Da Afghanistan Bank

Central Bank of Afghanistan

Quarterly Economic and Statistical Bulletin

Third Quarter-1387

September 2008 - December 2008

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Data Notes

Afghanistan uses the Persian calendar also known as the Jalali calendar, which was introduced on March 15, 1079 by the Seljuk Sultan Jalal-u-ddin Malik Shah I, based on the recommendations of a committee of astronomers, including Omar Khaiyam, at the imperial observatory in his capital city of Isfahan. It is a solar calendar in which each year begins on March 21. This Quarterly Bulletin covers developments in the Third quarter of 1387 which is equivalent September 22, 2008 – December 21, 2008 in the Gregorian calendar.

Afghanistan figures are in current afghani unless otherwise specified.

Billion means 1,000 million

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LIST OF ABBREVIATIONS:

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

MESSAGE OF THE GOVERNOR

I am pleased to present the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (Central Bank of Afghanistan) for the third quarter of 1387 (September 22 to December 21, 2008). This quarterly bulletin reflects the main developments in the Bank's activities aimed at keeping inflation low, maintaining the stability of the national currency and developing a robust banking sector in support of sustainable economic growth.

The third quarter of 1387 was characterized by extreme turbulence in the global economy. The sub-prime credit crisis in the United State ballooned into a global credit crunch that spread to all major economies around the world triggering the first global recession in decades. The hope that emerging economies would survive the downturn unscathed, because of decoupling from the global economy, were dashed as export demand from advanced economies dried up, leading to factory closures and layoffs in China and other export-driven emerging markets.

The global recession will have a silver lining for net-food importing countries like Afghanistan as the decline in commodity prices is likely to lead to a decline in imported inflation going forward. In Afghanistan headline inflation, as measured by year-on-year percentage changes in Kabul CPI increased slightly to 22.7 percent, up from 17 percent in the previous year. The main driver of the CPI was increases in the prices of food and oil.

Monetary policy in the quarter under review remained cautious, underpinned by the broader objective of maintaining price stability while supporting the development of capital markets. Currency in circulation was maintained below the PRGF ceiling through concerted foreign exchange auctions that averaged USD 40 million per week. The nominal exchange rate of the afghani to the USD depreciated slightly due to an increased demand for foreign currency associated with the annual pilgrimage and Eid holidays.

On the fiscal side, total expenditures in the quarter under review was AF 29,652 million, increasing sharply compared to the second quarter of the year. The sharp increase in expenditures was attributed largely to higher wages and salaries as well as increased development spending.

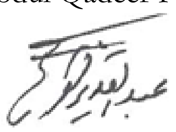
At the end of the third quarter, total operating expenditures stood at AF 19,827 million or about 15 percent of the total budget for the solar year 1387. Expenditure of the development budget stood at AF 9,824 million or 7 percent of the total development budget

The banking system continued to perform satisfactorily. Total assets of the banking system rose to AF 116.4 billion (USD 2.24 billion) at the end of the third quarter of 1387, up by 57 percent or AF 42.3 billion from December 2008. Loans amounted to AF 50.7 billion (USD 971 million) an increase of AF 15.1 billion (USD 290 million) or 44 percent from December 2008. Deposits stood at AF 92.9 billion (USD 1.8 billion) over the period under review; a 59 percent increase or and increase of AF 15.1 billion since December 2008. Deposits were largely denominated in USD (67 percent) with AF -denominated deposits lagging at 28 percent.

In the external sector, the trade deficit, the difference between exports and imports of goods, in the third quarter of 1387 stood at USD 536 million which is approximately 4 percent of GDP a reflection of low savings in the domestic economy and high investment requirements for post-conflict reconstruction. A comparison of merchandise trade in the third quarter of solar year 1387 with that in the third quarter of 1386 shows that imports decreased by 12 percent from USD 662 million to USD 740 million.

The outlook for the coming quarter remains favorable with Afghanistan well poised to weather the global economic crisis. Inflation is likely to continue to decline as the economy shrugs off the effects of the drought of 1386. Interest rates on capital notes—the discount security of the Central Bank—will also continue to decline. The exchange rate is likely to return to its long-run equilibrium of between 49-50AF/USD. Overall, macroeconomic stability will be maintained in the final quarter of the solar year.

Abdul Qadeer Fitrat



Governor, Da Afghanistan Bank
(Central Bank)

1

INTERNATIONAL ECONOMIC ENVIRONMENT

SUMMARY

World economic growth slowed to 1.1 percent in the quarter under review, reflecting deterioration in economic fundamentals as the global economy entered into its first recession in decades. Global growth in 2009 is projected to decline to 0.5 percent when measured in terms of purchasing power parity and to turn negative (-0.6 percent) when measured in terms of market exchange rates.

The weakening global economy led several countries to seek assistance from the International Monetary Fund (IMF). These include Iceland (USD 2.1 billion), Ukraine (USD 16.5 billion), Latvia (USD 1.7 billion), Serbia (USD 518 million), Hungary (USD 15.7 billion), El Salvador (USD 800 million), Belarus (USD 2.5 billion) and Pakistan (USD 7.6 billion).

Advanced economies contracted by 1.1 percent in the quarter under review. This was the third consecutive quarter of negative growth by advanced economies. The magnitude of the economic woes facing advanced economies is reflected in the OECD's Composite Leading Indicators (CLIs) which fell to its lowest level since the 1970s in December 2008. Developing countries were the only bright spot, in the quarter under review, registering average growth of 4.5 percent.

Inflation started to ease in the fourth quarter driven largely by the collapse in aggregate demand at the global level. Inflation in the United States, the world's largest economy, declined from 4.9 percent in September 2008 to 0.09 percent in December 2008. Commodity prices experienced a sharp decline in the last quarter of 2008 with oil prices dropping

below USD 100 per barrel from its peak of USD 147.27 reaching a new low of USD 40.06 per barrel on December 24, 2008.

Unemployment continued to increase in the fourth quarter of 2008 as firms laid-off workers in the face of declining consumer demand. The unemployment rate rose to 7.2 percent in the USA and 8 percent in the Euro area.

Financial markets performed poorly in the last quarter of 2008 as equity prices dropped sharply in the wake of negative news from the banking sector and the take-over of several key financial institutions like American Investment Group AIG) by the US government. Central banks cut policy rates several times during the quarter in order to ease the stress in the financial sector. However, despite the measures taken by central banks to improve credit provision, credit markets still remained frozen amid uncertainty as to the macroeconomic outlook.

1. ADVANCED ECONOMIES

Advanced economies contracted by 1.1 percent in the quarter under review. This was the third consecutive quarter of negative growth by advanced economies. The magnitude of the economic woes facing advanced economies is reflected in the OECD's Composite Leading Indicators (CLIs) which fell to its lowest level since the 1970s in December 2008 (see Figure 1.1 and Figure 1.2).

Figure 1.1: Composite Leading Indicators in OECD members

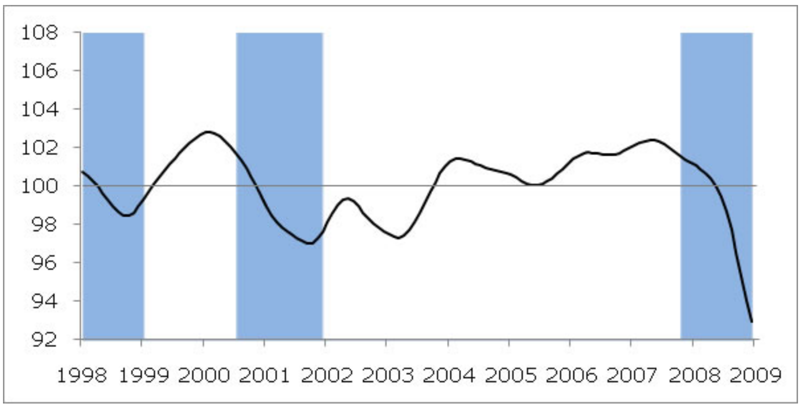
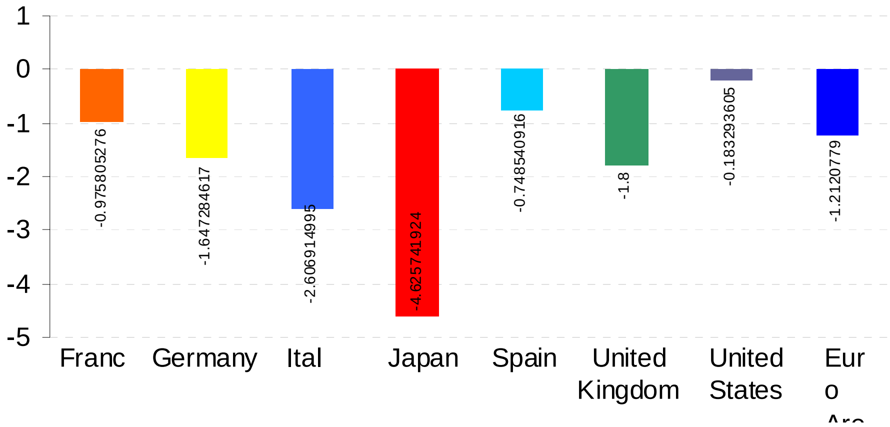


Figure 1.2: GDP Growth: fourth quarter of 2008

(Percentage change Year on Year)



1.1 United States

The United States economy shrank by 0.2 percent in the fourth quarter of 2008 and is expected to contract by 1.6 percent by the end of 2009. The fourth quarter contraction was the first quarterly decline in output (measured as the percentage change in real GDP compared with the same quarter previous year) since 1991. Consumer and business confidence was considerably weaker as aggregate demand in the economy took a nosedive and financial markets remained frozen in the wake of the collapse of major financial institutions and record level unemployment in the quarter under review.

Net exports was the largest contributor to the decline in real GDP in the fourth quarter followed by equipment and software. The trade deficit declined by 32.4 percent imports declined by 10.6 percent while exports declined by 1.6 percent between November 2007 and November 2008. In dollar terms, exports declined from USD 145.2 billion in November 2007 to USD 142.8 billion in November 2008. Imports dropped from USD 205 billion to USD 183.2 billion in the same period.

Major industrial companies laid-off a large number of workers due to weakening demand in the economy with the number of mass layoff events reaching 21,137 by the end of the year. The unemployment rate reached 7.2 percent in December 2008, up from 4.9 percent in the same month previous year.

On the monetary side, the Federal Reserve cut the federal funds rate twice during the final quarter 2008. On October 29 it lowered the federal funds rate from 2 to 1 percent and established a target range of 0.00 – 0.25 percent for the federal funds rate going forward.

1.2 Western Europe Economy

Economic activity in the euro area and the United Kingdom shrank by 1.8 and 1.2 percent respectively in the quarter under review. All major economies in the euro area recorded negative growth with Italy leading the way down with -2.6 percent, Germany -1.6 percent, France -0.97 percent and Spain -0.75 percent. Germany, the largest economy in the euro zone registered a negative quarter-on-quarter real GDP growth in the second and third quarters and is expected to experience negative GDP growth over the entire year. The UK economy also contracted in the fourth quarter in the wake of slowing domestic and foreign demand.

The trade deficit in Euro area was 7 billion euro in November 2008, compared to a trade surplus of 2.3 billion euro in November 2007. Exports fell by 10 percent and imports by 4 percent and the industrial new orders index fell by 26.2 percent and compared with October 2008, it was down by 4.5 percent.

Annual inflation in the euro area was 1.6 percent in December 2008 down from 3.2 percent in October 2008. As for the United Kingdom, annual inflation was 3.1 percent in December down from 4.5 percent in October. In brief, inflation was declining in almost all euro area members during the fourth quarter.

Unemployment remained high both in euro zone and in the U.K. The unemployment rate in the two regions was 7.9 percent and 6.1 percent respectively in the fourth quarter. In December 2008, the unemployment rate in the euro area was 8 percent up from 7.2 percent in the same month in the previous year. Spain has the highest unemployment rate among the euro area members; 14.4 percent in December 2008 compared with 8.7 percent in December 2007.

The European Central Bank (ECB) cut its main lending rate on December 4, 2008 by a record 0.75 percentage points to 2.5 percent, which took the rate to its lowest since March 2006. It was the third such rate-cut during the fourth quarter of 2008 after two previous cuts in interest rates by 50 basis points each. Prior to that, the interest rate stood at 4.25 percent.

The economic situation is envisaged to further worsen in 2009 as GDP growth in the euro area and the U.K will be -2 percent and -2.8 percent, respectively.

1.3 Japan

The Japanese economy contracted by 4.6 percent in the fourth quarter of 2008. This was the steepest decline in economic activity among advanced economies. The Japanese economy is projected to contract by 2.6 percent in the year 2009.

Japan's external trade was heavily affected by low level of foreign demand, which generated a major drag on GDP. Japan's exports fell by 15 percent from November 2007 to November 2008 and its imports by 0.6 percent in the same period. Its trade balance which had a surplus of almost USD 7 billion as of November 2007 turned to a deficit of USD 2.3 billion in November 2008.

Inflation, which was around 2 percent in the third quarter declined to 1 percent in the final quarter of the year. Inflation in October 2008 was 1.7 percent which declined to 0.4 percent in December 2008. All items of the CPI basket apart from food showed almost zero inflation in December 2008 with transportation and communication showing a drop of -5.1 percent. It seems that the risk of deflation is once again gaining momentum as Japan goes deep into recession. As to unemployment rate in Japan, it was 4.4 percent in December 2008 compared to 3.8 percent of December 2007.

The Japanese government announced three stimulus packages amounting to USD 716 billion during the fourth quarter in response to the recession. The authorities expect the stimulus packages will help restore business and consumer confidence and reignite demand in economy.

Box 1: Are capital controls good for the economy?

Capital controls are often a source of heated debate in the design of macroeconomic policies in low income countries. Some policymakers are in favour of imposing controls on capital flows as a means of preserving foreign exchange while others object to controls on capital flows which they see as a distortion to market mechanism.

Capital controls are taxes or restrictions on international transactions in financial assets. Capital flows create a surplus or deficit in the capital account of the balance of payments. A capital account deficit indicates that the country is accumulating net claims on the rest of the world by purchasing more assets and/or making more loans to the rest of the world than it is receiving. Hence, there's a *capital outflow* in the country. In contrast, a capital account surplus – or a *capital inflow* – indicates that the rest of the world is accumulating net claims on the country.

Countries often impose controls on inflows in order to prevent real appreciation of their exchange rate or to correct the incentives of financial institutions in taking excessive risks. Controls over capital outflows have also been used for permitting more freedom for monetary policy during balance of payments crises in the context of fixed exchange rates.

There appears to be an emerging consensus that capital controls in low income countries are detrimental to economic efficiency because they prevent productive resources from being used where they are most needed. However, it is worth mentioning, that capital controls have been explicitly permitted by the International Monetary Fund (IMF) Articles of Agreement (Article VI, Section 3).

It is well known that trade in assets (capital flows) provides substantial economic benefits by permitting nations to trade consumption today for consumption in the future – i.e. to engage in intertemporal trade. For example, by purchasing foreign assets today, a nation can build up claims on future income. In addition, capital flows permit countries as a whole to borrow in order to improve their ability to produce goods and services in the future and to find a source of finance for their investment projects for which they do not have sufficient savings at home. Countries with different age structures, saving rates, opportunities for investment, or risk profiles can benefit from trade in assets.

Nonetheless, a country cannot simultaneously have free capital flows, a fixed exchange rate and an independent monetary policy. This is known as the Impossible Trinity. A country must choose two out of three. The first choice is to have free capital movement and an independent monetary policy which means the country cannot have a fixed exchange rate. The second choice is to allow free flows of capital and to fix the exchange rate, but then the country loses the ability to run an independent monetary policy. In a sense, when a country fixes its currency to that of another country, it is adopting the other nation's monetary policy. The third choice is to restrict the international flow of capital, and then it is possible to both fix the exchange rate and conduct an independent monetary policy.

However, the benefits of capital flows may come with a cost, since they can complicate economic policy or even be a source of financial instability. Thus, governments may use capital controls to reduce the effects of capital flows. Controls may take the form of taxes, price or quantity controls, or absolute prohibition on international trade in assets.

Capital outflows can promote financial instability in low-income countries by creating a balance of payments crisis. This is because when domestic residents and foreigners pull their capital out of a country, the resulting capital outflow forces a country to devalue its currency. This is why some developing countries chose to close their financial markets when they faced a similar situation.

As for capital inflows, they create more serious problems than capital outflows, and that is the reason why controls on capital inflows have received more support from economists. Capital inflows can lead to a lending boom and excessive risk-taking on the part of banks which triggers a financial crisis. Banks tend to provide risky loans at home and search for low cost source of funds abroad – as long as the domestic currency is not devalued. Hence, the fact that the banking system is vulnerable to capital flows is a good justification for some countries – like Malaysia which imposed restrictions on capital movements in 1998 – to adopt capital controls in order to correct the distorted incentives in the banking system. Malaysia's switching to a closed financial sector was, however, supported by some economists like Jagdish Bhagwati (2004) and The Economist (May 1st 2003) magazine.

In fact, controls on outflows are ideally taken as a transitional measure to buy time to achieve goals, as an aid to reform rather than as a substitute (Krugman, 1998). Research shows that capital controls are ineffective and impose substantial costs on economies that outweigh any benefits. The effectiveness of capital controls depends on the rigour with which they are enforced (Obstfeld and Taylor, 1998). An IMF report on capital controls show that, in order to be effective, controls need to be comprehensive, strongly enforced and accompanied by necessary reforms and policy adjustments.

However, capital controls cannot be imposed in full range; they can be usually evaded through the channels used to permit trade in goods. In addition to administrative costs, capital importing countries receive less investment and grow more slowly with capital controls. Blocking the departure of capital temporally subsidizes investment but raises the perception of risk, increasing a risk premium and/or deterring future investment.

There is a consensus among economists that instead of imposing capital controls which later generate other serious policy problems, countries should attack problems at their source rather than with capital controls. (Krugman, 1998; Mishkin, 1998) For example, to cope with banks' incentive to take on excessive risk, a government can concentrate on reforming and strengthening the domestic financial structure – especially regulations on foreign borrowing.

In conclusion, many countries impose capital controls to help reconcile conflicting policy objectives when their exchange rate is fixed or heavily managed. However, capital controls usually impose substantial costs on the economy and cannot be used to sustain inconsistent policies. Under most circumstances, it is better to attack the source of the distortion directly rather than treating symptoms through capital controls.

Sources:

Neely, Christopher J., *An Introduction to Capital Controls*, Dec 1999

IMF, *Capital Controls: country experiences with their use and liberalization*, May 2000

Mishkin, Frederic S., *The Economics of Money, Banking, and Financial Markets*, 2004

2. REGIONAL ECONOMIES

Asian emerging and developing economies performed relatively well in the fourth quarter of 2008 compared to advanced economies. However, the rate of economic growth was well below their average growth rate and long-run potential. The reason for this was the sharp decline in demand for Asian products as major economies entered in recession and trade credit remained frozen.

The Chinese economy grew by 6.1 percent in the final quarter of 2008. This was 2.2 percentage points lower than the previous quarter and 3.8 percentage points lower than the first quarter of the year. The Indian economy grew by 6.1 percent in the fourth quarter. This was much lower than its five year average growth rate of 8.8 percent. Other ASEAN members (Indonesia, Malaysia, Thailand, Philippines) experienced an average growth rate of 4.1 percent.

Although inflation slowed at the global level due to declining food and oil prices, strong inflationary pressures remained in some Asian economies. In China, annual inflation rose by 2.4 percent in November 2008 and the consumer price index declined by 0.8 percent on month-on-month basis. In India, prices increased by 11.1 percent in December 2008 compared to 5.5 percent in the same month a year ago. In Pakistan, inflation stood at 24.7 percent in November, compared to 8.7 percent in the same month in the previous year. In December 2008, inflation in Indonesia was 10.2 percent down from its peak of 12 percent in July, compared to 5.5 percent in December 2007.

Business confidence continued to decline in the region, mainly in India and in Pakistan, due to high inflation, the worsening global economic climate and political and security concerns. According to the quarterly business expectations survey of the National Council for Applied Economic Research (NCAER) of India, the overall business confidence index (BCI) for the next six months continued to decline in India. The BCI declined by 17.8 percent in October 2008 compared with the same month in the previous year. India's biggest steel producer, Tata Steel, registered a huge loss in the fourth quarter 2008. Its profits at its Indian operations fell by 56 percent due to falling price of steel and higher raw materials.

In Pakistan, a high import bill and a decline in exports led to a deterioration in its foreign reserves and this significantly weakened its currency. The large current account deficit and huge fiscal deficit were the main reasons the Pakistan authorities requested a USD 7.6 billion stand-by arrangement from the International Monetary Fund (IMF). The first disbursement of USD 3 billion disbursement was made in November 2008.

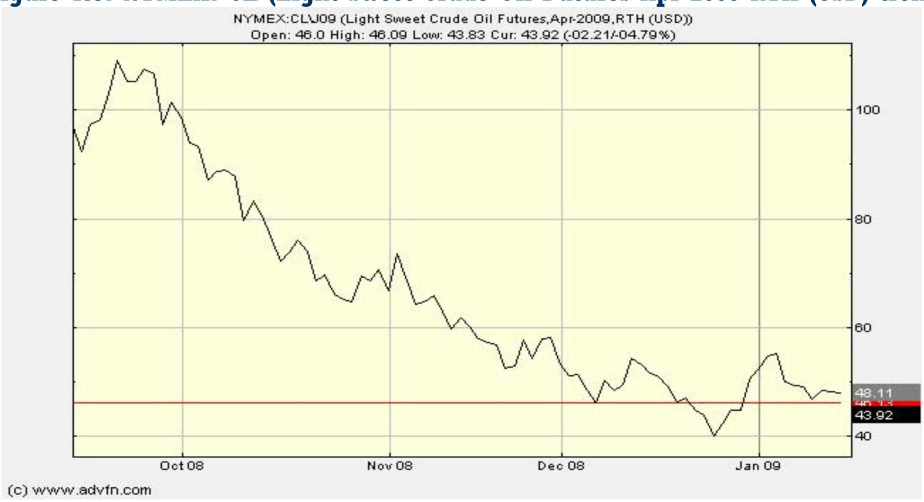
3. COMMODITY AND ASSET PRICES

3.1 Oil prices dropped in the fourth quarter

The slump in global demand has led to a collapse in commodity prices. In the fourth quarter 2008, oil prices plummeted by more than 50 percent although they remain higher in real terms than in the 1990s.

Oil prices which had dropped below USD 100 per barrel on September 15, 2008 from its peak of USD 147.27 on July 11, 2008 continued to drop during the fourth quarter reaching USD 40.06 per barrel on December 24, 2008. At the NYMEX Crude Oil Futures, the prices closed the fourth quarter at USD 50.57. The IMF's baseline petroleum price projection for 2009 is USD 50 a barrel.

Figure 1.3: NYMEX: CL (Light Sweet Crude Oil Futures Apr 2009 RTH (USD) trend

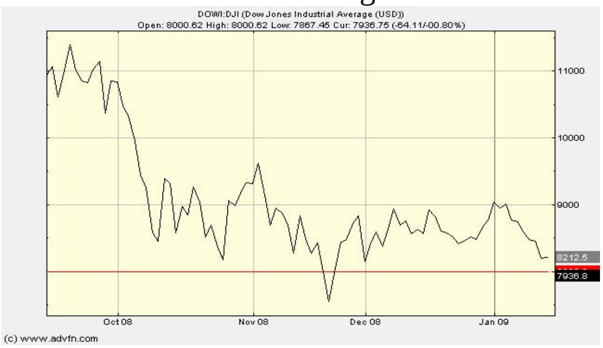


3.2 Equity markets

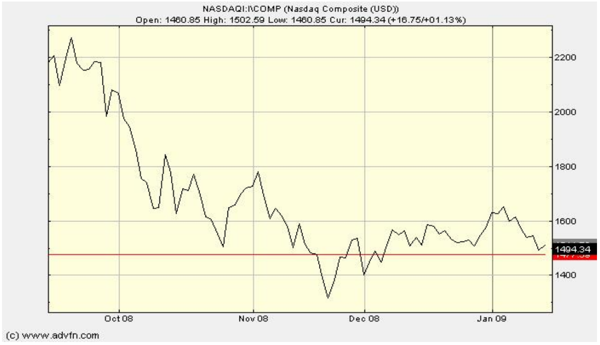
Stock markets received a major shock at the beginning of the fourth quarter of 2008. In October, almost all major stock markets dropped sharply. The Dow Jones was down 19.1 percent, NASDAQ was down 24 percent, S&P 500 was down 22.4 percent, FTSE was down 40 percent, DAX was down 17.2 percent, CAC 40 was down 20.8 percent and the Nikkei lost 22.5 percent of its value during the quarter.

Figure 1.4: Stock markets performance (Sept 15, 2008 – Jan 15, 2009)

Dow Jones Industrial Average

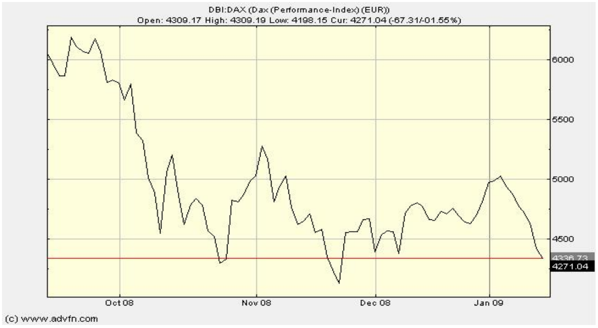


NASDAQ



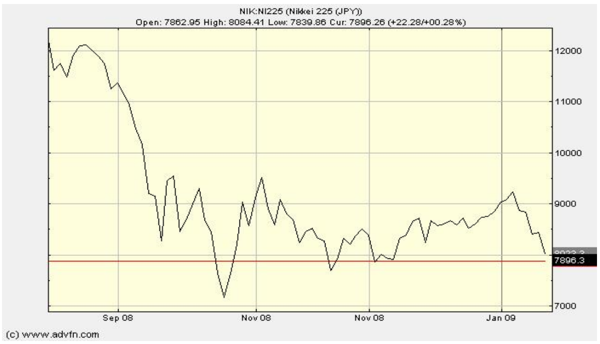
FTSE 100

DAX



CAC 40

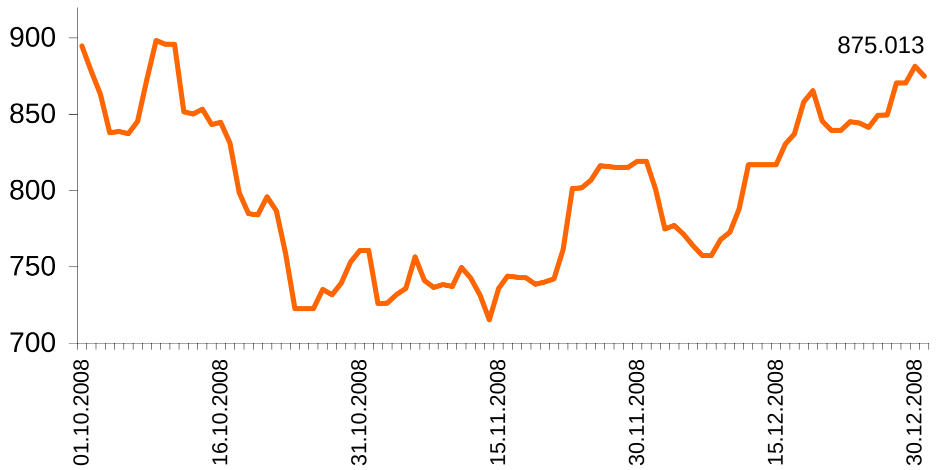
Nikkei



3.3 Gold prices

Gold prices continued its downward trend, at the beginning of the quarter, before experiencing a sharp U-turn on November 14th. Gold prices dropped from USD 894.9 per oz. on October 1st to USD 715.2 per oz. on November 14th and then started to increase, closing the quarter at USD 875 per oz. The increase in gold prices occurred after major decline in stock markets in October. This suggests a flight to safety as investors fled equity markets eventually pushing up the price of gold.

Figure 1.5: Gold prices in USD: quarter four 2008



Source: oanda.com

3.4 Global exchange rates

The USD started to appreciate against the euro in October 2008, but later lost its gains in December. However, it appreciated against pound sterling in the fourth quarter; from £ 0.55 per USD at the beginning of quarter to £ 0.69 at the end.

The Japanese Yen gained value against the US dollar surging from ¥ 104.9 on Oct 1st to ¥ 90.4 on Dec 31.

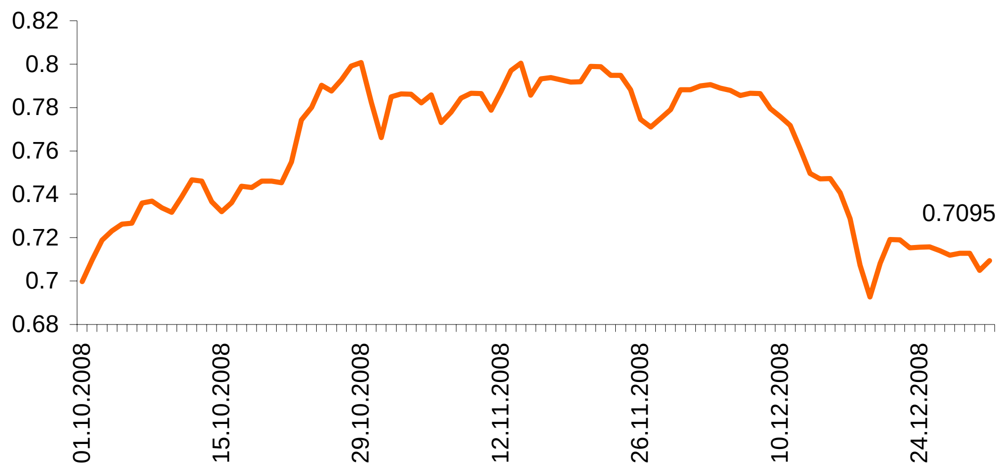
The Swiss franc appreciated from 1.10 to 1.06 in the quarter under review. It started the quarter by losing value to lose value against the USD in October and November. In the second week of December, it appreciated against the USD: USD 1 was CHF 1.22 at the beginning of the week dropping to CHF 1.07 at the end.

Table 1.1: USD Exchange Rates against Major Currencies in the Fourth Quarter of 2008

	EUR	GBP	JPY	CHF
Oct 1, 2008	0.70	0.56	104.89	1.10
Dec 31, 2008	0.71	0.69	90.38	1.06
Average	0.76	0.64	96.29	1.16
Max	0.80	0.69	106.05	1.22
Min	0.69	0.56	88.24	1.05

Source: oanda.com

Figure 1.6: Daily exchange rate USD/EUR



Source: oanda.com

In conclusion the international economic outlook is not favorable. With the global economy in the first recession in decades led by declining output in the world largest economies and signs of significant weakness in emerging powerhouses like China and India. The silver lining for Afghanistan is that the decline in food and oil prices as a result of the global recession will increase real household purchasing power and reduce inflationary pressures.

2

FISCAL DEVELOPMENTS

SUMMARY

The overall fiscal development in the third quarter of 1387 was mixed with some of the fiscal indicators showing good performance while the others did not.

On the negative side the budget deficit in the quarter under review was AF 1,991 million compared to a budget surplus of AF 841 million in the second quarter. This deterioration in the fiscal balance is grounds for concern.

On the positive side, income from capital property increased a staggering 4493 percent to AF 4.1 billion in the quarter under review.

Total domestic revenues increased to AF 13,027 millions in the quarter under review from AF 9,982 millions in the previous quarter, this represents a 31 percent increment and is an alarming trend. Total domestic revenues accounted for 2 percent of GDP, which is well below the regional average.

Total domestic revenues are composed of tax and non-tax revenues. Tax revenue declined to AF 6,503 million in the quarter under review from AF 7,035 million in the previous quarter. This represents a -8 percent decline

On the other hand non-tax revenues increased from AF 2,947 million in the previous quarter to AF 6,524 million in the quarter under review. This represents an increase of 121 percent.

On the spending side total expenditures increased to AF 29,651 million in the quarter under review from AF 28,383 million in the previous quarter. This reveals a 4 percent increase. Total expenditures accounted for 5 percent of GDP.

Total expenditures are classified into development and operating expenditures.

Development expenditures declined to AF 9,824 million in the quarter under review from AF 11,065 million in the second quarter. This represents an 11 percent decline.

On the other hand operating expenditures increased to AF 19,827 million in the quarter under review from AF 17,318 million in the previous quarter. This shows a 14 percent increase.

The total grants allotted to the operating expenditures declined to AF 7,414 million in the quarter under review from AF 9,572 million in the previous quarter. This represents 23 percent decline.

On the other hand total grants allotted to the development expenditures declined to AF 7,122 million in the quarter under review from AF 8,748 million in the previous quarter. This represents a 19 percent decline.

The main contributors to the development expenditures are ARTF, LOTFA, ADB, EC, World Bank, CNTF and others.

1. REVENUES

The total domestic revenues are classified as follow: taxes, customs duties, non-tax revenues and others (social contributions, income from capital properties, sale of goods and services, royalties, non tax fines and penalties, sale of land and buildings) and donors' contributions (see tables 2.1 and 2.2).

Total domestic revenues increased to AF 13,027 million in the quarter under review from AF 9,982 million in the previous quarter, this represents a 31 percent increment and is an alarming trend. Total domestic revenues accounted for 2 percent of GDP, which is well below the regional average.

Total domestic revenues are composed of tax and non-tax revenues. Tax revenues declined by 8 percent from AF 7,035 million in the second quarter to AF 6,503 million in the quarter under review (see Table 2.1).

On the other hand non-tax revenue increased by 121 percent from AF 2,947 million in the second quarter to AF 6,524 million in the quarter under review.

The total grants allotted to the operating expenditures declined to AF 7,414 million in the quarter under review from AF 9,572 million in the previous quarter. This represents 23 percent decline.

On the other hand total grants allotted to the development expenditures declined to AF 7,122 million in the quarter under review from AF 8,748 million in the previous quarter. This represents a 19 percent decline (see Table 2.6).

Key contributors to tax revenues in the quarter under review were the Large Taxpayer Office (LTO) and Medium Tax Payer Offices (MTO) which are located in Kabul.

More than 50 percent of the tax revenue came only from Kabul city, which is due to the fact that a large number of population live in Kabul besides the relatively strong central government. In terms of geographical distribution of customs revenues, the top five provinces (Herat, Balkh, Kandahar, Nangarhar and Nimroz) collectively accounted for about 80 percent of total customs revenues in the quarter under review.

Revenues from customs duties increased slightly by 0.007 percent from AF 3,018 million in the second quarter to AF 3,019 millions in the quarter under review. Sales tax revenues declined by 5 percent from AF 1,519 million in the second quarter to AF 1,516 millions in the quarter under review.

Total social contribution declined by 53 percent from AF 208 million in the second quarter to AF 97 millions in quarter under review (See table 2.3).

Table 2.1: Revenue Collection as of Third Quarter 1387 (in million AF)

Particulars	Q2 1387 Revenue Actual	Q3 1387 Revenue Actual	% ∆ from Q21387 to Q3 1387
Total Domestic Revenues (Tax and Non Tax)	9,982	13,027	31%
Total Tax Revenues	7,035	6,503	-8%
Non Tax Revenues	2,947	6,524	121%

Source: Ministry of Finance website and DAB staff estimations.

Table 2.2: Total Revenues in US dollar (in million of USD)

	Q2 1387	Q3 1387
Tax Revenue	141	130
Non Tax Rev	59	130

Figure 2.1: Revenue Collections Q3-1387
(in million USD)

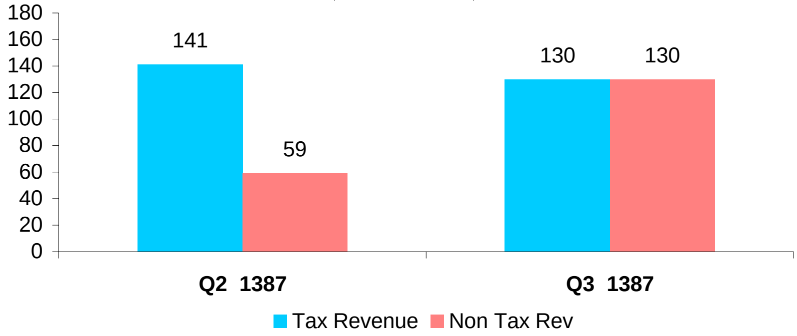


Table 2.3: Breakdown of Revenues into Components (in thousand of AF)

Taxation & Customs Revenues	Total revenue Q3 1387	Total revenue Q2-1387	%∆ from Q2 to Q3
Fixed Taxes	752,361	815,714	-8%
Income Taxes	814,561	1,215,203	-33%
Property Taxes	26,480	37,137	-29%
Sales Taxes	1,516,098	1,591,882	-5%
Excise Taxes	243		
Other Taxes	303,358	237,489	28%
Tax Penalties and Fines	71,243	118,907	-40%
Customs duties	3,019,005	3,018,799	0%
Total taxation revenues	**6,503,349**	**7,035,131**	**-8%**
Social contributions			
Retirement contributions	97,529	207,269	-53%
Total social contributions	**97,529**	**207,269**	**-53%**
Other revenue			
Income from Capital Property	4,124,748	89,804	4493%
Sales of Goods and Services	494,631	573,338	-14%
Administrative Fees	1,625,066	1,437,257	13%
Royalties	9,603	11,574	-17%
Non Tax Fines and Penalties	34,450	28,913	19%
Miscellaneous Revenue	224,028	588,262	-62%
Sale of Land and Buildings	11,547	10,527	10%
Total other revenue	**6,524,073**	**2,739,675**	**138%**

Source: Ministry of Finance website and DAB staff estimations.

2. EXPENDITURES

Total expenditures increased to AF 29,651 million in the quarter under review from AF 28,383 million in the previous quarter. This represents a 4 percent increase (see Table 2.4).

Total expenditures are classified into development and operating expenditures.

Development expenditures declined to AF 9,824 million in the quarter under review from AF 11,065 million in the previous quarter. This represents an 11 percent decline

On the other hand operating expenditures increased to AF 19,827 million in the quarter under review from AF 17,318 million in the previous quarter. This represents 14 percent increase (see table 2.4).

Recurrent expenditures are classified into the following five categories:

(a) Compensation of employees,

(b) Goods and services,

(c) Subsidies and grants,

(d) Interest payment,

(e) Acquisition of non-financial assets,

Expenditures on compensation of employees in the quarter under review declined to AF 11,719 million in the quarter under review from AF 11,800 million in the previous quarter. This represents 1 percent decline (see Table 2.6).

Expenditures on supplier stood to AF 10,423 million in the quarter under review up from AF 6,939 million in the previous quarter. This represents a 66 percent increase.

Expenditures on interest payments declined by 62 percent in the quarter under review compared with that in the second quarter. Expenditures on interest payments stood at AF 32,210 million in the quarter under review down from AF 51,738 million in the previous quarter. Expenditures on subsidies, grants and contribution, increased to AF 1,177 million in the quarter under review up from the AF 1,093 million in the previous quarter. This reveals an 8 percent increase.

The breakdown of the operating budget into its components is as follow:

The central (line) ministries operating expenditures stood at AF 11,820 million in the quarter under review compared to AF 9,253 million in the previous quarter.

This represents 27.7 percent increase. Expenditures of some populated and industrial provinces such as Herat stood at AF 726 million, Kabul AF 256 million, Paktiya AF 525 million, Balkh AF 733 million, Nangarhar AF 477 million, Kandahar AF 870 million and the rest of the operating budget was allotted to all other provinces.

Table 2.4: Core Expenditures as of Third Quarter 1387 (in million AF)

Types of expenditures	Q2 1387 Budget Actual	Q3 1387 Budget Actual	% Δ from Q21387 to Q3 1387
Core Budget Expenditures (Development and Operating Expenditures)	28,383	29,651	4%
Development Expenditure	11,064	9,824	-11%
Operating Budget	17,317	19,827	14%

Source: Ministry of Finance website/ DAB staff estimation

Table 2.5: Total Expenditures (in thousand of USD)

	Q2 1387	Q3 1387
Operating Budget	346	397
Development Budget	221	196

Figure 2.2: Afghanistan Budget
(in million USD)

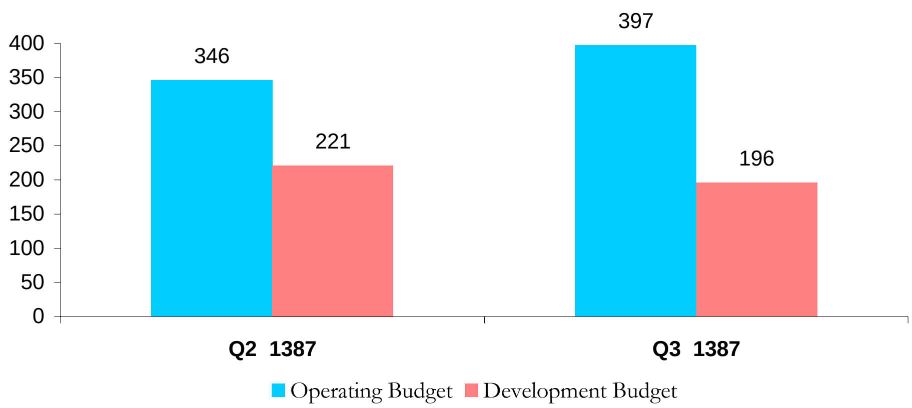


Table 2.6: Breakdown of Expenditures

	Q3 FY1387	Q2 FY 1387	%Δ from Q2 to Q3
Employees			
Salaries in cash	9,303,263	9,363,331	-1%
Salaries in kind	2,265,800	2,287,832	-1%
Salaries and wages advance	34,081	43,336	-21%
Social benefits in cash	116,757	105,950	10%
Social benefits - in kind	25		
Total employee expenditure	**11,719,926**	**11,800,450**	**-1%**
Supplier Expenditure			
Travel	303,684	293,345	4%
Communications	107,826	118,319	-9%
Contracted services	2,879,196	2,358,352	22%
Repairs and maintenance	870,367	504,104	73%
Utilities	288,686	219,096	32%
Fuel	678,816	584,883	16%
Tools and materials	1,292,581	1,098,551	18%
Other	399,101	322,439	24%
Advances and return of	3,603,599	1,439,779	150%
Total supplier expenses	**10,423,856**	**6,938,866**	**50%**
Subsidies, grants, contributions			
Grants	2,900	(350)	-929%
Social security benefits cash	707,472	917,693	-23%
Social assist benefit in cash	130,918	45,953	185%
Advance Subsides Grants	335,555	130,000	158%
Total subsidies, grants, contributions and pensions expenditure	1,176,845	1,093,295	8%
Capital expenditure			
Buildings and structures	3,882,187	2,930,732	32%
Machinery and equip (>50,000)	1,195,908	999,116	20%
Valuables	30		
Land	262,343	3,304	7841%
Capital advance payments	958,699	4,565,081	-79%
Total capital expenditure	**6,299,167**	**8,498,233**	**-26%**
Interest			
Interest	32,210	51,738	-38%
Total interest expenditure	**32,210**	**51,738**	**-38%**

Source: Ministry of Finance website/ DAB staff estimation

3. FINANCING THE CORE BUDGET

With expenditures growing faster than revenues, financing the core budget will be a major challenge for the rest of the year. Financing the budget deficit is really a daunting task and there are different sources of financing deficit

While cutting back on expenditures could be considered as an option to reduce the budget deficit, however, governments usually resort to domestic and foreign borrowing in order to finance the deficit.

Total expenditures exceeded total revenues by 16,624 millions in the quarter under review (see Tables 2.1 and 2.4)

Total loans in the quarter under review amounted to AF 8,769 million, while the total grants stood at AF 8,420 million in the same period. Loans and grants were one of the main contributors to financing the beget deficit in the quarter under review (see Table 2.7).

Afghanistan needs and has potential to increase its domestic revenues by undertaking structural reforms and ensuring transparency and efficiency. In addition to that Afghanistan has significant untapped mineral resources such as copper, iron, gold, coal and semi-precious stones. Despite considerable exploration and deposit identification, large-scale mining has had limited development and represents less than one percent of GDP.

Recently Afghanistan has taken the first step toward exploration and exploitation of Aynak copper mine. According to the relevant authorities, this project will generate a good level of income for the government, and provide job opportunities for more than 6,000 people directly and for thousands others indirectly.

Total FDI inflows associated with this project is projected at USD 2.8 billion over the next six years. The annual production rate of up to 200,000 tons of copper accounts for 1.3 percent of total world copper production. This will account for 2 percent of GDP in the next ten years. The fiscal revenues in terms of royalties and taxes are projected to be around USD 200 million per year, when the production rate reaches at its expected peak.

An ambitious program is also being planned to build the necessary infrastructure, which will boost activities in the construction, water and electricity, coal, and transport sectors.

Table 2.7: Loans and Grants, Q3-1387

Donor contributions	Operating Budget	Development Budget	Total
Afghanistan reconstruction trust fund	3,105,864	1,785,232	4,891,096
Law and order trust fund - Afghanistan	2,944,989		2,944,989
CSTC - MoD	584,336		584,336
Foreign loans			
World Bank		239,966	239,966
Asian Development Bank		1,110,663	1,110,663
Other		3,726	3,726
Donor revenue			
World Bank		1,282,087	1,282,087
European Commission		26,833	26,833
ADB		439,616	439,616
CNTF		446,582	446,582
Others	779,258	1,787,120	2,566,378
Total donor contributions	**7,414,448**	**7,121,825**	**14,536,272**

Source: Ministry of Finance website/ DAB staff estimation

3

INFLATION TRENDS AND OUTLOOK

SUMMARY

Afghanistan continued to suffer from imported inflation in the quarter under review although there were signs that the global economic recession could lead to downward pressure on food and energy prices.

Headline consumer price index (CPI), the broadest measure of general price level, stood at 194.2 at the end of the third quarter of 1387 representing an inflation rate of 22.7 percent up from 17 percent in the same period a year ago. The period average inflation rose to 30.5 percent in the quarter under review from 8.5 percent in the same quarter a year ago.

The increase in the CPI was mainly attributed to increases in the prices of food and oil. The food price index rose by 30.3 percent because of an increase in demand in international markets.

Core inflation as calculated by the trimmed mean also increased by 11.2 percent in the quarter under review up from 5.6 percent in the same quarter a year ago. The high and accelerating rate of core inflation remains a concern for monetary policy.

1. INFLATION IS MODERATING IN THE THIRD QUARTER

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation, as measured by year-on-year percentage changes in Kabul CPI, increased to 22.7 percent in the third quarter of 1387 up from 17 percent in the same quarter a year ago. The CPI measures the average price of a fixed set (or basket) of goods. The basket of goods is intended to reflect all the items a typical family buys to achieve some minimum standard of living in some base period (currently 2004). The CPI does not count the price of each item equally but weights each according to its share of total household expenditures in the base period, so that changes in the index from one period to the next are broadly reflective of changes in a representative household's current cost of living.

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

	Weight	1385				1386				1387		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3*	Q4	Q1	Q2	Q3*
Headline	**100**	**5.5**	**5.4**	**3.5**	**4.8**	**8.1**	**12.1**	**17**	**20.7**	**33.3**	**35.7**	**22.7**
Food and Beverages	**61.3**	**2.9**	**3.8**	**2.8**	**6.3**	**11.8**	**15.8**	**25.6**	**30.6**	**48.6**	**52.7**	**30.3**
Bread and Cereal	28	0.7	-0.2	-3.1	3.6	13	21.5	42.6	51.8	91.4	91.9	49.4
Milk and cheese	5.6	2.3	4.7	4.6	6.8	18.9	22	24.1	21.7	8.8	9.6	7.3
Oil and Fat	5.3	-1.2	2.6	6.9	17	43	36.7	42.5	45.2	20.2	27	-1.7
Non – Food	**38.7**	**9.4**	**7.6**	**4.4**	**2.5**	**3**	**7.1**	**5.4**	**6.9**	**10.3**	**10.8**	**10.5**
Housing	17.2	10.5	6.7	3.3	-1	1.3	10	5.4	6.5	10.3	9.9	10.3
Rents	7.1	8.6	1	-21.9	-27.1	-25.3	-19.9	-2.8	1.8	6.8	7.6	8.8
Construction materials	3.2	1.8	-5.4	-11.9	-11.3	-5.3	8.7	17.1	17.9	15.6	17.3	11.2
Fuel and Electricity	6.8	19.4	24.7	54.8	51.4	52.8	58.4	9.5	7.5	11.9	9.5	11.2
Transportation	2.3	23.7	27	16.5	31.2	16	8.5	14.6	23.9	40.5	25.9	21.3
Core inflation		**4.2**	**5.1**	**3.6**	**6.4**	**4.2**	**6.3**	**5.6**	**5.9**	**9.5**	**13.5**	**11.2**

Source: Central Statistical Office and DAB staff calculations.
* The y-o-y changes at the end of quarter, September – September

The breakdown of Kabul headline CPI inflation is presented in Table 3.1 and illustrated in Figure 3.4. The increase in Kabul headline CPI to 22.7 percent in the third quarter of 1387 from 17 percent in the same quarter a year ago was mainly the result of increases in the following five sub-indices.

First, the food sub-index which accounts for 61.3 percent of the CPI basket increased. This price index rose by 30.3 percent as a result of recent developments in international markets.

The supply of wheat and other staples in international markets decreased while demand increased in some major emerging market countries such as China and India. Bio-fuel production is one of the main contributors to the decline in supply of food staples. On the demand side, population growth and increasing income levels in some emerging countries, such as China and India are the major contributors to the increase in this sub-index.

Within Afghanistan, agricultural production has been badly affected by the drought especially in the central, northern and some parts of the south and east of the country. In addition, Pakistan and Tajikistan banned private wheat exports to Afghanistan. Overall, the upward trend in the food sub-index began in February 2007 and has continued its upward trend reaching a peak of 66.1 percent in May 2008. The food sub-index was volatile in the first nine months of 1387 and decreased to 30.3 percent in the quarter under review.

Second, the bread and cereals sub-index which accounts for 28 percent of the CPI increased. This price index rose dramatically by 49.4 percent in the quarter under review from 42.6 percent in the same quarter a year ago. The increase is attributed to recent developments in international markets including drought in major grain producing countries which was exacerbated by drought conditions in Afghanistan.

Third, the non-food sub-index which accounts for 38.7 percent of the CPI basket increased. This sub-index rose by 10.5 percent in the quarter under review compared to 5.4 percent in the same quarter a year ago. The main drivers of the increase are rents, fuel and electricity and transportation sub-indexes.

Fourth, the rents sub-index which accounts for 7.1 percent of the CPI basket increased. This sub-index rose by 8.8 percent in the quarter under review, compared to -2.8 percent in the same quarter a year ago. One of the reasons fore this rise could be attributed to the compulsory repatriation of Afghan refugees from neighboring countries such as Iran and Pakistan which led to increased demand for housing pushing up the rent sub-index.

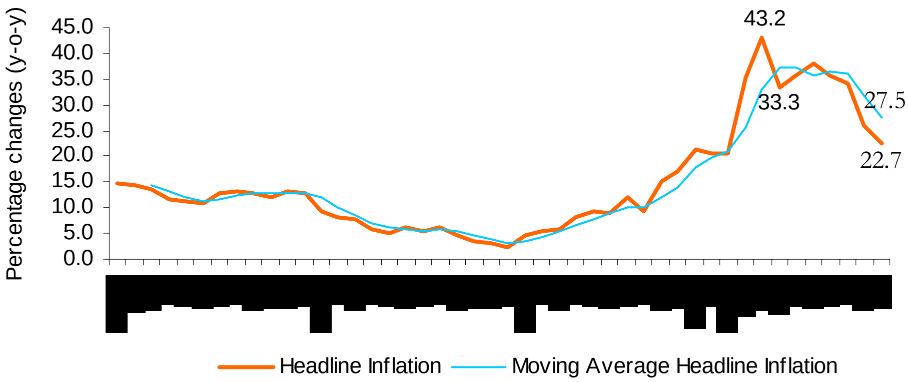
Fifth, the transportation sub-index which accounts for 2.3 percent of the CPI basket increased. This sub-index rose by 21.3 percent in the quarter under review to compare with 14.6 percent at the same quarter a year ago as a result of developments in international oil prices.

On the other hand the following categories of the Kabul headline CPI posted declines:

First, the construction material sub-index which accounts for 3.2 percent of the CPI basket declined. This sub-index declined by 11.2 percent in the quarter under review, compared to 17.1 percent in the same quarter a year ago.

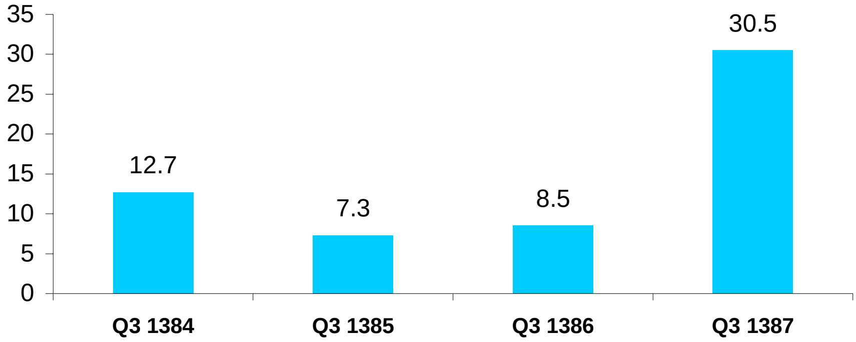
Second, the oil and fats sub-index which accounts for 5.3 percent of CPI basket declined. This sub-index fell by (-1.7) percent in the third quarter of 1387 compared to 42.5 percent in the same quarter a year ago.

Figure 3.1: Headline inflation: Kabul CPI



Source: Central Statistics Office and DAB staff calculations.

Table 3.2: Period Average: Kabul Headline Inflation
(end of quarters)

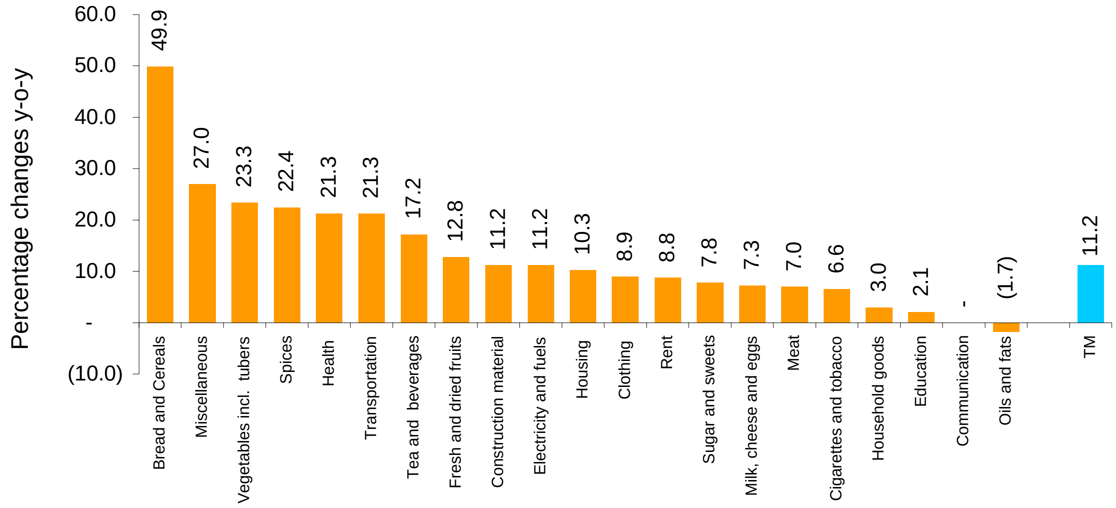


Source: Central Statistics Office and DAB staff calculations.

The volatility of Kabul inflation measured by its standard deviation was 5.8 percent in the third quarter of 1387, up from 3.3 percent in the same quarter a year ago. The volatility of inflation remains concern to the monetary policy.

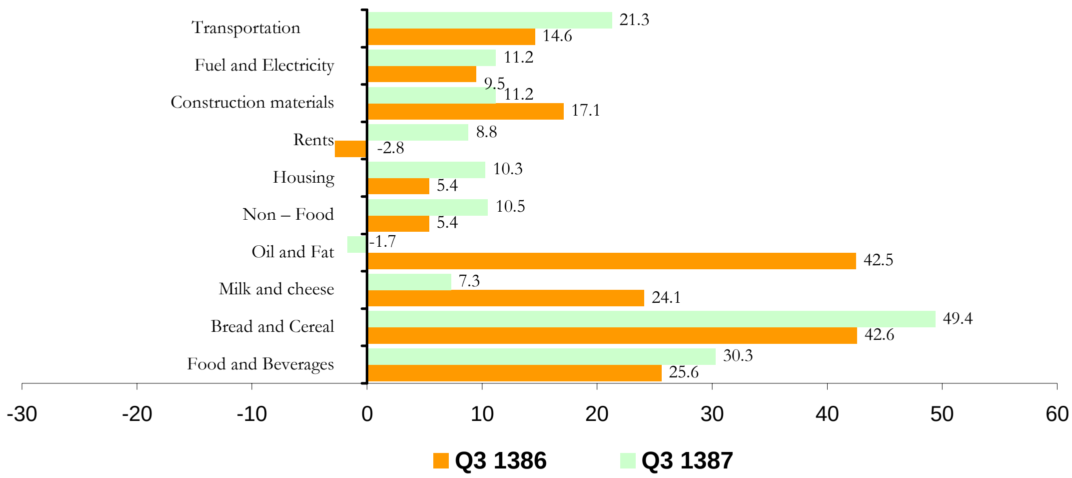
The analysis of inflation trends includes a measure of core inflation because comparing one period's price statistics with another period gives a crude measure of inflation (if the general level of prices has risen). In particular, such measures of inflation do not discriminate between relative price changes and inflation, so an increase in the price of a single item, such as food, may cause the price index to rise. For this reason, a measure of core inflation, which is obtained by excluding the most extreme items in the CPI basket, is used. The trimmed mean method of calculating core inflation eliminates the items with the greatest positive and negative fluctuations from the CPI basket and recalculates a more robust inflation measure which is not subject to criticism of standard core inflation indicators that exclude the same item (e.g. oil) from the CPI. Trimmed mean inflation stood at 11.2 percent in the third quarter of 1387 up from 5.6 percent in the same quarter one year ago.

Figure 3.3: 28%Trimmed Mean Inflation
(December 2008)



Source: Monetary Policy Department (DAB)/ Central Statistics Office

Figure 3.4: Contribution to Kabul CPI inflation



Source: Monetary Policy Department (DAB)/ Central Statistics Office

1.2 Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis. Headline inflation, as measured by year-on-year percentage changes in national CPI increased by 23.8 percent in the third quarter of 1387 up from 20.5 percent in the same quarter a year ago. The breakdown of national CPI into its respective components is presented in Table 3.2 and illustrated in Figure 3.5

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

	Weight	1385				1386				1387		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3*
Headline	100	**5.7**	**5.3**	**3.4**	**3.8**	**9.6**	**14.9**	**20.5**	**24.3**	**41.5**	**38.8**	**23.8**
Food and Beverages	61.3	**4.1**	**4.1**	**3.5**	**4.9**	**13**	**16.8**	**27.1**	**31.9**	**57.9**	**56.8**	**32.6**
Bread and Cereal	28	2.3	1.2	-1.1	3	16.2	20.8	41.8	50	100.4	97.4	51.5
Milk and cheese	5.6	7.9	6.6	7.1	6.6	10.9	15.1	14.7	15.6	14.8	13.7	10.6
Oil and fat	5.3	2.5	-0.2	4.9	3.2	24.5	40.3	42.2	52.3	40.6	27.3	0.3
Non – Food	**38.7**	**8**	**7**	**3.6**	**2.2**	**4.4**	**11.9**	**11**	**12.2**	**4.6**	**10.5**	**8.9**
Housing	17.2	8.9	5.1	1.5	-1.5	3.7	15	12.1	13.3	13.9	9.5	6.3
Rents	7.1	3.3	-4.2	-14.7	-20	-12.8	-3.7	4.7	11.7	9.1	3.5	4.3
Fuel and Electricity	6.8	17.9	21.8	26.1	25.3	28.6	40.4	18.6	14.8	18.7	14.3	7.5
Transportation	2.3	25.2	31.8	11.9	21.1	11.7	11.1	20.5	27.9	36.4	27.9	17.1
Core inflation		**4.9**	**5.3**	**4.1**	**5.2**	**11**	**10.4**	**10.2**	**10.8**	**12.4**	**11.7**	**9.9**

Source: CSO and DAB staff calculations.
* The figures reported in the Q columns are y-o-y changes at the end of that quarter.

The increase in the national CPI inflation to 23.8 percent in the third quarter of 1387 from 20.5 percent in the same quarter a year ago was the result of increases in the following sub-indices.

First, the food sub-index which accounts for 61.3 percent of the CPI basket increased. This sub-index rose by 32.6 percent at the end of quarter under review from 27.1 percent at the end of the same quarter a year ago. The main reasons behind this increase are thought to be the decline in supply and an increase in demand in international markets. The production of food in major food producing countries, such as USA, Canada, and Australia declined sharply due to poor weather conditions. In addition, the conversion of food grains into bio-fuels also contributed to the decline in global supply. On the demand side, population growth and increasing income levels in some emerging countries, such as China and India put upward pressure on this sub-index.

Second, the bread and cereals sub-index which accounts for 28 percent of the CPI basket increased. This sub-index rose by 51.5 percent at the end of quarter under review from 41.8 percent at the end of the same quarter a year ago as a result of developments in the food prices in international markets. The conversion of food grains into bio-fuels also contributed to the decline in global supply.

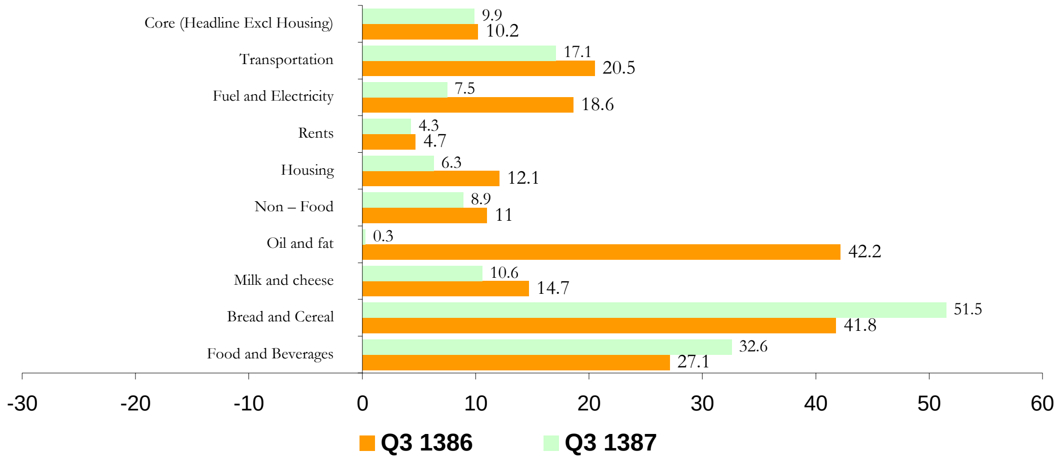
Security developments in the region have also contributed to a decline in food exports to Afghanistan. For example Pakistan banned private wheat export to Afghanistan, which caused this sub-index go up in this quarter.

On the other hand some categories of the national CPI posted declines:

First, the oil and fats sub-index which accounts for 5.3 percent of the CPI basket declined This sub-index declined by 0.3 percent at the end of third quarter of 1387 from 42.2 percent in the same quarter a year ago.

Second, the fuel and electricity sub-index accounts for 6.8 percent of the CPI basket declined. This sub-index declined by 7.5 percent at the end of the quarter under review from 18.6 percent at the end of the same quarter a year ago. The breakdown of national CPI is presented in Figure 3.5.

Figure 3.5: Contribution to national CPI inflation

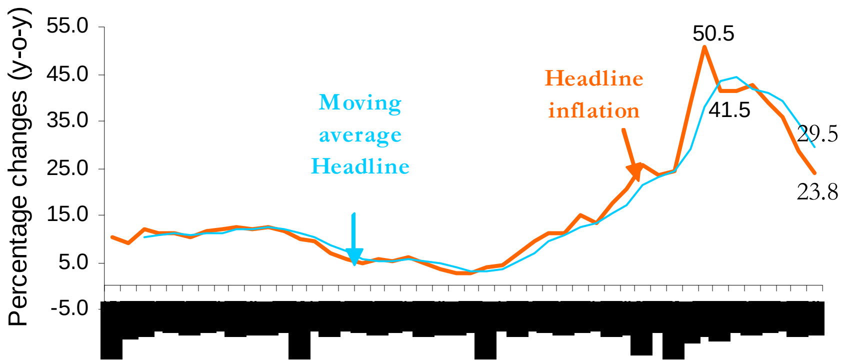


Source: Monetary Policy Department (DAB)/ Central Statistics Office

The volatility of inflation for national CPI as measured by the standard deviation in the third quarter of 1387 was 6.08 percent, up from 2.2 percent in the same quarter a year ago. The high rate volatility of inflation remains concern for monetary policy.

Figure 3.6 presents inflation trend for national CPI.

Figure 3.6: Headline inflation: national CPI



Source: Monetary Policy Department (DAB)/ Central Statistics Office

Box 2: Why CPI is used to measure Inflation?

The monthly Consumer Price Index (CPI) is one of the most closely watched statistics by Da Afghanistan Bank. The importance of the CPI lies in the fact that it measures the rate of change in the general price level which is a key indicator of macroeconomic stability. Therefore, it is of critical importance that the CPI should measure inflation accurately or that the degree of bias be known. However, four main sources of upward bias that cause the CPI to overstate inflation have been identified[1]:

- Quality bias
- Substitution bias
- New goods bias
- Outlet bias

Quality bias: This bias arises because some of the increase in the price of an item may be due to an improvement in quality, rather than being a pure price increase. For example, when car prices rise, this may be due to the addition of seat belts, air bags, or anti-smog devices, or to pure price inflation.

Substitution bias: Substitution bias occurs because the CPI measures the price changes of a fixed basket of goods and services and thus does not capture the savings that households enjoy when they change their spending in response to relative price changes of goods and services. For example, a rise in the price of beef leads people to buy more chicken in order to keep their food costs down. At least two types of substitution bias have been identified. The first is lower-level substitution bias and occurs when consumers substitute between similar items within a category (e.g., substituting between pippin and gala apples). The second type is called upper-level substitution bias and occurs when consumers substitute between items from different categories (computers for television sets, for example) in response to price changes.

New product bias: This bias occurs because new products, such as DVDs and cellular phones, are not introduced into the index until they are commonplace items. This means

[1] The Buskin Commission issued a report titled "Toward a More Accurate Measure of the Cost Of Living" on December 4, 1996, that concluded that in the USA the CPI overstated inflation by about 1.1 percentage points per year in 1996 and about 1.3 percentage points prior to 1996.

that the substantial price decreases and quality increases that occur during the early years following introduction are not captured by the index. A problem of dealing with this bias is that the CSO can never know in advance which of the many new products introduced each year will be successful and hence worthy of inclusion in the CPI.

Outlet bias: This type of bias is similar to substitution bias, but refers to where households shop rather than to what they purchase. As consumers move from shopping in small neighborhood shops to large shopping centers they may enjoy lower prices as a result of the large shopping centers offering high-volume purchases at reduced prices. The expansion of these establishments will not be adequately represented in the CPI, thus creating an upward bias.

Since the DAB uses the CPI as an indicator of price inflation, a more accurate index should make anti-inflationary monetary policy more effective. The public will have a better indicator to check how well the DAB is doing its job. This will require research to determine the magnitude of the bias and actions to remove the upward bias in inflation.

3. Quarterly changes in Kabul headline CPI

This section analyzes trends in quarter-on-quarter changes in Kabul headline CPI.

The Kabul headline CPI in the third quarter of 1387 fell by -4.3 percent from 8 percent in the second quarter of 1387. The decline in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages; This sub-index fell by -6.6 percent in the quarter under review from 8.1 percent in the second quarter of 1387 with a contribution of -8.6 percent by bread and cereals, -16.2 percent by oils and fats, -3.7 percent by vegetables and -0.3 percent by tea and beverages sub-indexes respectively.

Non-food; This sub-index rose by 0.5 percent in the quarter under review form 7.7 percent in the second quarter of 1387, with a contribution of -4.3 percent by construction materials, 3.3 percent by fuel and electricity, -2.4 percent by transportation and 1.8 percent by health sub-indexes. The reason behind the decline is believed to be the slowdown in the world economy as a result of which the price of crude oil fell below USD 100 per barrel in international markets. Table 3.3 presents price indicators for quarter-on-quarter changes in Kabul CPI.

Table 3.3: Quarter-on-Quarter Changes in Kabul Headline CPI

(percent changes quarter on quarter)

Consumer Price Index

(March 2004 = 100)

	Weight	1385				1386				1387		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	**100**	**-0.7**	**2.2**	**1.6**	**1.7**	**2.4**	**6.0**	**5.9**	**5.0**	**13.1**	**8.0**	**-4.3**
Food and Beverages	**61.3**	**-0.4**	**1.6**	**0.8**	**4.2**	**4.7**	**5.3**	**9.4**	**8.3**	**19.1**	**8.1**	**-6.6**
Bread and Cereal	28	-3.1	0.7	-0.3	6.5	5.7	8.2	17.0	13.4	33.3	8.6	-8.6
Meat	6	0.5	2.6	-0.3	1.5	-2.6	-4.6	5.1	6.6	-1.0	0.0	1.4
Oil and Fat	5.3	0.7	3.5	3.9	8.2	23.0	-1.1	8.3	10.2	1.8	4.5	-16.2
Vegetables	4.9	10.1	2.4	4.3	3.2	-5.7	11.5	0.2	0.6	13.5	12.2	-3.7
Tea and beverages	2	2.3	2.2	0.5	-0.7	1.4	2.3	-1.5	1.7	10.6	4.5	-0.3
Non – Food	**38.7**	**-1.2**	**3.0**	**2.5**	**-1.7**	**-0.7**	**7.1**	**0.8**	**-0.3**	**2.5**	**7.7**	**0.5**
Construction materials	3.2	-2.7	-2.9	-6.3	0.1	3.9	11.5	0.9	0.9	1.8	13.2	-4.3
Fuel and Electricity	6.8	-4.8	12.3	47.2	-3.7	-4.0	16.4	1.7	-5.4	-0.1	13.9	3.3
Transportation	2.3	18.0	19.8	-4.2	-3.1	4.3	12.0	1.3	4.3	18.8	0.3	-2.4
Health	2	2.8	0.8	0.5	3.0	0.1	0.7	0.0	2.5	4.5	11.4	1.8

Source: Central Statistics Office and DAB staff calculations.

1.4. Quarterly changes in national headline CPI

This section describes quarter-on-quarter changes in national headline CPI. The national headline CPI fell by -4.6 percent in the quarter under review from 5.2 percent in the second quarter of 1387. The decrease in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages; This price index decreased by -7 percent in the third quarter of 1387 compared with 5 percent in the second quarter of 1387. Bread and cereals sub-index fell by -10.4 percent and oil and fat by -14.6 percent and milk and cheese fell by 0.8 percent respectively.

Non Food; This sub-index fell by 0.7 percent in the quarter under review compared with 5.6 percent in the second quarter of 1387. The housing sub-index decreasing by -0.5 percent, rents fell by 1.3 percent, fuel and electricity -1.2 percent and transportation fell by -2 percent respectively.

Table 3.4 presents price indicators for quarter-on-quarter changes in national CPI.

Table 3.4: Quarter on Quarter Changes in National Headline CPI
(percent changes quarter-on-quarter)
Consumer Price Index
(March 2004 = 100)

	1385				1386				1387		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	**-1.7**	**2.27**	**1.89**	**1.3**	**3.8**	**7.2**	**7**	4.4	**18.2**	**5.2**	**-4.6**
Food and Beverages	**-1.9**	**2.32**	**1.09**	**3.3**	**5.8**	**5.8**	**10**	7.2	**26.7**	**5**	**-7**
Bread and Cereal	-4	2.9	-0.7	4.9	8.3	6.9	16.7	11	44.7	5.3	-10.4
Milk and Cheese	-0.2	1.6	4	1.6	3.9	5.4	3.6	1.9	3.1	4.4	0.8
Oil and Fat	-4.6	-0.5	7.1	1.5	15.2	12.0	8.5	8.7	6.4	1.5	-14.6
Non – Food	**-1.4**	**2.2**	**3.1**	**-1.5**	0.6	**9.5**	**2.3**	-0.4	**2.8**	**5.6**	**0.7**
Housing	-4.84	1.82	5.14	-3.3	0.2	13	2.5	-2.3	0.7	8.5	-0.5
Rents	-6.33	-1.55	-7.43	-6.3	2.1	8.7	0.6	0	-0.3	3.2	1.3
Fuel and Electricity	-5.53	8.54	24.2	-1.6	-3.1	18.6	5	-4.8	0.2	14.2	-1.2
Transportation	14.5	12.1	-1.3	-4.4	5.6	11.5	7.0	1.5	12.6	4.6	-2

Source: Central Statistics Office and DAB staff calculations.

2. INFLATION OUTLOOK

Afghanistan is a net importing country and is vulnerable to high global prices. However, the inflation rate remained above 30 percent in the first six months of the year, but it had a downward trend since beginning of the third quarter of 1387 reaching at 22.7 percent at the end of quarter under review. Considering the decline in the food and oil prices in the international markets, as well as measures taken by the Afghan government in response to shortage in wheat supply, it is expected that the downward trend in inflation will continue in the upcoming months and finally will result further stability in the prices.

2.1 Risks to inflation

In the foreseeable future risks to inflation remain. These risks include a prolonged liquidity surge due to foreign exchange inflows from remittances, the illegal opium trade and the donor funds.

4

MONETARY AND CAPITAL MARKET DEVELOPMENTS

SUMMARY

Monetary and capital market performance was positive in the quarter under review. The central bank kept liquidity at an adequate level which was favorable to overall economic activity.

Narrow money (M1) grew by 8.7 percent in the third quarter compared to 11.7 percent in the second quarter. Currency outside the depository corporations which is a component of narrow money grew by 8.2 percent in the quarter under review up from 6.2 in the previous quarter. However, quasi-money contracted by 21.6 percent, while it had a 7.5 percent growth in the previous quarter.

Reserve money which is composed of currency in circulation, bank deposits with the central bank (excess reserves, required reserves) and overnight deposit facility increased by 20 percent in the third quarter up from 8 percent in the previous quarter. This is due to a significant increase in bank deposits with the central bank, which increased by 116 percent in a quarterly comparison.

Net foreign assets (NFA) increased by 5.68 percent in the quarter under review down from 6.8 percent in the previous quarter. In contrast, net domestic assets (NDA) decreased by 3.01 percent (quarterly change) in the third quarter, while its reduction in the second quarter was even larger: a decrease of 11.6 percent.

1. PRGF MONETARY PROGRAM

Da Afghanistan Bank has two quantitative performance criteria and an indicative target under the PRGF framework designed jointly by DAB and the IMF. The three targets are a ceiling on currency in circulation (CiC) growth, a floor on net international reserves and an indicative target for reserve money. DAB successfully achieved all quantitative performance criteria in the third quarter of 1387.

Currency in circulation, the most liquid portion of money, remained on track in the quarter under review (Figure 4.1). The CiC growth ceiling under the PRGF program for the first quarter (June 19, 2008) was set at 9.12 percent, while the actual currency in circulation growth was 7.33 percent. As to the second quarter (Sep 21, 2008), currency in circulation ceiling was 18.24 percent while DAB closed the actual currency in circulation growth at 13.20 percent. The target for the third quarter (Dec 21, 2008) was 25.67 percent and the DAB managed to achieve a growth of 24.23 percent well below the PRGF ceiling.

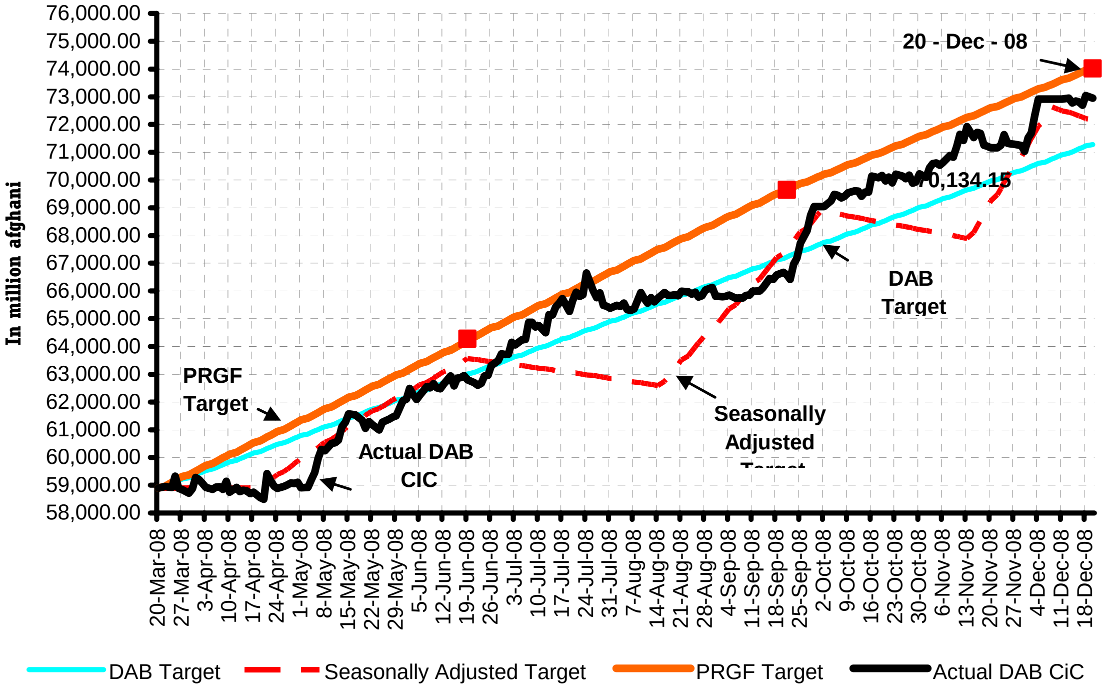
Reserve money increased by 20 percent in the third quarter up from 8 percent in the second quarter 1387. This is due to an increase in bank deposits with the DAB which expanded to AF 14.7 billion in the third quarter up from AF 6.8 billion in the second quarter. This shows an increase of 116 percent in the quarter under review compared to 34 percent growth in the previous quarter.

Table 4.1: PRGF and Actual CIC Growth

	Q1 (June 19, 08)	Q2 (Sept 21, 08)	Q3 (Dec 20, 08)
PRGF CiC Ceilings (%)	9.12	18.24	25.67
Actual CiC (%)	7.33	13.2	24.23
PRGF CiC Amount	64,271.79	69,644.29	74,016.79
Actual CiC Amount	63,217.85	66,675.79	73,173.09

Source: Monetary Policy Department (DAB)

Figure 4.1: Daily Currency in Circulation
(DAB Actual, Target and PRGF Ceiling) Third Quarter 1387



Source: Monetary Policy Department/DAB

Net domestic assets declined by 2 percent in the third quarter compared with the second quarter, while its quarter-on-quarter changes in the second quarter was 8 percent. This shows a -9 percent deviation form the Monetary Program. The decline in NDA is mostly due to a decrease in net claims on general government which reduced by 6 percent compared to a positive growth of 12 percent in the previous quarter. The net foreign assets stood at AF 160.9 million.

On the other side, net foreign assets increased by 9 percent in the third quarter up from 8 percent in the second quarter 1387. It is driven by foreign exchange reserves which increased by 10 percent up from 7 percent in the previous quarter. In addition, the decline in foreign liabilities of the DAB by 2 percent contributed also in raising the net foreign assets.

Table 4.2: Performance of Afghanistan Monetary Program, Third Quarter 1387 (In million AF)

	1387		Quarter Change (Q1 -Q2)	1387		Quarter Change (Q2- Q3)	Deviation From Target
	Q1	Q2		Q3			
	Actual	Actual		Target	Actual		
1. Net Foreign Assets (a+b)	**137,220**	**148,248**	**8%**	**162,106**	**160,987**	**9%**	**-1%**
(a) Foreign Assets (i+ii)	142,263	153,078	**8%**	168,061	165,745	**8%**	**-1%**
i. Foreign exchange reserve	133,872	143,667	**7%**	157,459	157,351	**10%**	**0%**
ii. Other foreign assets	8,391	9,411	**12%**	10,602	8,394	**-11%**	**-21%**
(b) Foreign liabilities	-5,043	-4,830	**-4%**	-5,954	-4,758	**-2%**	**-20%**
2. Net Domestic Assets (a+b)	**-69,362**	**-74,839**	**8%**	**-80,537**	**-73,196**	**-2%**	**-191%**
(a) Domestic Assets	-25,065	-27,956	**12%**	-36,973	-26,298	**-6%**	**-29%**
i. Net claims on general government	-25,065	-27,956	**12%**	-36,973	-26,298	**-6%**	**-29%**
(b) Other Items Net	-44,297	-46,883	**6%**	-33,625	-46,898	**0%**	**39%**
3. Reserve Money (a+b)	**67,858**	**73,409**	**8%**	**81,569**	**87,792**	**20%**	**8%**
(a) Currency in Circulation	62,755	66,582	**6%**	74,017	73,053	**10%**	**-1%**
(b) Bank deposits with DAB	5,103	6,826	**34%**	7,552	14,738	**116%**	**95%**

Source: International Monetary Fund and DAB staff calculation

1.1 Monetary and Financial Statistics

According to the monetary survey data, shown in Table 4.3, the supply of broad money (M2) expanded to AF 151.5 billion in the quarter under review up from AF 141 billion in the previous quarter. This shows an increase of 7.5 percent down from 11.5 percent in the previous quarter. Several factors can explain the slower growth of broad money in the third quarter, but mainly a drop of 21.6 percent in quasi money and an increase of 136.2 percent in foreign liabilities, mainly of commercial banks, have affected negatively the broad money.

Narrow money (M1) had also a slower growth in the third quarter which increased by 8.7 percent while its growth in previous quarter was recorded at 11.7 percent. Demand deposits stood at AF 76.8 billion in the third quarter. The pace of its growth was half of what it was in the second quarter: 9.2 percent in the third quarter compared to 17.3 percent in the previous quarter.

Quasi money, if compared with the previous quarter, declined significantly. It dropped to AF 4.5 billion in the third quarter down from AF 5.8 billion in the second quarter. This shows a negative growth of -21.6 percent, compared to a positive growth of 7.5 percent in the previous quarter.

As to broad money components, net foreign assets increased by 5.7 percent to AF 179.6 billion in the third quarter. However, its growth in the second quarter was slightly higher: 6.8 percent. Such a slower growth in NFA in the third quarter is marked by a remarkable hike in foreign liabilities which increased by 136.2 percent.

On the other hand, although net domestic assets had a negative growth, its quarterly contraction declined significantly in the third quarter: -3.01 percent down from -11.6 percent in the previous quarter. Net domestic credit increased by 27.1 percent up from 13.3 percent, and capital accounts balance decreased by 6.9 percent compared to a positive growth of 2.6 percent in the second quarter. As to “other items net”, it turned to have a negative balance in the third quarter (AF -3.150 billion) compared to its positive balance in the previous quarter.

Table 4.3:Monetary Aggregates, Third Quarter 1387 (in million AF)

	1387		Quarter Change Q1-Q2	Difference Q1 - Q21	1387	Quarter Change Q2 - Q3	Difference Q2-Q3
	Q1	Q2			Q3		
	Amount	Amount			Amount		
1- Narrow Money(M1)	**121,074**	**135,225**	**11.7%**	**14,152**	**147,005**	**8.7%**	**11,780**
Currency outside depository corporations	*61,052*	*64,850*	**6.2%**	3,798	*70,142*	8.2%	5,292
Demand Deposits	60,021	70,375	**17.3%**	10,354	76,863	9.2%	6,488
2- Quasi Money	**5,399**	**5,804**	**7.5%**	**405**	**4,553**	**-21.6%**	**-1,251**
In Afghani	2,614	2,633	0.8%	20	1,835	-30.3%	-798
In Foreign currency	2,785	3,171	**13.8%**	385	2,717	-14.3%	-453
3- Broad Money(M2)	**126,473**	**141,029**	**11.5%**	**14,557**	**151,558**	**7.5%**	**10,529**
Determinants							
1- Net Foreign Assets	**159,186**	**169,963**	**6.8%**	**10,778**	**179,622**	**5.68%**	**9,659**
(a) Foreign Assets	165,098	175,445	**6.3%**	10,348	192,571	**9.76%**	**17,126**
DAB Foreign exchange reserves	138,672	149,529	7.8%	10,857	161,733	8.16%	12,204
Other foreign assets	26,425	25,916	-1.9%	-509	30,839	18.99%	4,923
(b) Foreign Liabilities	5,912	5,482	-7.3%	-430	12,949	136.21%	7,467
2. Net Domestic Assets	**-32,713**	**-28,934**	**-11.6%**	**3,779**	**-28,064**	**-3.01%**	**870**
(a) Net Domestic Credit	12,993	14,715	13.3%	1,723	18,707	27.13%	3,992
Net Claim on General Govt	-31,867	-35,748	12.2%	-3,881	-35,226	-1.46%	522
Claims on other Sectors	44,859	50,463	12.5%	5,604	53,933	6.88%	3,470
(b)Other Items Net	-40	3,221	-8056.9%	3,261	-3,150	-197.81%	-6,371
(c) Capital Accounts	45,665	46,870	2.6%	1,205	43,621	-6.93%	-3,249

Source: Monetary Survey Section, Monetary Policy Department DAB

According to Figure 4.2, bank deposits as share of broad money grew by 50.7 percent in the third quarter up from 49.9 percent in the second quarter 1387. This is due to an increase in foreign currency deposits which is shown in Figure 4.4. Foreign currency deposits which make more than 75 percent of total bank deposits increased by 17.6 percent compared to 8.4 percent in the second quarter.

Figure 4.2: Bank Deposits as Share of Broad Money (%)

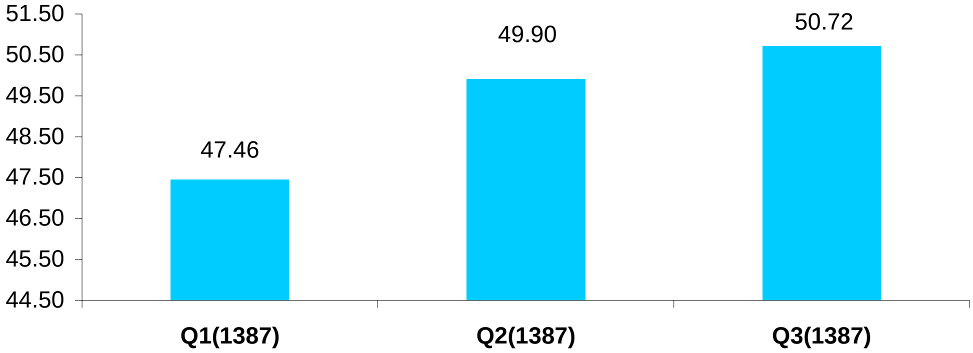


Figure: 4.3: Transferable Deposits in DAB

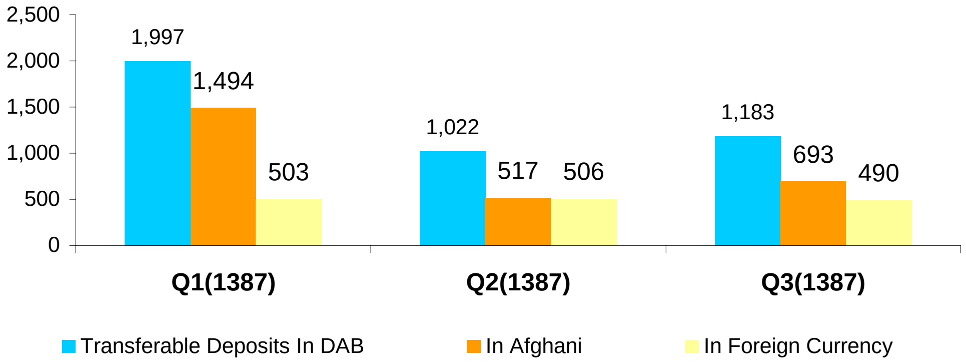
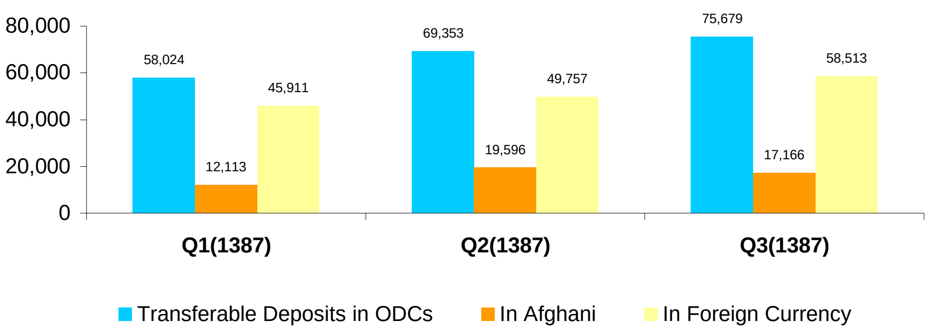


Figure 4.4: Transferable Deposits in ODCs



2. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

2.1 Capital Note Auctions

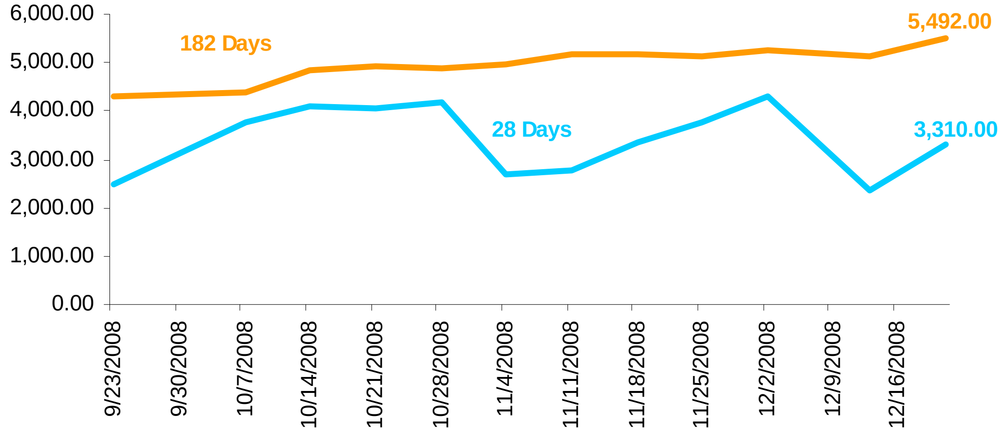
Capital notes (CNs) are short-term Afghani-denominated securities sold by the central bank at weekly auctions. Capital notes are discount securities, which mean that they are issued and traded at a discount to face value. Discount securities make only one payment, the face value on the maturity date.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

The amount to be auctioned is announced every Monday to the banks electronically. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase desired values of capital notes at different discount prices. Bids have to be submitted before 11:00 am on the auction day.

The amounts awarded in the quarter under review fluctuated between AF 125 million and AF 2.18 billion for 28 day notes and between 50 million and AF 600 million for the 182 day notes. The amounts announced for both 28 day and 182 day notes were AF 200 million and AF 100 million respectively. In the quarter under review, the outstanding stock of 28 day notes fluctuated between 2.5 billion and AF 4.3 billion. It dropped by 700 million at end of the 3rd quarter to the outstanding amount of AF 3.3 billion. On the other hand, the stock outstanding of 182 day notes had an over all increase of AF 1.2 billion. It made the outstanding amount increase to AF 5.4 billion, during the last week of the quarter under review.

The total outstanding stock of both maturities stood at AF 8.8 billion at the end of the reporting period (Figure 4.5).

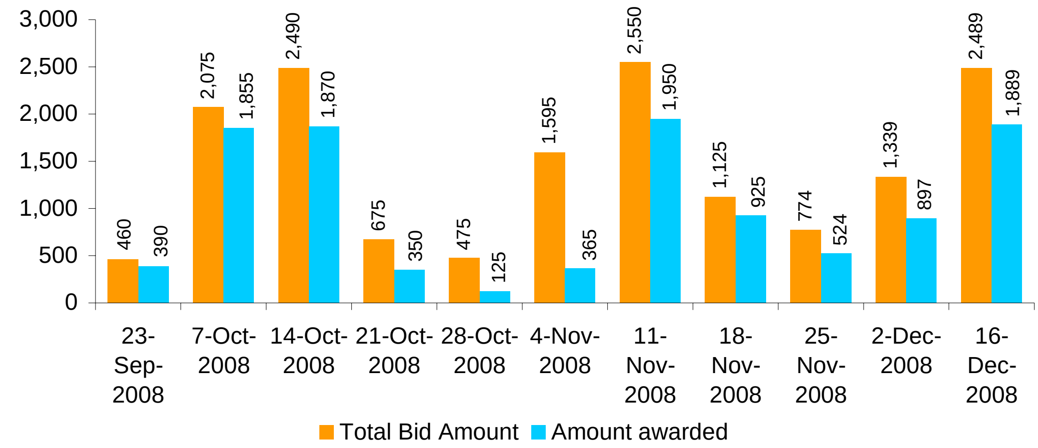
Figur 4.5: Capital Notes Stock outstanding (million AF)



Source: Market Operations Department, DAB.

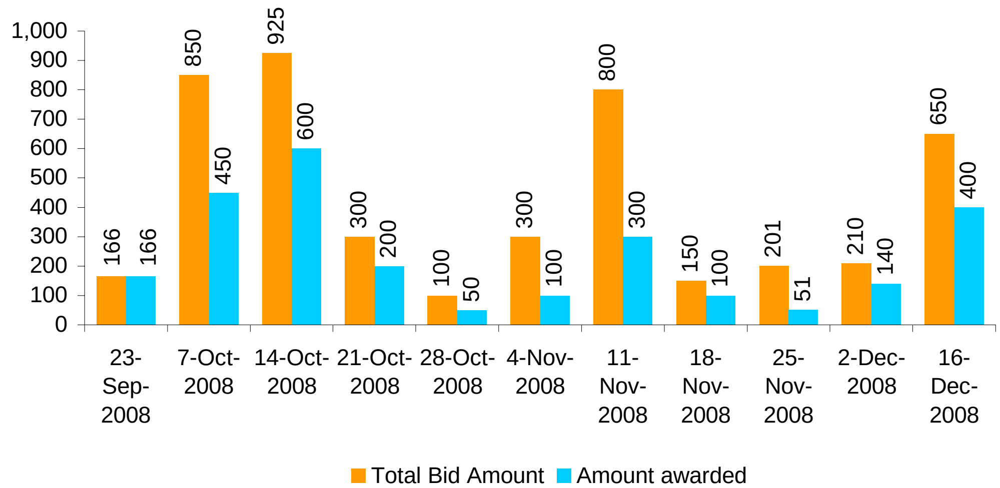
The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the bid amount for 28 days notes was AF 1,603 million and amount awarded was AF 1,110 million for a cover ratio of 1.44. The bid amount for 182 day note was AF 454 million and amount awarded was AF 258 million for a cover ratio of 1.76. Comparing the cover ratio in the third quarter to that in the previous quarter, the cover ratio for the 28 day note was 1.18 and for 182 day note it was 1.68. Although, the awarded amount was much higher than the announced volume, still it oversubscribed by AF 493 million 28 day notes and 195 for 182 day notes. This reflects that there is still high demand for CNs from commercial bank, despite large amount of supply by DAB. (Figure 4.5 for 28 day CNs and Figure 4.6 for 182 day CNs).

Figure 4.6: Demand and Awarded amount for 28 Days Notes (Amount in Million AF)



Source: Market Operations Department, DAB

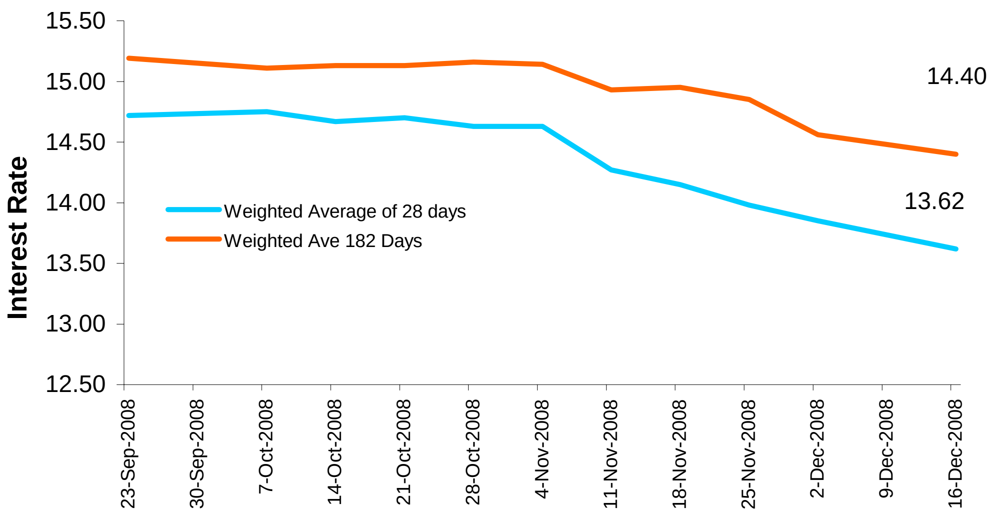
Figur 4.7: Demand and Awarded amount for 182 Days Notes (Amount in Million Afs)



Source: Market Operations Department/ DAB

The weighted average interest rate declined by 110 basis points 28 day notes and 79 basis points 182 day notes during the quarter under review. It ranged between 14.72 percent and 13.62 percent; and 15.19 percent to 14.40 percent for 182 day maturity. The weighted average interest rates in the previous quarter were14.49 percent to 15.98 percent; and 16.26 to 14.99 percent respectively (Figure4.7).

Figure 4.8: Weighted Average of 28 day and 182 Day Capital Notes Interest Rate



Source: Market Operations Department, DAB

2.2 Term Structure of Interest Rates

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

The yield curve for December 20, 2009 is positive.

Figure 4.9: Term Structure of Interest Rates Yield Curve as of Dec 20, 2008

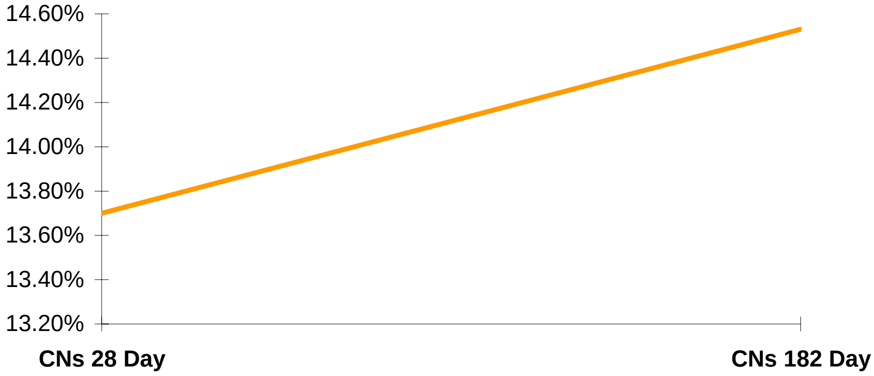
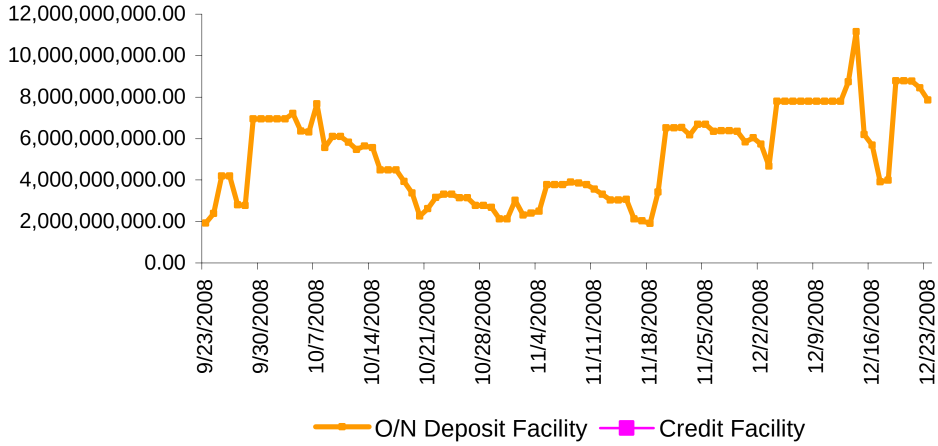


Figure 4.10: Over Night Deposit Balances (Amount in AF)



Source: Market Operations Department, DAB

2.3 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted towards required reserves. The interest rate on the overnight deposit facility is now 350 basis points below 28 auction cut-off rate (based on a circular to all banks approved by DAB Supreme Council on Feb 27, 2007). The outstanding amount of deposit facility balances fluctuated between AF 1.7 billion and AF 11.1 billion. The quarter under review ended with stock outstanding amounting to AF 8.7 billion.

Overnight Credit Facility: This facility is used by banks for short term cash needs. The facility allows banks to borrow Afghani from Da Afghanistan Bank on an overnight basis when they face a short fall in cash flow. The rate that the banks are charged for this facility is 350 basis points above the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only (according to the circular of Feb 27, 2007). None of the banks benefited from the facility during this period.

During the quarter, required reserves averaged AF 443,604,670.00 per bank, while excess reserves (including overnight deposits) averaged AF 380,640,230.32 per bank. These figures were AF 255,659,470.00 and AF 264,580,076.00 respectively during the previous quarter.

Required reserves were remunerated at 350 basis points below the cut off rate of 28 days capital notes auction rate or equal to the deposit facility rate.

Figure 4.11: Excess Reserves (Deposit Facility not included) (thousand AF)

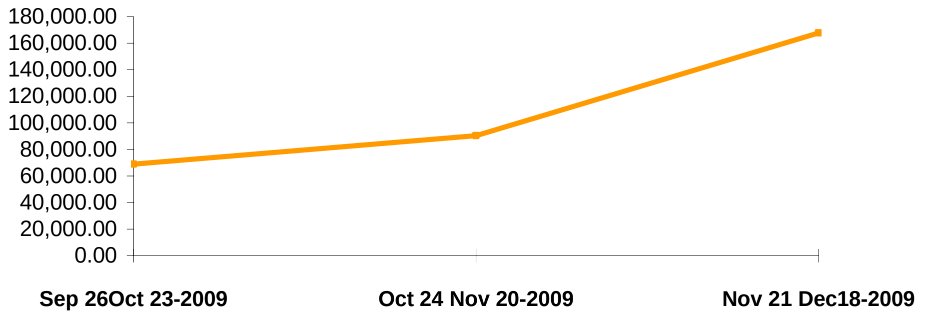


Table 4.4: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	No. Winning Bids	No. of total bids	Cut of Rate	Low Bid	Weighted Average
23-Sep-2008	200	390	460	5	5	14.50%	14.60	14.72
7-Oct-2008	200	1,855	2,075	7	8	14.79%	14.56	14.75
14-Oct-2008	200	1,870	2,490	8	8	14.78%	14.50	14.67
21-Oct-2008	200	350	675	5	6	14.75%	14.60	14.70
28-Oct-2008	200	125	475	2	5	14.65%	14.66	14.63
4-Nov-2008	200	365	1,595	3	6	14.55%	14.40	14.63
11-Nov-2008	200	1,950	2,550	7	7	14.43%	14.10	14.27
18-Nov-2008	200	925	1,125	5	4	14.25%	14.10	14.15
25-Nov-2008	200	524	774	5	3	14.11%	13.95	13.98
2-Dec-2008	200	897	1,339	4	6	13.95%	13.70	13.85
16-Dec-2008	200	1,889	2,489	6	6	13.70%	13.50	13.62
23-Dec-2008	200	2,180	3,189	2	7	13.25%	13.10	13.13

Source: Market Operations Department (DAB)

Table 4.5: Auction of 182 Day Capital Notes

Date	Auction Amount	Amount awarded	Total Bid Amount	No. Winning Bids	No. of total bids	Cut of Rate	Low Bid	Weighted Average
23-Sep-2008	100	166	166	3	3	15.20%	15.18	15.19
7-Oct-2008	100	450	850	3	4	15.19%	15.00	15.11
14-Oct-2008	100	600	925	3	4	15.18%	15.05	15.13
21-Oct-2008	100	200	300	2	2	15.17%	15.10	15.13
28-Oct-2008	100	50	100	1	2	15.16%	15.16	15.16
4-Nov-2008	100	100	300	1	2	15.14%	15.14	15.14
11-Nov-2008	100	300	800	3	2	15.00%	14.85	14.93
18-Nov-2008	100	100	150	2	1	14.95%	14.95	14.95
25-Nov-2008	100	51	201	3	1	14.85%	14.85	14.85
2-Dec-2008	100	140	210	2	3	14.70%	14.50	14.56
16-Dec-2008	100	400	650	3	4	14.53%	14.20	14.40
23-Dec-2008	100	540	790	3	5	14.20%	14.15	14.17

Source: Market Operations Department (DAB)

3. Foreign Exchange Market

3.1 Foreign Exchange Rates:

The daily historic review of the exchange rate, AF vis-à-vis USD, for the third quarter of 1387 (Dec 20, 08) is shown in figure 4.12. The exchange rate of afghani reveals a fluctuated trend in the quarter under review. As can be seen from the figure 4.12, afghani exchange rate began to depreciate against US dollar from the beginning of the quarter under review, reaching its lowest rate of AF 52.67 per USD on Oct 28, 08. One of the main reasons behind this depreciation is thought to be the excess demand for USD driven by pilgrims through the quarter, while second reason can be the recent appreciation of USD against some major currencies in the international exchange markets.

On the end quarter basis afghani against USD depreciated by 3.3 percent from AF 50.47 per USD at the beginning of the quarter to AF 52.14 per USD at the end of the quarter under review. On the annual basis afghani depreciated by 3.39 percent in the quarter under review from AF 49.87 per USD in the third quarter of 1386 to AF 51.56 per USD in the quarter under review.

On the annual basis, afghani appreciated against Pakistani rupee (PKR) and Euro by 21.33 percent and 5.47 percent respectively in the quarter under review.

Figure 4.12: Daily Average Exchange Rate (AF/USD): Q3 1387
(March 22, 08 to Dec 20, 08)

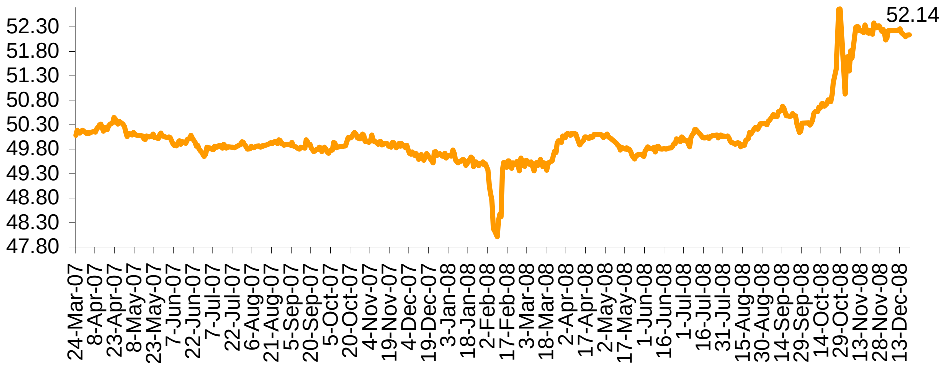


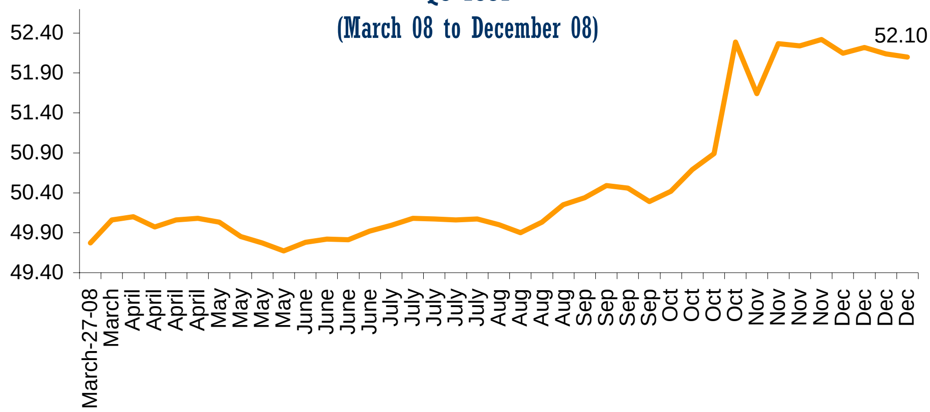
Table 4.6: Exchange Rate against selected currencies Q3 1387

Period	USD	PKR	EURO
Average for Q3 1387	51.56	0.6459	67.91
Average for Q3 1386	49.87	0.821	71.84
% Appreciation (-) or depreciation(+) of AF against respective currency	**3.388**	**-21.33**	**-5.47**
Closing rate on Dec 20, 08	52.14	0.67	72.12
Closing rate on Sep 20, 08	50.47	0.65	72.61
% Appreciation (-) or depreciation(+) of AF against respective currency	**3.3**	**3.08**	**-0.675**

Source: Monetary Policy Department/ Market operations Department/ DAB

Figure 4.13: Weekly Average Exchange Rate (AF/USD): Q3 1387

(March 08 to December 08)



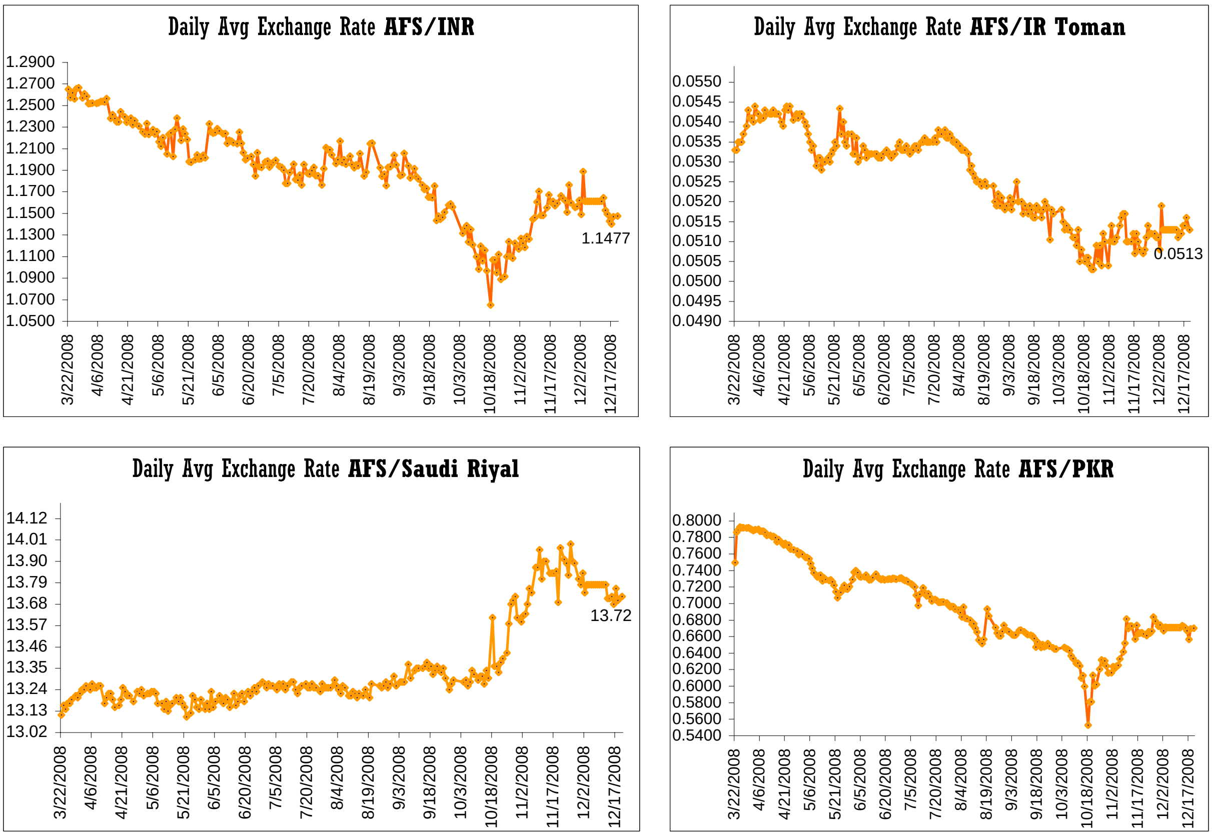
The exchange rate movement on the weekly basis is depicted in Figure 4.13. As can be seen from the Figure 4.13, afghani started appreciating slightly *vis-à-vis* USD from AF 50.08 per USD in mid July 2008, to AF 49.9 per USD in mid Aug 08. But afghani started depreciating against USD up to end of the quarter under review reaching at AF 50.49 per USD.

The standard deviation of the exchange rate movement stood at 0.8 percent in the quarter under review compared with the 0.14 percent in same quarter a year ago.

The slight difference in standard deviation between two quarters shows that exchange rate of afghani against USD has been stable in the quarter under review.

The comparison of historic review of the daily average exchange rate of afghani against some other major currencies as of Dec 21, 08 is shown in Figure 4.14.

Figure 4.14: Daily Exchange Rates of some major currencies



3.2 Foreign Exchange Auction:

Foreign exchange auctions are the key instrument to smooth fluctuations in the currency in circulation which is a performance criterion under the PRGF program. Da Afghanistan Bank (DAB) has maintained its bi-weekly sterilization policy, to mop up extra liquidity arising principally from the government and international organizations' expenditures in Afghanistan. The foreign exchange auction size is determined by a liquidity forecasting framework, which takes in account the money demand on one hand and the currency growth ceiling agreed by the DAB with the IMF on the other hand.

Table 4.8 summarizes the results of the DAB foreign exchange auctions in the quarter under review (September 23 to December 20, 2008).

In the quarter under review the announced amount of the auction stood at USD 390 million, while the awarded amount reached USD 370 million. The weighted average of the entire 23 awarded auctions rate (sale price of the USD) was 51.48, covering September 23 to December 20, 2008. The total number of awarded bidders in the quarter under review stood at 587 compared with the previous quarter in which there were 27 auctions of USD 328.63 million. The weighted average was 50.1 with the participation of 591 bidders.

Table 4.7: Auction summary

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market mid rate	Amount Announced	Amount Awarded	No of Awarded Bidders
23-Sep-08	34	50.47	50.32	50.44	50.48	10.00	9.20	19
27-Sep-08	30	50.12	49.96	50.04	50.14	10.00	10.40	23
04-Oct-08	38	50.39	50.16	50.30	50.33	10.00	15.75	30
07-Oct-08	38	50.39	50.16	50.30	50.34	15.00	11.40	30
11-Oct-08	41	50.57	50.21	50.52	50.57	15.00	14.55	21
14-Oct-08	48	50.74	50.10	50.72	50.73	15.00	17.15	21
18-Oct-08	43	50.82	50.55	50.75	50.73	25.00	15.85	22
21-Oct-08	43	50.82	49.71	50.79	50.77	20.00	11.25	19
25-Oct-08	42	51.72	50.45	51.63	50.34	20.00	12.50	20
28-Oct-08	47	53.32	51.50	52.10	52.67	20.00	16.70	39
01-Nov-08	50	50.75	50.30	50.30	50.93	20.00	16.4	29
04-Nov-08	54	51.43	50.63	51.30	51.40	20.00	18.65	21
08-Nov-08	43	52.40	51.15	52.21	52.07	10.00	15.5	17
11-Nov-08	53	52.33	51.90	52.33	52.30	10.00	17.8	38
15-Nov-08	49	52.23	50.04	52.01	52.18	20.00	18.85	32
18-Nov-08	51	52.20	51.70	52.03	52.19	20.00	18.10	34
22-Nov-08	52	52.11	51.75	52.05	52.15	20.00	11.35	20
25-Nov-08	57	52.32	52.05	52.25	52.28	20.00	18.85	24
29-Nov-08	53	52.20	51.85	52.13	52.21	20.00	14.7	22
02-Dec-08	53	52.05	51.85	52.02	52.03	20.00	18.15	21
13-Dec-08	49	52.30	51.90	52.18	52.26	20.00	25.1	34
16-Dec-08	52	52.13	51.90	52.06	52.13	20.00	24.5	31
20-Dec-08	51	52.12	51.95	52.08	52.14	20.00	17.3	20
Total amount sold in million USD						390.00	370.00	587.00

Source: Market Operations Department (DAB)

5

BANKING SYSTEM PERFORMANCE

SUMMARY

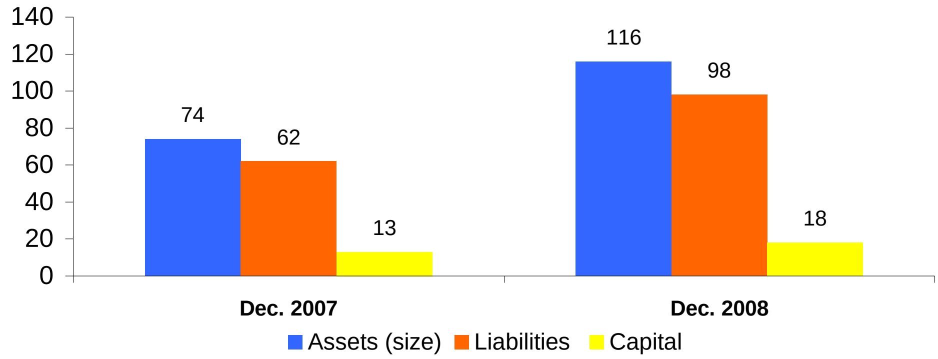
The banking sector continued to perform satisfactorily in the quarter under review. Total assets of the banking system rose to AF 116.4 billion (USD 2.24 billion) at the end of the third quarter of 1387, up by 57 percent or AF 42.3 billion from December 2008. Loans amounted to AF 50.7 billion (USD 971 million) an increase of AF 15.1 billion (USD 290 million) or 44 percent from December 2008. Deposits stood at AF 92.9 billion (USD 1.8 billion) over the period under review - a 59 percent increase or an increase of AF 15.1 billion since December 2008. Deposits were largely denominated in USD (67 percent) with AF -denominated deposits lagging at 28 percent. However, the AF-denominated deposits have been growing steadily from 18 percent recorded in the beginning of year. Total capital of the banking system stood at AF 17.9 billion (USD 327 million).

Overall the banking sector was profitable, earning a year-to-date net profit of AF 1.46 billion (USD 28 million) compared to the same period in the previous year for an overall return on assets (ROA) of 2.02 percent which was higher than previous year (0.60 percent). The main causes for the improvement in ROA are significant increases in interest income and non-interest income which more than completely offset notable increases in overhead expenses. One of the state-owned banks has lost AF 439 million due to allocation of high credit provision amounting AF 704 million and incurring losses in FX revaluation amounting AF 107 million.

1. Assets of The Banking System

The banking system continued to grow at a brisk rate in the quarter under review. Total assets (the size) of the banking system at the end of the third quarter 1387 stood at AF 116.4 billion (USD 2.24 billion) up by 57 percent or AF 42.3 billion (USD 810 million) from December 2008 (Figures 5.1 and 5.2). The major contributors to this increase were the increase in loans of AF 15.1 billion) and cash in vault/claims on DAB of AF 20.6 billion. The remaining portion is made up of other asset categories such as claims on financial institutions, "other assets except interest receivable" and "net due from" (NDF). The most important components of the banking system's total asset portfolio are loans that comprise 44 percent, claims on financial institutions standing at 15 percent, cash in vault/claims on DAB at 29 percent, NDF at 6 percent, and other assets except interest receivable (4 percent). The rapid increase in the relative importance of loans can be traced to immediate deployment of attracted funds into new loans (55 percent), while the remaining portion was mainly retained in the form of liquid assets.

Figure 5.1: Growth Rate of the Banking System
increased by 57 percent or AF 42.3 billion



Source: Financial Supervision Department/DAB

The major components of assets, as a percentage of total assets, are discussed hereafter:

1.1 Claims on Financial Institutions

Claims on financial institutions are still the third largest among various asset categories, currently comprising AF 17.1 billion – a 21 percent increase since December 2007. This indicates that the banking sector channels a portion of its attracted funds as deposits in other financial institution when credible borrowers are not found. Later on for liquidity purposes or after getting loan application from low-risk borrowers, these assets are then substituted for higher income earning assets.

Figure 5.2: Size of Banking Sector (total assets)
Increased by 57 percent or AF 42.3 billion

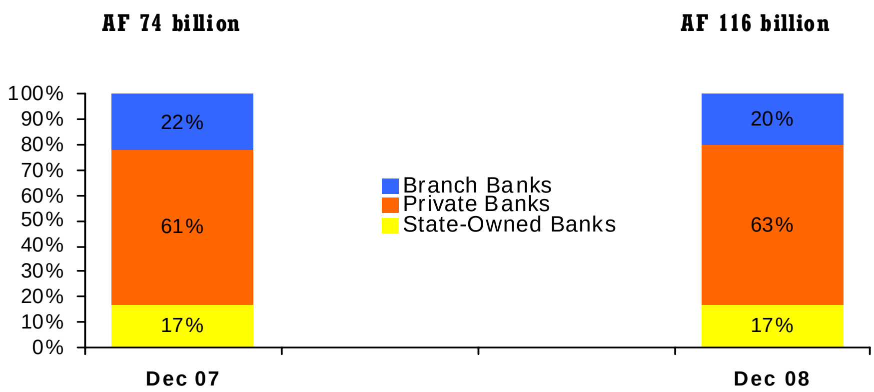
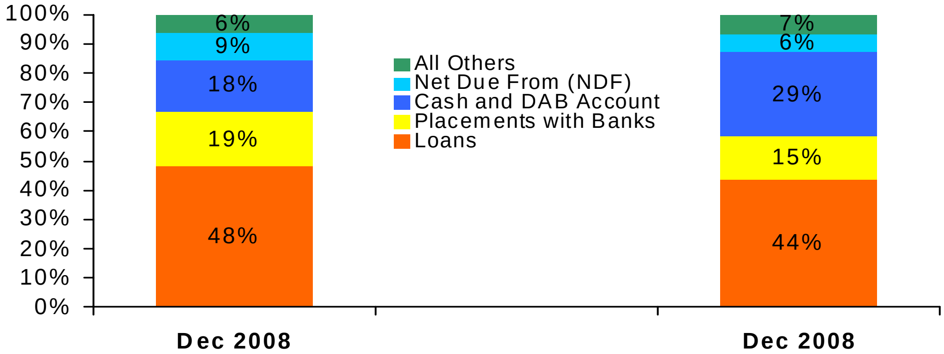


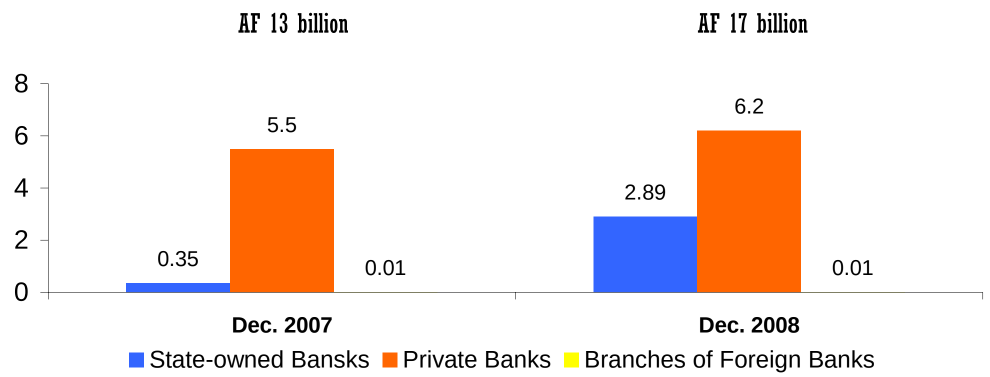
Figure 5.3: Major Asset Categories
(As percentage of Total Assets)



1.2 Net Loans

The loan portfolio continues to grow totaling AF 50.7 billion (USD 971 million) as of December 30, 2008 – a 43 percent increase since December 2007 or 44 percent of total assets. This clearly shows that loans constitute the largest part of total assets. As a result of increase in gross loans, the loan loss reserves increased from 1 percent to 1.19 percent since Dec. 2007. Though in general, 81 percent of the growth in the banking sector's loan originated from private banks, but 57 percent of the total comes from one bank only.

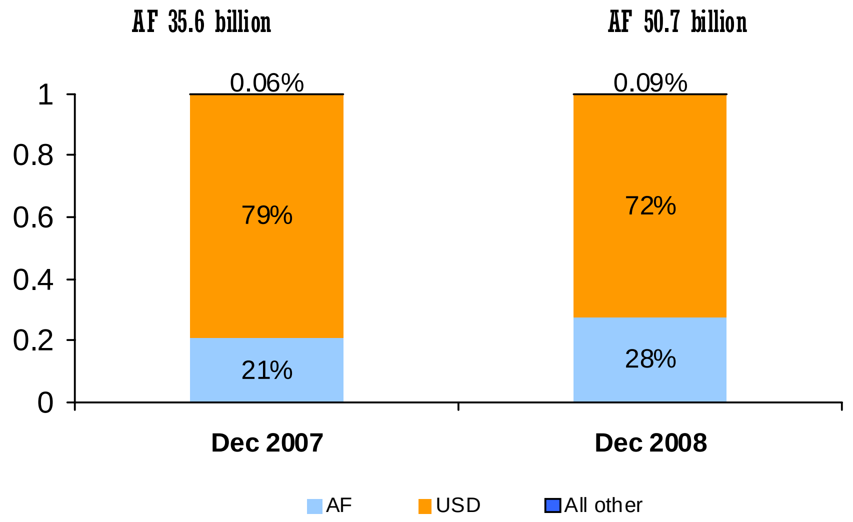
Figure 5.4: Claims on Financial Institutions



Source: Financial Supervision Department/DAB

Private banking sector is the leading creditors increasing their portfolio both in absolute terms as well as when measured as a percentage of total loans which are at AF 41 billion and 81 percent of total loans respectively

Figure 5.5: Currency Composition of Loans



Source: Financial Supervision Department/DAB

By far, the major component of loan portfolio is other commercial loans (72 percent) with major concentration in trading which is 51.6 percent of total gross loans. This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend and some sectors, like agriculture, has not benefited much from this increase.

1.3 Non-performing loans

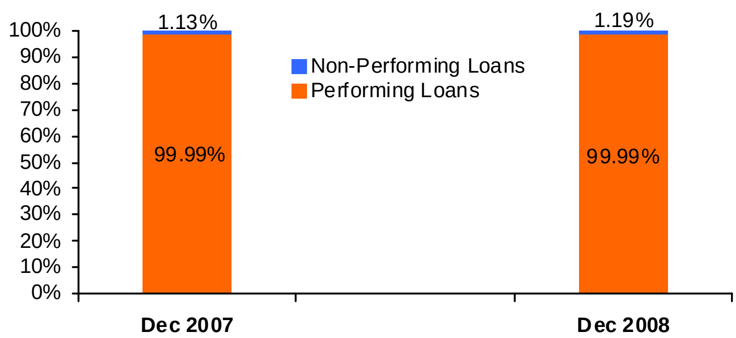
The banking system's non-performing loans stood at 1.19 percent of gross loans an increase of 194 million since December 2007. Though the low NPL is a positive indicator of the quality of the banking sector's portfolio but on the other had it is a source of concern to regulatory authorities too as it has been increasing in absolute terms.

1.4 Adversely-classified loans

Adversely-classified loans increased to AF 908 million from AF 695 million at the end of December 2008. However, their share in total gross loans slightly decreased to 1.81 percent. Loans under "watch" category 4.01 percent of total gross loans and compared to the third quarter of 1386 have increased by 1.55 percentage points. This trend should be monitored closely to ensure the quality of loan portfolio. However, it is too early to say whether this indicates increase in adversely-classified loans, or if it due to more conservative approach of regulatory authorities on loan classification.

Adversely-classified loans are greater than non-performing loans, which is what one would expect given the definitions of these two indicators of troubled assets.

Figure 5.6: Quality of Loan Portfolio



Source: Financial Supervision Department/DAB

1.5 Cash in Vault and Claims on DAB

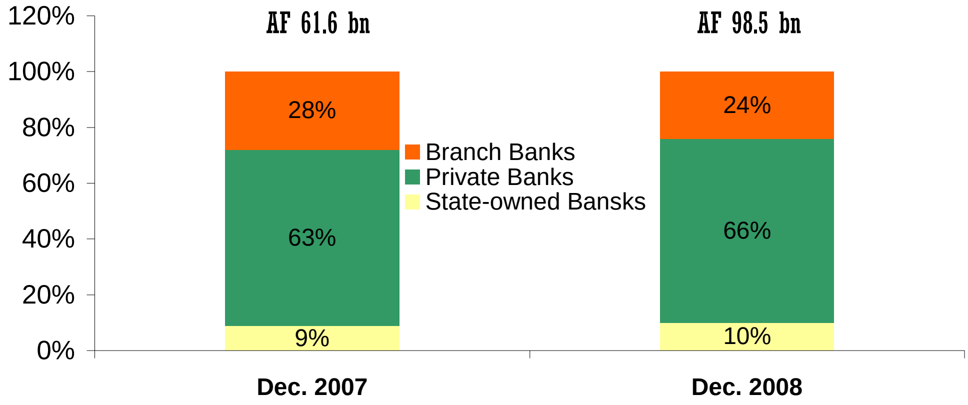
Cash in vault and claims on DAB remains the second largest category of total assets, increasing both in absolute as well as in percentage of total assets. The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

2. LIABILITIES

Total liabilities of the banking sector was AF 98.5 billion - up by 60 percent from

December 2007. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Figure 5.7: Liabilities of the Banking Sector
Increased by 60 percent or AF 36.9 bn



2.1 Deposits

Deposits are the major component of liabilities currently standing at AF 92.9 billion - a 59 percent or AF 34.4 billion increase since December 2007. Private banks attracted AF 62.2 billion deposits which makes 67 percent of the total increase. Total deposits increased in absolute terms as well as in percent of total liabilities. Interest payable remains the second major component of liabilities up by 106 percent since December 2007.

Increases in deposits of foreign branches were the result of increases in total assets with unrelated parties for the period, indicating a shift from a source of funds for the home office towards active engagement within the country.

Figure 5.8: Major Liability Categories

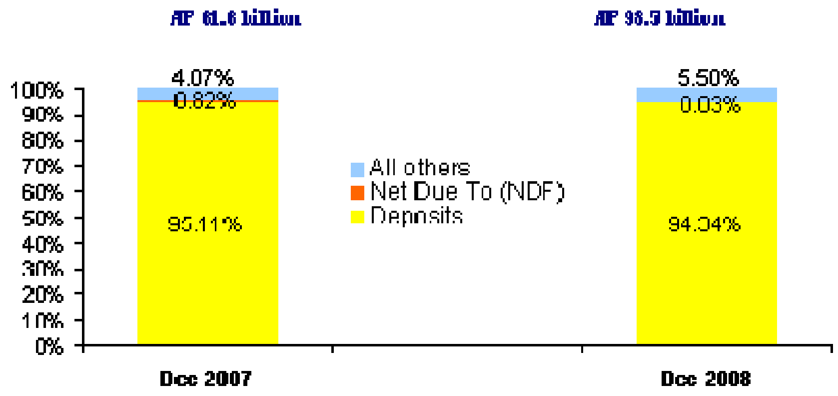
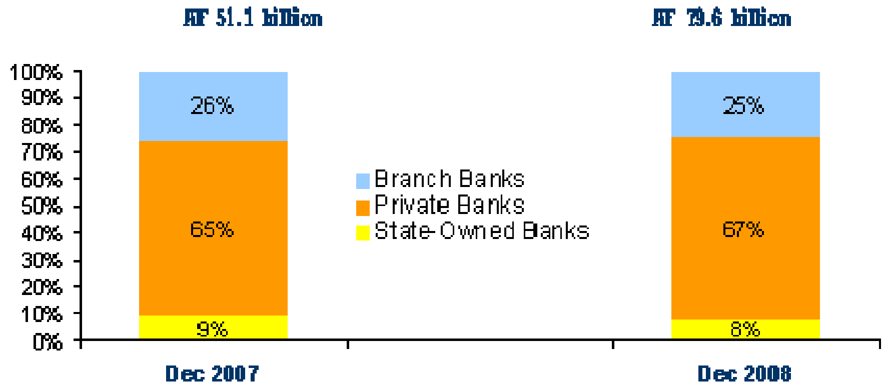


Figure 5.9: Deposits Increased by AF 28.5 billion or 56 percent

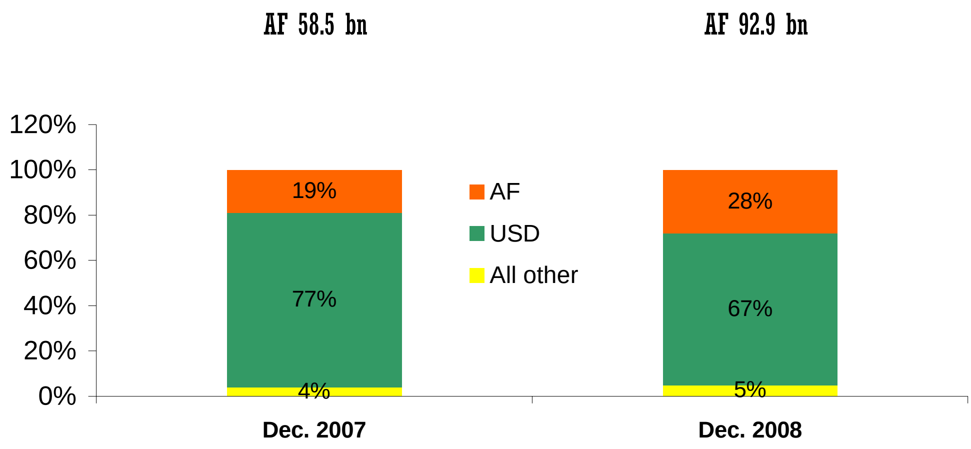


Source: Financial Supervision Department/DAB

2.2 Capital

The banking system, as a whole, is well capitalized. Total financial capital at full-fledged banks is AF 17.87 billion, up by 43 percent since December 2007. If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 17.87 billion comprises 15.4 percent of AF 116.4 billion (total assets), which is well below the benchmark.

Figure 5.10: Currency Compositio of Deposits

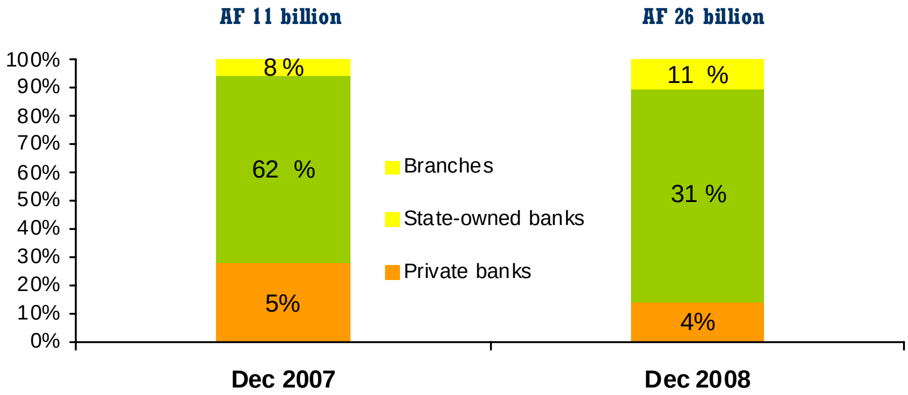


Source: Financial Supervision Department/DAB

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

The NDT position has significantly decreased from AF 502 million in December 2007 to AF 26 million during this period. The NDF position has increased both in absolute terms as well as a percentage of total assets. Only one bank is in a favorable NDT position, much smaller number than the relatively large, unfavorable NDF positions for the remaining four banks. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted. They are simply sending their acquired funds to their international networks. The largest NDF position by a branch of foreign bank was AF 4.8 billion, down by 19 percent compared to the same quarter in 1386.

Figure 5.11: Afghani Denominated Deposits as Percentage of Total Deposits



Source: Financial Supervision Department/DAB

2.3 Profitability

The banking system in general is profitable. Total net profit of the banking sector during the third quarter of 1387 is AF 1.5 billion, which has resulted on an overall return on assets (ROA) of 2.02 percent, up by 116 percent compared to the third quarter of 1386, where total net profit amounted to AF 674 million or an overall return on assets (ROA) of 1.42 percent.

The main contributors to the increase in ROA are significant increases in net interest income and non-interest income which more than completely offset notable hikes in overhead expenses and FX revaluation losses.

Private banks are the most profitable group of banks accounting for 84 percent of the total net profit of the banking system. Foreign branches were next accounting for 27 percent while state-owned banks accounted for -11 percent of the total net profit of the banking system. Three banks were not profitable with total negative net profit of AF 514 million. About 85 percent of this loss was belonging to one bank, which has incurred a net loss of AF 439 million because of huge allocation of credit provision for the month of December.

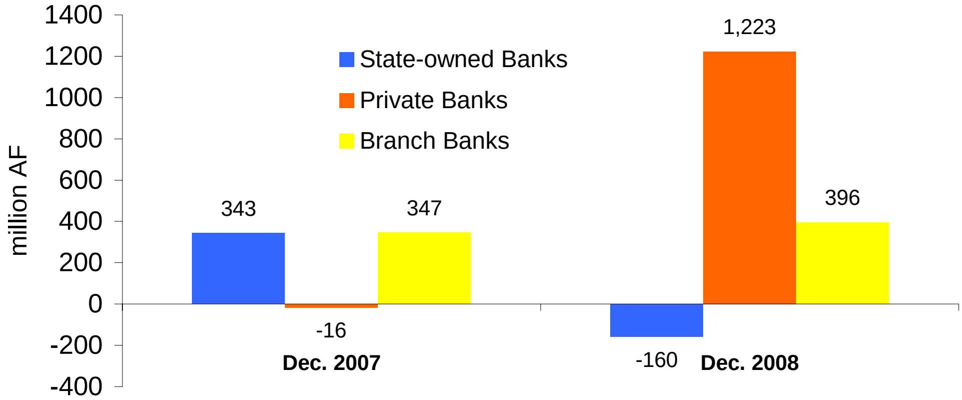
The major component of income was net interest income (NII) which amounted to AF 5.8 billion, up by 79 percent since December 2007.

The second major component of income is other non-interest income (ONII) which totaled AF 2.8 billion, a 210 percent increase since December 2007.

The most important component of expenses is the non-interest expense (NIE), currently equal to AF 5.4 billion, a 212 percent increase compared to the third quarter of 1386.

The efficiency ratio, (*net interest income* + *trading account gain/loss* + *other non-interest income* **divided** *by operating expenses*) of the system as a median stands at 1.52, slightly up by 0.05 percentage point since the third quarter of 1386. Seven banking institutions ended up with lower efficiency ratios compare to the median of the banking system.

Figure 5.12: Profitability



2.4 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is within the limits established by the DAB. However, only one bank is non-compliant with limits set for overall as well as for individual currency open FX position, which is highly above the set threshold. The number of banks in violation of regulatory limits has decreased since third quarter of 1386 but still warrants prompt corrective action by DAB. Branches of foreign banks are not subject to limitations on open FX position since that risk is managed on a whole-bank basis and not branch-by-branch.

2.5 Interest Rate Risk

Interest rate sensitivity of the banks remained largely unchanged since December 2007 and all banking institutions are in an asset sensitive position (benefiting from an increase in the interest rate).

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

The major reason for the overwhelming asset-sensitivity of the banks is the large excess of interest-earning 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.

6

EXTERNAL SECTOR DEVELOPMENTS

SUMMARY

The external sector faced significant challenges when the global economic crisis was rapidly expanding its grasp and leading some of the large economies to economic uncertainty. The global economic crisis was further intensified in the third quarter of 1387 which had an adverse effect on the external sector and weakened donor contributions and support to Afghanistan. The trade deficit, the difference between exports and imports of goods, in the third quarter of 1387 stood at USD 536 million which is approximately 4 percent of GDP a reflection of low savings in the domestic economy and high investment requirements for post-conflict reconstruction. A comparison of merchandise trade in the third quarter of solar year 1387 with that in the third quarter of 1386 shows that imports increased by 12 percent from USD 662 million to USD 740 million. Imports were dominated by capital goods and others such as spare parts machinery and industrial supplies. Exports increased by 158 percent to USD 204 million and were dominated mostly by food items (USD 132 million). With respect to the direction of trade, Pakistan remained Afghanistan's major export destination with a 41 percent share of total exports, followed by India with 21 percent share of total exports in the third quarter of 1387.

In the quarter under review, net international reserves (NIR) increased from USD 2,285 million in the third quarter of 1386 to USD 3,016 million almost 32 percent increase. (See Table 6.4 and Figure 6.7 below) The increase in NIR was a reflection of the inflow of donor grants, financing the activities of multi-national force stationed in

Afghanistan and foreign direct investment (FDI).

Reserve liabilities of the depository corporations increased by 75.80 percent from USD 92 million to USD 161.75 million in the period under review. This increase is due to the increase in FX-denominated deposits with commercial banks from USD 37.75 million in the third quarter of 1386 to 66.38 million in the third quarter of 1387 by almost 76 percent which accounted for 61 percent of total liabilities.

1. MERCHANDISE TRADE

At the end of third quarter of 1387 the trade deficit stood at USD 536 millions or 4 of GDP. In comparison to the third quarter of 1386 the trade deficit significantly decreased by approximately 8 percent of USD 45 million. Table 6.1 shows merchandise by its main categories, percent changes and the trade deficit as a percent changes and the trade deficit as percentage of GDP from 1384 up to third quarter of 1387. Imports of USD 740 millions were dominated by capital goods and others (USD 299 millions) and industrial supplies (USD 229 millions). Exports of USD 204 millions were dominated by food items (USD 132 million) and others (USD 42 million).

Table 6.1: Merchandise Trade (Million USD)

	1384		1385		Q3 1386		Q3 1387	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	2,471	100	2,744	100	661.33	100	740.59	100
Industrial supplies	541	21.9	68	2.48	123.60	18.69	229.06	30.93
Capital goods & others	1,207	48.83	1,133	41.29	399.60	60.42	299.50	40.44
Fuel & lubricants	245	9.9	354	12.9	28.87	4.37	39.43	5.32
Exports	384	100	416	100	79.25	100	204.53	100
Carpets & Rugs	207	53.93	187	44.8	31.06	39.19	26.00	12.71
Food items	104	27.13	165	39.66	24.78	31.27	131.82	64.45
Leather & Wool	37	9.51	31	7.39	8.31	10.49	4.9	2.40
Medical seeds & others	36	9.42	34	8.16	14.74	18.60	41.81	20.44
Trade Balance	-2,087.02		-2,327.73		-582.08		-536.06	
Trade Balance as % of GDP	31.28		-28.19		-6.066		-4.17	

Source: Central Statistics Office and DAB staff calculations

2. DIRECTION OF TRADE

Tables 6.2 and 6.3 compare the direction of trade in the third quarter of 1386 with the third quarter of 1387. Pakistan remained Afghanistan's largest export destination with 41 percent share of total exports in the third quarter of 1387 compared to 63 percent in the third quarter of 1386. Exports to Pakistan have increased significantly by 68 percent from USD 50 million in the third quarter of 1386 to USD 84 million in the third quarter of 1387. India is the second major export destination for Afghan products. Exports to India increased by almost 290% percent from USD 11 million in the third quarter of 1386 to USD 43 million in the third quarter of 1387. In conclusion, sub-continent of India retained its position as major export destination for Afghanistan. In the third quarter of 1386 exports to the Commonwealth of Independent States (CIS) were USD 6 million compared to USD 42 million in the third quarter of 1387 a significant increase of 584 percent. This can be attributed to the construction of the bridge that connects Afghanistan with Tajikistan through Sher Khan Bandar (port) and offers a new era of trade between Afghanistan and the Central Asian stats. Moreover, the Hyratan Bandar (port with Uzbekistan) also plays an important role in trade with northern neighbors of Afghanistan.

Table.6.2: Direction of External Trade for third Quarter of 1386 (millions USD)

Country Name	Exports		Imports		Trade Balance
	Amount	% Shares	Amount	% Share	
Pakistan	50.07	63.18	121.86	18.43	-71.79
India	11.47	14.47	44.14	6.67	-32.67
Iran	1.50	1.89	51.52	7.79	-50.02
Japan	0.00	0.00	55.15	8.34	-55.15
Germany	0.39	0.49	20.90	3.16	-20.51
China	0.16	0.20	98.79	14.94	-98.63
Common Wealth	6.53	8.24	140.78	21.29	-134.25
England	0.00	0.00	3.48	0.53	-3.48
Saudi Arabia	0.54	0.68	0.00	0.00	0.54
Other Countries	8.59	10.84	124.71	18.86	-116.12
Total	**79.25**	**100**	**661.33**	**100**	**-582.08**

Table.6.3: Direction of External Trade for third Quarter of 1387 (millions USD)

Country Name	Exports		Imports		Trade Balance
	Amount	% Shares	Amount	% Share	
Pakistan	84.31	41.22	113.55	15.33	-29.24
India	43.60	21.32	40.50	5.47	3.10
Iran	4.81	2.35	63.80	8.61	-58.99
Japan	0.00	0.00	10.90	1.47	-10.90
Germany	0.11	0.05	13.20	1.78	-13.09
China	0.30	0.15	111.1	15.00	-110.80
Common Wealth	42.30	20.68	226.21	30.54	-183.91
England	0.00	0	7.83	1.06	-7.83
Saudi Arabia	3.80	1.86	0.00	0.00	3.80
Other Countries	25.30	12.37	153.50	20.73	-128.20
Total	**204.53**	**100**	**740.59**	**100**	**-536.06**

Figure.6.1: Direction of Exports (% share) in Q3-1387

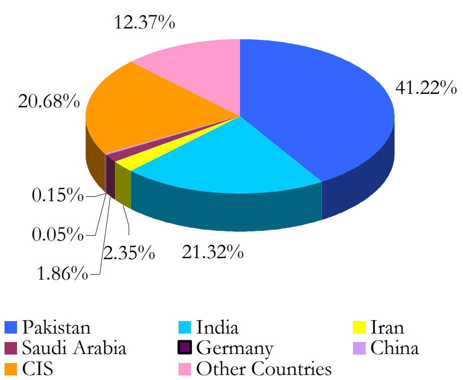
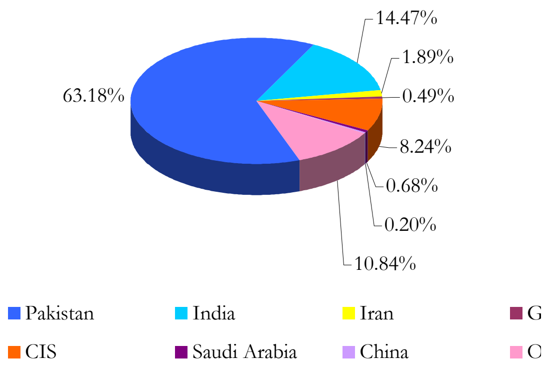


Figure.6.2: Direction of Exports (% share) in Q3-1386



Source: Central Statistics Office and DAB staff calculations.

2.1 Composition of Trade

Figures 6.3 and 6.4 present the composition of total imports for the third quarter of 1386 through the third quarter of 1387. The composition of imports in the third quarter of 1387 shows that imports of capital goods and others had the largest share at 60 percent followed by industrial supplies with 19 percent, consumer goods such as textile, cloths, footwear etc. stood at 17 percent. On the other hand, fuel and lubricants stood at about 4 percent of total imports to Afghanistan.

Figure 6.3: Composition of imports (share%) in Q3-1386

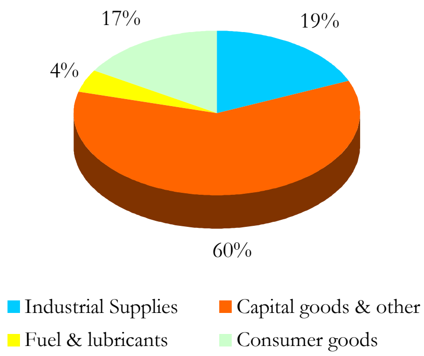
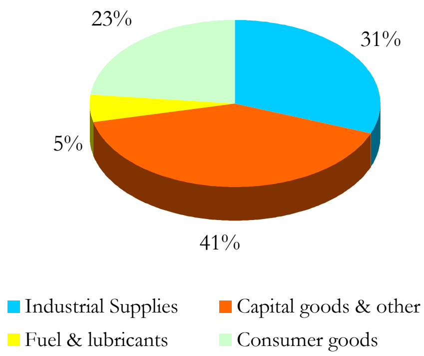


Figure 6.4: Composition of imports (share%) in Q3 - 1387



Source: Central Statistics Office and DAB staff calculations.

Comparing imports for the third quarter of 1386 with that of the third quarter of 1387 shows that the composition of imports has changed significantly. The share of capital goods decreased to 41 percent in the third quarter of 1387 compared to 60 percent share in the third quarter of 1386. The second biggest item in the third quarter was industrial supplies which increased to 31 percent up from 19 percent in the third quarter of 1386. In addition, the share of consumer goods which was 17 percent during the third quarter of 1386 increased slightly to 23 percent in the third quarter of 1387. There was also slight increase in the import of fuel and lubricants in the third quarter of 1387 to 5 percent from 4 percent in the third quarter of 1386.

Figures 6.5 and 6.6 compare the composition of total exports for the third quarter of 1386 with the third quarter of 1387. Figure 6.5 shows the composition of total exports for the third quarter of 1386 by main commodities and products. The largest export category was carpets & rugs with 39 percent followed by food items with 31 percent of total exports, medical plants/seeds with 19 percent, and leather and wool with 11 percent.

Figure 6.6 shows the composition of total exports for the third quarter of 1387 by main commodities and products. The composition of exports changed in the third quarter of 1387 compared to the third quarter of 1386. There is also a considerable boost in the export of dry fruits from 27 percent in the third quarter of 1386 to 54 percent in the quarter under review. The second largest component is the medical plants/seeds standing at 20 percent of total exports while carpets constitute 13 percent, fresh fruits 11 percent and leather & wool only 2 percent of the total exports.

Figure 6.5: Composition of Exports (share%) in Q3 1386

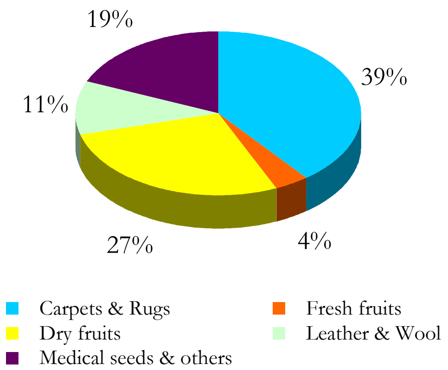
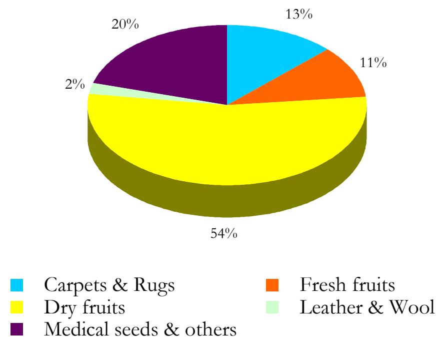


Figure 6.6: Composition of Exports (share%) in Q3-1387



Source: Central Statistics Office and DAB staff calculations.

2.2 External Debt

Afghanistan's public and publicly guaranteed external debt prior to the application of traditional debt relief mechanisms is estimated at USD 11,939.4 million in nominal terms as of March 20, 2006 (Table 6.4). Afghanistan's external debt strategy continues to focus on providing a stable foundation for debt sustainability over the long term. The mechanism through which external debt sustainability is currently being pursued is under the HIPC (Heavily Indebted Poor Countries) Initiative. On July 19, 2007 the group of major official creditors known as the Paris Club reached agreement on significant debt reduction with the Government of Afghanistan. The cancellation of approximately USD 10 billion in external debt will amount to a 92 percent reduction in Afghanistan's debt to its three Paris Club creditors namely Germany, the Russian Federation and the United States.

The three creditors intend to cancel the remaining debt under the Enhanced Heavily Indebted Poor Counties Initiative. The Paris Club agreement also calls for comparable treatment from Afghanistan's other bilateral creditors.

The Russian Federation accounts for the vast majority of total external debt (93.4 percent before the application of an up-front discount on its debt) Afghanistan's debt to the U.S. is approximately USD 108 million. HIPC debt relief will be an important step towards normalizing Afghanistan's relations with the international financial community and will help advance Afghanistan on the road towards debt sustainability and economic growth.

Table 6.4: External Debt as of March 20, 2006 (in units indicated)

	In million USD	Percent of total
Total external debt	11,934.40	100
Bilateral	11,382.10	95.4
Paris Club	11,283.50	94.5
Russian Federation/1	11,127.90	93.2
United States	111.7	0.9
Germany	43.9	0.4
Non-Paris Club	98.5	0.8
Multilateral	557.3	4.7
of which: IDA	300.8	2.5
Asian Development Bank	254.6	2.1
Memorandum Items:		
NPV of debt after traditional debt relief/2	1,118.30	……..
(in percent of exports)/3	305.8	……..

Source: Data provided by Afghan authorities; and IMF staff estimates.

1/ Before up-front 80 percent discount on Russian debt

2/After up-front 80 percent discount on Russian debt priority the application of traditional debt relief.

2.3 Net International Reserves

The level of Afghanistan's net international reserves (NIR) is an important determinant of the overall performance of the external sector and a key quantitative performance criterion under the PRGF program. Developments in the level of NIR reflect trends in export earnings, foreign direct investment and disbursements by donors and multi-national forces stationed in Afghanistan. NIR is defined as the difference between reserve assets and reserve liabilities.

In the quarter under review, net international reserves (NIR) increased from USD 2,285 million in the third quarter of 1386 to USD 3,016 million recording an almost 32 percent increase. (See Table 6.4 and Figure 6.7 below) The increase in NIR was a reflection of the inflow of donor grants, financing the activities of multi-national force stationed in Afghanistan and foreign direct investment (FDI).

Reserve liabilities increased by 75.80 percent from USD 92 million to USD 161.75 million in the period under review. This increase is due to the FX-denominated deposits with the commercial banks which have increased from USD 37.75 million in the third quarter of 1386 to 66.38 million in the third quarter of 1387 by almost 76 percent.

Another key indicator, the monthly import cover, increased from 10 months in the third quarter of 1386 to 12 months in the quarter under review. This is well above the NIR floor in the PRGF program of five months and indicates that the country can comfortably maintain the necessary external liquidity to support the balance of payments.

Table 6.5: Net International Reserves, second and third quarters SY 1386 and 1387 (Million USD)

	1386				1387			
	Q2	% change	Q3	% change	Q2	% change	Q3	% change
Net international Reserves (million US Dollar)	2,208.60	27.42	2,284.97	23.17	2,766.10	25.2	3,015.81	31.98
Reserve assets	2,293.40	29.2	2,376.98	25.80	2,901.20	26.5	3,177.56	33.68
Reserve Liabilities	84.9	106.2	92.01	168.63	135.1	59.2	161.75	75.80
Commercial bank deposits in foreign currency	30.2	-15.3	37.75	48.75	38.3	26.9	66.38	75.84
Nonresident deposits in foreign currency	2.6	-52.7	2.19	-75.32	1.6	-38.6	0.18	-91.70
Use of Fund resources	52.1		52.07		95.2	82.8	95.19	82.81
Gross Intl. Reserves (in months of import)	12		11		15		13	
Net Intl. Reserves (in months of import)	11		10		14		12	

Source: Monetary Policy Department/ DAB

Figure 6.7: Net International Reserves: Q3-1386 and Q3-1387