPITAL MARKET DEVELOPMENTS

**T**his chapter provides a detailed report on the developments in the monetary and capital market sector in the third quarter of FY1393 (2014). In addition, this chapter will shed light on the role and performance of Da Afghanistan Bank (DAB) in promoting and developing of Afghanistan's monetary and capital market.

### ***I - MONETARY PROGRAM***

Under the monetary policy framework (MPF), reserve money remained the key operational target (performance criterion) in the period under review, while currency in circulation was set as the indicative target, designed for achieving DAB's primary objective of domestic price stability.

DAB conducts monetary policy to maintain an overall sustainable domestic price level, avoiding prolonged inflationary and deflationary pressures. DAB uses the monetary aggregate regime, by which DAB is able to adjust its monetary policy implementation. The monetary targets and

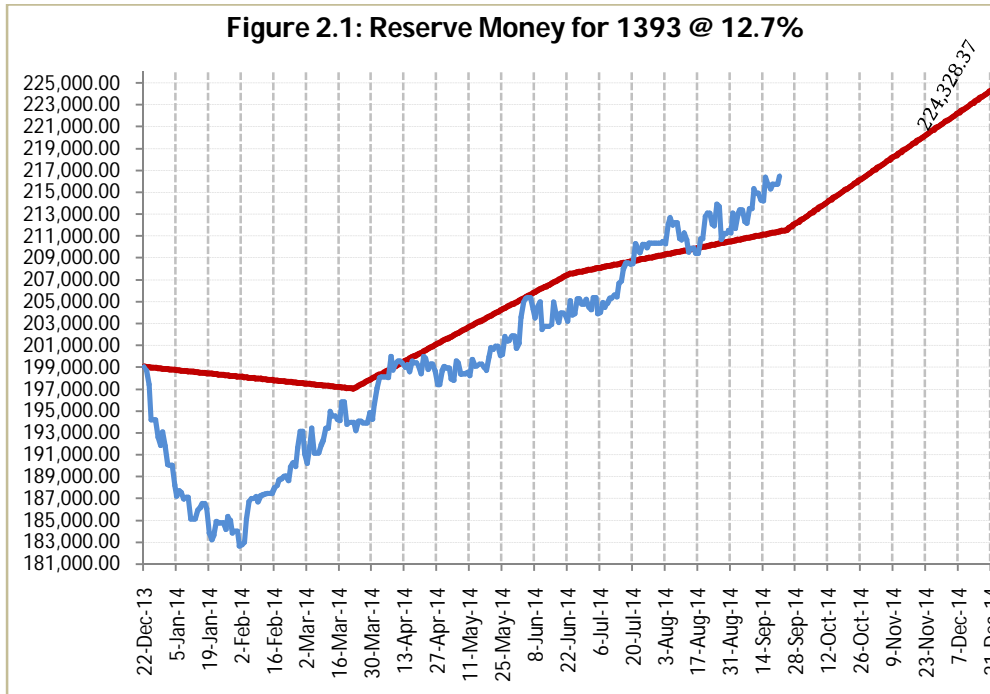
the progress towards achieving those targets are reported regularly. Consequently, public and market receives required information on the monetary policy stance.

The precise amount of reserve money (RM) conducive to support the domestic price stability is determined using the quantitative theory of money. For the Fiscal year 1393 (2014), the annual growth targets for reserve money and currency in circulation were revised upward from 8 percent to 12.7 percent each.

The actual reserve money grew by 11.1 percent at the end of the third quarter of FY1393 (Sept. 2014), compared to the beginning of the year. The actual reserve money stood at AF 198.757 billion at the beginning of the year, however, it increased to AF 203.673 billion at the end of the third quarter, surpassing the ceiling by AF 22.098 billion. The main reasons behind the sharp increase in actual reserve money were the uncertain political and economic environment in the country, which led US dollar and other foreign currencies to be used as the store of value, secondly, the

increased government spending on security and defense sectors during the period under

review, was the other factor causing an increase in the currency in circulation.

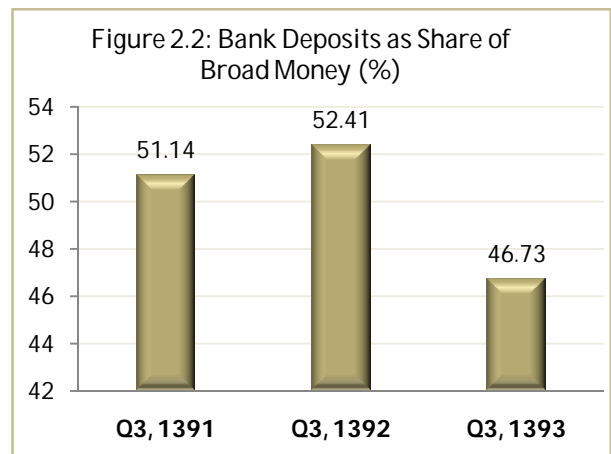


Source: Monetary Policy Department/DAB

## 2- MONETARY AGGREGATES

DAB's Monetary Policy department (MPD) compiles monetary aggregates- narrow money (M1) and broad money (M2) through MFS methodology and definition. In Afghanistan, narrow money includes all physical money, coins and currency, demand deposits, and other liquid assets of the commercial banks held in Da Afghanistan Bank, while in construction of broad money the degree of liquidity of a wide array of financial assets are evaluated, focusing on the extent to which each type of financial

asset provides liquidity and store value (IMF).



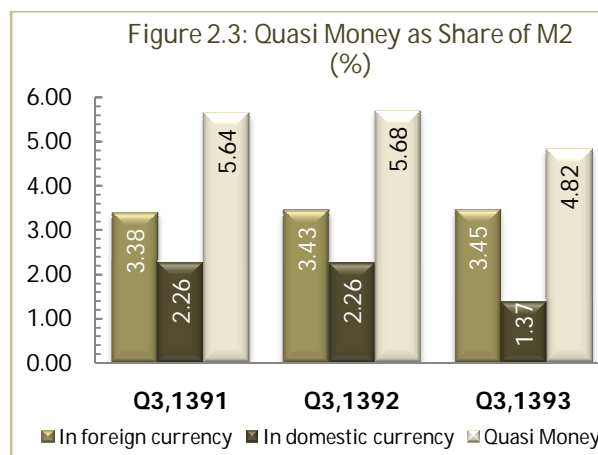
Source: Monetary Policy Department/DAB



Broad money (M2) grew at a relatively moderate rate compared to the previous quarter. In the third quarter of FY1393, M2 stood at AF 384,856 million, representing an increase of 3.82 percent compared to 6.53 percent growth recorded in the same quarter of FY1392. The growth in M2 was mainly driven by an increase in narrow money (M1), which constitutes a major portion of M2. The other component of M2 had a negative growth of 7 percent. M1 registered a growth rate of 4.45 percent, down from 6.6 percent in the same quarter of 1392.

Meanwhile, quasi money or time deposits, the other component of M2, had a decline of 7 percent, compared to 4.3 percent increase recorded in the same quarter of last year.

Hence, the dominant factor responsible for a slower pace of growth in broad money in the third quarter of FY1393 was a slower growth in M1. The share of quasi money in broad money is too small therefore; its impact on broad money is negligible.



Source: Monetary Policy Department/DAB

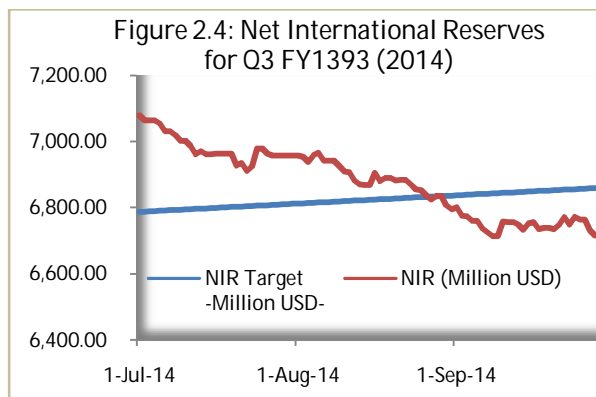
### 3- NET INTERNATIONAL RESERVES

International reserves, also referred as foreign exchange reserves, has several definitions; the most widely accepted definition is “consisting of official public sector foreign assets that are available and controlled by the monetary authorities, for direct financing of payment imbalances, and directly regulating the magnitude of such imbalances, through intervention in the exchange rate markets to affect the currency exchange rate and/or for other purposes” (IMF)

The international reserves of Da Afghanistan Bank consist of monetary gold, reserve position and holdings with the IMF, special drawing Rights (SDR), and reserves of strong major foreign currencies such as the U.S dollar, euro and British Pound. The international reserves of Afghanistan had an upward trend since the transitional

government, mainly due to inflows received as grants. It is essential for DAB to hold adequate amount of international reserves for the following reasons.

- International reserves are held as formal backing for the domestic currency. Holding adequate level of international reserves is very crucial to safeguard the value of the domestic currency.
- International reserves are also important for a timely payment of international payment obligations, and to finance international trade, hence increases demand for liquid reserves that can be used to settle trade obligations.
- Da Afghanistan Bank utilizes its international reserves to manage money in circulation and to maintain stability in the exchange rate of afghani against the foreign currencies. The level of the DAB net international reserves was recorded at USD 6.679 billion at the beginning of the year and ended up at USD 6.771 billion at the end of the third quarter of 1393 (2014). DAB has auctioned a total of USD 2.373 billion to meet the demand of the market and to prevent unnecessary volatility in the exchange rate of afghani against the major currencies.



Source: Monetary Policy Department/DAB

Table 2.1: Monetary Aggregate, Q3 FY 1393 (Jul 21 to Sep 20, 2014) million AF

	Q3, 1391	Q3 1392	Y-o-Y Δ	Difference	Q3, 1393	Y-o-Y Δ	Difference
	Amount	Amount			Amount		
<b>1- Net Foreign Assets</b>	<b>402,836</b>	<b>477,519</b>	<b>18.5%</b>	<b>74,682</b>	<b>455,865</b>	<b>-4.53%</b>	<b>-21,654</b>
(a) Foreign Assets	431,860	509,707	18.0%	77,847	483,699	-5.10%	-26,008
DAB Foreign exchange reserves							
Gold	359,457	417,195	16.1%	57,738	398,942	-4.37%	-18,252
Other	57,634	60,424	4.8%	2,790	47,509	-21.37%	-12,915
Other foreign assets	301,823	356,770	18.2%	54,947	351,433	-1.50%	-5,337
(b) Foreign Liabilities	72,404	92,513	27.8%	20,109	84,757	-8.38%	-7,756
<b>2. Net Domestic Assets</b>	<b>-71,415</b>	<b>-116,551</b>	<b>63.2%</b>	<b>-45,136</b>	<b>-71,009</b>	<b>-39.07%</b>	<b>45,541</b>
(a) Net Domestic Credit	-46,463	-57,482	23.7%	-11,020	-17,812	-69.01%	39,670
Net Credit to Nonfinancial Public Sector	-86,937	-103,787	19.4%	-16,850	-62,850	-39.44%	40,937
Net Credit to Central Government	-86,736	-103,522	19.4%	-16,786	-62,718	-39.42%	40,804
Credit to Central Government	32,789	33,949	3.5%	1,160	33,206	-2.19%	-743
Liabilities to Central Government	119,525	137,471	15.0%	17,946	95,924	-30.22%	-41,547
Net Credit to State & Local Government	0	0	0.00%	0.000	0.000	0.00%	0.000
Net Credit to Public Nonfinancial Corporations	-201	-265	31.9%	-64	-132	-50.16%	133
Credit to Private Sector	41,274	47,654	15.5%	6,380	46,188.21	-3.08%	-1,466
Net Credit to Other Financial Corporations	-800	-1,349	68.7%	-549	-1,150.46	-14.74%	199
(b) Capital Accounts	78,367	104,833	33.8%	26,466	99,419	-5.16%	-5,414
(c) Other Items Net	53,415	45,764	-14.3%	-7,651	46,222	1.00%	458
<b>3- Broad Money (M2)</b>	<b>331,422</b>	<b>360,968</b>	<b>8.9%</b>	<b>29,546</b>	<b>384,856</b>	<b>6.62%</b>	<b>23,888</b>
Narrow Money (M1)	312,727	340,449	8.9%	27,722	366,299	7.59%	25,850
CiC (Currency outside depository corporations)	143,250	151,255	5.6%	8,005	186,443	23.26%	35,188
Demand Deposits	169,477	189,195	11.6%	19,718	179,856	-4.94%	-9,338
Other Deposits (Quasi Money)	18,695	20,519	9.8%	1,824	18,556	-9.56%	-1,962
In Afghani	7,492	8,142	8.7%	650	5,272	-35.25%	-2,870
In Foreign currency	11,203	12,377	10.5%	1,174	13,285	7.34%	908
Securities Other Than Shares	0.000	0.000	0.00%	0	0.000	0.00%	0.000

(Source: Monetary Survey Section, Monetary Policy Department DAB)

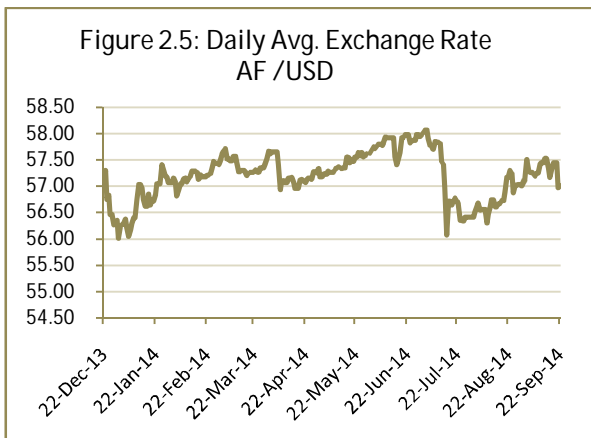
#### 4- FOREIGN EXCHANGE MARKET

Da Afghanistan Bank uses managed floating exchange rate regime and

intervenes in the exchange rate market on a regular basis to mop up excessive money supply from the market, preserve the value of the domestic currency, to maintain

favorable reserve position, and to ensure external balance without compromising on the overall goal of macroeconomic stability. During the third quarter of the fiscal year 1393, afghani appreciated against some major currencies.

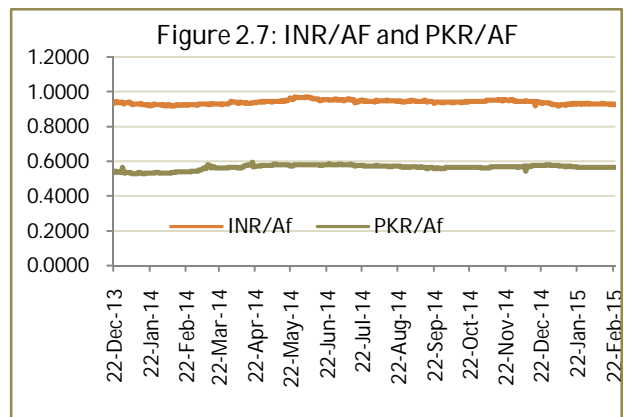
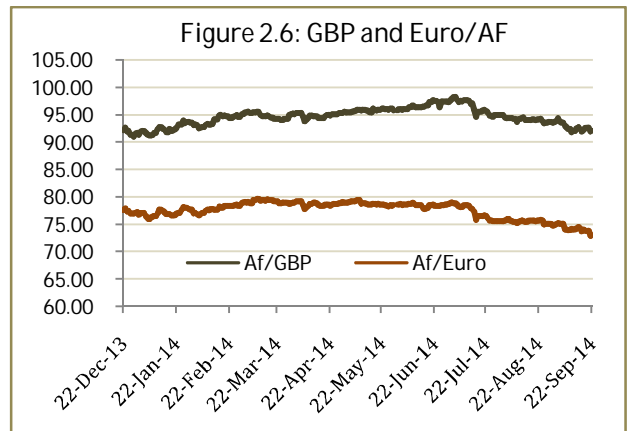
Despite of the increase in the value of the U.S. dollar during Q3 2014 in the international markets, DAB was successful to maintain a stable exchange rate of afghani against the U.S. dollar. The daily historic review of the average exchange rate of AF against the U.S. dollars for the fiscal year 1393 is shown in the Figures below.



Source: Monetary Policy Department/ DAB

Similarly, afghani strengthened against the Euro, GBP, and INR by 6.37 percent, 9.02 percent, and 1.37 percent respectively. Afghani appreciated against the PKR and

IRR by 4.11 percent; and 1.67 percent respectively.



### 4.1 Foreign Exchange Auction

Under the open market operations, DAB intervenes in the market and sells foreign currencies to licensed commercial banks and authorized money exchange dealers through a transparent bi-weekly auction process. The main objective of the FX auction is to control the growth of money supply and adjust

the volatility and fluctuation of the nominal exchange rate of afghani.

Da Afghanistan Bank auctioned a total of USD 2.373 billion in the first 9 months of the year under review, while total

demand was USD 3.332 billion in the period under review. On average, a total of USD 33 million was awarded in each auction.

**Table 2.2: Foreign Exchange Auction for Q3 FY1393**

Auction Date	Market Ex Rate	Cut off Price	Amount Announced	Amount Awarded	Demanded amount
24-Dec-13	56.75	56.64	50.00	50.25	75.10
28-Dec-13	56.27	56.12	50.00	49.93	65.78
31-Dec-13	56.01	55.92	40.00	39.80	69.35
4-Jan-14	56.37	56.40	35.00	34.55	59.95
7-Jan-14	56.17	56.18	30.00	19.65	50.75
11-Jan-14	56.75	56.84	25.00	25.60	47.35
14-Jan-14	56.95	56.84	25.00	24.65	32.20
18-Jan-14	56.85	56.87	25.00	25.30	39.15
21-Jan-14	56.71	56.65	25.00	19.65	35.80
25-Jan-14	57.04	57.00	25.00	20.10	30.90
28-Jan-14	57.20	57.18	30.00	29.85	40.20
1-Feb-14	57.07	57.06	30.00	24.00	36.95
4-Feb-14	56.81	56.80	25.00	9.25	27.50
8-Feb-14	57.14	57.16	20.00	19.70	33.42
11-Feb-14	57.14	57.12	20.00	20.50	28.45
16-Feb-14	57.26	57.22	20.00	17.05	22.70
18-Feb-14	57.21	57.20	20.00	19.65	25.50
22-Feb-14	57.20	57.16	20.00	19.85	25.95
25-Feb-14	57.32	57.32	20.00	24.10	30.95
1-Mar-14	57.41	57.39	30.00	30.00	38.60
4-Mar-14	57.65	57.64	30.00	35.20	44.65
8-Mar-14	57.48	57.30	40.00	30.90	36.30
12-Mar-14	57.44	57.16	35.00	30.25	32.25
15-Mar-14	57.30	57.11	35.00	34.75	39.25
18-Mar-14	57.20	57.12	35.00	34.70	50.95
23-Mar-14	57.31	57.27	25.00	25.35	35.35
25-Mar-14	57.26	57.23	25.00	24.50	37.95
29-Mar-14	57.40	57.40	25.00	30.05	40.25
1-Apr-14	57.61	57.53	35.00	34.45	49.50
8-Apr-14	57.09	56.96	60.00	51.65	72.15
12-Apr-14	57.15	57.16	30.00	33.05	49.65
15-Apr-14	57.07	57.00	35.00	34.45	43.85
19-Apr-14	57.11	57.05	30.00	32.65	39.10
22-Apr-14	57.06	57.02	30.00	31.45	45.55
26-Apr-14	57.12	57.12	30.00	31.20	46.60
29-Apr-14	57.25	57.24	30.00	30.70	45.00
3-May-14	57.22	57.20	40.00	34.75	56.40
6-May-14	57.28	57.30	30.00	28.20	48.55
10-May-14	57.32	57.31	30.00	31.60	43.15
13-May-14	57.35	57.32	35.00	36.50	44.50
17-May-14	57.55	57.49	30.00	29.35	40.50
20-May-14	57.50	57.47	30.00	30.00	43.40
24-May-14	57.64	57.60	30.00	33.85	44.05
27-May-14	57.55	57.36	35.00	35.05	35.95
31-May-14	57.62	57.55	35.00	34.15	47.95
03-Jun-14	57.71	57.68	35.00	34.40	54.05
07-Jun-14	57.77	57.78	35.00	41.20	54.25

10-Jun-14	57.92	57.90	40.00	41.00	61.30
17-Jun-14	57.63	57.48	60.00	60.35	85.65
21-Jun-14	57.97	57.96	35.00	35.35	55.55
24-Jun-14	57.82	57.73	40.00	39.95	49.90
28-Jun-14	57.97	57.93	40.00	40.90	55.05
1-Jul-14	57.97	57.90	40.00	39.90	50.90
5-Jul-14	57.90	57.87	40.00	40.00	54.15
8-Jul-14	57.70	57.62	40.00	40.00	46.05
12-Jul-14	57.80	57.72	35.00	34.35	43.55
15-Jul-14	56.96	56.81	35.00	35.20	41.55
19-Jul-14	56.64	56.52	30.00	36.35	38.25
22-Jul-14	56.71	56.61	30.00	39.45	48.55
26-Jul-14	56.34	56.25	35.00	39.40	52.30
2-Aug-14	56.51	56.42	35.00	35.25	41.80
5-Aug-14	56.54	56.46	35.00	35.35	46.60
9-Aug-14	56.30	56.26	35.00	36.30	51.65
12-Aug-14	56.74	56.73	35.00	37.25	61.85
16-Aug-14	56.67	56.68	40.00	40.30	64.05
23-Aug-14	57.29	57.22	35.00	36.30	48.70
26-Aug-14	57.02	57.02	35.00	35.85	49.35
30-Aug-14	57.00	56.99	35.00	35.30	50.20
2-Sep-14	57.50	57.48	35.00	35.00	61.10
6-Sep-14	57.24	57.17	35.00	38.65	45.05
13-Sep-14	57.51	57.46	35.00	34.70	42.15
16-Sep-14	57.16	57.07	35.00	33.20	48.60

## 5. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

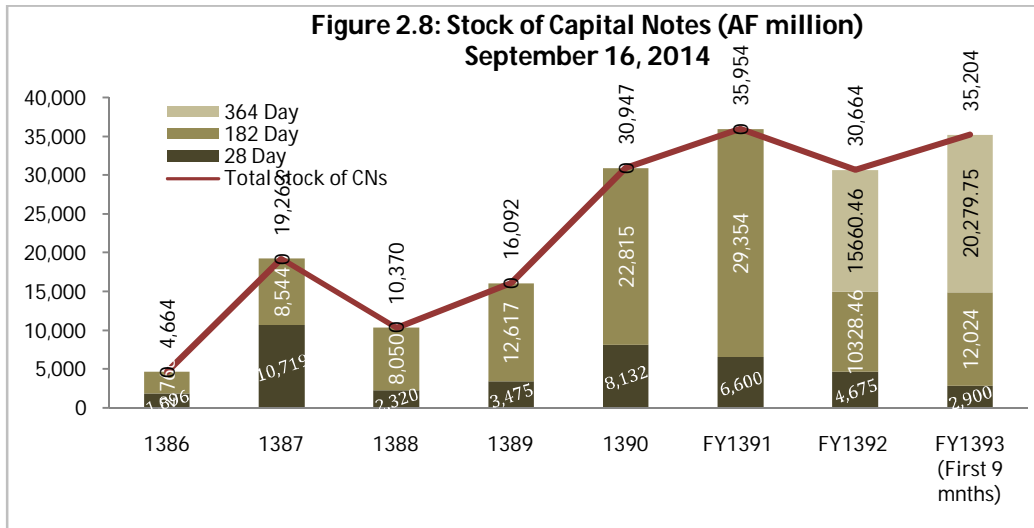
### 5.1 Capital Notes Auctions

The DA Afghanistan Bank uses Capital Notes (CNs) as the secondary monetary tool. DAB issues CNs to the licensed commercial banks on a weekly basis with

the maturities of 364 day, 182 day, and 28 day.

The purpose of issuing Capital Notes, apart from liquidity management, is to help reduce pressures on the FX auction, which reduces the level of international reserves.

For the third quarter of FY 1393, the total outstanding stock of Capital Notes was recorded at AF 35.2 billion.







**THE INFLATION  
TREND AND  
OUTLOOK**

**3**



# 3

## THE INFLATION TREND AND OUTLOOK

**T**he world economy has been struggling with the devastating aftermath effects of the global financial crisis for the last 6 years. Major economies, including the US, the UK, and the European Union experienced long periods of major economic meltdown concomitant with ever-increasing unemployment, and large and unsustainable national debt to GDP ratios. The impact of global financial crisis on the world economy has been very deep such that it is called “great recession” by many economists. Although, a broad set of conventional and unconventional monetary and fiscal policies have been implemented by the US and the EU governments to end the economic recession in these countries, but these measures have not resulted in any promising outcome yet. Meanwhile, Asian economies have been acting as the engine of the world economy during this period and China in particular, has played a very important role in propelling the world economy ahead in 2008 to 2010.

Today, according to all evidences on the state of the world economy, it is clear that the expansionary phase of the world economy has come to an end and we are facing the down side phase of the business cycle. Therefore, expecting a rise in the level of economic activities is not a phenomenon that we should be expecting in an approximated period of the next four years.

A dramatic fall in crude oil prices in the international oil markets over the last 3 months is aligned with a considerable decline in the level of industrial outputs in countries including China, Germany, Japan, and France. The downturn trend in aggregate demand and business activities hold out that the economic recession is on the horizon again.

In the light of the prevailing global economic situation, massive fall in oil prices and deterioration of aggregate demand, global inflation has declined over the third quarter of 2014. In the United States and Euro area due to a considerable decline in industrial output, commodity prices have decreased. A fall in commodity prices coupled with lower

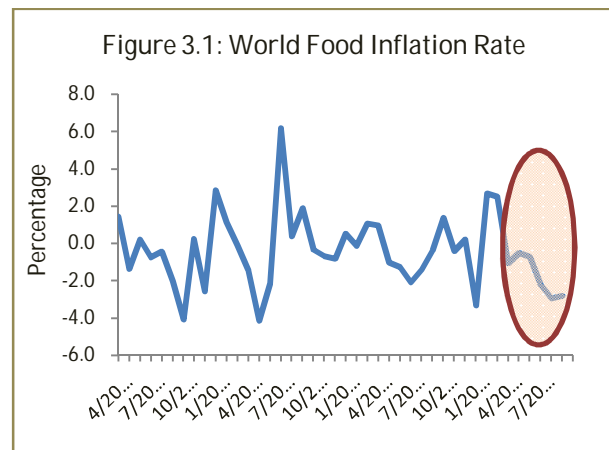
international oil price has put a downward pressure on the headline inflation in these countries.

Similar to the developed nations, emerging economies of Asia have also experienced a downward inflation trend over the last quarter. China, the main destination for raw materials and oil in Asia has experienced a downturn in its economic activities. Demand for China's productions has been adversely affected by the economic recession that dominates the developed countries and especially the European economies. A simultaneous fall in aggregate demand, coupled with lower oil and commodity prices further oppressed the inflationary forces in this part of the world as well.

Crude oil price in international market has approximately declined by 10 percent over the quarter under review. For instance, the Brent Oil Price hit USD115 per barrel in the last June, by September the price had slid down to USD 95 per barrel. Since oil is a highly weighted component of the headline inflation, a fall in its price in such a scale can lead to a considerable decline in global production costs and inflation. The deflationary pressure on oil prices is due largely to a significant increase in the supply levels by oil producer countries coupled with lower demand by industrial economies.

Similar to oil, the price of foodstuff has also registered a significant decline in the quarter

under review (third quarter of FY2014). The FAO's Food Price Index shows an average of 5.9 percent deflation in overall global food prices in this period<sup>1</sup>. Owing to a bumper harvest in the US, the prices of wheat and corn experienced a drop of 27 percent and 25 percent, respectively, compared to price levels in May this year. Similarly, palm oil index and cotton index showed a drop in the price of these products.



In response to the benign international inflation environment, annual inflation in Afghanistan has also declined from 7.98 percent in September 2013 to its lowest rate of 4.21 percent since 2014. Besides the lower global food and oil prices, subdued global economic growth, and anemic global aggregate demand conducive to lower inflation levels internationally, the subdued level of inflation in Afghanistan can be attributed to a range of internal factors

<sup>1</sup>FAO's website.

including political and economic situation of the country.

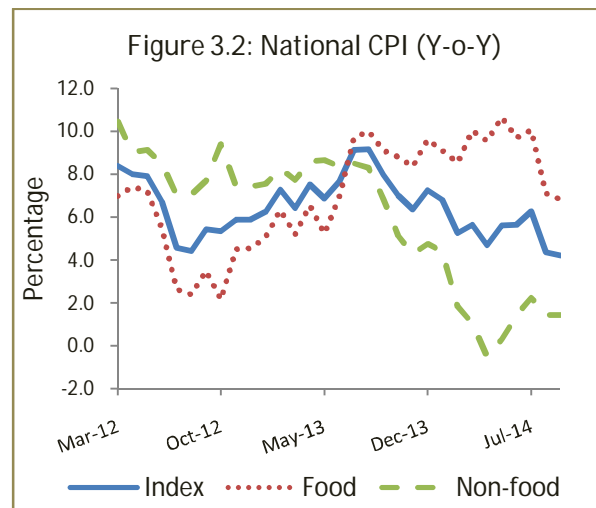
The political and security uncertainties surged to their peak over the third quarter of the FY2014. As a result of the uncertain political panorama, the level of economic activities and investment considerably declined, implementation of projects was postponed, and many NGO's and companies lay off their employees. Lower investment and household demand emanating from dim investment prospects and the increasing unemployment level had an adverse effect on aggregate demand in the country. Lower demand increased the deflationary pressures and depressed the general price levels in the economy.

## I - CONSUMER PRICE IN AFGHANISTAN

Nationwide inflation in Afghanistan depicted a downward trend in the first three quarters of FY2014 in continuation of the prevailing trend that started in the third quarter of the previous year (FY2013). The inflationary pressures started weakening from the second half of the previous fiscal year (FY2013). Since then, except for a few minor oscillations, which had a more seasonal background, the nationwide inflation has experienced a general downward trend.

The nationwide CPI inflation reached to its peak of 9.2 percent in September 2013. A

year later in September 2014, it reached 4.2 percent, the lowest inflation rate experienced since 2011. Observing the data, it is easily recognizable that the decline in the inflation level over this period was due mainly to a dramatic fall in the prices of the Non-Food component of the CPI inflation.



Source: National Statistics Organization/DAB Staff calculation

Among all, the prices of housing, electricity, and fuel, subcomponent of CPI, which carries the biggest weight in Non-Food component of the CPI, registered a remarkable decline. The inflation rate in this subcomponent of national CPI was registered at 9.3 percent in August 2013. Over the last quarter of FY2013 and the first half of FY2014, the inflation rate for this subcomponent (Housing, Electricity, and Fuel) turned into a deflation rate of 10.4 percent, an

approximate decline of 19.7 percent over one year period.

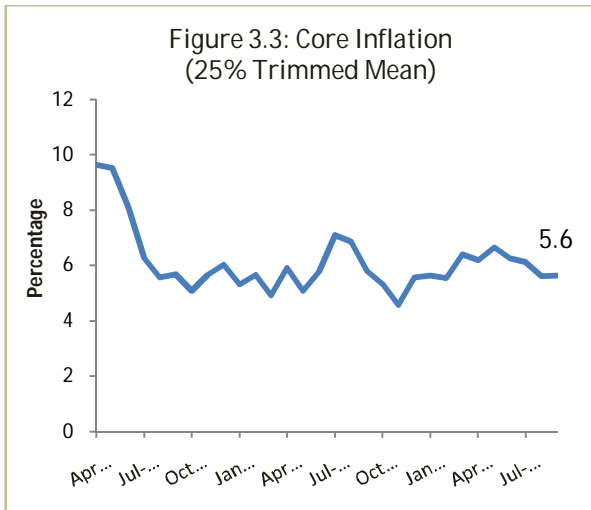
The downward trend in the country's general price level can be attributed to a range of factors, including a lower international oil price, low investment demand owing to uncertainties emanating from upcoming withdrawal of international forces, and the political uncertainties stemming from prolonged issues related to the presidential election.

Da Afghanistan Bank (DAB) expects inflationary pressures in the near future, predicting the current political turbulences of the country will be resolved and the economy would start to recover from the current standstill situation, though, the consumer price index due mainly to a benign international inflation environment is still expected to remain modest and in the single digit territory.

Observing the Kabul CPI, it is clear that the inflation rate in the capital city is following the general pattern of nationwide inflation. Year over year inflation rate in September 2014 is recorded at 1.2 percent, which is way below the 5.7 percent of inflation in the same period of the previous year. Similar to the national figures, inflationary pressures in Kabul started easing from the second half of FY2013.

The Non-food component of CPI depicted a considerable decline owing to the same reasons that were discussed earlier. Non-Food component of Kabul CPI contains the major favorable developments in inflation rate over the period under review. Inflation in this component of Kabul headline CPI recorded a significant decline compared to a year ago, representing a deflation rate of 1.6 percent (Y-o-Y), down from an inflation rate of 8 percent in the previous year. It is noticeable that the fluctuations in Kabul headline inflation are an extreme version of the oscillations in the nationwide inflation rate.

To eliminate the effects of outlier and to get a better picture of the persistent inflation trends in the country, we measured core inflation. Core inflation measured by 25 percent trimmed mean (TM) represented an inflation rate of 5.6 percent in both, September 2014 and its preceding month (August).



Source: National Statistics Organization/DAB Staff calculation

## 1.1 Developments in National Headline Inflation

### 1.1.1 Annual Developments

The national headline inflation, which is measured by the percentage changes in national CPI, has experienced a considerable decline over the period started from August 2013 up to now (Sept. 2014). The broadest measure of the general price level (National Headline Inflation) in the country was recorded at 4.2percent by the end of the third quarter of FY2014, which is way below its level of 8 percent in the same period of the previous year.

The inflation rate of Food and Beverages component of national CPI, which carries the biggest weight in the consumer price basket has considerably fallen from 9.1 percent in the third quarter of 2013 to 6.8 percent (Y-o-

Y) in the third quarter of FY2014. Bread & cereals, meat, milk, and vegetables are the key and the highest weighted subcomponents of the Food sub-index; therefore, to analyze the developments in the food section, these items are important to be focused on.

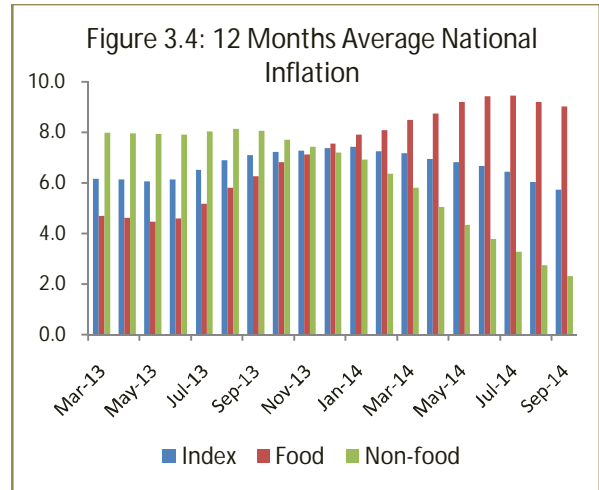
Comparing the current figures to the figures of the last year, an overall favorable inflationary trend is observed. Bread and Cereal, registered a decline of 3.6percent over one year period, reaching 11percent (Y-o-Y) in the current quarter. Similar to Bread & Cereals, other subcomponents including Meat, Milk & Cheese & Eggs, and Vegetables have also experienced a downward trend over the period of September 2013 to September 2014.

Such a decline in food inflation can partly be explained by an overall fall in global food prices over the last year. For instance, owing to a bumper cereal production in the US, the prices of wheat and corn experienced a drop of 27 percent and 25 percent respectively. Similarly, palm oil index shows a drop in the price of this product over the same period.

The most favorable developments in national CPI inflation have been observed in the non-food section of the CPI. The overall annual inflation in the non-food section has declined from 6.8 percent (Y-o-Y) in September 2013 to 1.4 percent at the end the reporting

period. Among all items in non-food section, the housing subcomponent of the CPI, which carries the greatest weight, declined remarkably from an inflation rate of 6.8 percent (Y-o-Y) in the third quarter of 2013 to a deflation rate of 8.8 percent in the quarter under review. A set of factors, including lower demand for rental houses and a weaker business confidence due to the prevailing political uncertainty in the country can be recognized as some of the reasons for such a considerable price fall in this subcomponent of CPI. In contrast to the housing and fuel, furnishing & household goods and transportation subcomponents of the non-food section, have experienced a rise in the level of their inflation over the same period. Depreciation of domestic currency

against foreign currencies and security problems are noted as the causes of inflation hike in these subcomponents.



Source: National Statistics Organization/DAB Staff calculation



**Table 3.1: Breakdown of National Headline CPI**

(Percent changes year on year)

(March 2011=100)

	Weight	1391-FY*			1392				1393		
		Q1	Q2	Q3	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Overall Index</b>	<b>100.0</b>	<b>6.8</b>	<b>5.4</b>	<b>5.9</b>	<b>6.4</b>	<b>7.6</b>	<b>8.0</b>	<b>7.2</b>	<b>5.6</b>	<b>5.6</b>	<b>4.2</b>
<b>Food and beverages</b>	<b>52.0</b>	<b>5.5</b>	<b>3.5</b>	<b>4.5</b>	<b>5.2</b>	<b>6.9</b>	<b>9.1</b>	<b>9.6</b>	<b>10.0</b>	<b>9.7</b>	<b>6.8</b>
Bread and Cereals	17.7	2.2	4.6	8.4	12.8	13.7	14.6	9.1	9.5	11.4	11.0
Meat	7.2	13.8	12.9	10.2	6.0	5.3	6.6	5.0	2.6	3.4	3.7
Milk, cheese and eggs	4.8	9.7	7.9	8.8	4.9	4.1	7.8	5.0	6.5	6.1	2.1
Oils and fats	4.0	5.2	0.3	3.5	-0.5	-2.3	-0.4	0.3	1.8	1.7	0.9
Fresh and dried fruits	4.8	16.1	6.3	-5.3	-3.2	-2.0	-0.1	4.4	8.5	9.9	9.2
Vegetables	7.9	5.1	-4.4	1.0	-3.3	6.6	15.3	30.7	30.3	24.3	7.1
Sugar and sweets	2.9	0.5	-2.8	-0.3	3.4	4.7	2.8	2.4	2.5	-1.6	-0.2
Spices	0.9	26.7	11.8	15.3	8.8	10.2	5.6	8.1	10.5	9.4	12.0
Non-alcoholic beverages	1.8	16.3	17.1	13.9	7.6	8.5	6.8	6.6	7.4	3.7	4.0
<b>Non-Food</b>	<b>48.0</b>	<b>8.6</b>	<b>7.7</b>	<b>7.4</b>	<b>7.7</b>	<b>8.4</b>	<b>6.8</b>	<b>4.7</b>	<b>1.1</b>	<b>1.4</b>	<b>1.4</b>
Tobacco	0.4	4.5	0.7	9.7	11.5	19.5	21.2	10.9	8.4	3.0	0.6
Clothing	7.0	13.7	8.3	7.7	8.0	10.3	8.9	8.8	8.3	8.1	6.9
Housing	20.7	11.6	12.7	12.2	11.8	11.1	6.8	1.8	-8.5	-9.1	-8.8
Furnishing and household goods	7.0	-5.4	-4.5	0.0	3.9	6.0	6.5	8.7	8.5	10.4	10.3
Health	3.3	1.7	4.4	7.7	11.3	13.0	11.2	8.0	8.8	9.0	10.3
Transportation	4.7	13.1	6.6	-0.3	-2.5	-1.5	3.6	5.8	16.6	20.1	19.5
Communication	1.1	0.2	-2.7	-4.3	-6.7	-6.4	-4.5	-2.5	-1.5	-1.4	-2.0
Education	0.7	4.7	6.7	5.2	7.1	1.7	1.8	1.8	1.9	5.0	4.0
Information and Culture	0.1	10.8	1.9	5.3	3.2	3.5	2.6	2.3	6.5	5.4	7.1
Restaurants and Hotels	1.0	5.9	10.4	8.2	2.4	2.8	3.7	1.8	2.6	2.4	4.6
Miscellaneous	1.8	19.2	17.7	9.1	5.5	5.2	6.6	8.0	7.6	10.2	8.2
<b>Core inflation (28% TM)</b>		<b>8.1</b>	<b>5.7</b>	<b>6.0</b>	<b>4.9</b>	<b>5.8</b>	<b>5.8</b>	<b>5.6</b>	<b>6.4</b>	<b>6.3</b>	<b>5.6</b>
<b>Core inflation (Headline excl. B&amp;C, O&amp;F and T)</b>		<b>7.7</b>	<b>5.9</b>	<b>5.8</b>	<b>5.9</b>	<b>7.4</b>	<b>7.2</b>	<b>7.2</b>	<b>4.3</b>	<b>3.6</b>	<b>1.7</b>

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

\*Afghanistan's financial year (Dec to January) began from 1391, therefore includes 3 quarters.

## 1.1.2 Quarterly Developments

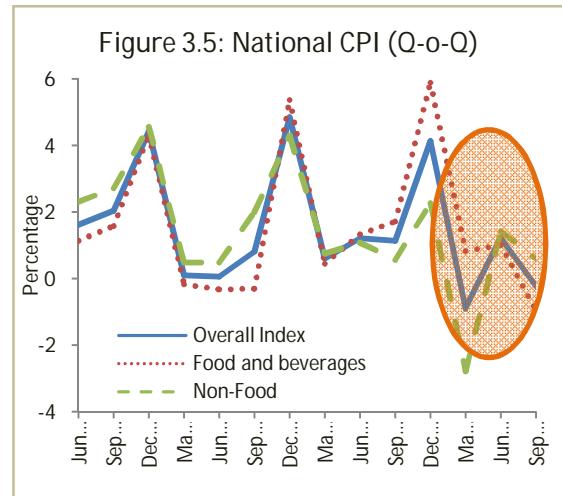
To closely observe what is happening to inflation in the most recent period, it is necessary to compare the quarter-over-quarter changes in the overall CPI and its various components. Observing the quarterly developments of national headline inflation provides us with the opportunity to explore other aspects of inflationary trend which are somewhat obscured in the annual trends.

Headline inflation soars over the fourth quarter and reaches to its peak in December of each year. Despite following the general pattern, inflation rate over FY2014 has some unique characteristics which are explainable only in the light of the prevailing political and economic state of the country.

Unlike the previous years, there is a greater dispersion between the food and non-food components of nationwide inflation. After experiencing a dwarf peak, non-food recorded a sharp decline, reaching the minimum level of -2 percent in March 2014. Furthermore, a downward biased kink in the inflation rate was observed that will result in a further dwarf peak in the next quarter.

An annual drop of 3.8 percent in national headline inflation, including a drop of 1.4 percent over the third quarter of FY2014, can be attributed to a range of factors. To find the roots of such changes, we put one step further in our analysis and bring the components and subcomponents of the

national inflation into the limelight of our further investigation.



Although, the quarterly figures of national headline inflation depict a trend similar to the annual patterns that we analyzed in this text earlier, the behavior of individual components of the CPI was somewhat mixed. The headline inflation recorded a deflation rate of 0.2 percent (Q-o-Q) in the quarter under review compared to an inflation rate of 1.2 percent in the preceding quarter.

On a quarterly basis, the prices of bread and cereals increased by 2.7 percent in the third quarter compared to 4.1 percent recorded in the previous quarter. The deflationary pressure on prices of fruit and vegetables subcomponents over the current quarter, dragged down the prices of these items even further, comparing to the previous quarter.

The most important Non-food subcomponent, Housing and fuel, represented a modest improvement reaching to a deflation rate of 0.1 percent in the third quarter compared to the preceding quarter.

**Table 3.2: Breakdown of National Headline CPI**

(Percent changes quarter-on-quarter)

(March 2011 = 100)

	1391-FY*			1392				1393		
	Q1	Q2	Q3	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Overall Index</b>	<b>0.1</b>	<b>0.8</b>	<b>4.8</b>	<b>0.6</b>	<b>1.2</b>	<b>1.1</b>	<b>4.1</b>	<b>-0.9</b>	<b>1.2</b>	<b>-0.2</b>
<b>Food and beverages</b>	<b>-0.3</b>	<b>-0.3</b>	<b>5.4</b>	<b>0.5</b>	<b>1.3</b>	<b>1.7</b>	<b>5.9</b>	<b>0.8</b>	<b>1.0</b>	<b>-1.0</b>
Bread and Cereals	1.6	2.2	8.4	0.2	2.4	3.0	3.2	0.6	4.1	2.7
Meat	0.7	0.6	2.1	2.6	0.0	1.8	0.6	0.3	0.7	2.1
Milk, cheese and eggs	-0.6	1.2	3.9	0.4	-1.4	4.8	1.2	1.9	-1.8	0.8
Oils and fats	1.7	-1.2	1.4	-2.3	-0.2	0.7	2.1	-0.9	-0.2	-0.1
Fresh and dried fruits	0.7	-2.9	-3.6	2.7	2.0	-1.0	0.7	6.7	3.4	-1.7
Vegetables	-7.8	-8.5	14.5	0.0	1.7	-1.0	29.9	-0.3	-3.0	-14.7
Sugar and sweets	0.1	3.8	1.9	-2.3	1.3	1.9	1.5	-2.1	-2.8	3.3
Spices	2.5	2.1	2.9	1.0	3.8	-2.1	5.3	3.3	2.7	0.3
Non-alcoholic beverages	2.1	3.2	2.3	-0.2	3.0	1.6	2.1	0.5	-0.6	1.9
<b>Non-Food</b>	<b>0.5</b>	<b>2.0</b>	<b>4.3</b>	<b>0.8</b>	<b>1.1</b>	<b>0.6</b>	<b>2.3</b>	<b>-2.8</b>	<b>1.4</b>	<b>0.6</b>
Tobacco	0.4	-1.9	11.0	2.1	7.5	-0.5	1.5	-0.2	2.2	-2.8
Clothing	-0.1	2.3	3.9	1.7	2.1	0.9	3.8	1.2	1.9	-0.2
Housing	1.1	3.6	6.7	0.1	0.4	-0.4	1.7	-10.0	-0.3	-0.1
Health	0.2	3.0	4.3	3.4	1.8	1.3	1.2	4.2	2.0	2.5
Transportation	-0.8	-2.1	1.5	-1.0	0.2	2.9	3.6	9.1	3.2	2.4
Communication	-1.7	-2.7	-1.3	-1.1	-1.4	-0.7	0.7	-0.1	-1.3	-1.3
Education	4.6	0.8	-0.1	1.7	-0.6	0.8	0.0	1.8	2.4	-0.2
Information and Culture	-0.2	0.8	1.2	1.3	0.1	0.0	0.9	5.5	-1.0	1.6
Restaurants and Hotels	0.2	0.2	1.7	0.2	0.6	1.1	-0.1	0.9	0.4	3.3
Miscellaneous	0.6	0.5	2.6	1.6	0.3	2.0	4.0	1.2	2.8	0.1

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

\*Afghanistan's financial year (Dec to January) began from 1391, therefore includes 3 quarters.

## II- Developments in the Kabul Headline Inflation

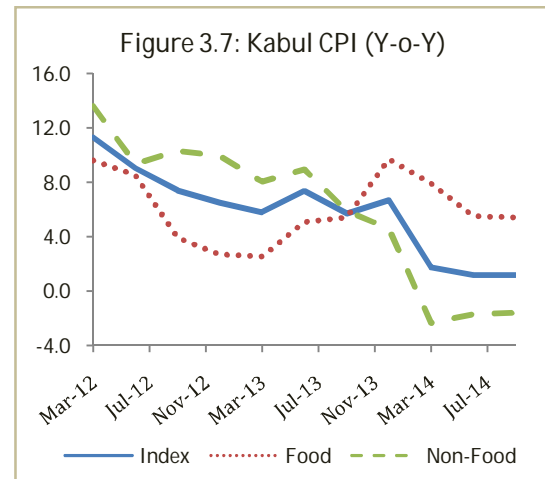
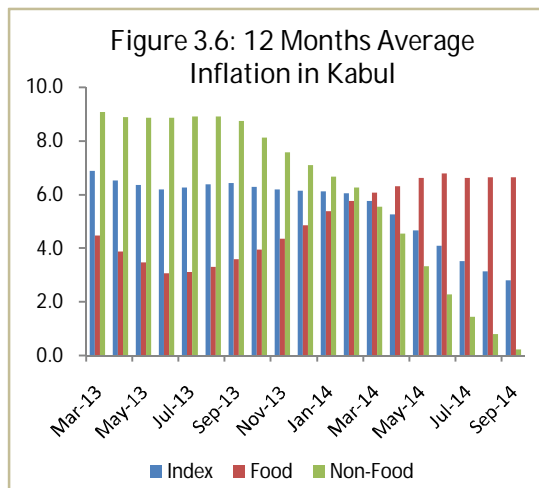
Kabul is a home to more than 5 million of its inhabitants, one sixth of Afghanistan's

population approximately. Kabul city is not only a political capital of the country, but also is the capital of its economic activities. Due to its unique position, any developments in economic variables of the city would have

a direct effect on the overall economic state of the country. In the following lines the fluctuations in the general price level of the city is explored.

## 2.1 Annual Developments

Inflation trend in Kabul was consistent with the inflation patterns of the country. Similar to the developments in the overall price level, Kabul headline inflation registered a considerable decline, standing at 1.2 percent (Y-o-Y) at the end of the third quarter of FY2014, far below the inflation rate of 5.7 percent over the same period in the previous year. The causes behind this decrease could be mainly attributed to a fall in the non-food component of the consumer price index.



Source: National Statistics Organization/DAB Staff calculation

The food component of the Kabul CPI did not post any considerable changes over the one year period (Sept. 2013- Sept. 2014). This is while the items comprising this component of the CPI have shown mixed behaviors in terms of inflation developments over the same period. For instance, while bread & cereals and edible oil subcomponents have registered a sharp decrease in their inflation levels, milk & Cheese and fresh & dried fruits recorded a sharp increase in inflation compared to the previous September.

Inflation rate in bread & cereals fall from 12.6 percent<sup>34</sup> to 6.6 percent (Y-o-Y) and inflation rate of edible oil declined from 3.4 percent to a deflation rate of 5.1 percent. Milk price increased sharply, standing at 8.7 percent (Y-o-Y), compared to a deflation rate of 1 percent in the same period a year ago. Similar to milk, fresh & dried fruit prices experienced a considerable rise in their prices over the same period.

In contrast to a constant inflation rate in food component, the non-food

component of the Kabul CPI has recorded a considerable decline, representing a deflation rate of 1.6 percent (Y-o-Y) compared to an inflation of 5.9 percent over the same period a year ago. Such a fall in prices of this type of goods can be attributed to the surging political uncertainty and the resulted aggravated

security situation that led to a dramatic fall in investment demand. Lower investment demand in the period caused a huge fall in demand for durable goods, pushing the price level down as far as the durable goods market experienced a short period of deflation in May 2014.

**Table 3.3: Breakdown of Kabul Headline CPI**

(Percent changes year on year)  
(March 2011=100)

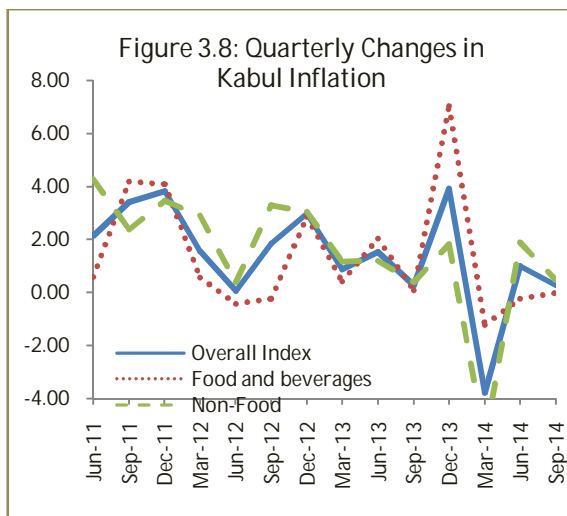
	Weight	1391*			1392				1393		
		Q1	Q2	Q3	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Overall Index</b>	<b>100</b>	<b>9.0</b>	<b>7.4</b>	<b>6.5</b>	<b>5.8</b>	<b>7.4</b>	<b>5.7</b>	<b>6.7</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>
<b>Food and beverages</b>	<b>52.0</b>	<b>8.5</b>	<b>4.0</b>	<b>2.7</b>	<b>2.6</b>	<b>5.1</b>	<b>5.4</b>	<b>9.7</b>	<b>7.9</b>	<b>5.5</b>	<b>5.4</b>
Bread and Cereals	17.7	6.7	7.2	10.3	11.8	13.4	12.6	10.4	7.7	4.8	6.6
Meat	7.2	15.8	15.5	14.2	9.3	5.3	3.4	4.2	-1.4	-1.4	3.8
Milk, cheese and eggs	4.8	9.6	6.1	5.3	0.4	-2.0	-1.0	2.3	6.1	9.9	8.7
Oils and fats	4.0	9.8	-0.7	0.7	0.1	-0.4	3.4	1.1	-0.9	-3.1	-5.1
Fresh and dried fruits	4.8	27.4	11.9	-12.6	-8.6	-6.3	-4.2	2.3	6.5	8.8	7.4
Vegetables	7.9	4.9	-3.5	-3.2	-6.5	7.2	8.6	30.0	24.7	15.8	8.9
Sugar and sweets	2.9	-1.6	-4.7	-2.3	2.0	1.1	-1.1	-1.4	-0.5	-6.9	-3.5
Spices	0.9	29.7	35.6	37.9	14.2	9.0	4.0	4.8	8.3	7.0	9.2
Non-alcoholic beverages	1.8	10.1	8.7	3.9	4.1	6.8	6.4	6.6	7.8	2.1	2.6
<b>Non-Food</b>	<b>48.0</b>	<b>9.4</b>	<b>10.3</b>	<b>9.9</b>	<b>8.0</b>	<b>8.9</b>	<b>5.9</b>	<b>4.6</b>	<b>-2.3</b>	<b>-1.7</b>	<b>-1.6</b>
Tobacco	0.4	7.8	7.6	6.1	6.1	10.0	11.6	10.3	11.0	13.3	11.5
Clothing	7.0	3.6	3.8	5.1	3.7	7.5	4.9	5.8	7.8	11.5	11.3
Housing	20.7	15.9	18.0	16.1	11.7	12.3	7.0	3.6	-12.2	13.2	13.1
Furnishing and household goods	7.0	-4.3	-6.0	-1.1	3.8	3.8	4.9	6.8	6.2	13.4	13.2
Health	3.3	6.2	15.9	18.9	20.9	19.4	9.1	7.9	7.8	7.3	8.7
Transportation	4.7	5.3	1.8	-2.1	-4.4	-1.9	3.2	8.0	33.3	33.2	32.1
Communication	1.1	0.1	-0.4	-0.4	-0.4	-1.2	-0.7	-0.7	-0.8	-2.2	-4.0
Recreation and Culture	0.7	-2.4	1.7	-2.5	0.5	0.7	1.0	0.9	-0.1	2.8	1.9
Education	0.1	0.5	1.2	1.3	1.7	0.9	-0.2	2.0	14.0	14.6	19.1
Restaurants and Hotels	1.0	3.1	12.5	6.9	0.8	0.0	0.0	0.0	1.5	2.3	5.2
Miscellaneous	1.8	22.5	19.5	4.4	2.4	0.9	2.8	5.0	4.3	7.9	3.8
<b>Core inflation (28% TM)</b>		<b>7.1</b>	<b>6.6</b>	<b>3.7</b>	<b>3.3</b>	<b>3.7</b>	<b>3.5</b>	<b>4.4</b>	<b>5.3</b>	<b>5.7</b>	<b>6.2</b>
<b>Core inflation (Headline excl. B&amp;C, O&amp;F and T)</b>		<b>9.8</b>	<b>8.3</b>	<b>6.5</b>	<b>5.5</b>	<b>7.0</b>	<b>6.7</b>	<b>6.0</b>	<b>-1.3</b>	<b>-1.3</b>	<b>-3.8</b>

Source: Central Statistics Office/Monetary Policy Department, DAB staff calculation.

\*Afghanistan's financial year (Dec to January) began from 1391, therefore includes 3 quarters.

## 2.2 Quarterly Developments

The quarterly developments in Kabul CPI narrate another version of the same story of decreasing inflation rates. The overall index slightly declined over the quarter under review, representing an inflation rate of 0.3 percent quarter over quarter at the end of the third quarter of FY2014 compared to an inflation rate of 1 percent over the previous quarter.



The food component of the CPI increased slightly from a deflation rate of 0.2 percent (Q-o-Q) in the preceding quarter. Bread & cereals and meat subcomponents of the CPI, which carry the highest weights in the food sub-index, registered a rise in the price level.

In contrast, vegetables recorded a considerable decline in its price. It fell to a deflation rate of 11 percent (Q-o-Q) from a deflation rate of 3.9 percent over the quarter under review.

The inflation of non-food component decreased to 0.5 percent (Q-o-Q) in the third quarter of FY2014, compared to 1.9 percent in the second quarter.

At the end it is noticeable that the pattern of changes in the rate of inflation across the CPI components in Kabul CPI was very similar to what was experienced nationwide.

**Table 3.4: Quarter-on-Quarter Changes in Kabul CPI**

(Percent changes quarter-on-quarter)  
(March 2011=100)

	1391*			1392				1393		
	Q1	Q2	Q3	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Overall Index</b>	<b>0.0</b>	<b>1.8</b>	<b>3.0</b>	<b>0.8</b>	<b>1.5</b>	<b>0.3</b>	<b>3.9</b>	<b>-3.8</b>	<b>1.0</b>	<b>0.3</b>
<b>Food and beverages</b>	<b>-0.4</b>	<b>-0.2</b>	<b>2.8</b>	<b>0.4</b>	<b>2.0</b>	<b>0.1</b>	<b>7.0</b>	<b>-1.2</b>	<b>-0.2</b>	<b>0.0</b>
Bread and Cereals	3.4	4.0	4.3	-0.4	4.9	3.2	2.4	-2.8	2.0	5.1
Meat	1.2	1.1	1.7	5.1	-2.6	-0.8	2.5	-0.5	-2.5	4.4
Milk, cheese and eggs	-2.5	2.4	2.3	-1.7	-4.9	3.5	5.7	2.0	-1.5	2.5
Oils and fats	1.2	-2.4	2.1	-0.7	0.7	1.3	-0.2	-2.6	-1.6	-0.8
Fresh and dried fruits	0.4	-5.3	-8.8	5.4	2.9	-3.2	-2.7	9.9	5.1	-4.5
Vegetables	-9.7	-6.5	13.8	-2.6	3.4	-5.3	36.2	-6.6	-3.9	-
Sugar and sweets	1.8	4.5	2.0	-6.1	0.9	2.3	1.7	-5.2	-5.6	6.0
Spices	7.1	4.5	2.2	-0.3	2.2	-0.2	3.0	3.1	0.9	1.8
Non-alcoholic beverages	0.3	2.1	0.8	0.9	2.9	1.8	0.9	2.0	-2.6	2.3
<b>Non-Food</b>	<b>0.4</b>	<b>3.3</b>	<b>3.1</b>	<b>1.1</b>	<b>1.2</b>	<b>0.4</b>	<b>1.8</b>	<b>-5.6</b>	<b>1.9</b>	<b>0.5</b>
Tobacco	1.5	0.7	2.6	1.2	5.2	2.2	1.4	1.9	7.4	0.5
Clothing	-1.8	2.6	2.7	0.3	1.8	0.1	3.6	2.2	5.2	-0.1
Housing	0.8	4.6	4.4	1.5	1.4	-0.3	1.0	-14.0	0.1	-0.1
Furnishing and household goods	1.4	0.4	0.0	2.0	1.3	1.5	1.9	1.4	8.2	1.3
Health	2.5	12.0	3.5	1.7	1.3	2.4	2.3	1.6	0.8	3.7
Transportation	-2.0	-2.5	1.4	-1.3	0.5	2.6	6.1	21.9	0.5	1.7
Communication	0.1	-0.6	0.0	0.0	-0.7	-0.1	0.1	-0.1	-2.1	-1.9
Recreation and Culture	-1.1	0.7	-1.1	2.0	-0.8	1.0	-1.2	1.0	2.0	0.1
Education	-0.1	0.8	-1.1	2.0	-0.9	-0.3	1.1	14.0	-0.3	3.6
Restaurants and Hotels	0.8	0.0	0.0	0.0	0.0	0.0	0.0	1.5	0.8	2.9
Miscellaneous	1.3	0.1	0.0	1.1	-0.2	1.9	2.2	0.4	3.2	-1.9

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

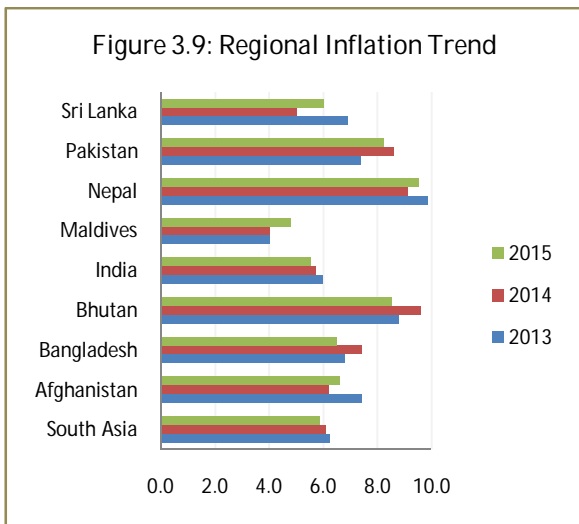
\*Afghanistan's financial year (Dec to January) began from 1391, therefore includes 3 quarters.

### III - REGIONAL INFLECTION TREND

Afghanistan is a member of South Asian Association for Regional Cooperation. Due to

geographical closeness and similarities in economic development levels, a major part of Afghanistan's trade is conducted within the SAARC member countries; therefore, its

economic condition is highly dependent on the state of the economy in these countries, especially the economic status of neighboring countries such as India and Pakistan. Therefore, in this section we review the inflationary trends in the region and more specifically in India and Pakistan.



In the light of a benign international inflationary environment, except for the first half of the year, a soft inflationary environment has been prevailing in South Asian countries over the FY2014. At the beginning of the year due mainly to a disappointing harvest and a short-lived shock caused by rising crude oil prices, inflationary pressures arose in the region, but later these unfavorable pressures were abated and the consumer prices fell and stabilized at a lower level.

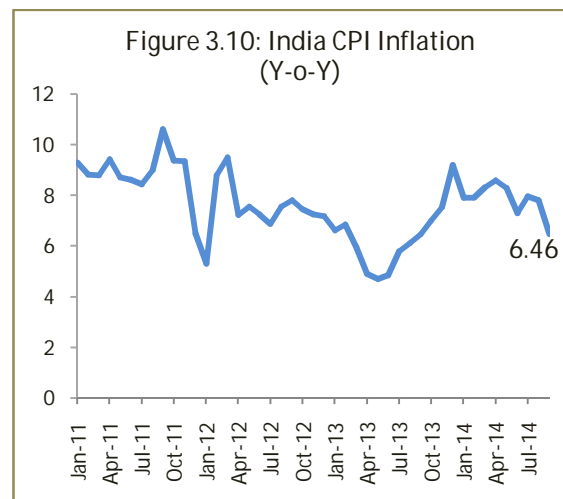
### 3.1. India

To obtain its targets for lower inflation, Central bank of India has kept the monetary policy tight and raised the policy rate by 25 basis points in January of the current year.

Headline inflation indicates an inflation rate of 6.46 percent (Y-O-Y) in the third quarter of FY2014, representing no change in the inflation compared to the same quarter of the previous year.

Due to a disappointing monsoon and a consecutive weak harvest, food prices increased over the first half of the current year, but later on the inflationary pressure on food softened in the third quarter.

The inflation rate in the non-food component of the CPI followed the general downturn trend that dominates the global manufacturing market.



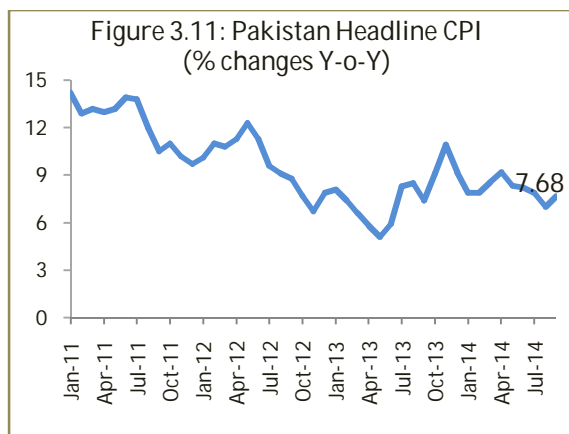


### 3.2. Pakistan

Pakistan has been facing with security and political challenges over the current year, which had unfavorable impacts on inflationary pressures in the country. In addition to security and political problems, due to a weak harvest the food prices rose which increased the inflationary pressures in the first half of the FY2014.

National headline inflation slightly increased to 7.68 percent in September 2014 from 7.40 percent in the same quarter of the previous year.

In response to rising inflationary pressures and to contain the inflation rate within the targeted range, central bank of Pakistan tightened the monetary policy by increasing the policy rates by 100 basis points. Increase in policy rates sent a clear message to consumers that the central bank is firm on its decision to harness the inflation rate. The inflationary expectations stabilized and the inflation rate fell over the third quarter of the year under review.



## IV – NEAR TERM INFLATION OUTLOOK

Being a net importing country, inflation in Afghanistan reflects the developments in global inflationary environment. In the light of a softened global and regional inflationary environment emanating from a lower economic growth in major economies of the world, lower global prices of crude oil, lower global commodity prices, bumper harvest in the US, and expectations for a strong harvest in Afghanistan and South Asian countries no rise in inflation levels is expected in the near term.

The headline inflation is expected to remain at the current level over the remaining quarter (fourth quarter) of the FY2014. The inflation in food component of CPI is expected to remain stable given a favorable monsoon and a strong harvest in neighboring countries including India and Pakistan.

Assuming a successful and peaceful transition of political power, the business confidence would strengthen and investment demand would increase in the country.

### 4.1. Risks

Since Afghanistan imports a wide range of commodities, including both, food and non-food items any development, favorable or unfavorable, in the production of the importing goods can change the inflationary pressures in the country. In particular,

cereals and fuels have a strong impact on food and energy prices in Afghanistan. Therefore, a sudden change in prices of such items remains a risk to the stability of general price levels in Afghanistan. In addition, because of the same reason, a

depreciation of Afghani against the foreign currencies remains another foreseeable risk to future inflation trends in Afghanistan that requires a prudent monetary policy in the country.

**THE EXTERNAL  
SECTOR  
DEVELOPMENTS**

**4**



# 4

## EXTERNAL SECTOR DEVELOPMENTS

This chapter highlights the major developments in the external sector in the third quarter of FY1393. Based on the available data, the external sector performance weakened in the quarter under review, the current account deficit improved, while the capital flows witnessed a downward trend in the third quarter of the FY 1393. The trade balance position worsened as the total imports exceeded far the total exports. On the other hand, the Net International Reserves (NIR) increased slightly by only one percent in the quarter under review. However, the external debt stock decreased by 15 percent. The external debt policy pursued by the government helped the external debt position to stay within the manageable limits.

Most importantly, the debt service payments should be monitored in order, not to restrict the financing of key development programs.

### I. BALANCE OF PAYMENTS

#### 1.1. Current Account

During the third quarter of the FY 1393, the deficit in current account balance improved by 30 percent compared to the third quarter of the FY 1392, as a result of increased inflows from the exports of goods, a decrease in outflows in the services account, a decrease in imports of good, as well as a reduction in income account and current transfers (net) during the third quarter of the FY 1393.

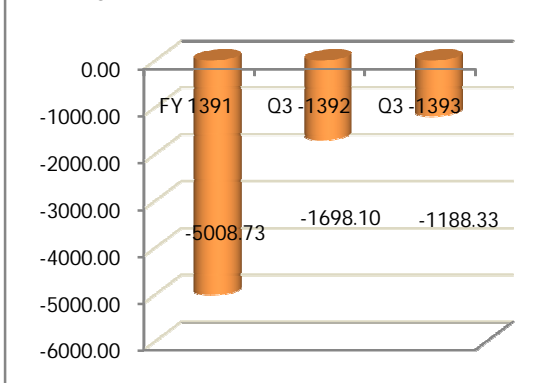
The available data shows that the consumer goods imports accounted for 32 percent of total imports in the reporting period.

**Table 4.1: Current Account Balance**

	FY 1391	Q3 -1392	Q3 -1393
<b>Current account balance</b>	<b>-5008.73</b>	<b>-1698.10</b>	<b>-1188.33</b>
Trade balance	-6306.86	-2362.86	-1584.71
Exports	261.63	146.59	172.48
Imports	-6568.49	-2509.45	-1757.19
Services A/c	368.51	309.82	242.69
Income A/c	269.87	112.76	46.31
Current Transfers	659.75	242.18	107.38

Source: CSO/DAB staff calculations

Figure 4.1: Current Account Balance



Source: CSO/DAB staff calculations

## 1.2. Capital and financial Accounts

Afghanistan's net capital account decreased by almost 54 percent from USD 713.77 million in the third quarter of the FY 1392 to USD 326.91 million in the third quarter of the FY 1393. This outcome in the capital account was only from capital transfers which decreased by almost 52 percent from USD 714.67 million to USD 343.82 million in the third quarter of the FY 1393.

Likewise, net financial accounts which shows (net acquisition and disposal of financial assets and liabilities), turned from a surplus position of USD 473.06 million recorded in the third quarter of the FY 1392, to a deficit position of USD 330.62 million in the third quarter of the FY 1393, (table 2 chart 2).

This development could be attributed to a significant decline in the country's reserve assets, foreign direct investment (FDI), and portfolio investment inflows. Further analysis reveals that the country's assets abroad decreased from USD -86.80 million

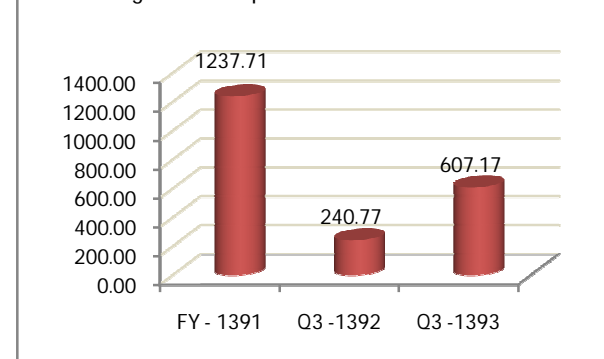
recorded in the third quarter of FY 1392 to USD 56.93 million in the third quarter of the FY 1393.

likewise, the aggregate financial liabilities, increased from USD 23.40 million to USD -39.26 million in the same period as a result of lower financial flows occasioned by the insecurity challenges, that affected both FDI and portfolio investments.

**Table 4.2: Capital and Financial Accounts**

	FY - 1391	Q3 - 1392	Q3 - 1393
Capital and financial account	<b>1237.71</b>	<b>240.77</b>	<b>607.17</b>
Capital account	2615.74	713.77	326.91
Capital transfers	1776.42	714.67	343.82
Financial account	-949.26	-473.06	330.62
Reserve Assets	-702.19	-413.89	316.96

Figure 4.2: Capital and Financial Account

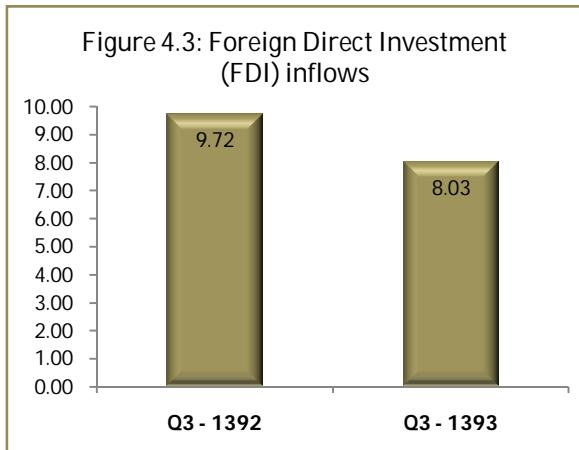


### 1.2.1. Foreign Direct Investment (FDI)

According to the available data, Afghanistan's foreign direct investment (FDI) depicted significant decline of 17 percent in the third quarter of the FY 1393 compared to the same period of the FY1392. As shown in Figure 4.3, the FDI declined by

21 percent from USD 9.72 million in the third quarter of the FY 1392 to USD 8.03 million in the third quarter of the FY 1393.

The decline in the level FDI was mainly due to the security and political uncertainty.



### 1.3. Merchandise Trade

The Merchandise trade statistics shows that trade deficit narrowed to 32 percent, from USD 2,214.12 million in the third quarter of the FY 1392 to a deficit of USD 1,512.20 million in the third quarter of the FY 1393. The trade deficit makes up approximately 7 percent of GDP.

Aggregate imports decreased significantly by 29 percent, while total exports boosted by almost 26 percent in the third quarter of the FY 1393.

According to merchandise trade statistics, total imports for the period under review was recorded USD 1665.98 million, where this figure was USD 2336.48 million in the

similar period last year. The decrease in expenditure of total imports were due to three importing categories, in particular fuel and lubricants, which decreased by 65 percent, from USD 677.37 million in the third quarter of the FY 1392, to USD 249.64 million in the third quarter of the FY 1393. Capital goods and others declined by 28 percent from USD 923.79 million in the third quarter of the FY 1392, to USD 666.83 million in the quarter under review, industrial supplies diminished by 41 percent, from USD 305.22 million to USD 179.72 million.

On the other hand, imports of consumer goods rose by almost 32 percent, from USD 430.10 million in the third quarter of the FY 1392, to USD 569.79 million in the third quarter of the FY 1393.

Total Exports increased by 26 percent, from USD 122.36 million, to USD 153.78 million in the third quarter of the FY 1393.

Based on the trade statistics, all export categories exhibited upward trend in the period under review. Carpets and rugs rose significantly by 96 percent, from USD 15.90 million in the third quarter of the FY 1392 to USD 31.14 million in the third quarter of the FY 1393. Food items such as the fresh and dry fruits, medical seeds and others category, remained the leading categories driven the overall exports up.

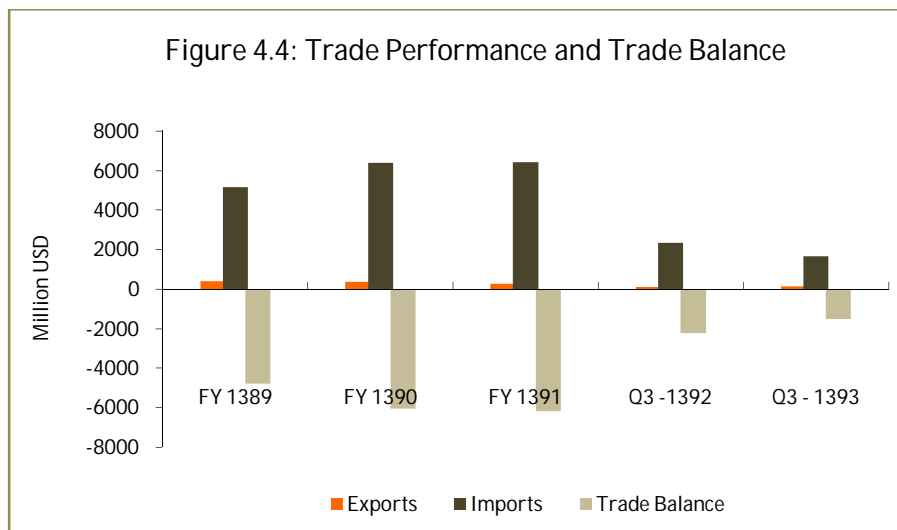
Conversely, exports of leather and wool significantly dropped by 37 percent, from USD 20.73 million in the preceding and corresponding quarter to USD 13.08 million in the review quarter.

Table 4.3 illustrates the main categories of the merchandise trade from 1389 up to end of the third quarter of FY 1393.

**Table 4.3: Merchandise Trade** (in million USD)

Years	FY 1389		FY 1390		FY 1391		Q3 - FY1392		Q3 - FY 1393	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
<b>Imports</b>	<b>5,154.31</b>	<b>100%</b>	<b>6,388.37</b>	<b>100%</b>	<b>6,419.67</b>	<b>100%</b>	<b>2,336.48</b>	<b>100%</b>	<b>1,665.98</b>	<b>100%</b>
Industrial supplies	602.48	11.7%	614.77	9.6%	969.88	15.1%	305.22	13.1%	179.72	10.8%
Fuel and Lubricants	1,022.66	19.8%	2,184.59	34.2%	1083.65	16.9%	677.37	29.0%	249.64	15.0%
Consumer goods	803.67	15.6%	857.38	13.4%	1255.48	19.6%	430.10	18.4%	569.79	34.2%
Capital goods and other	2,725.50	52.9%	2,731.63	42.8%	3,111	48.5%	923.79	39.5%	666.83	40.0%
<b>Exports</b>	<b>388.37</b>	<b>100%</b>	<b>375.03</b>	<b>100.0%</b>	<b>261.63</b>	<b>100%</b>	<b>122.36</b>	<b>100%</b>	<b>153.78</b>	<b>100%</b>
Carpets & Rugs	68.83	18%	46.60	12.4%	8.4	3.2%	15.90	13.0%	31.14	20.2%
Food Items	156.35	40%	133.39	35.6%	104.23	39.8%	41.38	33.8%	56.68	36.9%
Leather & Wool	53.84	14%	28.07	7.5%	26.82	10.3%	20.73	16.9%	13.08	8.5%
Medical seeds & others	109.35	28%	166.97	44.5%	122.15	46.7%	44.35	36.2%	52.88	34.4%
<b>Trade Balance</b>	<b>-4,765.94</b>		<b>-6,013.34</b>		<b>-6,158.04</b>		<b>-2,214.12</b>		<b>-1,512.20</b>	
<b>Trade Balance as % of GDP</b>	<b>-28%</b>		<b>-33%</b>		<b>-31%</b>		<b>-11%</b>		<b>-7%</b>	

Source: CSO and DAB staff calculations





### 3. DIRECTION OF TRADE

The main export destinations for Afghanistan are Pakistan, Iran, India, China, and Common Wealth of Independence States (CWS).

According to the merchandize trade statistics, in the quarter under review, Pakistan remained on the top among the export destination.

In the quarter under review, Afghanistan's exports to Pakistan increased by about 42 percent, from USD 44.21 million in the preceding quarter to USD 62.92 million. The major export items to Pakistan were carpets and rugs, fresh and dry fruits, cotton, medical seeds and others.

Export of carpet and rugs increased sharply to USD 27.79 million in the period under review, from USD 0.83 million in the preceding quarter.

Similarly, export of food items such as fresh and dry fruit to Pakistan rose to USD 21.83 million, up from USD 10.10 million recorded in the preceding.

India ranked the second largest export destination with a share of about 24.33 percent among the others. Afghanistan's total exports to India increased by almost 17

percent, from USD 32.09 million to USD 37.41 million. The increase in total exports to India was mainly dominated by medical seeds, food items (fresh dry fruit),.

The Commonwealth of Independent States (CIS) was the third largest exports destination with a share of about 7.76 percent among others in the period under review.

Afghanistan's total exports to CIS countries increased from USD 1.56 million in the third quarter of the FY 1392, to USD 11.94 million in the third quarter of the FY 1393.

Iran remained the fourth largest export destination with a total share of 6.17 percent among others. The total exports of Afghanistan to Iran increased by 71 percent from USD 5.56 million in the third quarter of the FY 1392 to USD 9.49 million in the period under review. The increase in total exports to Iran was mainly due to food items, dry fruit & oil seeds, and unspecified item.

However, China was the last largest export destination with a share of almost 2.84 percent in the third quarter of the FY 1393. Total exports to China declined from USD 5.03 million recorded in the third quarter of the FY 1392, to USD 4.36 million in the reporting period.

**Table 4.4: Direction of External Trade: Q3 – FY1393** (in million USD)

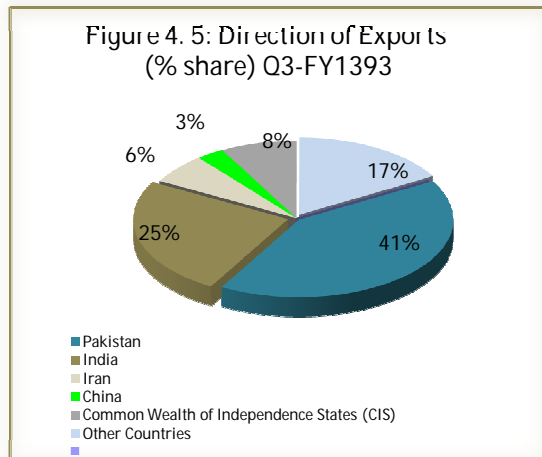
Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	62.92	40.92%	312.00	18.73%	-249.08
India	37.41	24.33%	22.64	1.36%	14.77
Iran	9.49	6.17%	256.82	15.42%	-247.33
Germany	2.25	1.46%	7.56	0.45%	-5.31
China	4.36	2.84%	222.00	13.33%	-217.64
England		0.00%	1.39	0.08%	-1.39
Saudi Arabia	0.25	0.16%		0.00%	0.25
USA		0.00%	26.64	1.60%	-26.64
Common Wealth of Independent States (CIS)	11.94	7.76%	387.94	23.29%	-376.00
Japan		0.00%	27.71	1.66%	-27.71
Other Countries	25.16	16.36%	401.28	24.09%	-376.12
<b>Total</b>	<b>153.780</b>	<b>100%</b>	<b>1,665.98</b>	<b>100%</b>	<b>(1,512.20)</b>

*Source: CSO and DAB staff calculations*

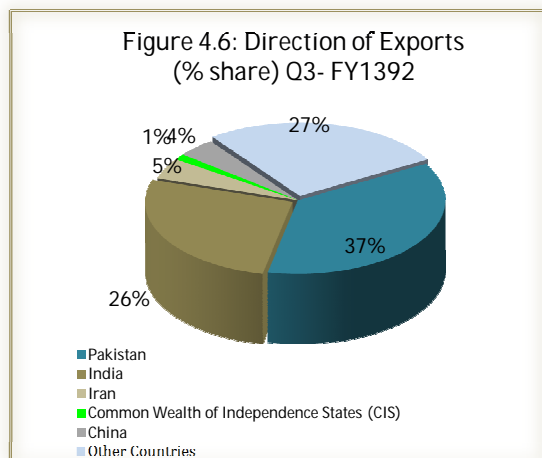
**Table 4.5: Direction of External Trade: Q3 - 1392** (In million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	44.21	36.13%	355.50	15.22%	-311.29
India	32.09	26.23%	38.15	1.63%	-6.06
Iran	5.56	4.54%	468.97	20.07%	-463.41
Germany	1.62	1.32%	48.94	2.09%	-47.32
Common Wealth of Independence States (CIS)	1.56	1.27%	674.98	28.89%	-673.42
China	5.03	4.11%	96.25	4.12%	-91.22
Saudi Arabia	0.00	0.00%		0.00%	0.00
Japan		0.00%	13.64	0.58%	-13.64
England		0.00%	4.04	0.17%	-4.04
United States		0.00%	16.99	0.73%	-16.99
Other Countries	32.29	26.39%	619.02	26.49%	-586.73
<b>Total</b>	<b>122.36</b>	<b>100.00%</b>	<b>2336.48</b>	<b>100.00%</b>	<b>-2214.12</b>

*Source: CSO and DAB staff calculations*



Source: CSO and DAB Staff calculations



Source: CSO and DAB Staff calculations

### 3.1 Composition of Trade

The composition of imports in the third quarter of the FY 1393 indicates that imports of consumer goods had the largest share in the basket of imports. The import of consumer goods increased by 32.5 percent, up from USD 430.10 million in the third quarter of the FY1392 to USD 569.79 million in the reporting quarter. This increase was mainly due to the higher domestic demand

for foreign goods, which incurred expenditure on certain food items in the period under review.

The second largest share recorded for capital goods and others, which rose slightly by 40 percent in the third quarter the FY 1393 from 39.5 percent in the third quarter of the FY1392. Expenditure on import of capital goods and others in total imports dropped by almost 28 percent, standing at USD 666.83 million in the third quarter of FY 1393, compared to USD 923.79 million in the same period of preceding year.

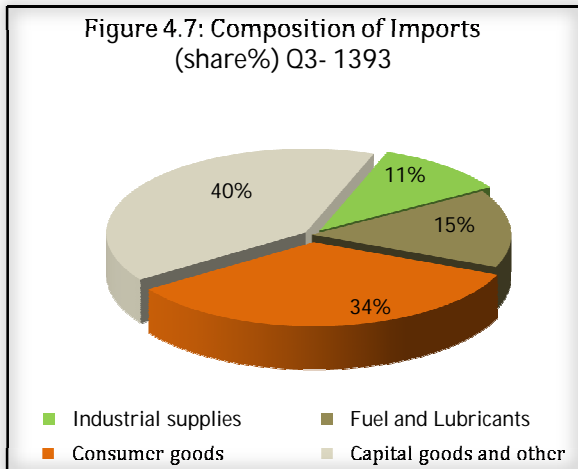
Expenditure on imports of fuel and lubricants (Petroleum Oil) in total of imports declined considerably by about 63 percent from USD 677.37 million with a share of 29 percent in the third quarter of the FY 1392, to USD 249.64 million with a share of 15 percent in the period under review.

Likewise, the last largest share was recorded for industrial supplies, which declined to 10.8 percent from 13.1 percent in the third quarter of the FY 1393.

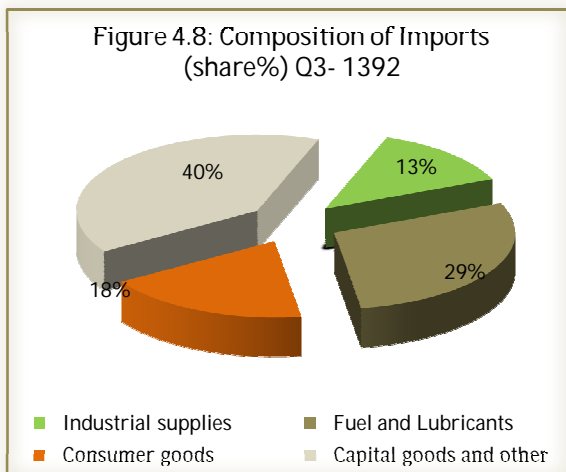
Expenditure on imports of industrial supplies in total imports decreased by about 41 percent, from USD 305.22 million in the preceding quarter to USD 179.72 million in the quarter under review.

Industrial supplies, which include metals, fertilizer, chemical, and cement, posted a decline due to the reduction in the number of development projects all over the country as

a result of political and security uncertainties.



Source: Central Statistics Office and DAB staff calculations



Source: Central Statistics Office and DAB staff calculations

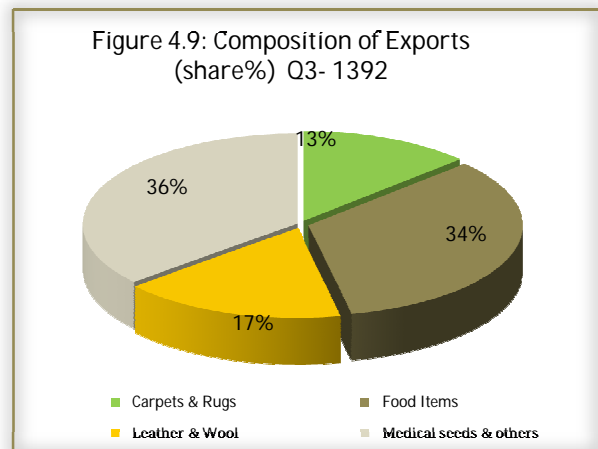
According to the merchandise trade statistics, food items had the largest share in total exports in the third quarter of the FY1393. Exports of food items increased 37 percent form USD 41.38 million in the third quarter of the FY 1392 to USD 56.68 million in the review quarter.

The second largest Share in total exports was recorded for medical seeds, despite its share has declined from 36.2 percent to 34.4 percent in the quarter under review.

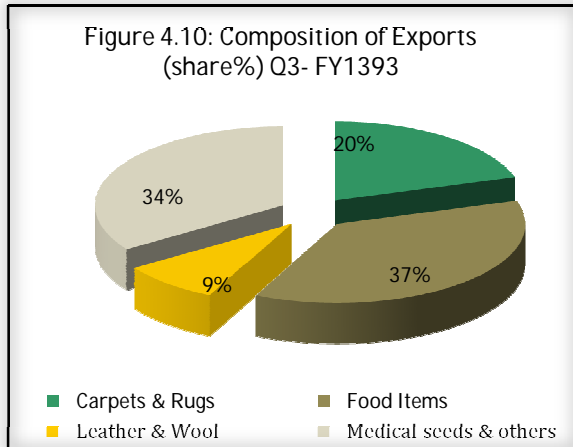
In addition, carpets and rugs which are considered the main component of Afghanistan’s exports in the past decades had the third largest share in total exports in the quarter under review.

Base on quarterly comparison of merchandize trade statistics, export of carpets and rugs increased by about 96 percent in the quarter under review. The exports of carpet and rugs that was recorded at USD 15.90 million in the previews quarter, increased to USD 31.14 million in the quarter under review.

Exports of leather and wool declined by almost 37 percent from USD 20.37 million to USD 13.8 million in the quarter under review.



Source: Central Statistics Organization/DAB staff calculation



Source: Central Statistics Organization/DAB staff calculation

#### 4. EXTERNAL DEBT

Afghanistan's external debt decreased by 15 percent or USD 399.58 million, from USD 2,684.75 million in the third quarter of the FY 1392 to USD 2,285.17 million in the quarter under review. The decline in total external debt could be attributed to long-term components, like the external commercial loan payment, narrowing NIR deposits and Special Drawing Rights (SDR) allocated by the International Monetary Fund (IMF).

During the quarter under review, loan principal repayments made to the

International Development Association (World Bank), Islamic Development Bank (IDB), Asian Development Bank (ADB), and Saudi Fund for Development (SFD), while service charges were paid to the International Development Association, ADB, IDB and OPEC FUND.

Meanwhile, International Development Association as a major multilateral creditor to Afghanistan, and Bulgaria as a non-Paris Club creditor to Afghanistan made some debt forgiveness only on principal, and ADB made debt forgiveness on principle and service charges during the quarter under review.

Based on MoF data, Afghanistan's total loan amounts payable to the Paris Club creditors at the end of the third quarter of the FY 1393 stood at USD 943.64 million which is payable to Russian federation.

In other words, Afghanistan's total debt from the Paris club members stands at about 41.29 percent of total current external debt which has decreased by about 18.1 percent compared to the same period of preceding year.

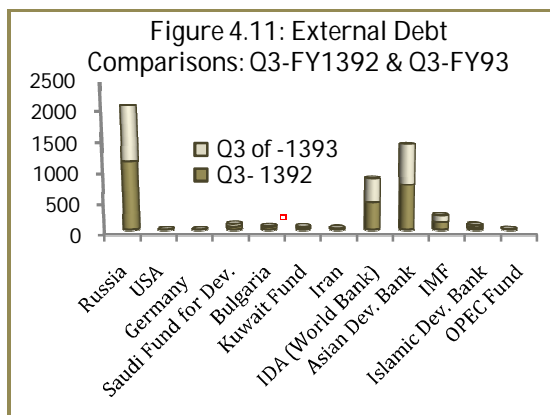
**Table 4.6: External Debt: Q3 - FY1393** (in units indicated)

	In million USD	Percent of total
Total external debt	2,285.17	100.00
Bilateral	1,030.72	45.10
Paris Club	943.64	41.29
Russian Federation	943.64	41.29
United States	-	0.00
Germany	-	0.00
Non-Paris Club	87.09	3.81
Multilateral	1,254.45	54.90
of which: IDA (World Bank)	410.32	17.96
Asian Development Bank	686.02	30.02
International Monetary Fund	113.30	4.96
Islamic Development Bank	43.03	1.88
OPEC Fund	1.79	0.08

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

Furthermore, Non-Paris Club members including, Saudi Fund for Development, Bulgaria, Kuwait fund and Iran stood at USD 87.09 million in the third quarter of the FY 1393.

On the other hand, multilateral credits stood at USD 1,254.45 million compared to USD 1,394.71 million at the end of the same quarter of last year.



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

## 5. NET INTERNATIONAL RESERVES

According to the latest available data the Net International Reserves (NIR), increased slightly by about one percent, standing at USD 6,771.29 million, up from USD 6,703.47 million recorded in the same period of last year. The increase in the level of NIR was mainly due to the increase in the reserve assets which increased from USD 7,140.69 million in the third quarter of the FY 1392 to USD 7,160.32 million in the reviewed quarter.

On the other hand, reserve liabilities declined by almost 11 percent from USD 437.22 million in the third quarter of the FY 1392 to USD 389.03 million in the quarter under review, this demonstrates that the reserve assets are higher than the reserve liabilities. The decrease in reserve liabilities

is mainly attributed to the commercial banks deposits in foreign currency which decreased from USD 300.16 million in the third quarter of FY1393 to USD 270.02 million, representing a 10.04 percent decrease. The use of fund resource depicted a 13.18 percent decreased from USD 136.92 million in Q3 FY1392 to USD 118.88 million.

The reserve liability of nonresident deposits in foreign currency remained unchanged during the quarter under review.

The increase in the net reserves were mainly from the export earnings, foreign direct investment, current transfers, earning on foreign exchange deposits in foreign deposit-taking corporations, and the expenditures of the ISAF troops as well as the international aid.

**Table 4.7: Net International Reserves, Q3 - 1393 (million of USD)**

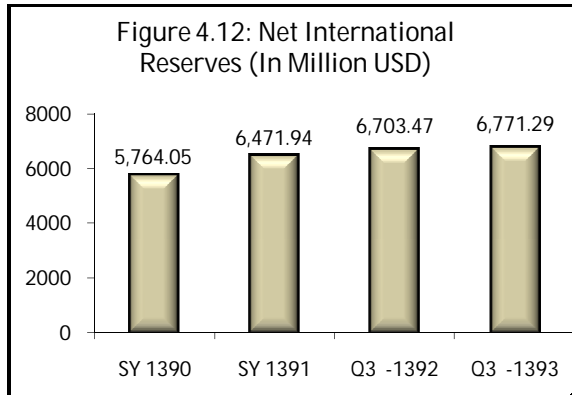
Changes in the previous quarter	1390	% Changes	1391	% Change	Q3 - 1392	% change	Q3 - 1393	% change
Net International Reserves (million US Dollar)	<b>5,764.05</b>	23.22	<b>6,471.94</b>	12.28	<b>6,703.47</b>	3.58	<b>6,771.29</b>	1.01
Reserve Assets	<b>6,130.38</b>	22.71	<b>6,866.79</b>	12.01	<b>7,140.69</b>	3.99	<b>7,160.32</b>	0.27
Reserve Liabilities	<b>366.34</b>	10.91	<b>394.85</b>	7.78	<b>437.22</b>	10.73	<b>389.03</b>	-11.02
Commercial bank deposits in foreign currency	<b>227.72</b>	4.00	<b>245.00</b>	7.59	<b>300.16</b>	22.51	<b>270.02</b>	-10.04
Non-resident deposits in foreign currency	<b>0.11</b>	-89.57	<b>0.11</b>	0.00	<b>0.14</b>	23.87	<b>0.14</b>	0.00
Use of Fund resources	<b>138.51</b>	17.53	<b>149.73</b>	8.10	<b>136.92</b>	-8.56	<b>118.88</b>	-13.18
Gross Intl. Reserves (in months of import)	<b>11.52</b>		<b>12.84</b>		<b>27.51</b>		<b>38.68</b>	
Net Intl. Reserves (in months of import)	<b>10.83</b>		<b>12.10</b>		<b>2.87</b>		<b>36.58</b>	

The increase in the Net International Reserves (NIR) could be attributed to significant inflows of foreign exchange, particularly from foreign and personal remittances. The current position of Afghanistan Net International Reserves (NIR) is providing a good cushion of the capacity of monetary policy and support of balance of payments.

Currently, Net International Reserves (NIR) on average supports almost 36 months of

imports, while countries with 6 months coverage of imports enjoy a relatively comfortable reserve position.

Chart 12: represents the Net International Reserves (NIR) of Afghanistan for the past few periods.



Source: Monetary Policy Department, DAB



**THE FISCAL  
SECTOR  
DEVELOPMENTS**

**5**



# 5

## FISCAL DEVELOPMENTS

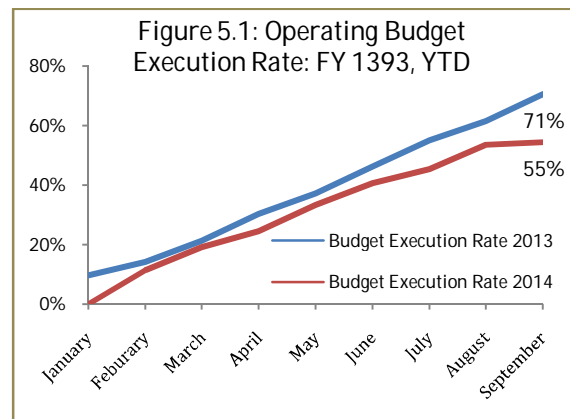
The uncertainty, related to the political and security transition, has shaded the overall economic activities in the country. In addition, the prolonged presidential election process exacerbated the situation as the elections went to the second round. The delay in the announcement of the results of the presidential election, led to further economic problems. The impacts on the fiscal sector were more significant, the level of revenue collection dropped dramatically, compared to the same period of the previous year. The fall in revenue collection constrained the funds available for the government expenditures.

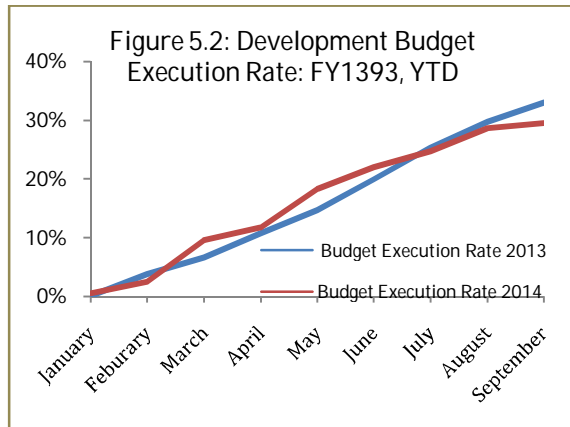
The lower revenue collection, and the foreign aid dependency, has limited the government's options to raise the level of expenditures. The preliminary estimations shows a budget deficit of 6 percent for the FY1393, but further developments over the period holds out

that the budget deficit would be much higher than the estimated figure.

### I. BGET EXECUTION RATE

Based on the available data, a significant decline in the budget execution rate over the first three quarters of FY1393 has been observed, compared to the same period of the preceding year. About 55 percent of the operating budget has been implemented by the end of the third quarter, which represents a 16 percent decline compared to a year ago.





Similarly, the development budget execution rate at the end of the third quarter of FY1393 indicates a weak performance, exhibiting a 4 percent decline compared to a year ago. By the end of the third quarter, the development budget execution rate reached to 29 percent of the total development budget for FY1393, while the execution rate for the same period of the last year was 33 percent.

The decline in the budget execution rate could be attributed to several factors and most importantly due to a reduction in domestic revenue collection, and donors' funds. A noticeable decrease in the government revenue collection, and a simultaneous delay and reduction in donors' funds affected the government's expenditures, which led to spending cuts in discretionary and non-discretionary expenditures. In response to these unfavorable developments in public

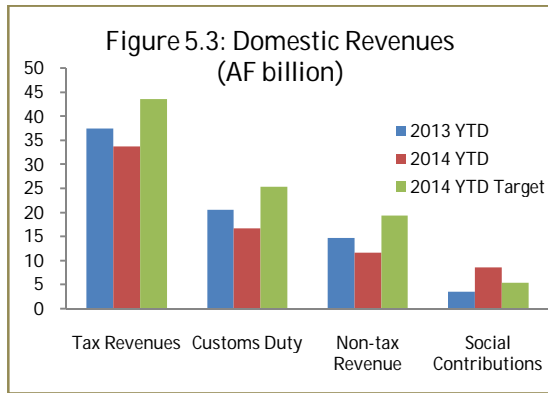
finance of the country, the budget execution rate declined over the third quarter of the FY1393.

### 1.1. Budget Deficit

As a result of a shortfall in government revenues and donor's contribution, the national budget deficit increased over the first three quarters of the FY1393. The budget deficit increased to AF 32.4 billion by the end of the third quarter (September 2014), from a budget surplus of AF 34.3 billion recorded in the same period of last year. Out of total national budget deficit of AF 32.4 billion, AF 22.2 billion was the deficit in the operating budget and the remainder AF 8.9 billion was the deficit observed in the development budget.

## II. REVENUE COLLECCTION

As a result of persisting uncertainties in the country, the domestic revenue collections dropped significantly in the first three quarters of FY1393. A significant decrease was observed in total import of commodities, and a lower and belated income tax payment in the period under review.

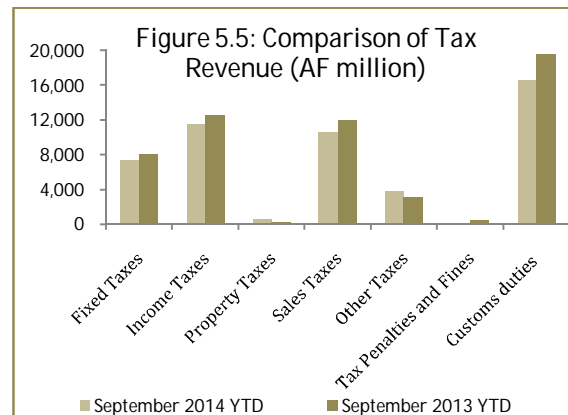
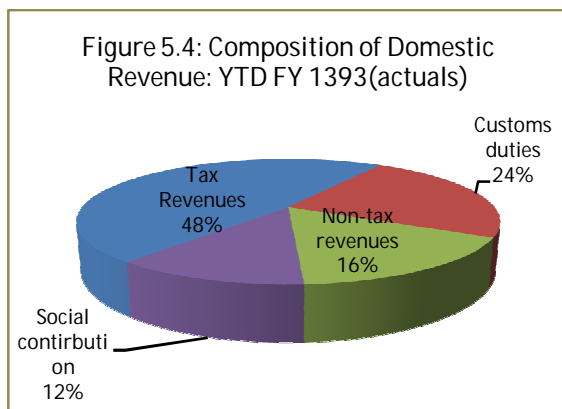


Total domestic revenue, including both tax and non-tax revenue, stood at AF 23.1 billion in the third quarter of FY1393, representing a decline of AF 4.6 billion compared to the same quarter of the previous year. Observing the YTD figures for the total domestic revenues holds out that the actual YTD figure of AF 70 billion is well below the targeted level, by 25 percent. Breaking down the total domestic revenues into its tax and non-tax components, provides a better picture of the developments in the domestic sources of budget.

## 2.1. Tax Revenue

Revenue collected from taxes constitutes the largest portion (around 79 percent, including customs duties) of the total domestic revenue. Total tax revenue in the third quarter of the current fiscal year shows a considerable decline of 28 percent, compared to the same period of the last year. Total collected tax revenue was AF 15.7 billion, down from AF 21.7 billion recorded in the third quarter of FY1392.

Customs duties which is the largest contributor to the total tax revenue, demonstrated a 26 percent decline over the third quarter of the current year, compared to the third quarter of the preceding year. The customs duties stood at AF 16.6 billion (YTD), this represents a 15 percent decline compared to AF 19.5 billion recorded in the same period of the previous year.



## 2.2. Non-tax Revenues

Retirement contributions, which is the only component of the social contribution category of domestic revenues, stood at AF 2.8 billion (YTD), that represents a 13 percent increase over the first three quarters of the current fiscal year, compared to the same period of FY 1392.

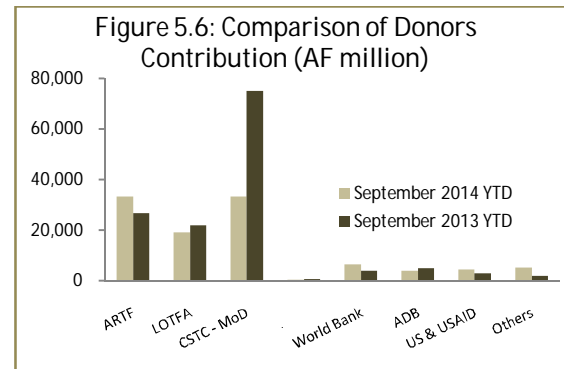
The other category of the domestic revenues, which is comprised of all non-tax revenues of the government, excluding the social contribution, stood at AF 18.1 billion (YTD), compared to AF 17.5 billion in the same period of last year, represents a 3 percent increase. The main contributors to this component of domestic revenue, include income from capital and properties, sales of goods and services, administrative fees, royalties, and non-tax fines and penalties.

## 2.3. Grants

Total donor contributions for the current fiscal year national budget (operating and development) were estimated to be about AF 268.1 billion, consisting 64 percent of the total national budget. After all, the actual contribution of donors reached AF 105.4 billion, up to the end of the third quarter of FY1393 which comprises only 39 percent of the total committed assistance.

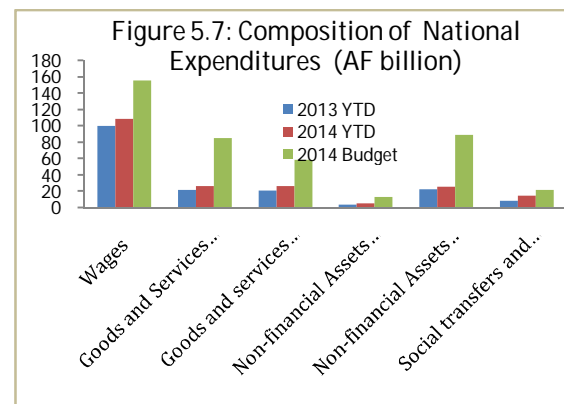
The total donors' contribution under the ARTF program over the first three quarters of FY1393 was AF 33.4 billion

that represents a 25 percent increase over the same period of the previous fiscal year. Out of this amount, AF 23.4 billion was contributed to the operating budget and the rest was contributed to the development budget.



## III. EXPENDITURES

The government expenditures comprised of operating and development expenditures. Total expenditure in the first nine months of FY1393 was AF 209 billion, compared to AF 180.1 billion recorded in the same period of the preceding year, this represents a 16.1 percent increase.



**THE BANKING  
SECTOR  
PERFORMANCE**

**6**





# 6

## BANKING SYSTEM PERFORMANCE

The asset base of the banking sector dropped by 1.64 percent or AF 4.00 billion during the quarter under analysis compared to 1.79 percent growth in the month of June 2014, registering 1.86 percent decrease since the preceding period (Sep. 2013). The decline in banking system assets was mainly due to decrease in deposits.

Gross loan portfolio of the banking sector witnessed a decrease of 4.57 percent or AF 2.14 billion (3.14 percent increase in June 2014) over a quarter standing at AF 44.76 billion. Compared to Sep. 2013, gross loans depicted 5.14 percent decrease. The decrease in the loan portfolio is mainly on account of repayment, settlement and charge-off of loans, besides new loans have been disbursed as well.

Deposits the main funding source in the banking sector stood at AF 200.54 billion, comprising 96.09 percent of the total liabilities of the sector decreased by 1.99 percent against the 2.82 percent increase in the previous quarter (June, 2014), mainly attributed to prolonged election

process and prevailed uncertainty in the economy. The Deposits were largely denominated in USD (60.44 percent) with Afghani denominated deposits lagging at 35.84 percent. AF-denominated deposits indicated an increase of 2.97 points against the 7.57 percent increase in June, 2014 while USD denominated deposits was down by 5.03 points against 0.26 percent decline in June, 2014.

The capital base of the banking sector remained strong at AF30.12 billion, although decreased slightly on account of a decrease in profitability of the banking sector. Capital adequacy ratio (CAR) of the banking sector recorded at 26.26 percent. All the banking institutions are above the set limits for CAR.

Banking sector profit declined over a quarter, resulting in 0.37 percent Return on Assets (ROA) against 0.56 percent and 2.97 percent Return on Equity (ROE) against 4.57 percent in June, 2014. Profits amounted to AF 297 million compared to AF 457 million recorded in June, 2014. State-owned Banks, Private Banks and Branches of Foreign banks ended up with profits during the quarter under analysis.

## 1. ASSETS OF THE BANKING SYSTEM

The asset size of the banking sector decreased by 1.64 percentage points against the 1.79 percent growth recorded in June 2014. Figure 6.1

The breakdown of total assets reveals that the most obvious increase was registered in inter-bank claims, which increased by AF1.10 billion (1.68 percent) over a quarter, followed by investments increasing by AF647 million (4.85 percent) during the quarter under analysis. The

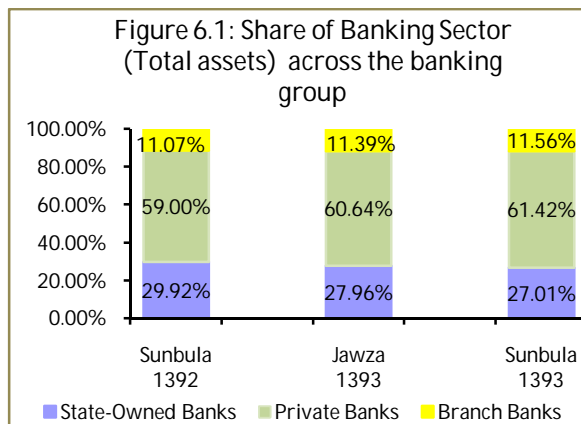
net-loans, "other" category of total assets and "cash in vault, and claims on DAB" witnessed a decrease of 5.15 percent or AF 2.29 billion, 3.72 percent or AF 0.75 billion and 2.74 percent or AF 2.70 billion respectively.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (40.19 percent), inter-bank claims (28.04 percent), net loans (17.68 percent), and "other assets" (8.21 percent), and investments make 5.86 percent of the total assets.

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

Assets	Sunbula 1392 Sep. 2013	Jawza 1393 June 2014	Sunbula1393 Sep. 2014	% of Total Asset/Liabilities	Q-o-Q Changes
Cash in vault and claims on DAB	105,619	98,694	95,989	40.19%	-2.74%
Inter-bank claims	57,056	65,863	66,971	28.04%	1.68%
Investments	10,498	13,357	14,006	5.86%	4.85%
Loans (Net)	44,527	44,526	42,230	17.68%	-5.15%
NDF	2,980	-	-	-	-
Others	22,680	20,376	19,618	8.21%	-3.72%
<b>Total</b>	<b>243,360</b>	<b>242,816</b>	<b>238,814</b>		<b>-1.64%</b>
<b>Liabilities</b>					
Deposits	208,881	204,620	200,542	96.09%	-1.99%
Borrowings	2,971	3,767	4,057	1.94%	7.69%
NDT	1,336	-	-	-	-
Other	11,805		4,180	4,096	1.96%
<b>Total</b>	<b>224,993</b>	<b>212,567</b>	<b>208,695</b>		<b>-1.82%</b>

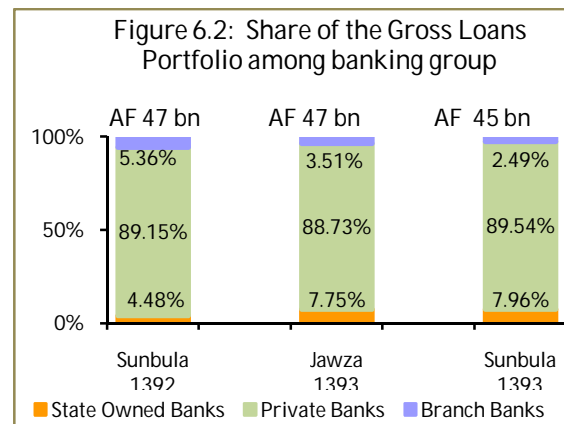
*Source: Financial Supervision Department (FSD)/DAB*



Source: Financial Supervision Department/DAB

## 1.1 Gross Loans

Total gross loans indicated AF 2.14 billion or 4.57 percent decrease since last quarter, constituting 18.75 percent of the total assets. The decrease in loan portfolio is mainly attributed to repayment of loans; settlement and charge-off of loans; meanwhile new loans have been disbursed as well. Increases in lending were observed at three banking institutions, whereas eleven banking institutions decreased their portfolio. While the remaining two banks (NKB and PNB) did not participate in lending; Gross loan portfolio showed decrease across the banking groups. Private Banks with 89.54 percent share in total portfolio posted 3.70 percent or AF 1.54 billion decrease. Branches of foreign banks holding 2.49 percent of the portfolio was down by 32.38 percent or AF 534 million and state-owned banks having a 7.96 percent share declined by 72 million during the quarter under analysis.



Source: Financial Supervision Department/DAB

### 1.1.1. Loan Loss Reserves

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

By the end of September 2014 (Sunbula 1393), the total provision cover of the system was 5.66 percent of the total gross loans compared to 5.08 percent in the previous quarter, ending June, 2014.

### 1.1.2. Distribution of Credit

In order to broad-based the loan portfolio and broaden the risk diversification and financial access besides new avenues of earning DAB have diversified the sector wide distribution of Other Commercial Loans to thirty sectors<sup>2</sup>. Sector wide analysis reveals that the major portion of the loan portfolio is classified as "other commercial loans" (79.64 percent against

<sup>2</sup> Accounting Circular No. 93/01 dated 26/06/1393

81.92 in June, 2014), mainly in “construction and building” (13.28 percent), “retail trading” (9.30 percent), and “petroleum and lubricants” (9.04 percent) sectors. Agriculture and Mortgage loans showed a slight decrease, making 2.36 percent and 7.90 percent of the total loans. Concentration in construction and building, retail trading, petroleum and lubricants and mortgage loans to the exclusion of all other types of lending has been the dominant trend. Loans designated to SME and Micro Credit sectors posted an increase of AF 2.19 billion currently are AF 7.22 billion provided by six banking institutions. Lending is picking up; although not significantly in some loan categories related to important sectors of the economy, e.g. agriculture, mining and communication sectors etc. Concentration

of loans to a few sectors of the economy would expose banks to credit risk in the event of crisis situation associated with that sector, inversely affecting the overall banking sectors, banks should closely monitor the potential risk associated with key sectors given the high NPL ratio. About 81.02 percent of the loans was designated in Kabul with Herat and Balkh provinces in the second and third places respectively. The proportion of loans in other provinces was negligible. The designation of loans by sector, geography and institution is not adequately diversified, but it is expected that with time the distribution of loans will improve. It is desirable that all banks take active part in lending, so as to diversify lending services and properly perform their role in financial intermediation.

**Table 6.2: Sectoral Distribution of Credit**

Ratios	Hoot1387 (Mar 2009)	Hoot1388 (Mar 2010)	Hoot1389 (Mar 2011)	Hoot1390 (Mar 2012)	Qaws1391 (Dec. 2012)	Qaws1392 (Dec. 2013)	Jawza1393 (June 2014)
Commercial Real Estate and Construction Loans	0.19	19.92	25.98	2.85	2.29	2.02%	1.65%
<b>Other Commercial Loans</b>	-	-	-	-	-	-	0.00%
Mining	-	-	0.02	0.72	0.11	0.07%	0.11%
Manufacturing	0.01	1.22	2.72	13.32	11.88	9.36%	9.74%
Trade	0.51	32.29	34.16	27.84	28.30	29.81%	35.82%
Communication	0	1.04	1.23	0.94	2.35	3.70%	3.44%
Service	0.09	4.84	6.72	11.95	15.94	22.11%	22.01%
Utilities	0.01	2.47	0.03	0.3	0.07	0.05%	0.93%
Others	0.09	25	8.42	10.89	10.50	10.00%	9.86%
Agricultural Loans	0	0.88	0.75	2.06	2.66	2.38%	2.50%
Consumer Loans Residential Mortgage Loans to Individuals	0.02	1.33	1.01	0.82	0.74	0.24%	0.26%
All Other Loans	0.01	7.3	8.95	15.65	14.46	10.84%	8.29%
	0.05	3.69	10	12.65	10.71	9.41%	8.53%

Source: Financial Supervision Department/DAB

### 1.1.3. Classification of Loans

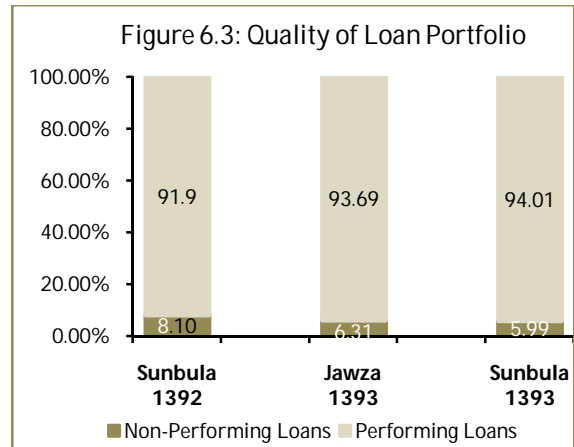
#### 1.1.3.1 Non-performing loans

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

By the end of September 2014 the growth in non-performing loans decelerated by AF 275 million stands at AF 2.68 billion or 5.99 percent of total gross loans against AF 2.95 billion or 6.31 percent of the total gross loans in the preceding quarter, 79 percent of the NPLs relates to one State-owned bank and two Private banks.

FSD is closely working with financial institutions and required them to design and implement plans to improve their asset quality.

The sector wide distribution of NPL reveals that a major portion of NPLs originates from commercial loans and residential and mortgage loans to individuals. Credit quality in communication and residential and mortgage loans deteriorated, while in manufacturing, trade, services and agriculture sectors, improved.



Source: Financial Supervision Department/DAB

#### 1.1.3.2 Adversely-classified loans

Adversely classified loans (substandard, doubtful)<sup>3</sup> depicted AF 166 million increase over the last quarter amounting to AF 4.96 billion, constituting 11.08 percent of the total gross loans. Compared to June, 2014 adversely classified loans increased by AF 755 million, mainly attributed to one private bank in the system.

#### 1.1.3.3. Loans classified Watch

Loans classified in the "watch"<sup>4</sup> category are AF 4.40 billion, which makes 9.83 percent of total gross loans decreased since the previous quarter (March, 2014) attributed mainly to one private bank in the system. Moreover, seven banking

<sup>3</sup> Assets on which the payment of principal or interest is due and remains unpaid for 61-90 days (Substandard) and for 91-539 days (Doubtful) as per accounting letter No. 03/92 dated 16/09/1392

<sup>4</sup> Assets on which the payment of principal or interest is due and remains unpaid for 31-60 days (Watch)

institutions witnessed an increase in the watch loans category, while two banks posted a decrease in the watch loans. This category of loans requires close monitoring, as it may lead to more adversely classified loans (Substandard, Doubtful) and losses in the future.

#### 1.1.3.4 Loans classified loss<sup>5</sup>

Loans classified loss amounts to AF 66 million or 0.14 percent of total gross loans are up by AF 8 million from the previous quarter. AF 66 million loss loans came from three banking institutions.

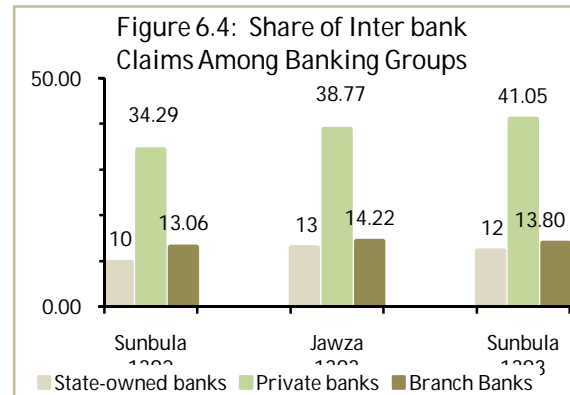
### 1.2 Inter-Bank Claims

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

AF 66.97 billion – 28.04 percent of total assets registered AF 1.10 billion increases since the previous quarter (June, 2014), attributed to a number of banking institutions, indicating that the banking sector has channeled a portion of its attracted funds as deposits in other financial institutions, if creditable borrowers were not found. These institutions are both inside and outside the country. Later on, if needed, for liquidity purposes or after receiving applications from low-risk borrowers,

<sup>5</sup> Assets on which the payment of principal or interest is due and remains unpaid for 540 days or more (Loss) as per Accounting Letter No. 03/92 dated 16/09/1392

these assets can be substituted to higher income earning assets.



Source: Financial Supervision Department/DAB

### 1.3. Investment

The investment<sup>6</sup> portfolio of the banking sector increased by 4.85 percent or AF 648 million standing at AF 14.00 billion or 5.86 percent of total assets over the previous quarter came from six banking institutions. Major part of the sector's investment took place outside Afghanistan by three commercial banks and two branches of foreign banks.

### 1.4 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the largest category, making 40.19 percent of the total assets, showed a decrease of AF 2.70 billion, both in absolute as well as in percentage of total

<sup>6</sup> Investments include investment in bonds, associated companies, in a subsidiary and in a bank

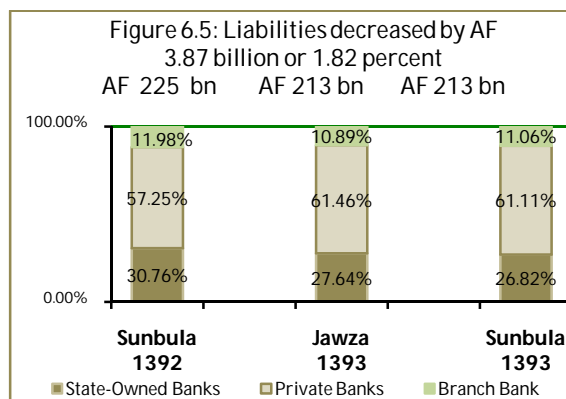
assets for the previous quarter, ending June 2014. The decrease in cash in vault and claims on DAB is attributed to decrease in the deposit base of the banking sector.

The banking sector is fully compliant with required reserves regulation and is deploying slowly and prudently the attracted funds into other types of assets.

## 2. LIABILITIES

Total liabilities of the banking sector decreased by AF 3.87 billion or 1.82 percent standing at AF 208.69 billion against AF 212.56 billion in the preceding quarter (June, 2014). Other components of total liabilities showed increases over the last quarter.

The majority of liabilities is made up of deposits (96.09 percent). This is an indication of public confidence, and good public relations and marketing policies of the banking sector, with “other liabilities” at second and borrowings in third place.



Source: Financial Supervision Department, DAB

## 2.1. Deposits

Deposits, the main funding source, decreased by AF 4.07 billion or 1.99 percent, against the 2.82 percent increase recorded in June 2014. The decrease in the deposit base of the banking sector, mostly attributed to the prolonged election process, delay in election results and prevailed uncertainty in the economy.

Afghani denominated deposits indicated a 2.97 percent increase (7.57 percent increase in June, 2014) accounting for 35.84 percent of total deposits, while US dollar denominated deposits were down by 5.03 percent (0.27 percent decrease in June, 2014) making 60.44 percent of the total deposits of the system.

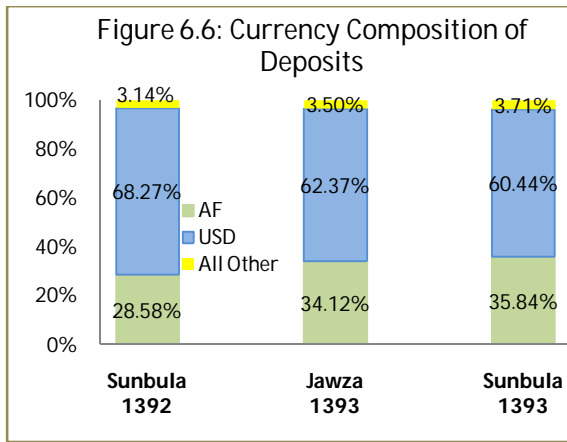
Private Banks attracted AF 124.55 billion deposits, down by 0.59 percent against the 3.94 percent increase in the previous quarter, making up 62.10 percent of the system’s deposits.

The share of state-owned banks has decreased to AF54.69 billion since preceding quarter (June 2014) accounted for 27.27 percent of the system’s deposits.

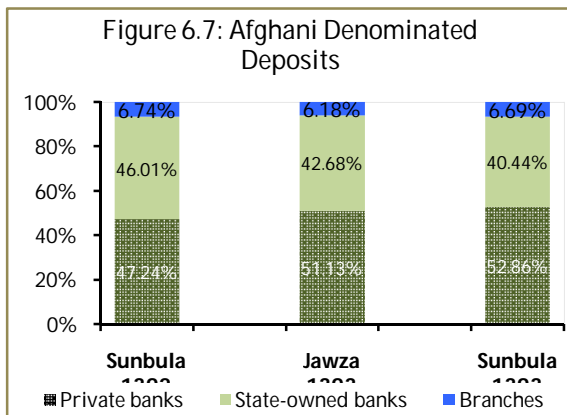
The share of branches of foreign banks stood at AF 21.29 billion, decreased by 1.63 percent, making up 10.61 percent of total deposits of the system.

In terms of types of deposits, demand deposits accounted for 76.21 percent of

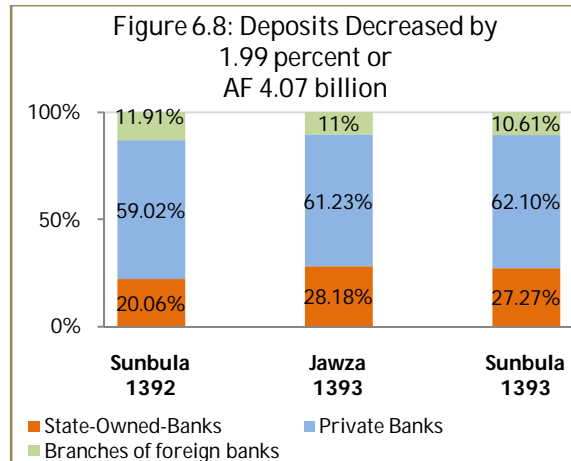
the total deposit base, up by 1.09 percent, saving deposits with 19.52 percent of total deposits was in the second place, and depicted 6.85 percent increase while time deposits making up 4.26 percent of the total deposit portfolio, was down by 24.99 percent since June.2014.



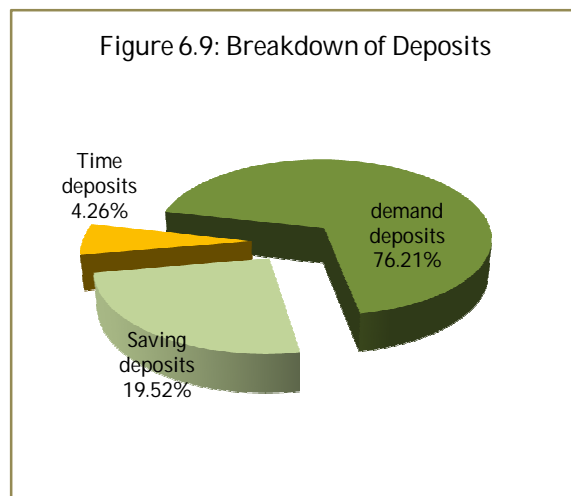
Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB

## 2.2 Borrowings

The share of borrowings in the total funding structure of the system increased by 7.69 percent standing at AF 4.05 billion at the end of the September 2014, making 1.94 percent of total liabilities in comparison with 6.98 percent decrease in the last quarter. The current borrowing position is attributed to three banking institutions.



## 2.3 Liquidity

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

### 2.3.1 Liquidity Ratio (the broadest measure)

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

Generally, a surplus liquidity position was observed in the banking sector during this period. 71.98 percent of the sector's total assets are comprised of liquid assets. The ratio of the broad liquidity as a median for the whole system stood at 67.85 percent. All banking institutions were well above the minimum required level.

## 2.4 Capital

In order to strengthen the capital base of the banking system and enhance its stability, DAB increased the minimum

Paid-in capital requirement to AF 1.00 billion, and all banking institutions are required to fulfill the requirement. One branch of a foreign bank falls below the minimum capital requirement of one billion AF, the mentioned branch has given an exemption till its liquidation.

Otherwise the system is well capitalized. The capital fund of the banking sector stands at AF 30.11 billion, decreased slightly by 0.43 points or AF 130 million on account of the decrease in the profitability of the banking sector.

On an aggregate basis the Capital Adequacy ratio of the banking sector stands at 26.26 percent. Table 6.5

A disaggregate analysis shows that all banks in the system registered capital adequacy ratio above the minimum threshold (12 percent of risk-weighted assets). The Basel benchmark for capital to risk weighted is 8 percent.

## 2.5 Profitability

On a cumulative for the third quarter of 2014 (Sep.2014) the banking sector earned AF 297 million profits against AF 458 million profits in previous quarter June, 2014.

The deterioration in the profitability of the banking sector is ascribed to an increase in non-interest expense mostly came from FX losses, losses on investments and a decrease in non-interest income. While net-interest

income increased and taxes decreased over the quarter, but less than to offset the increase in the above mentioned items.

As a result the returns on assets (ROA) worsen from 0.56 percent to 0.37 percent and return on equity deteriorated from 4.57 percent to 2.97 percent in the quarter under analysis. Table 6.5

On a cumulative basis six banking institutions have incurred AF 188 million losses against AF 282 million losses posted by two banks in the June, 2014.

On core income basis one bank ended with losses, against two banks in the previous quarter.

On an aggregate basis, Private Banks, branches of foreign banks, and State-Owned Banks ended up with profits.

**Table 6.3: Key Financial Soundness Indicators of the banking Sector**

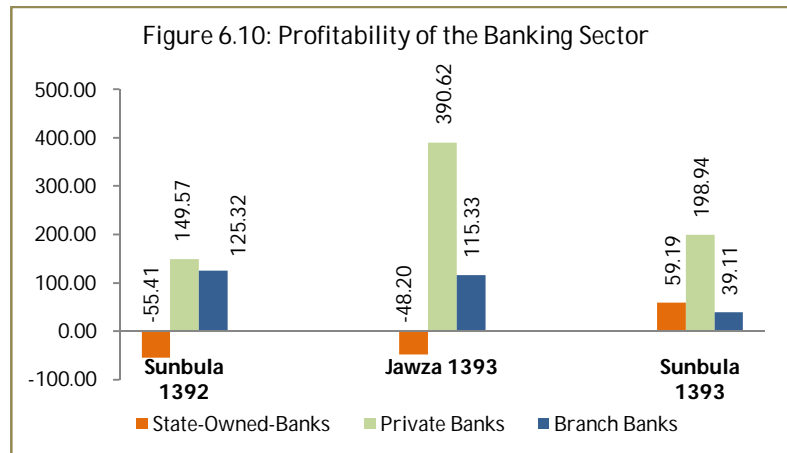
Ratio	1387 (Mar 2009)	1388 (Mar 2010)	1390 (Mar 2011)	1390 (Mar 2011)*	1390 (Mar 2012)	1391 (Dec. 2012)	1392 (Dec. 2013)	1393 (Sep. 2014)
Total Capital Adequacy Ratio	29.81	25.81	-14.46	30.39	23.06	21.84	26.34	26.26
Tier 1 Capital Adequacy Ratio	29.72	24.19	-14.51	30.29	23.98	19.97	24.65	26.13
Non-Performing Loans to Total Gross Loans	1.15	0.5	48.4	3.75	5.15	5.31	5.10	5.99
Return on Assets ( ROA)	1.74	1.41	-20.08	0.24	-1.21	-0.54	0.74	0.37
Return on Equity ( ROE)	10.61	10.35	-520.66	1.9	-17.9	-7.17	10.03	2.97
Liquidity Ratio (Broad Measure Median)	40.02	59.19	63.32	63.83	57.37	72.13	67.93	67.85
Liquid Assets to Total Assets	23.8	0.38	40.58	47.01	55.82	63.75	73.18	71.98

\*Excluding Kabul Bank

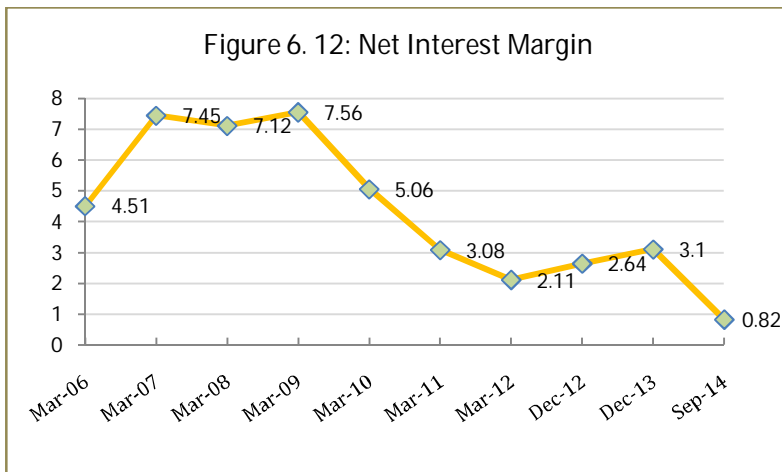
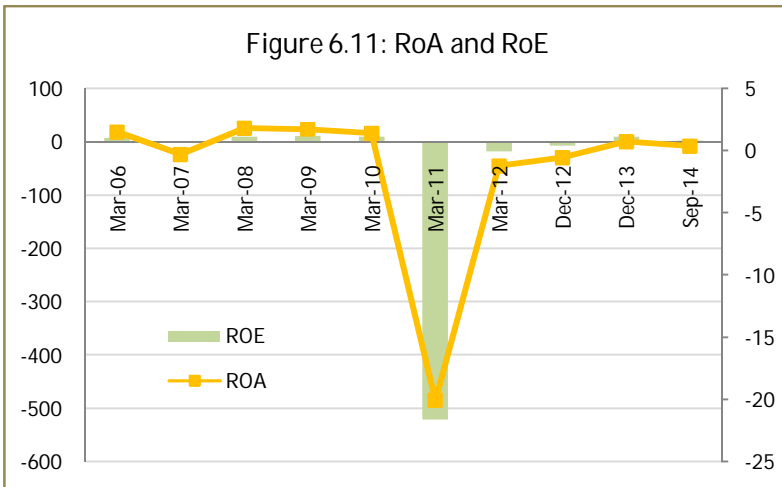
**Source:** Financial Supervision Department/ DAB

**Table 6.4: P/L Schedule**

Items	1392 (Sep. 2013)	1393 (June 2014)	1393 (Sep. 2014)	%change Q-o-Q
Interest income	2,441	2,322	2,462	6.02%
Interest expense	423	419	472	12.64%
Net interest income	2,017	1,903	1,990	4.57%
Non-interest income	1,204	1,384	1,232	-10.98%
Non-interest expenses	1,783	1,562	1,741	11.45%
Salary cost	851	896	884	-1.33%
Credit provisions	305	276	240	-13.04%
P/L before tax	282	553	357	-35.44%
P/L after tax	219	458	297	-35.15%



Source: Financial Supervision Department/DAB



## 2.6 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for the overall open FX position, except 5 banking institutions, including 2 branches of foreign banks holding open FX positions on the overall and on an individual currency (USD and EURO long positions) basis violated the limits. These banks need to bring their FX positions under the set limit; otherwise the

decrease in value of the above mentioned currencies or the depreciation in these currencies can lead the banks to more losses.

The impact of change in exchange rate upon the regulatory capital of the system reveals that a 20 percent appreciation in the exchange rate would increase the regulatory capital of the system by AF 8.80 billion, and vice versa. Similarly, a 4 percent change would correspond to AF 1.76 billion and vice versa.

## 2.7 Interest Rate Risk

Overall the banking system is in an interest-rate sensitive position. However, calculations made from the Interest Rate Sensitivity Schedules of all banks reveal that, the net-interest income of the system over the next 12 months may increase by AF 1.63 billion in an event of an increase in the market interest- rate (upward interest rate shock) by 3 percentage points. Conversely, if the interest rate decreases by 3 percentage points (downward interest rate shock) interest income will decline by AF 1.63 billion. For one banking institution, if the interest-rate increases by 3 percentage points, that will decrease in their net interest

income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because, like FX risk, interest-rate sensitivity of the banks is the large excess of risk is theoretically managed on a whole-bank basis).

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



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