Da Afghanistan Bank

Economic & Statistical Bulletin

Third Quarter, 2018

Monetary Policy Department

Da Afghanistan Bank

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Note:

Afghanistan's fiscal year has changed effective from 2012 (1391). The new fiscal year begins on December 21st each year. This bulletin analyzes economic developments during the third quarter of fiscal year 2018, which covers July 21st, 2018 to September 20th, 2018.

CONTENTS

LIST OF FIGURES

LIST OF TABLES

ABBREVIATIONS

DAB	Da Afghanistan Bank
GOA	Government of Afghanistan
FEMA	Foreign Exchange Market in Afghanistan
CPI	Consumer Price Index
NCPI	National Consumer Price Index
KCPI	Kabul Consumer Price Index
TM	Trimmed Mean
MOF	Ministry of Finance
CMEA	Ex-Soviet Trading Block
ARTF	Afghanistan Reconstruction Trust Fund
LOTFA	Law and Order Trust Fund for Afghanistan
MPD	Monetary Policy Department
GDP	Gross Domestic Product
WGP	World Gross Product
NSIA	National Statistics and Information Authority
CIS	Commonwealth of Independent States
IMF	International Monetary Fund
IDB	Islamic Development Bank
SDR	Special Drawing Rights
RM	Reserve Money
CiC	Currency in circulation
NIR	Net International Reserves
GIA	Gross International Asset
FX Auction	Foreign Exchange Auction
CNs	Capital Notes
ONDF	Overnight Deposit Facility
ONCF	Overnight Credit Facility
CA	Current Account
FA	Financial Account
FDI	Foreign Direct Investment
FSD	Financial Supervision Department
LCs	Letters of Credit
ODCs	Other Depository Corporations
ROA	Return on Assets
ROE	Return on Equity
NPL	Non-performing Loan

Message

From the Governor

"Da Afghanistan Bank (DAB) policies/efforts are geared towards protecting the most vulnerable segments of society by focusing on price stability -DAB's primary mission- through implementing a sound and effective monetary policy"

EXECUTIVE SUMMARY

Global economic growth during the third quarter of fiscal year 2018 is estimated to have inclined at 3.1 percent. Among the advanced economies, the US projected stronger growth while the Euro zone and UK have experienced slower pace of growth in the period under review. On the other hand, Japan's GDP shrunk over the period under review.

Similarly, growth was uneven among the emerging economies. Intensifying trade tensions, a stronger US dollar and higher oil prices hampered some of the developing and emerging economies. However, some oil exporting countries saw positive effects.

From the beginning of the fiscal year to the end of the third quarter of FY 2018, DAB auctioned a total amount of USD 1,686.44 million to absorb the excess liquidity from the market and as well as to mitigate the sharp fluctuations in the exchange rate of Afghani against foreign currencies.

Meanwhile, Afghani depreciated 9 percent against the US dollar from the beginning of the fiscal year till the end of the quarter under review. Commodity prices buffeted by geopolitical and macroeconomic events. Energy prices gained 3 percent in 2018 (Q-o-Q), partly in response to the impending re-imposition of sanctions on Iran by the United States along with continuing declines in production in Venezuela.

Asset base of the banking sector increased by 0.16 percent during the third quarter of 2018, standing at AFN 308.14 billion. The increase in banking system assets was mainly powered by increase in deposits.

The capital base of the banking sector fluctuated and decreased by 0.34 percent standing at AFN 35.64 billion. The decrease in capital base attributed to quarterly losses.

Banking sector incurred net profit amounting to AFN 353 million for the third quarter of 2018 against AFN 925 million net profits in the preceding quarter. State-Owned Banks (SOB) along with branches of foreign banks (BFB) ended up with profit, while Private Banks (PB) ended up with loss in the review period.

The external sector worsened in the third quarter of the FY 2018 as compared with the same quarter of the previous year, recording a current account deficit of 21 percent and a deficit of USD 734.86 million in the balance of payments (BOPs).

According to the monetary statistics, reserve money (RM) has negative growth of 10 percent, higher than 8 percent of the FY 2017. Currency in circulation (CiC), as a major component of RM, recorded negative growth of 1.5 percent from beginning of FY 2018 till the end of the third quarter.

NIR increased slightly by 2.6 percent accumulating of USD 189.05 million at the end of third quarter of FY 2018.

1

Global Economic Environment

1

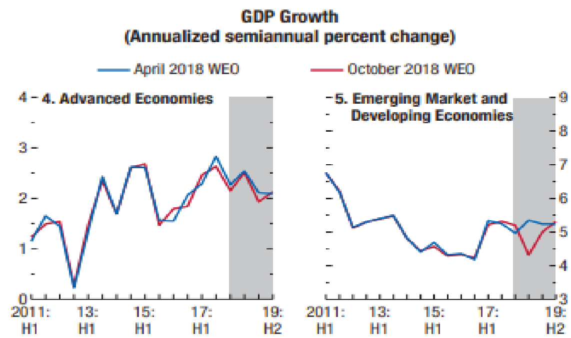
GLOBAL ECONOMIC ENVIRONMENT

Global growth is estimated to have grown at 3.1% in the third quarter of 2018. Among the advanced economies, the US projected stronger growth while the Eurozone and UK have experienced slower pace of growth in the third quarter of 2018. On the other hand, Japan's GDP shrunk over the same period.

Among the emerging countries growth was uneven as well. Intensifying trade tensions, a stronger US dollar and higher oil prices hampered some of the developing and emerging economies. However, some oil exporting countries saw positive effects.

The escalation of trade protectionism has raised serious concerns about future of global trade. The trade war between US and China that began in the second quarter intensified in the third, even while both nations attempted to resume negotiations. Both countries continued to impose tariff on each other's products three times in this quarter.

Figure 1. Advanced Economies and Emerging Economies GDP growth



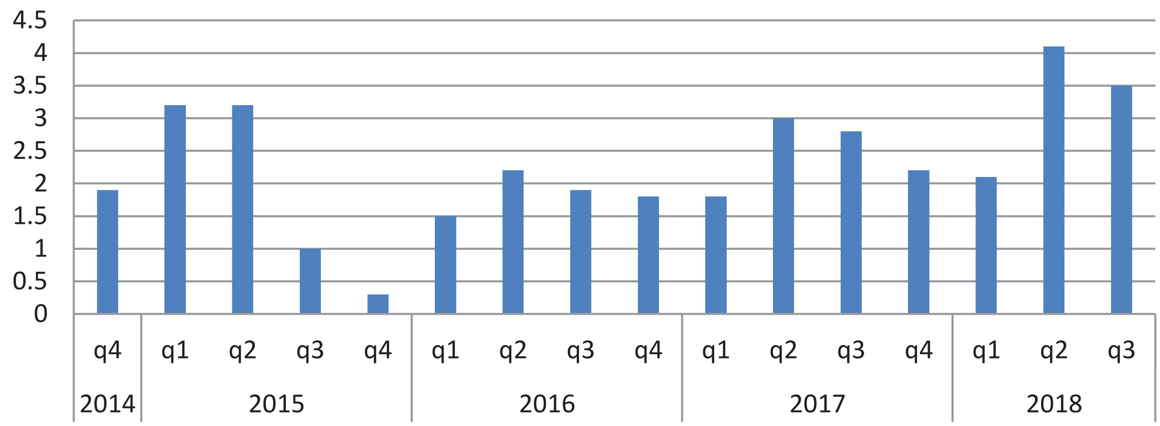
Source: IMF World Economic Outlook

I. ADVANCED ECONOMIES

1.1.1 The United States Economy

The US economic growth slowed down in the third quarter than the previous quarter. According to the Commerce Department, the GDP increased at a 3.5% annualized rate which is well above the government's 3% target. The government's 1.5 trillion tax cut stimulus package is considered to be the main driver of growth. It has boosted consumer spending and business investment. Consumer spending increased at 3.6% rate in the third quarter which is reflected in the strong domestic demand and increased imports. According to the government reports, after-tax profits increased at 3.3 percent rate in the third quarter while it rose to 2.1% pace in the second quarter.

Figure 1.2: The US Real GDP Growth Rate 2014-2018

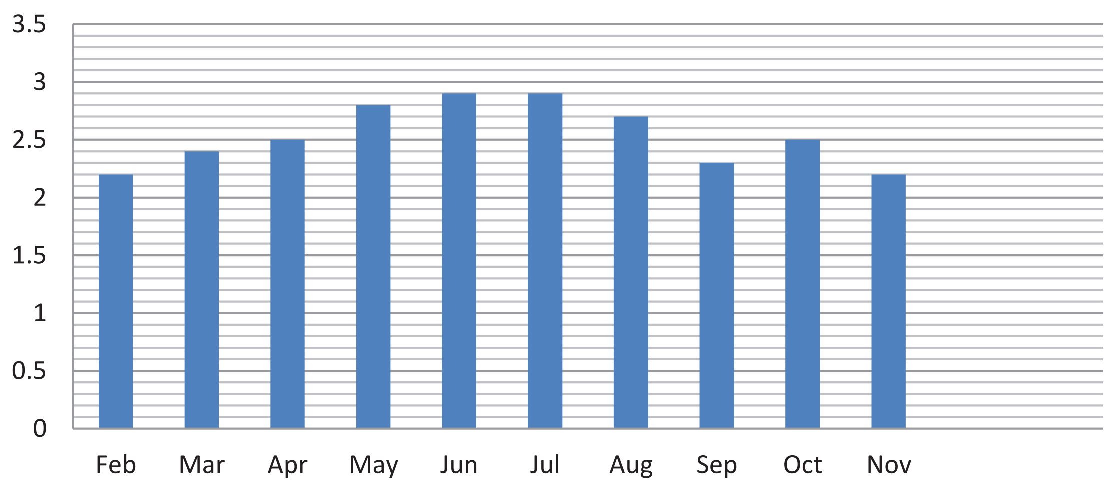


Source: Bureau of Economic Analysis, U.S. Department of Commerce

Though imports increased in this quarter, but some of the imports were used to stockpile inventories as trade tension increases. Inventory investment added up 2.27 percent to the growth.

However, economists cast doubt over the continuation of the economic expansion. Business spending on equipment shows to have decreased at the end of the third quarter and higher interest rates are slowing demand for housing. Furthermore, China's retaliatory tariffs has decreased the US exports. Imports increased faster in the third quarter while the decrease in exports was much sharper, which in turn leads to a wider trade gap. Growth is expected to slow down in the fourth quarter around 2.5% and even decline further down in 2019 as fiscal stimulus effects diminishes and trade war continues with China. Inflation rate continued to decline throughout the quarter from 2.9% in July to 2.3% in September, 2018.

Figure 1.3: The US Inflation Rate from April, 2018 – Jan, 2019

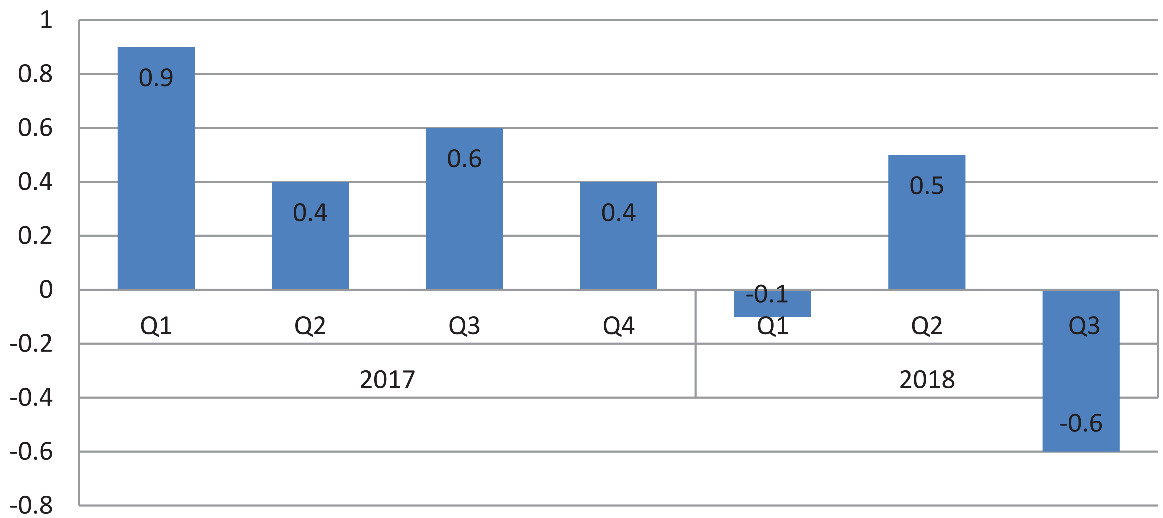


Source: Bureau of Labor Statistics, US Department of Labor

1.1.2 The Economy of United Kingdom

According to Office for National Statistics (ONS), growth accelerated in the third quarter of 2018. The GDP growth was 0.6% on quarter on quarter terms and 1.5% in annual term which were 0.4% and 1.2% in the second quarter respectively.

Figure 1.4: The UK GDP Growth from Q1, 2017- Q3, 2018



Source: Office for National Statistics, U.K.

In terms of production, the construction sector strengthened, largely due to more favourable weather conditions and a supportive base effect, while the manufacturing sector recovered from a contraction in the previous quarter, on greater output of motor vehicles. In contrast, growth in the service sector slowed. In terms of expenditure, private consumption grew at 0.5% from previous quarter, likely by a faster real wage growth. Government consumption expanded 0.6%. Meanwhile, fixed investment moved from a 0.5% decline in Q2 to a 0.8% expansion in the third quarter. However, the recovery in fixed investment was driven by stronger public investment, as business investment decreased for the third consecutive quarter for the first time since the financial crisis in 2008.

The external sector contributed to growth in the review quarter. Exports rose 2.7% during the reference period, driven by greater goods export while imports were flat. As a result, the external sector of UK contributed 0.8 percentage points to growth.

1.1.3 The Economy of Germany

The German GDP growth turned negative at -0.2% in the review quarter for the first time since early 2015. Negative growth is partly attributed to the slowdown in global demand and uncertainties caused by Brexit and has hurt German exports and investment this year. In addition, the 25% increase in oil prices between April and early October has hurt consumer spending.

Despite the construction industry operating at capacity limits, the labour market improving continually, and above-average wage and pension increasing, the GDP shows negative growth. There was a temporary reduction in car production and hampered delivery of key commodities by river due to this year's drought.

Another reason for this reduction is Germany's car industry which plays a key role in export-related growth, has also struggled with new emissions standards following the "Dieselgate" cheating scandal that has rocked the sector in recent years. According to data released by German Association of the Automotive Industry, car production in September fell 24% from the same month a year before.

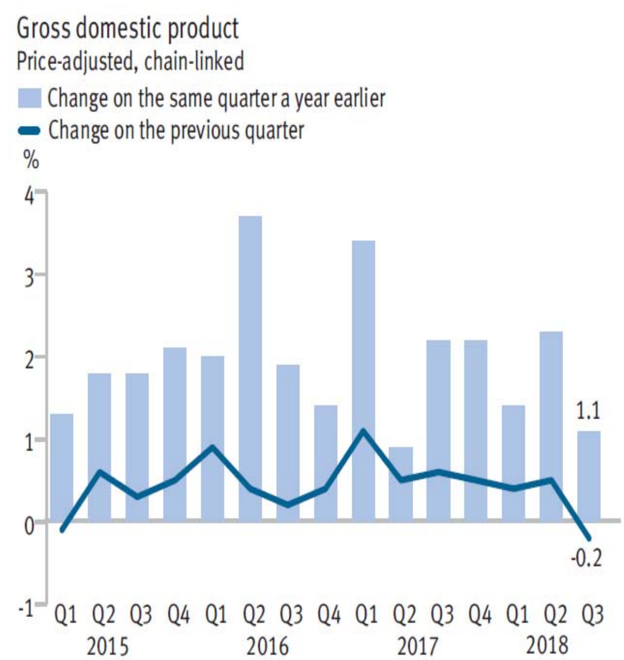


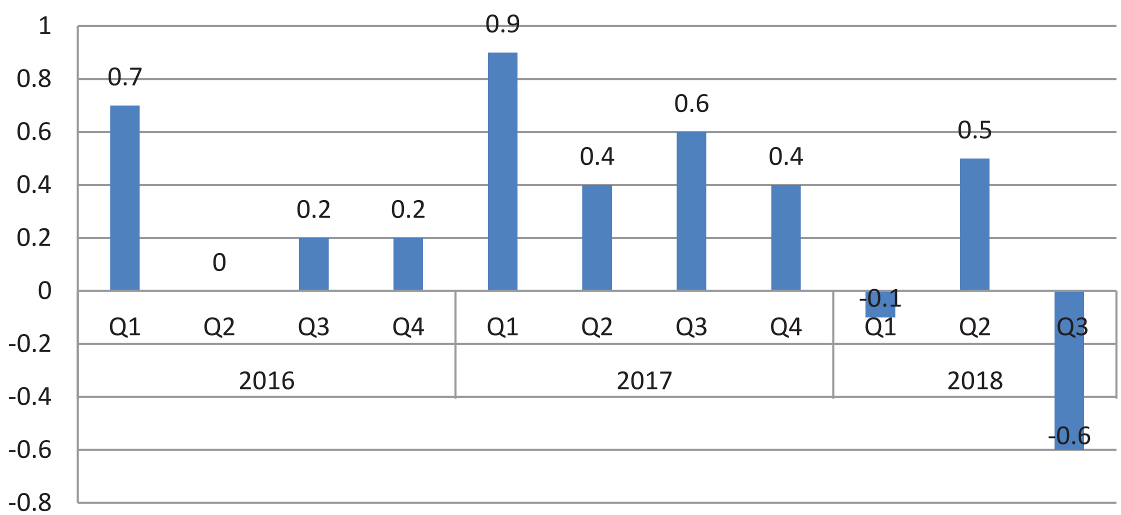
Figure 1.5: The GDP Growth Rate of Germany Q1, 2015–Q3, 2018
Source: Federal Statistics Office (DESTATIS), Germany

1.1.4 The Economy of Japan

The Japanese economy contracted the most in over four years in the third quarter of FY 2018 as capital expenditure declined, which is caused by decreased demand both at home and overseas as the exporting country feels the trade tension heat.

According to the data published by Cabinet Office the gross domestic product shrank at an annualized rate of 2.5%, deeper than an initial estimate of a 1.2% contraction and against economists' median estimate for a 1.9% decline which marked the sharpest contraction (q-o-q) since the third quarter of 2009.

Figure 1.6: The GDP growth rate of Japan (annual) Seasonally Adjusted 2014–2018



Source: Cabinet Office, Japan

The Private consumption, which accounts for roughly 60% of GDP, declined 0.2% in July-September from the previous three months, and the external demand dropped by 0.1%. However, housing investment grew by 0.6% quarter-on-quarter terms. Weak private consumption, supply chains and factory output is attributed to natural disaster. Furthermore, trade policy issue is another factor as US government is proposing to put tariffs on automobile imports from Europe and Japan.

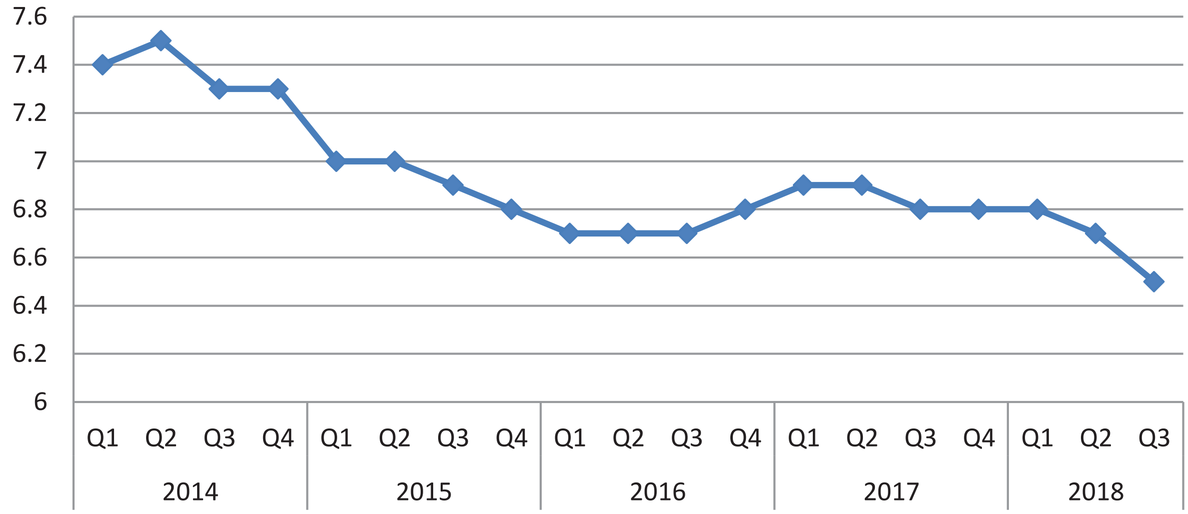
II. EMERGING MARKET ECONOMIES

1.2.1 The Economy of China

China's economy growth was 6.5% in the reference period over a year before which is lower than the first two quarters.

The service sector grew at 7.7% which also contributed for 60.8% of the GDP in the first three quarters. Manufacturing grew slower at 6.7% while the mining sector turned from contraction to expansion at 1.8%. Furthermore, online retail sales expanded 27.0% from the same period previous year.

Figure 1.7: The GDP Growth Rate of China 2014-2018



Source: National Bureau of Statistics of China

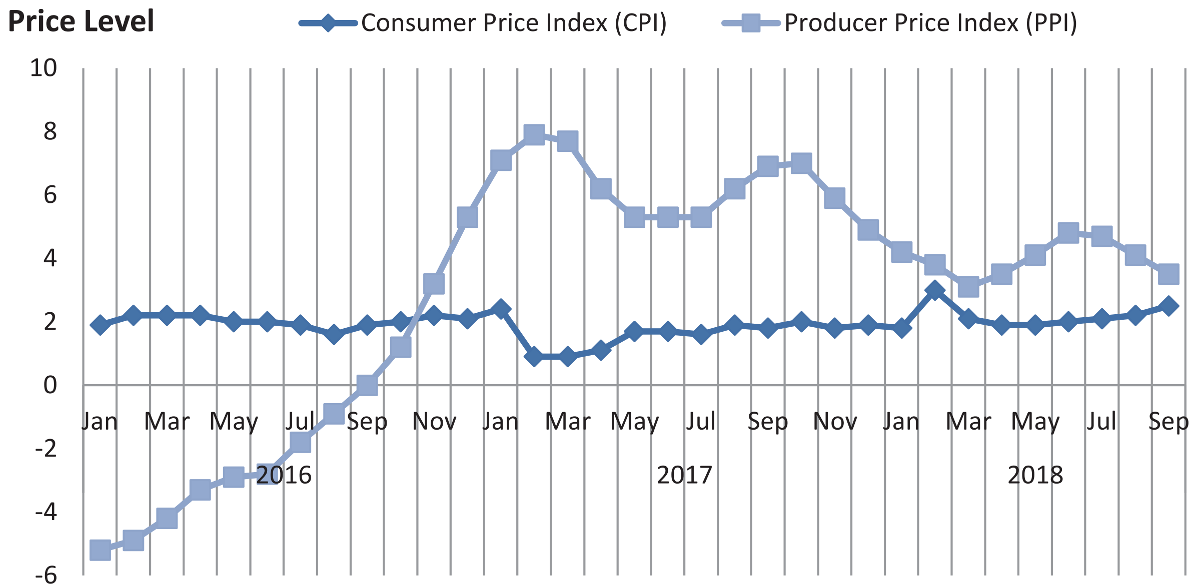
On the other hand, consumer spending decreased throughout the year to 9.3% in the third quarter, from 9.8% and 9.4% in the first and second quarters respectively. Industrial sector which grew stronger in the first two quarters slowed down in the third quarter. The first three quarters' aggregate growth rate was 6.4% which is lower than 0.3% than the same pervious previous year.

Automotive output growth which decreased significantly in the first quarter, but improved over the second and third quarter. However, the first three quarter aggregate was lower than the same period previous year.

Furthermore, exports grew by 14.5% and imports by 14.3% in US-Dollar terms in September. Though in the first quarter Chinese economy faced with a rare trade deficit, but it improved in the second and third quarters of 2018. Export is expected to increase in the fourth quarter as well.

Consumer price index saw a seasonal rise in the first quarter but slowed again in the second quarter. Recovering again, it closed with an over-all value of 2.5% in the third quarter. Producer prices have softened continuously from October 2017, reflecting a weaker demand for industrial goods.

Figure 1.8: China's CPI and PPI 2016-2018



Source: German Chamber of Commerce in China

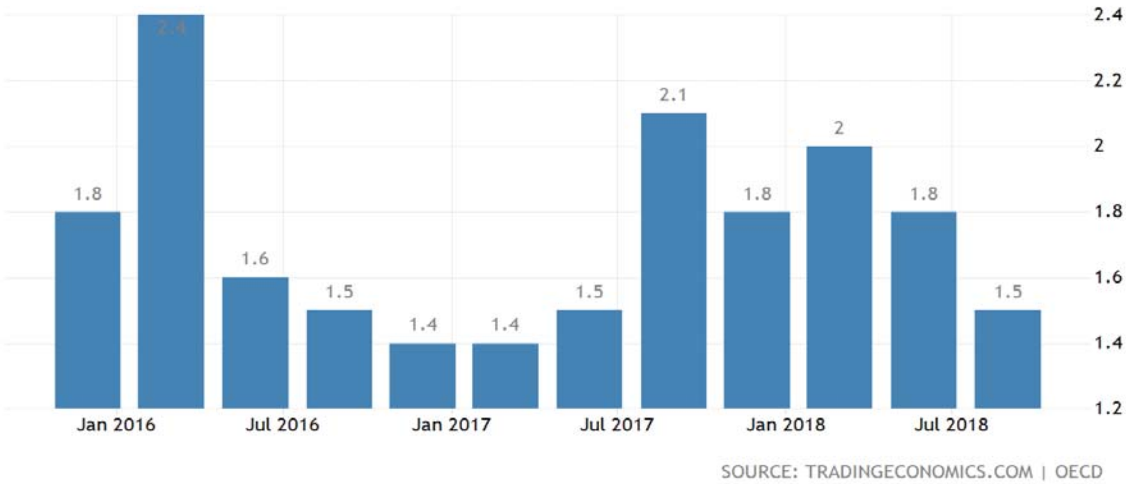
1.2.2. The Economy of India

In the second quarter of fiscal year 2018 which ran from July to September—GDP grew 7.1% in year-on-year terms. Slower manufacturing growth and 2.4% contraction in mining contributed to decline in growth. Furthermore, higher oil prices, weakening of the currency and liquidity issues impacted private consumption and private consumption decreased from 8.6% in quarter 1 to 7.0% in quarter 2 which also in turn contributed to lowering economic growth.

Export of goods and services increased a strong 13.4% in second quarter, up from 12.7% in the first quarter. Meanwhile, import growth went up to 25.6% in Q2, likely due to higher oil prices, which is far higher than the previous quarter's 12.5% reading. The external sector consequently subtracted 2.4 percentage points from economic growth in the second quarter of FY 2018, significantly more than the first quarter's 0.3 percentage-point deduction.

On the other hand, public consumption increased at an accelerated rate of 12.5% in Q2 compared to 10.0% in the previous quarters. Furthermore, fixed investment also increased 12.5% in second quarter up from 10.0% in the first quarter.

Figure 1.9: GDP Annual Growth Rate of India Jan, 2016- Jul, 2018



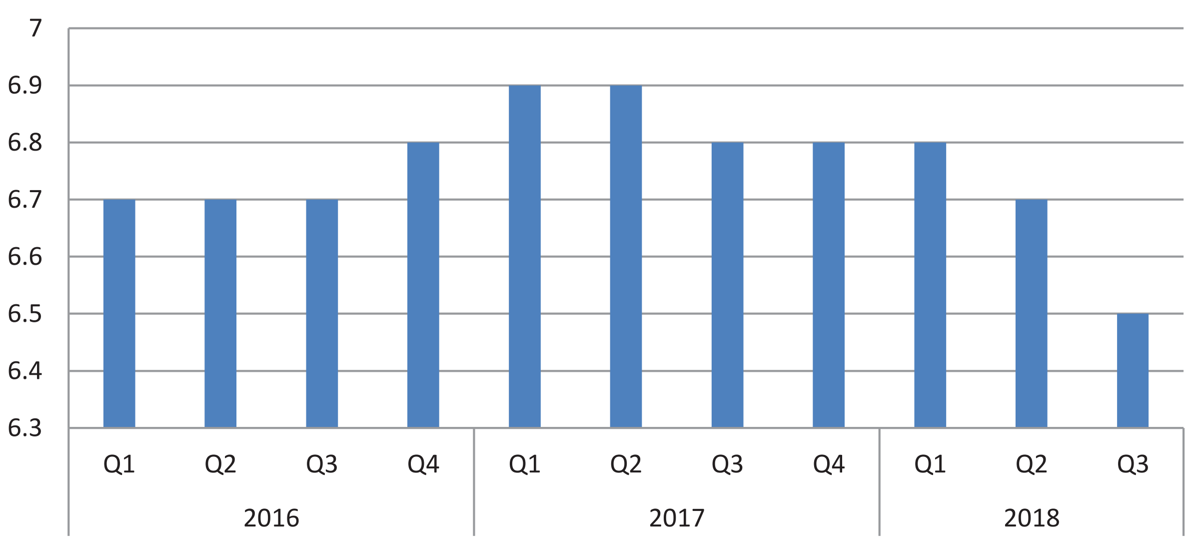
Source: Organization for Economic Co-operation and Development (OECD)

1.2.3 The Economy of Turkey

According to data released by Turkstat, the Turkish GDP grew at 1.6% in the third quarter of 2018 which was below market expectation as the country continued to deal with currency crisis, high inflation and high interest rates during the same period.

Domestic demand decreased significantly in this period and the private consumption growth slowed down to 1.1% from second quarter's 6.4% year on year, caused by increasing price pressures and weaker consumer sentiment. Furthermore, fixed investment on construction, machinery and equipment decreased sharply from second quarter's 4.2% to 3.8% year on year basis in the third quarter. In contrast, government spending growth maintained the robust momentum.

Figure 1.10: The GDP Growth Rate of Turkey Jan, 2016 - July, 2018



Source: Turkish Statistical Institute

The inflation rate of Turkey reached 11.13 percent in 2017, while this figure was recorded 7.79 percent in 2016. The CPI rose for transportation 1.69%, miscellaneous goods and services 0.05%, hotels, cafes and restaurants 0.47% and for clothing and footwear -2.39%, while the index declined only for food and non-alcoholic beverages amongst the main groups by 1.52%.

In 2017. Within average prices of 414 items in the index, prices of 48 items remained unchanged, while 242 items increased and prices of 124 items recorded lower prices.

The seasonally adjusted unemployment rate of Turkey was recorded at 10.9 percent. Number of unemployed persons aged 15 years old and over has realized as 3 million 454 thousand persons with 124 thousand persons increase in 2017 compared to the previous year. Unemployment rate realized as 10.9% without any change. Unemployment rate realized as 9.4% with 0.2 percentage point decrease for male and 14.1% with 0.4 percentage point increase for female.

In the same year, non-agricultural unemployment rate realized as 13% without any change. While youth unemployment rate including 15-24 age group realized as 20.8% with 1.2 percentage point increase. unemployment rate for 15-64 age group occurred as 11.1% without any change.

Turkey’s foreign trade gap rose to $76.7 billion in 2017, with a 36.8 percent year-on-year increase, official data has shown.

The country’s exports in 2017 amounted to over $157.05 billion, a 10.2 percent rise compared to the previous year. However, the Turkish Statistical Institute (TÜİK) announced that the Imports climbed 17.7 percent to $233.79 billion.

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German Chamber of Commerce in China	https://china.ahk.de
Turkish Statistical Institute	www.turkstat.gov.tr
Trading Economics	tradingeconomics.com
Organization for Economic co-operation and Development	http://www.oecd.org/
Focus Economics	www.focus-economics.com/
World Bank Group	www.theworldbank.org/

2

Money and Capital Market Development

2

MONETARY AND CAPITAL MARKET DEVELOPMENT

According to the monetary statistics, reserve money (RM) has negative growth of 10 percent in the FY 2018, higher than 8 percent of the FY 2017. Currency in circulation (CiC) as a major component of RM recorded negative growth of 1.5 percent from beginning of FY 2018 to the end of the third quarter.

Reserve money (RM) and Currency in Circulation (CiC) growth, which are Da Afghanistan Bank's operational and indicative targets, remained well below the targets during the course of the quarter under review. Narrow money (M1), stood at AFN 430,049 million at the end of third quarter of the year under review, registering a growth of 4 percent. Broad money (M2) demonstrated similar behavior, representing a growth rate of 3.60 percent (Y-o-Y), standing at AFN 466,660 million at the end of third quarter of FY 2018.

In order to mitigate excessive fluctuation of AFN exchange rate against foreign currencies and manage liquidity in the market, DAB uses FX and CNs auctions under the open market operations.

From the beginning of the financial year to the end of the third quarter of FY 2018, DAB has auctioned a total amount of USD 1686.44 million to absorb the excess liquidity from the market and as well as to mitigate the sharp fluctuations in the exchange rate of Afghani against foreign currencies. The total outstanding amount of CNs stood at AFN 39.515 billion at the end of the period under review.

Meanwhile, Afghani depreciated 9 percent against the US dollar from the beginning of the fiscal year till the end of the third quarter of FY 2018.

I. MONETARY PROGRAM

Reserve money remained the key operational target of the monetary policy during third quarter of FY 2018, while currency in circulation was set as the indicative target.

DAB applies quantitative theory of money to determine the amount of reserve money (RM) for the purpose of supporting domestic price stability, which is DAB's primary objective. Hence, targets for RM and CiC are based on expected economic growth and expected inflation during the concerned period. For the fiscal year 2018, the ceilings for reserve money and currency in circulation growth is 12 %. It is merit mentioning that from the beginning to the end of FY 2018 actual RM and CIC had negative growth by 10 and 1.5 percent, mostly both are bellow to the targets. DAB has auctioned USD 1,686.44 million via open market operation and sold USD 10 Million to Brishna (Afghan state owned electricity enterprise) to mop up the excess liquidity from the market and to prevent intense fluctuations of Afghani nominal exchange rate against foreign currencies, especially internationally convertible currencies.

The Figure 2.1 and 2.2 illustrate the ceiling and the actual reserve money and currency in circulation for the period under review.

Figure 2.1: Reserve Money for the FY 2018

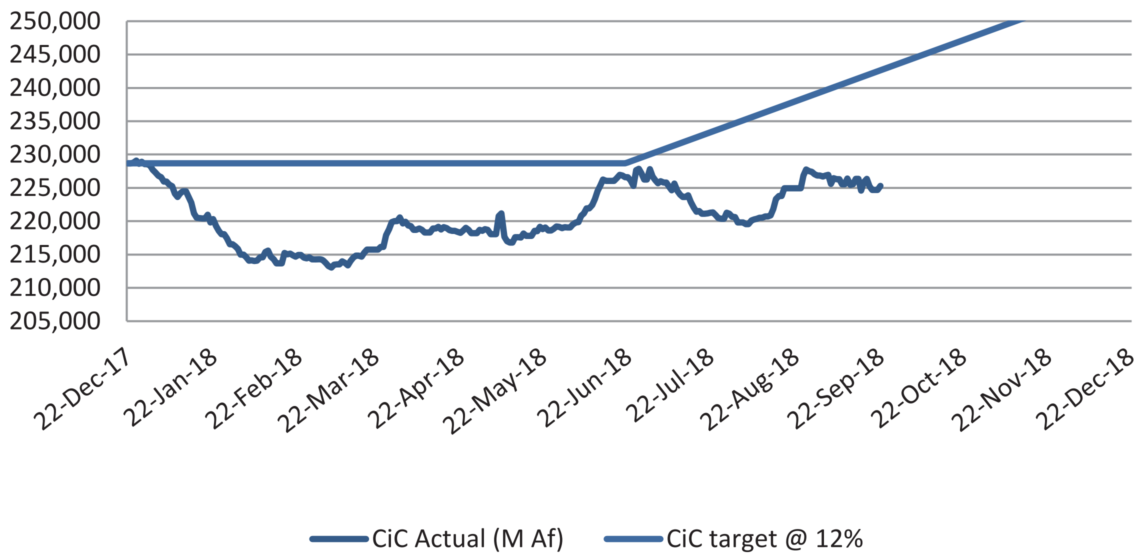
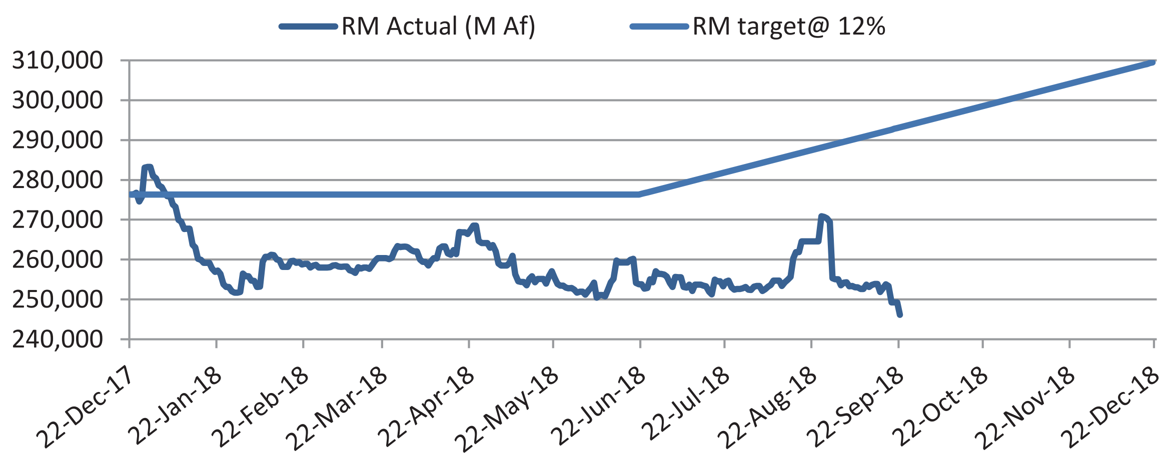


Figure 2.2: CiC for the FY 2018 (Dec. 22, 2017 to Dec. 22, 2018)



Source: Monetary Policy Department/DAB

II. MONETARY AGGREGATES

Narrow money and broad money are compiled based on Monetary and Financial Statistics Manual and Compilation Guide.

Narrow money (M1) includes currency outside depository corporations and demand deposits, while broad money (M2) includes narrow money components and other less liquid assets or quasi money.

As shown in Table 2.3, narrow money (M1) grew 4 percent till the end of the third quarter of fiscal year 2018, almost lower growth with the same period of FY 2017.

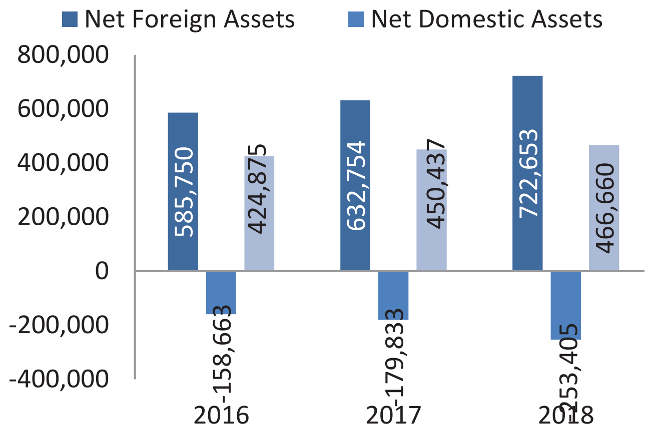
Currency outside depository corporations or CiC, which accounts for 50.16 percent of M1, grew by 1.19 percent , but lower from 3.4 percent growth of the same period in the previous year, showing difference of AFN 2,533 million. Demand deposits which are the other components of M1, experienced a growth of 7.35 percent at the end of third quarter of FY 2018, while its growth rate was 6.4 percent in same period of previous year. Demand deposit in comparison with the previous year shows a difference of AFN 14,673 million.

Broad money (M2) expanded by AFN 466,660 million in the quarter under review from AFN 450,437 million in the previous year, showing an increase of 3.60 percent, but lower from 6 percent growth of the same period in the previous year. Slower growth in broad money is mainly attributed to deceleration in the growth of currency in circulation and other deposits. The data shows that M1 with a share of 92.15 percent, remained the main contributing component of M2.

Quasi money (other deposits), which is the other component of M2 had negative growth of 2.61 percent (y-o-y) at the end of the third quarter of 2018. Quasi money constitutes 7.85 percent of broad money during the year under review, which is lower than 8.35 percent at the third quarter of FY 2018. Therefore, the impact of changes in quasi money on M2 is negligible. The year-on-year change of Afghani denominated time deposits stood at AFN 12,308 million, showing a negative growth of 19.68 percent, while the foreign currency denominated time deposits rose by 9.13 percent, reaching to AFN 24,304 million. Afghani-denominated time deposits and foreign currencies denominated time deposits constituted 2.64 percent and 5.21 percent of M2 respectively.

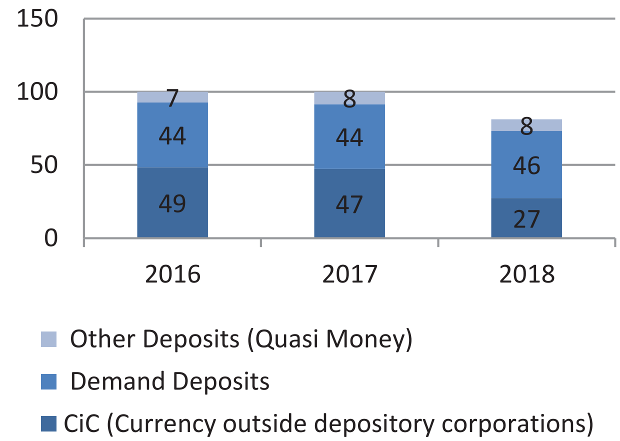
Demand deposits as a share of broad money stood at 45.93 percent at the end of the third quarter of year under review (Figure 2.3).

Figure 2.3: Net Foreign Assets, Net Domestic Assets and Broad Money



Source: Monetary Policy Department/DAB

Figure 2.4: CIC, Demand Deposits and Quasi-money as Share of Broad Money (%)



Source: Monetary Policy Department/DAB

Table 2.1: Monetary Aggregate for the FY 2018 (12/22/2017 to 9/22/2018)

In Million AFN	September-16 Q3 Amount	September-17 Q3 Amount	Y-o-Y Δ	Difference	September -18 Q3 Amount	Y-o-Y Δ	Difference
1- Net Foreign Assets	585,750	632,754	8.0%	47,004	722,653	14.21 %	89,900
(a) Foreign Assets	595,982	645,612	8.3%	49,630	736,722	14.11 %	91,110
DAB Foreign exchange reserves	489,881	541,629	10.6%	51,747	610,646	12.74 %	69,018
Gold	62,246	62,533	0.5%	287	64,078	2.47%	1,545
Other	427,635	479,095	12.0%	51,460	546,568	14.08 %	67,473
Other foreign assets	106,101	103,984	-2.0%	-2,117	126,076	21.25 %	22,092
(b) Foreign Liabilities	10,232	12,858	25.7%	2,627	14,069	9.41%	1,210
2. Net Domestic Assets	-158,663	-179,833	13.3%	-21,170	-253,405	40.91 %	-73,571
(a) Net Domestic Credit	-46,994	-54,608	16.2%	-7,614	-85,849	57.21 %	-31,241
Net Credit to Nonfinancial Public Sector	-94,915	-101,228	6.7%	-6,313	-134,258	32.63 %	-33,030
Net Credit to Central Government	-95,009	-101,323	6.6%	-6,313	-134,353	32.60 %	-33,030
Credit to Central Government	27,685	19,457	- 29.7%	-8,228	10,918	- 43.89 %	-8,539
Liabilities to Central Government	122,694	120,780	-1.6%	-1,914	145,271	20.28 %	24,491
Net Credit to State & Local	0.000	0.000	0.0%	0	0.000	0.00%	0

Government							
Net Credit to Public Nonfinancial Corporations	94	94	0.0%	0	94	0.00%	0
Credit to Private Sector	49,305	47,771	-3.1%	-1,534	49,506	3.63%	1,736
Net Credit to Other Financial Corporations	-1,384	-1,150	-16.9%	234	-1,098	-4.59%	53
(b) Capital Accounts	135,072	151,725	12.3%	16,652	191,747	26.38%	40,023
(c)Other Items Net	23,403	26,500	13.2%	3,096	24,192	-8.71%	-2,308
3- Broad Money (M2)	424,875	450,437	6.0%	25,563	466,660	3.60%	16,223
Narrow Money (M1)	393,809	412,843	5%	19,034	430,049	4%	17,206
CiC (Currency outside depository corporations)	206,175	213,170	3.4%	6,995	215,703	1.19%	2,533
Demand Deposits	187,634	199,673	6.4%	12,039	214,346	7.35%	14,673
Other Deposits (Quasi Money)	31,065	37,594	21.0%	6,529	36,611	-2.61%	-983
In Afghani	10,964	15,323	39.8%	4,359	12,308	-19.68%	-3,015
In Foreign currency	20,102	22,271	10.8%	2,170	24,304	9.13%	2,032
Securities Other Than Shares	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Source: Monetary Section, Monetary Policy Department/DAB

III. NET INTERNATIONAL RESERVE (NIR)

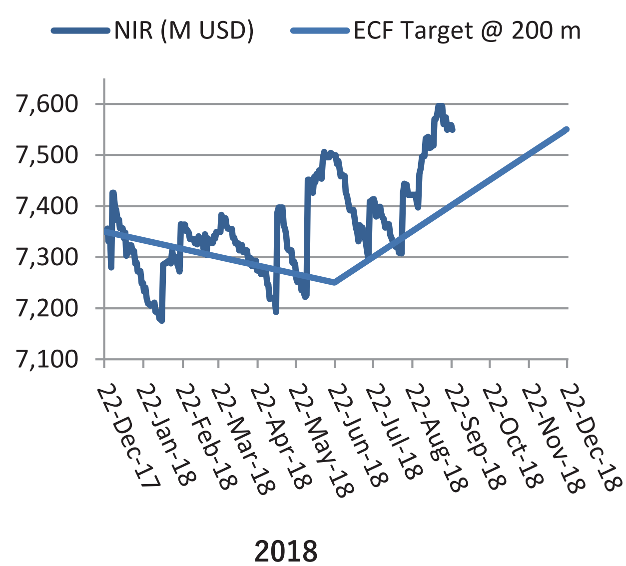
Da Afghanistan Bank holds international reserves, which consist of monetary gold, reserve position and holdings of Special Drawing Rights (SDR) with the IMF, as well as major foreign exchange such as US dollars, Euro, Great British Pound and others. The Net International Reserves (NIR) of Afghanistan,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

NIR increased slightly by 2.6 percent accumulating of USD 189.05 million at the end of third quarter of FY 2018.

NIR accumulation ceiling was set at USD 7,402.80 million, while in actual case, NIR reached to USD 7,534.41 million for the mentioned period under review.

Figure 2.5 illustrates actual and target trend of NIR during period under review of 2018.

Figure 2.5: NIR actual and target Q3, FY



Source: Monetary section, Monetary Policy Department/DAB

IV. FOREIGN EXCHANGE MARKET

4.1 Exchange Rates

Da Afghanistan Bank's (DAB) ultimate goal is to maintain price stability. In order to achieve and maintain this goal, DAB puts its focus to utilize its monetary instruments, via the open market operations, effectively with sound policy implementation.

During the first to the end of third quarter of FY 2018, Afghani relatively depreciated against the Great British pound, European Euro and Swiss Franc, United States Dollar, United Arab Emirates dirham and Saudi Riyal, while it was appreciated against Indian rupee, Pakistani Rupee and Iranian Toman.

The daily historic review of the average exchange rate of Afghani against the U.S. dollars and other foreign currencies from the beginning of year to the end of the third quarter of FY 2018 are shown in figures below.

Figure 2.6: Daily Average Ex-rate of Afghani against USD for till the end of Q3, FY 2018

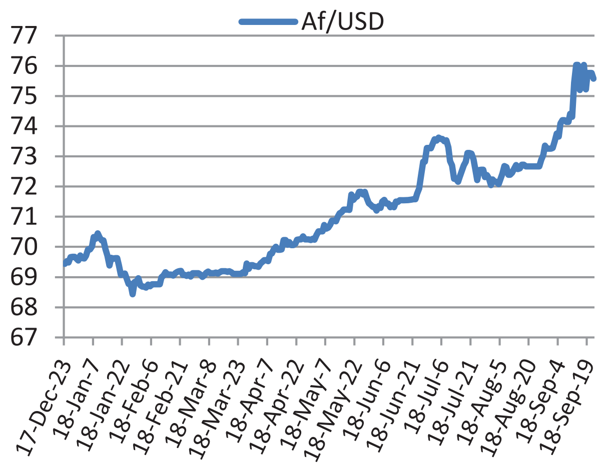


Figure 2.7: Daily Average Ex-rate of Afghani against GBP & Euro Q3, FY 2018

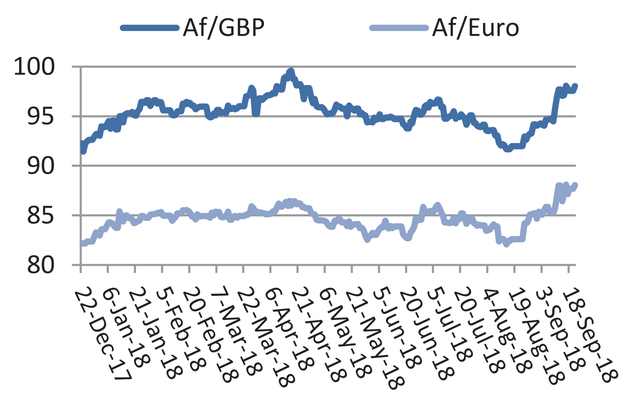


Figure 2.8: Daily Average Ex-rate of Afghani against INR & PKR Q3, FY 2018

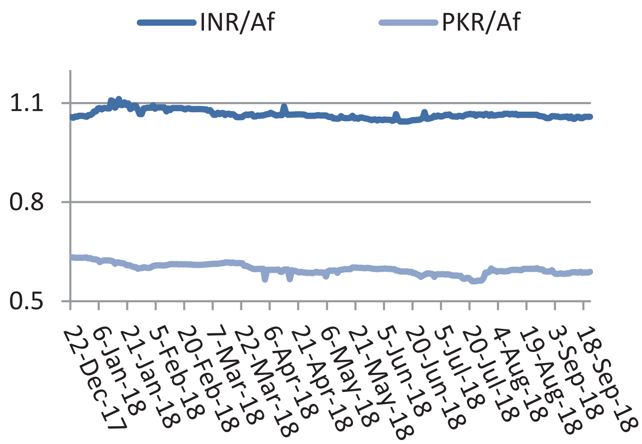
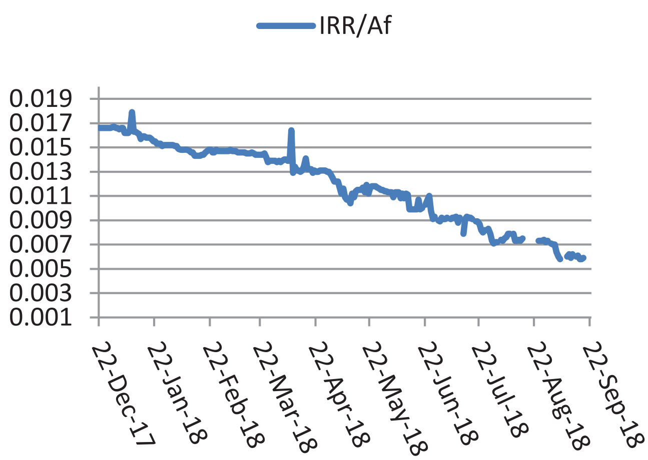


Figure 2.9: Daily Average Ex-rate of Afghani against IRR Q3, FY 2018



Source: Monetary Section, Monetary Policy Department/ DAB

V. OPEN MARKET OPERATION & LIQUIDITY CONDITIONS

2.5.1 Foreign Exchange Auction

In order to control the money supply and maintain price stability in domestic market, DAB manages the reserve money growth close to its ceiling by conducting FX (USD) auctions three times a week and a weekly capital notes auctions, which are the primary monetary instruments. DAB continued the FX auction to mop up excess liquidity from the market and to smooth out excessive volatility of the exchange rate of Afghani against foreign currencies, especially the U.S dollar.

From the beginning of FY 2018 to the end of the third quarter , DAB auctioned a total amount of USD 1,686.44 million, while the total demand was USD 2,354.89 million. On average, 50 bidders participated in each auction and 38.67 bids were announced as the winning bids with the average amount of USD 19.60 million sold in each auction and the total withdrawal of AFN is recorded AFN 119.68 billion . The data for the end third quarter of FY 2017 recorded a total auctioned amount of USD 1,320.88 million, with a total demand of USD 1,838.01 million. On average, 44 bidders participated in each auction and 31.38 bids were awarded with an average amount of USD 12.23 million in each auction and the total withdraw is recorded AFN 89.608 billion.

Figure 2.10, shows the total amount of USD, awarded and demanded through auctions for the beginning of FY 2018 to the end of third quarter.

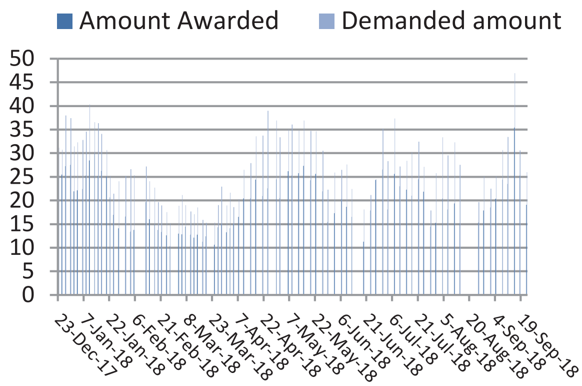


Figure 2.10: USD awarded and demanded amount till the end of Q3, FY 2018

Source: Monetary Policy Department/DAB

2.5.2 Capital Notes Auction

Capital notes are Afghani denominated short–term securities offered by DAB to the primary market customers, which are licensed commercial banks on weekly basis.

Da Afghanistan Bank uses Capital Notes (CNs) as a monetary tool to manage the money supply growth. Capital notes are used to absorb the excess liquidity of the commercial banks.

Currently, DAB offers capital notes with the maturities of one week, one month, three months, six months and one year.

Total outstanding stock of capital notes reached AFN 39.515 billion at the end of third quarter of FY 2018, which shows a decrease of AFN 2.05 billion compared to AFN 41.57 billion at the end of the third quarter of FY 2017. The main reason for decreasing of outstanding compared to same period of previous year scale down of auction of 182, 364 Days capital notes is that considering to the current economic situation in the country, DAB has gradually decreased the auction of 182 and 364 day capital notes as well as their interest rates in order to encourage investment and increase peoples' access to finance. Lower interest rates on these notes will facilitate the issuance of banking credits to the public with simple requirements and lower interest.

The outstanding stock of 7-days capital notes stood at AFN 6.9 billion, 28 days CNs outstanding amount stood at AFN 18.45 billion, while 91 days outstanding stock of CNs recorded the amount of AFN 11.9 billion. The stock of outstanding for 182 days stood at 2.3 billion respectively. Total interest paid to CNs figured out to AFN 58.98 million till the end of the third quarter of year under review.

In addition, the weighted average interest rate for 7-days capital note was 0.15 percent, for 28 days security recorded at 0.34 percent, for 91 days notes was 0.46, for 182 days notes was 0.89 and in 364 days there was no auction in capital notes from beginning of FY 2018 to the end of third quarter, which are generally in lower levels than the same period of the previous year.

Figure 2.11: Capital notes stock of outstanding from the beginning of the FY 2018 to the end of the third quarter

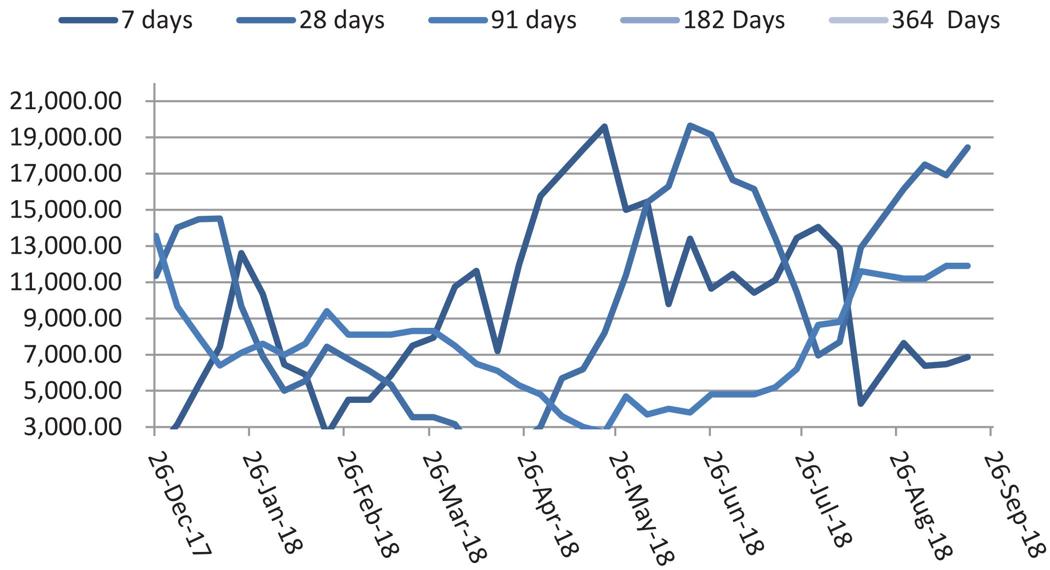
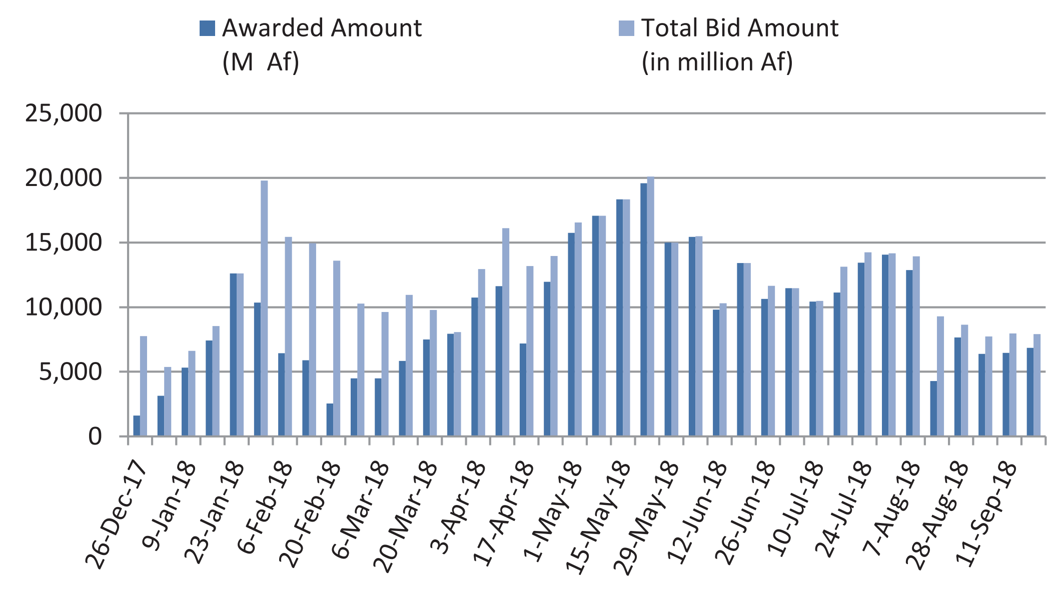


Figure 2.12: 7 Day CNs demanded and awarded amount in Million AF



Source: Monetary Section, Monetary Policy Department, DAB

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Figure 2.13: 28 days CNs demand and awarded amount from the beginning of the FY 2018 to the end of the third quarter

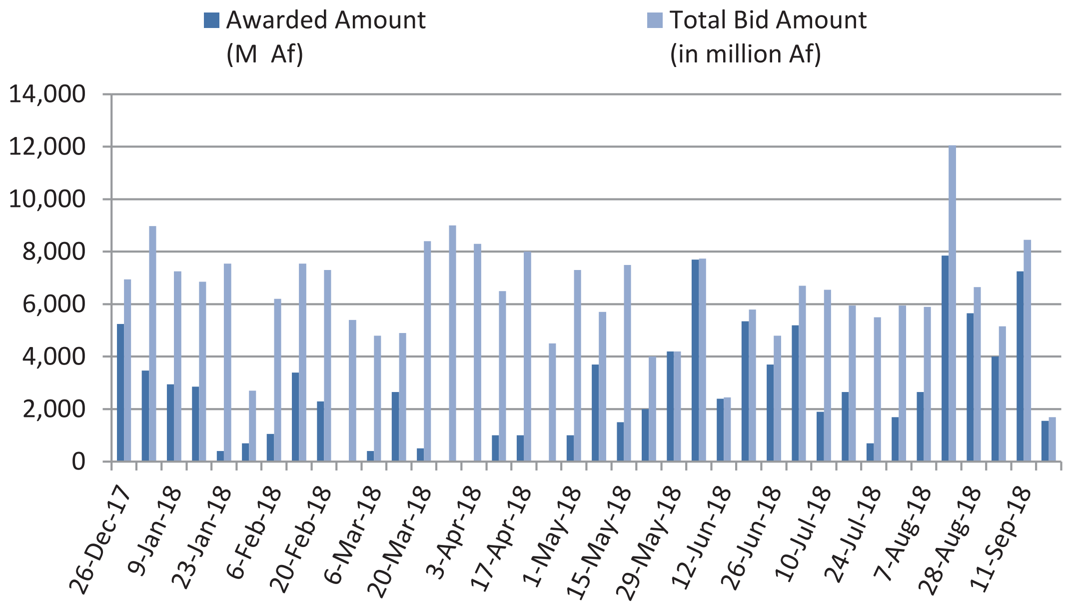


Figure 2.14: 91 days CNs demand and awarded amount

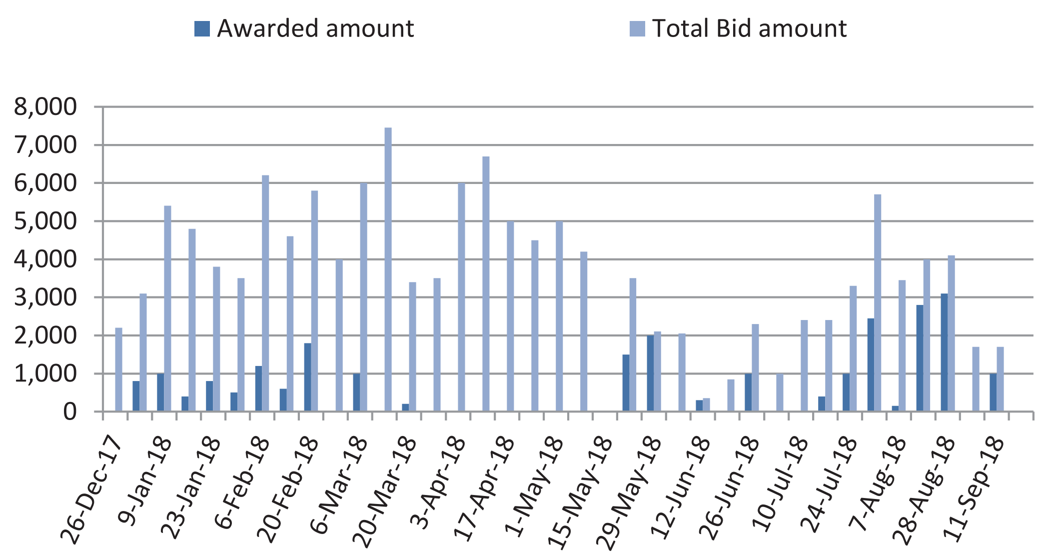
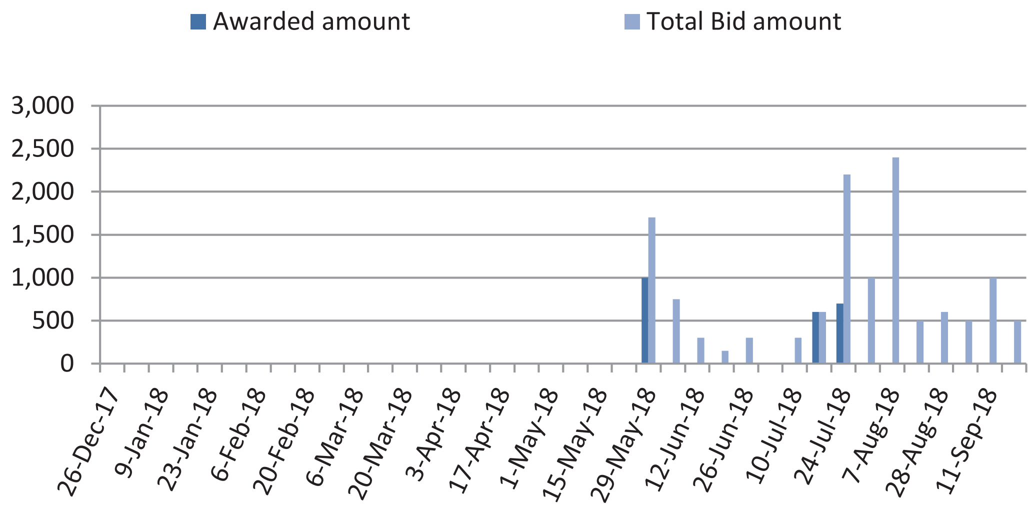


Figure 2.15: 182 days CNs demand and awarded amount



Source: Monetary Sector, Monetary Policy Department/DAB

2.5.3 Required and Excess Reserves

Commercial banks are required to hold 8 percent of their total deposits as obligatory reserves with DAB for their Afghani denominated accounts and 10 percent for foreign currency denominated accounts. Now the required reserves are held in the currency of denomination (domestic and foreign), unlike the previous practice, which required reserves for all deposits were maintained in domestic currency. No interest is given for such deposits to commercial banks. It shows the AFN 6,136.46 million and USD 224.31 million and Euro 22.98 million recorded at the end of third quarter of FY 2018.

Overnight Deposit Facility (ODF)

This facility is available to all commercial banks to gain interest on their excess balances. The interest rate on the overnight deposit facility is now 10 basis points. (Based on a circular to all banks approved by DAB's Supreme Council on September 11, 2017).

The average outstanding amount of overnight deposit facility recorded AFN 22,132.01 million from beginning of FY 2018 to the end of the third quarter and the payment of interest rate to the mentioned facility reached to AFN 16.7 million for the same period.

Overnight Credit Facility (OCF)

This facility is used by banks for short term cash needs. The facility allows banks to borrow Afghani from Central Bank on an overnight basis when they face a shortfall in cash flow. The rate that the commercial banks are charged for this facility is 10 basis points above the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only.

During the period under review, no bank has used the credit facility.

3

Inflation Trend and Outlook

3

INFLATION TREND AND OUTLOOK

Commodity prices in the third quarter of 2018 were buffeted by geopolitical and macroeconomic events. Energy prices gained 3 percent in 2018 Q3 (q-o-q), partly in response to the impending re-imposition of sanctions on Iran by the United States along with continuing declines in production in Venezuela. As a result, crude oil prices are expected to average $72 per barrel (bbl) in 2018 (up from $53/bbl in 2017) and $74/bbl in 2019. This represents a sizable upward revision from the April 2018 forecast. Moreover, risks to the oil price forecast are to the upside in the short-term, given the recent decline in spare capacity. In contrast, metal and agricultural prices declined 10 and 7 percent, respectively, in the third quarter of 2018 amid robust supplies and trade disputes. Metal prices are expected to stabilize in 2019 whereas agricultural prices are expected to gain almost 2 percent. This edition also examines how energy and metal commodity markets have evolved over the past 20 years. It shows that China has been the main driver of commodity demand growth, particularly for coal and metals, but that its demand is likely to slow while other emerging market economies are unlikely to emulate China.

After gaining momentum earlier in this year, most agricultural commodity prices weakened significantly in the third quarter of 2018. This was mostly in response to upward revisions to production estimates for key crops as well as to a lesser extent currency depreciations among some commodity exporters. Oil and meals suffered the largest losses following china's 25 percent tariff on U.S. soybeans.

Energy: The World Bank energy price index rose by 3 percent in the third quarter of 2018 and is more than 40 percent higher than the same period in 2017, with strong gains across oil, coal and natural gas. For crude oil, prices have been supported by a combination of robust demand and supply concerns. Production continues to decline in Venezuela, while the impacts of U.S. sanctions on Iranian oil exports is expected to be larger than in 2012. Limited spare capacity among OPEC members and the decline in stocks this year suggests the oil market is relatively tight at present and prices are susceptible to supply shocks. Prices are expected to increase average 33 percent till the end of 2018, compared to 2017 and non-energy prices are projected to be roughly stable, gaining about 2 percent in 2018. Downward risk to the price forecast comes from escalating trade tension. On upward risk include persistently high energy prices which would raise fuel costs and fertilizer prices.

Energy prices increased by 3 percent in third quarter of 2018 and are more than 40 percent higher than the same period in 2017, with strong gain in oil, coal and natural gas. Oil prices were volatile in third quarter of 2018, with the price of Brent crude oil reaching a low of $ 70/bbl. in august before peaking at $ 78/bbl. in the month of September 2018. The increase in prices partly reflected continued production losses in Venezuela, and concerns that the reintroduction of sanctions on Iran by the United States may have a greater than-expected impact on Iranian oil production and exports.

The above facts and figures show that key energy and non-energy, including industrial and agricultural commodity prices has increased in third quarter of 2018. They are projected to further show moderate steady pace in global commodity market in the fourth quarter of 2018 as well, which will have direct and indirect effects on Afghanistan national inflation rate till the end of 2018.

Non-energy: The World Bank's precious metals price index declined 8 percent in the third quarter (q/q), reaching its lowest level since Q1, 2016. The decline was sharpest in platinum (down 10 percent) followed by silver and gold. Contraction of physical demand of gold from China and India, weaker investment demand, an appreciation of the U.S. dollar, and tighter monetary policy in several advanced economies, have all contributed to the weakness. Precious metals prices are projected to decline by almost 1 percent in 2019 in addition to the 2 percent loss in 2018 owing to continued tightening of monetary policy and a further weakening of demand. Upside risks to the forecast include the possibility of a weaker-than-expected dollar or a slower pace of monetary policy tightening in the U.S. Conversely, downside risks stem mainly from further strengthening of the U.S. dollar and weakening of physical demand.

Agriculture: After gaining momentum earlier in the year, most agricultural commodity prices weakened significantly in the third quarter of 2018. This was mostly in response to upward revisions to production estimates for key crops and, to a lesser extent, currency depreciation among some commodity exporters. Oils and meals suffered the largest loss following China's 25 percent tariff on U.S. soybeans. On average, the agricultural price index is expected to be roughly unchanged in 2018 compared to 2017. Mainly owing to higher cost of energy and fertilizers. Downside risks to the price forecast emanate from escalating trade tensions. On the upside, high energy prices could lift prices of energy-intensive crops, notably grains and oilseeds. Higher energy prices raise operating costs, increase fertilizer prices, and encourage bio-fuels production. Prices are expected to slightly increase till the end of 2018 and are projected to gain 2 percent in 2019 as input costs rise, including energy and fertilizers.

I. CONSUMER PRICES IN AFGHANISTAN

Currently, Currently, the consumer price index (CPI) in Afghanistan is compiled on the base prices of April 2015 while previously; the CPI was calculated on the base prices of March 2011. Similarly, in this revision, the CPI components are also aligned with new weights. As per data from the National Statistics and Information Authority (NSIA) and analysis of Da Afghanistan Bank (DAB), the following results were observed in the third quarter of 2018 in consumer price index of Afghanistan.

Based on year over year comparison, changes in the consumer price index exhibited a disinflation rate of 0.1 percent on average in the third quarter of 2018 lower than 4.5 percent observed in the third quarter of the previous year. The decrease in the inflation rate was caused by many economic factors. Such as, low local demand and newly established greenhouses in different parts of the country. Additionally, based on the World Bank commodity report, most items of the global food index indicated lower prices in 2018 compared to 2017.

While on the other hand, the inflation measured on quarter-on-quarter basis, indicates price increase in the period under review. Observing the data for the third quarter of 2018, the average inflation rate increased to 0.1 percent in third quarter of 2018, higher than average rate of -1.1 percent recorded in the previous quarter of current year.

Kabul CPI shows that headline inflation in the capital increased to 0.9 percent in the third quarter of 2018 compared to 0.2 percent recorded in second quarter of 2018, while on contrary it declined on year over year basis. Analyzing the Kabul headline CPI, the inflation rate decreased to 0.9 percent on average in the third quarter of 2018 from 4.6 percent recorded in the same quarter of the previous year. However, the index has increased to 0.9 percent on average from 0.2 percent observed in the previous quarter.

3.1 Developments in National Headline Inflation (Y-o-Y)

3.1.1 Annual Developments

The headline consumer price index observed a significant decline on year-over-year basis in the third quarter of 2018. As per the available data, the headline inflation measured on year-over-year basis, declined to 0.9 percent on average in the third quarter of 2018 from 4.6 percent recorded in the same period of previous year. When calculated on monthly basis, a disinflation rate of 0.9 percent, 0.8 percent, and 0.9 percent were recorded in the months of July 2018, August 2018 and September 2018 respectively, compared to inflation rate of 5.1 percent, 4.8 percent and 3.9 percent in the months of July 2017, August 2017 and September 2017 respectively.

In food index, the inflation rate declined to -2.6 percent on average in the third quarter of 2018 from 6.2 percent observed in the same quarter of 2017. In the above mentioned index, the deflationary pressures came from lower prices of bread and cereals, meat, milk, cheese and eggs, oil and fats, spices, vegetables, sugar and sweets as well as non-alcoholic beverages. The largest decline was recorded in the prices of vegetables and spices which decreased to -17.2 percent and -15.6 percent on average from 21 percent and -3.4 percent in the same quarter of the previous year. Similarly, decrease was observed in all other components of food index during the period under review.

In non-food category, the inflation declined to average 2.7 percent in the third quarter of 2018 from 2.9 percent observed in the same quarter of 2017. Substantial decreases were noted in price index of tobacco, housing and health which declined to (4.5%), (2.1%), and (0.5%) on average in the third quarter of 2018 from (8.0%), (4.6%) and (1.0%) recorded in the second quarter of 2017. On the other hand, an upward trend observed in the price index of clothing and transportation which increased to 3.6 and 9.4 percent on average in the third quarter of 2018 from 1.6 and 6.2 percent recorded in the same period of previous year respectively.

The core inflation also showed downward slope in the third quarter of 2018 compared to the same quarter of 2017. The trimmed mean which is the most common measure of core inflation, dropped to 1.3 percent on average in the third quarter of 2018 from 3.1 percent observed in the same period of previous year. In addition, the CPI inflation, excluding bread and cereals, oil and fats and transportation also declined to -0.6 percent in third quarter of 2018 down from 4.3 percent calculated in the same period of 2017.

Table 3.1: National Headline Inflation FY 2017-18

Period	Weight	Jul-17	Aug-17	Sep-17	Average (3 month)	Apr-18	May-18	Jun-18	Average (3 month)	Jul-18	Aug-18	Sep-18	Average (3 month)
	2017							2018					
	Based on Apr 2015												
Overall Index	**100.0**	**5.1**	**4.5**	**3.8**	**4.5**	**-0.5**	**-1.1**	**-1.6**	**-1.1**	**-0.1**	**0.1**	**0.2**	**0.1**
Food & Non-Alcoholic Beverages	**47.8**	**7.4**	**5.9**	**5.4**	**6.2**	**-2.6**	**-3.6**	**-5.0**	**-3.7**	**-3.5**	**-2.5**	**-1.9**	**-2.6**
Bread and Cereals	**14.6**	4.0	4.3	3.2	3.8	1.5	0.4	-1.4	0.2	0.6	1.0	3.3	1.6
Meat	**7.5**	7.3	4.4	4.8	5.5	0.0	0.1	-1.3	-0.4	-0.8	0.1	1.1	0.1
Milk, cheese and eggs	**4.7**	2.0	2.1	3.7	2.6	-0.5	-0.4	-0.7	-0.5	0.9	1.0	1.0	1.0
Oils and fats	**4.6**	9.1	9.6	6.1	8.3	-0.2	-1.2	-2.5	-1.3	-1.6	-2.2	-2.2	-2.0
Fresh and dried fruits	**5.0**	5.9	6.3	6.9	6.4	1.1	2.5	-3.7	0.0	1.3	3.3	0.0	1.5
Vegetables	**6.0**	24.7	18.0	20.2	21.0	-10.5	-17.3	- 17.3	-15.0	- 18.3	- 16.1	- 17.2	-17.2
Sugar and sweets	**2.7**	3.6	-0.4	-2.9	0.1	-11.3	-9.7	-9.4	-10.1	-8.3	-7.6	-3.6	-6.5
Spices	**1.3**	1.1	-3.7	-7.5	-3.4	-22.4	-20.7	- 19.8	-21.0	- 17.2	- 15.7	- 13.9	-15.6
Non-alcoholic beverages	**1.4**	3.2	2.7	2.3	2.7	1.9	2.0	1.2	1.7	2.0	2.6	2.2	2.3
Non-Food Items, Tobacco & Services	**52.2**	**3.0**	**3.3**	**2.4**	**2.9**	**1.6**	**1.5**	**1.7**	**1.6**	**3.1**	**2.6**	**2.3**	**2.7**
Tobacco	**0.3**	8.5	8.8	6.7	8.0	3.2	2.8	3.4	3.1	4.2	4.2	5.2	4.5
Clothing	**4.6**	1.6	2.5	0.8	1.6	3.2	2.9	2.6	2.9	3.3	3.6	3.8	3.6
Housing	**19.1**	4.7	5.3	3.7	4.6	0.8	0.6	1.1	0.8	3.5	2.1	0.8	2.1
Furnishing and household goods	**11.9**	2.3	2.3	1.9	2.2	2.7	2.1	1.6	2.1	2.1	2.2	2.8	2.4
Health	**6.2**	1.0	0.9	1.2	1.0	0.3	0.1	0.0	0.2	0.8	0.5	0.2	0.5
Transportation	**4.3**	7.0	6.4	5.3	6.2	2.1	4.2	5.8	4.0	9.2	9.4	9.7	9.4
Communication	**1.7**	-3.3	-2.8	-2.3	-2.8	-0.1	0.1	0.1	0.1	0.2	0.2	0.4	0.3
Information and Culture	**1.1**	-3.5	-3.8	-5.1	-4.2	-1.7	-0.4	-0.4	-0.8	-1.6	-0.7	0.5	-0.6
Education	**0.4**	5.7	3.7	0.1	3.1	10.2	10.3	10.0	10.2	8.5	5.6	4.5	6.2
Restaurants and Hotels	**1.1**	-0.2	0.2	-0.3	-0.1	2.1	2.1	2.1	2.1	3.4	2.7	3.0	3.0
Miscellaneous	**1.4**	2.5	2.7	2.8	2.7	2.8	2.1	3.5	2.8	3.2	3.2	2.7	3.0
CPI ex. B & C, O & F, and T		**5.0**	**4.2**	**3.7**	**4.3**	**-1.0**	**-1.6**	**-2.0**	**-1.5**	**-0.7**	**-0.4**	**-0.7**	**-0.6**
30% trimmed mean		**3.7**	**3.1**	**2.4**	**3.1**	**0.9**	**0.9**	**0.2**	**0.7**	**1.2**	**1.4**	**1.4**	**1.3**

Source: National Statistics and Information Authority/Monetary Policy Department, DAB

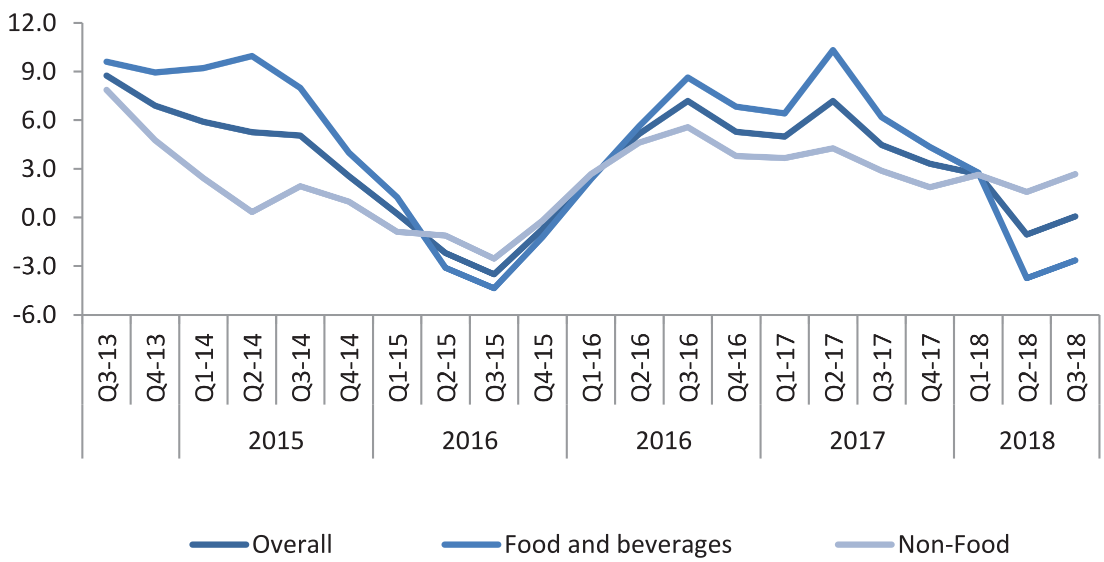
3.1.2 Quarterly Developments in National Headline Inflation

The quarterly inflation exhibited positive trend and prices jumped up both in food and non-food items. The national headline inflation calculated on quarter on quarter basis increased to 0.1 percent on average in the third quarter of 2018 from -1.1 percent recorded in the previous quarter of same year. The main increase in the headline inflation rate was the result of high prices observed in both food and non-food items.

On quarterly basis, the food inflation increased to 0.1 percent on average in the third quarter from -3.7 percent recorded in the previous quarter of 2018. The prices of food items such as, bread and cereals, meat, milk cheese and eggs, sugar and sweets, fresh and dried fruits and non-alcoholic beverages increased on quarterly basis. On contrary, the prices of oil and fats and vegetables decreased from the previous quarter. However, in this category, the largest quarterly increases were recorded in spices, sugar and sweets and bread and cereals prices which were recorded as -15.6 percent, -6.5 percent and 1.6 percent compared to previous quarter figures -21.0 percent, -10.1 percent and 0.2 percent respectively.

Similarly, the non-food inflation increased to 2.7 percent on average in the third quarter of 2018 from 1.6 percent recorded in the previous quarter of 2018. In this category, the prices of education item decreased with big margin. On the other hand, stable and higher prices observed in all other sub items of non-food category, the prices went up for tobacco, clothing, housing, health, transportation, communication, information and culture, restaurants and hotels in third quarter of 2018.

Figure 3.1: Quarterly Average National Headline Inflation



Source: NSIA/Monetary policy Department, DAB

Figure 3.2: Quarterly Trimmed Mean

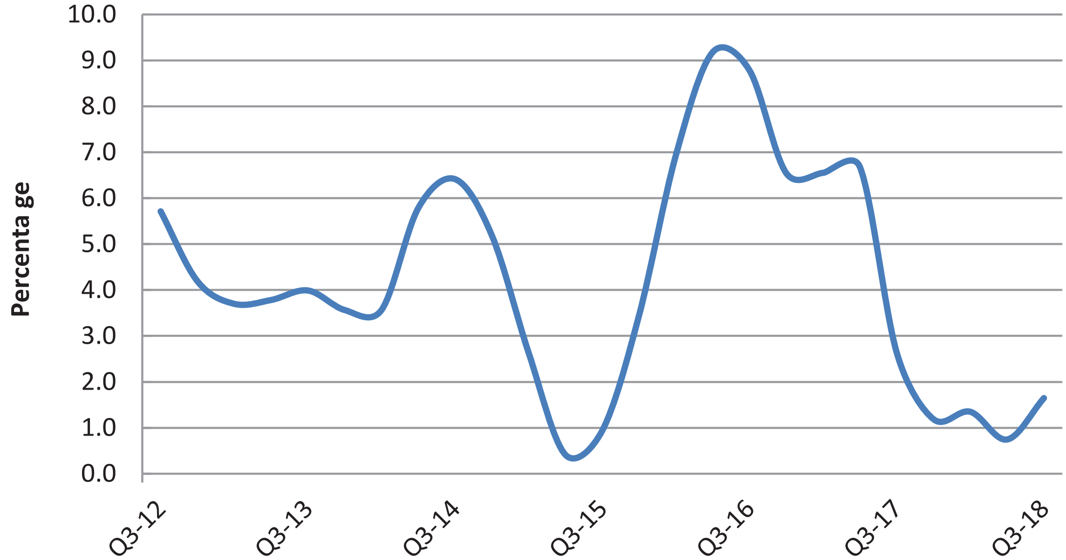
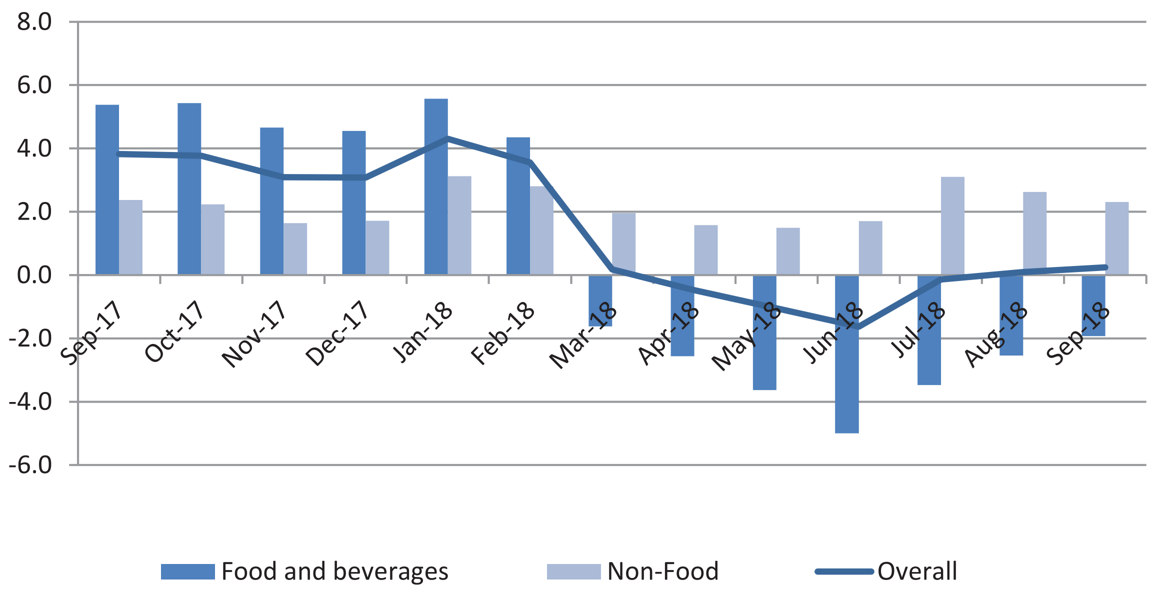


Figure 3.3: National Headline Inflation (Y-o-Y)



Source: NSIA/Monetary Policy Department, DAB staff calculation

3.2 Developments in Kabul Headline Inflation

3.2.1 Annual Developments

The headline CPI inflation in Kabul declined to 0.9 percent on average in the third quarter of 2018 from 4.6 percent recorded in the third quarter of the previous year.

The food index, which is accounted for 37.2 percent of the overall weight of the overall index, exhibited a deflation rate of -2.5 percent in the third quarter of 2018. In this category, the deflationary pressures came from lower prices in bread and cereals, meat, sugar and sweets, milk, cheese and eggs, fresh and dried fruits, vegetables, spices and non-alcoholic beverages. On contrary, oil and fats price exhibited higher price during the period under review. Overall, the food inflation decreased to -2.5 percent on average in third quarter of 2018 from higher 7.7 percent recorded in the same quarter of previous year.

The inflation of non-food items which comprise 62.8 percent weight of the whole index, increased to 3.0 percent on average in the third quarter of 2018 from 2.7 percent in the same period of 2017. The increase is mainly caused by higher prices of clothing, furnishing and household, health, communication, information and culture, education, restaurant and hotels and miscellaneous items. However, in this category, the inflation in clothing increased to 4.9 percent on average from 0.1 percent and health price increased to 2.3 percent on average from -2.2 Percent observed in the same period of previous year.

On the other hand, the core inflation excluding bread & cereals, fats and oils and transportation indicated a decline in the period under review compared to the same period of previous year. In the third quarter of 2018, the core inflation rate decreased to 0.6 percent on average while the rate was recorded 4.5 percent in the third quarter of 2017. The 30% trimmed mean reflected a disinflation rate of 1.6 percent on average in the third quarter of 2018 compared to 2.6 percent in the same quarter of 2017.

3.2.2 Quarterly Developments in Kabul Headline Inflation

The quarter on quarter measure of headline inflation in Kabul showed an upward movement which caused inflation in overall index. The headline inflation in Kabul increased to 0.9 percent on average in third quarter of 2018 from 0.2 percent recorded in the previous quarter of current year.

Inflation in the food index exhibited decrease which dropped to -2.5 percent on average in the third quarter of 2018 from -1.5 percent observed in the previous quarter. In this category, the prices of bread and cereals, meat, milk, cheese and eggs, fresh and dried fruits and vegetables led to disinflation rate during the period under review. In this category, the highest decline was observed in the price index of fresh and dried fruits which declined to 2.5 percent on average in the third quarter of 2018 from 8.9 percent compared to previous quarter. On the other hand, the inflation in sugar and sweets index showed an increase on quarterly basis and it increased to -4.2 percent on average in the third quarter from -7.7 percent observed in the previous quarter of 2018.

On the other hand, the Non-food category of the CPI exhibit inflationary pressure during the third quarter of 2018. Inflation in this category increased to 3.0 percent on average in the third quarter compared to 1.3 percent recorded in the previous quarter. This increase in non-food inflation is mainly driven by higher prices of Tobacco, clothing, housing, furnishing and household goods, transportation and communication items among which the largest difference was observed in the price of transportation item which increased to 6.3 percent in the third quarter of 2018 from 1.9 percent recorded in the previous quarter of 2018.

Afghanistan being dependent on imports, the inflation rate in Afghanistan is going to be affected by upward and downward price movements in world commodity market. After analyzing current global commodity market and its forecasts, commodities prices will experience an upward move in coming years from 2019-2013. Based on the World Bank reports crude oil, agriculture, metals and natural gas prices will go up in coming years which will have direct effects on Afghanistan imports and national inflation.

National inflation has shown downward movement in third quarter of 2018 when matched on year over year comparison and it showed upward movement when matched on quarter to quarter comparison. According to Da Afghanistan Bank, the inflation rate will go up steadily with passage of time, based on the historical data and current analysis, the central bank of Afghanistan forecasts inflation rate 1 to 2 percent for 2019 and 2 to 5 percent from 2020 to 2023. National inflation is projected to increase and the prospects will be subject to course of factors.

Afghanistan currency (Afghani) has been depreciating continuously against the U.S. dollar as the U.S. fed continued the course of gradual policy normalization and raising interest rates by 25 basis points on 26 September 2018. One additional hike is likely to happen in December 2018.

The drought that has been started from the first phase of 2018 is intensifying and it is expected to further aggravate the already poor malnutrition status within the 20 affected provinces. It has worsened the ongoing challenges to food security caused by the continuous war and weak labor market. The drought will have impact on food supply which will lead to key driver of higher food price inflation in next quarter and throughout 2018 and 2019. The drought is expected to negatively impact one million people with another two million, sensing the effects of it in the incoming months as with growing population there will be supply shortages and excessive demand in the country.

The imposition of U.S. financial and economic sanctions on Iran in August 2018 has put Afghanistan and Iran important trade projects in jeopardy. Since Iran has been the major trade partner of Afghanistan and each year Afghanistan imports around $ 2 billion of goods and fuel.

Afghanistan imports are at a greater quantity from neighboring countries, national inflation rate is often influenced by imported inflation of Iran, Pakistan, China, Tajikistan and Uzbekistan. Additionally, the exchange rate of the local currency has been depreciating continuously. This case is not only in Afghanistan, but in the whole region especially with Afghanistan Trade partner countries.

Finally, the inflation rate in Afghanistan appears to increase further in 2019 as Afghani has been depreciating against U.S. dollar which will accelerate national inflation in the country. Additionally, Since Afghanistan is deeply dependent on imports from neighboring countries (Iran and Pakistan) their currency has been depreciating dramatically since 2018 and will further be depreciating in coming years. Moreover U.S. sanctions on Iran and U.S. fed decision to increase interest rates as well as crude oil production cuts will lead to higher international and national commodity prices.

Figure 3.4: Kabul Annual Average Inflation 2004-2018

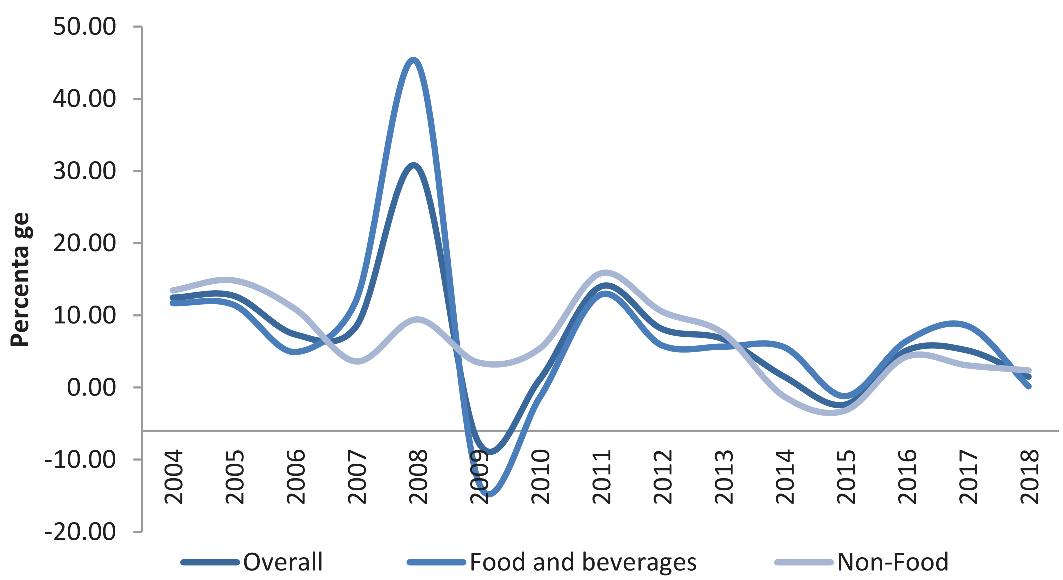
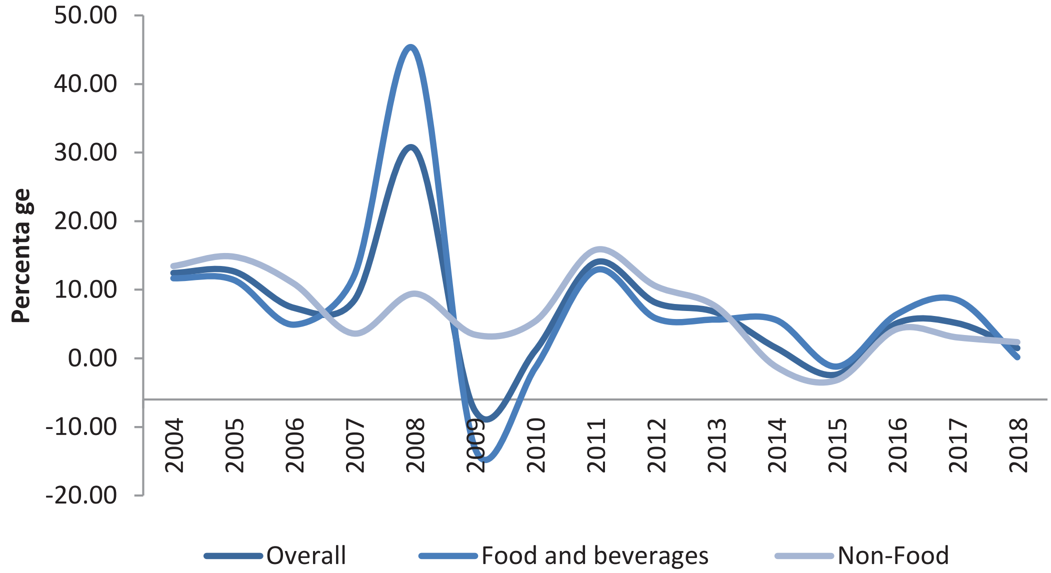


Figure 3.5: Kabul Headline Inflation 2004-2018



Source: NSIA/ Monetary Policy Department, DAB

Table 3.2: Kabul headline inflation 2018

Period	2017					2018							
	Based on April 2015												
	Weight	Jul-17	Aug-17	Sep-17	Average (3 month)	Apr-18	May-18	Jun-18	Average (3mounth)	Jul-18	Aug-18	Sep-18	Average (3mounth)
Overall Index	**100.0**	**5.1**	**4.8**	**3.9**	**4.6**	**0.8**	**0.4**	**-0.6**	**0.2**	**0.9**	**0.8**	**0.9**	**0.9**
Food & Non-Alcoholic Beverages	**37.2**	**9.2**	**7.5**	**6.4**	**7.7**	**-0.2**	**-0.7**	**-3.7**	**-1.5**	**-2.9**	**-2.4**	**-2.1**	**-2.5**
Bread and Cereals	**9.8**	3.6	4.5	2.4	3.5	2.6	1.2	-0.2	1.2	0.8	0.6	4.1	1.8
Meat	**6.4**	10.9	6.3	7.1	8.1	3.3	2.3	-1.7	1.3	-0.9	1.3	2.9	1.1
Milk, cheese and eggs	**3.2**	0.5	-0.1	1.1	0.5	-2.9	-0.9	-0.9	-1.6	1.7	1.5	0.4	1.2
Oils and fats	**3.6**	13.7	14.8	4.7	11.1	-2.2	-2.1	-3.3	-2.5	-3.1	-2.5	-1.1	-2.3
Fresh and dried fruits	**5.2**	5.6	9.4	8.7	7.9	11.1	14.5	1.2	8.9	4.8	4.2	-1.6	2.5
Vegetables	**4.2**	31.9	22.7	26.9	27.1	-9.4	-15.8	-15.2	-13.5	-19.2	-18.2	-21.8	-19.7
Sugar and sweets	**2.8**	10.3	4.8	2.9	6.0	-8.2	-6.8	-8.2	-7.7	-6.8	-5.4	-0.5	-4.2
Spices	**1.0**	-1.7	-6.7	-9.5	-6.0	-16.3	-17.6	-14.8	-16.2	-14.1	-16.7	-15.3	-15.4
Non-alcoholic beverages	**0.9**	0.5	-2.1	-3.3	-1.6	1.6	2.0	0.1	1.2	2.1	1.9	2.2	2.1
Non-Food Items, Tobacco & Services	**62.8**	**2.6**	**3.2**	**2.3**	**2.7**	**1.4**	**1.1**	**1.5**	**1.3**	**3.4**	**2.9**	**2.7**	**3.0**
Tobacco	**0.3**	15.5	15.7	11.3	14.2	2.3	1.4	2.1	1.9	5.5	4.6	5.0	5.0
Clothing	**4.8**	-0.7	2.2	-1.3	0.1	2.7	3.0	3.4	3.0	4.3	4.7	5.7	4.9
Housing	**23.5**	5.9	7.2	5.8	6.3	0.2	-0.8	-0.3	-0.3	4.2	2.8	1.3	2.8
Furnishing and household goods	**17.6**	2.3	1.9	1.5	1.9	2.8	1.8	1.6	2.1	2.1	2.3	3.3	2.6
Health	**5.3**	-3.3	-2.5	-0.7	-2.2	2.3	2.9	2.1	2.4	3.3	2.3	1.3	2.3
Transportation	**4.6**	5.0	4.6	4.2	4.6	-0.7	2.4	4.1	1.9	6.1	5.9	6.8	6.3
Communication	**2.0**	-4.4	-4.2	-4.3	-4.3	-0.3	0.2	0.2	0.0	0.2	0.2	0.8	0.4
Information and Culture	**1.7**	-5.9	-6.0	-8.1	-6.7	-2.8	-0.5	-0.9	-1.4	-3.3	-2.3	0.0	-1.9
Education	**0.7**	8.0	5.4	0.4	4.6	13.9	14.0	13.9	13.9	11.8	8.2	6.6	8.9
Restaurants and Hotels	**1.0**	-3.3	-5.3	-5.0	-4.5	3.0	3.2	3.6	3.3	2.4	2.4	4.1	2.9
Miscellaneous	**1.3**	2.4	1.9	1.6	2.0	1.2	1.6	5.7	2.8	2.2	3.1	2.3	2.5
CPI ex. B & C, O & F, and T		**5.0**	**4.5**	**4.0**	**4.5**	**0.8**	**0.3**	**-0.7**	**0.1**	**0.8**	**0.7**	**0.3**	**0.6**
30% trimmed mean		**3.5**	**2.8**	**1.6**	**2.6**	**0.7**	**1.0**	**0.5**	**0.7**	**1.5**	**1.6**	**1.9**	**1.6**

Source: NSIA/Monetary Policy Department, DAB

4

External Sector Developments

4

EXTERNAL SECTOR DEVELOPMENT

The external sector worsened in the third quarter of the FY 2018 as compared with the same quarter of the previous year, recording a current account deficit of 21 percent and a deficit of USD 734.86 million in the balance of payments (BOPs).

Despite of increasing exports earnings, imports expenditure together with higher out-payments to the services account, as well as a notable decline in official grants (current transfers) caused current account deficit to rise. Meanwhile, the BOP recorded a higher deficit as a result of worsened current account balance together with lower inflows to the capital account (capital transfers) and continued outflows from the financial account in terms of portfolio and other investment during the quarter under review.

I. BALANCE OF PAYMENTS

During the quarter under review, the current account deficit increased significantly by 21 percent to a value of USD 1009.77 million from the deficit of USD 833.60 million recorded in the third quarter of the FY 2017 (Table 4.1, Figure 4.1).

The extension in current account deficit was primarily on account of increasing in out-payments of the services account, a lower inflows to the secondary income account in the form of grants and a slightly increase in merchandise trade deficit.

Trade deficit increased by 1 percent which is brought about by a larger increase in merchandise exports relative to imports. Earnings from export of goods as a total increased by 4 percent to a value of USD 261.88 million in the third quarter of the FY 2018 from a value of USD 251.37 million recorded in the third quarter of the FY 2017.

Likewise, expenditure on imports of goods slightly increased by 1 percent to a value of USD 1,650.51 million in the third quarter of the FY 2018 from a value of USD 1,626.12 million recorded in the third quarter of the previous year.

In the services account, net services out-payments decreased by 12 percent to a value of USD 180.09 million in the third quarter of the FY 2018 from a value of USD 205.19 million recorded in the third quarter of the FY 2017, mainly on the back of a rise in net earnings from construction, transportation and other business services.

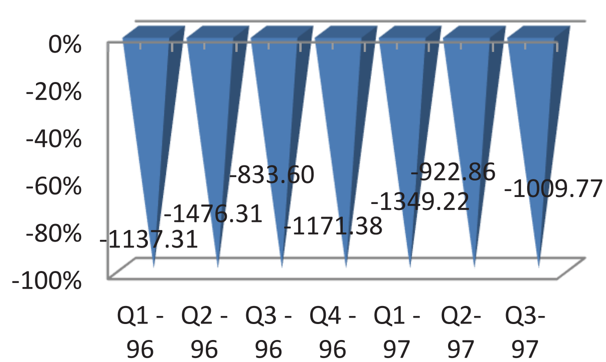
Net private transfer receipts, mainly representing remittances by Afghans employed overseas, significantly rose by 25 percent to a value of USD 95.42 million in the third quarter of the FY 2018 from a value of USD 76.53 recorded in the corresponding quarter of the previous year.

Net current transfers (grants) to the government sector declined by 38 percent to a value of USD 411.58 million in the third quarter of the FY 2018 from a value of USD 659.61 million recorded in the third quarter of the previous year.

1.1 Current Account Balance

The current account deficit (including official transfers) increased by 28 percent to USD 4,683.11 million from USD 3,647.72 million reported in the previous year, reflecting the widening of trade deficit, increase in out payment of the services account and the decline in the surplus of unrequited transfers (official transfers) to the government sector.

Figure 4.1: Current Account Balance



Source: NSIA/DAB staff calculations

1.2 Capital Account

The surplus in the capital account of the balance of payments decline by 15 percent to a value of USD 461.96 million in the third quarter of the FY 2018 from a value of USD 541.96 million recorded in the third quarter of the FY 2017 as a result of lower inward of capital transfers to the government sector, corporations and households (Table 4.1, Figure 4.2).

1.3 Financial Account

Under financial account of the Balance of Payments (BOPs), foreign investment is an important component which consists of foreign direct investment (FDI), foreign portfolio investment (FPI) and Other Investments.

Net FDI inflows to the country increased by 23 percent to a value of USD 12.02 million in the third quarter of the FY 2018 from a value of USD 9.79 million recorded in the third quarter of the FY 2017.

Net portfolio investment depicted an outflow of USD 24.37 million in the third quarter of the FY 2018, primarily in the money market instrument segment, as compared with net outflow of USD -11.57 million recorded in the corresponding quarter of the previous year.

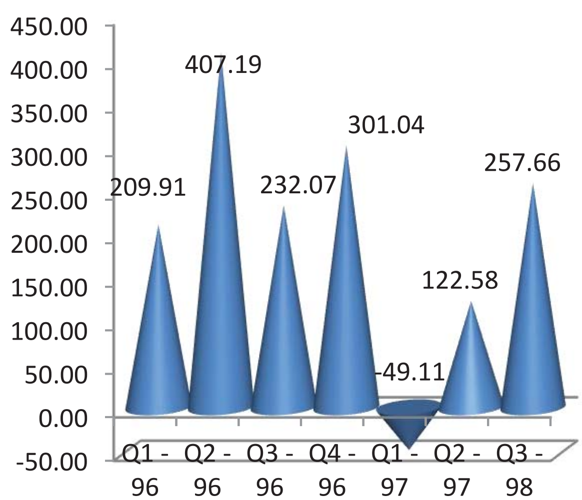
Further analysis reveals that the country's other aggregate financial assets abroad increased to a value of USD 69.33 million in the third quarter of the FY 2018 from a value of USD -100.29 million recorded in the corresponding quarter of the FY 2017 (Table 4.1, Figure 4.3).

On the other hand, total aggregate financial liabilities decreased to a value of USD -15.75 million in the third quarter of the FY 2018 from a value of USD 27.64 million recorded in the same quarter of the previews year.

Reserve assets (on a BOP basis) declined by 70 percent to a value of USD 114.34 million in the third quarter of the FY 2018 as compared to a value of USD 384.32 million recorded in the corresponding period of the previous year as a result of declining foreign exchange reserves.

The financial account balance as a total recorded a value of USD 204.30 million in the third quarter of the FY 2018 as compared to a value of USD 309.9 million recorded in the third quarter of the FY 2017.

Figure 4.2: Capital and Financial Account (in million USD)

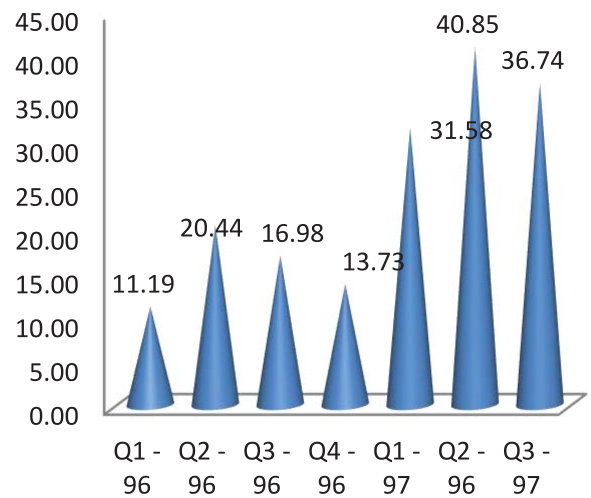


Source: NSIA/DAB staff calculations

1.4 FDI and Portfolio Inflow

According to the available data, the foreign direct investment (FDI) related net inflows registered 36.74% from 16.98% in the same period of FY 2017. FDI shows 116% incline in the reporting period of Q3, 2018.

Figure 4.3: Afghanistan Foreign Direct Investment Inflows (in million USD)



Source: NSIA/DAB staff calculations

II. MERCHANDISE TRADE

This part of the report presents an analysis of the Afghanistan's merchandise trade performance in the third quarter of the FY 2018 in comparison with the trade performance in the third quarter of the FY 2017.

Afghanistan's trade balance has been in a deficit position since long period implying that the total value of imported goods has been greater than the total value of exported goods (Table 4.2, Figures 4.4).

During the quarter under review the external merchandise trade deficit increased by 2 percent to a value of USD 1,515.41 million in the third quarter of the FY 2018 from a value of USD 1,478.47 million recorded in the third quarter of the previous year.

Aggregate exports of goods indicated an increase of 4 percent to a value of USD 261.88 million in the third quarter of the FY 2018, higher than a value of USD 251.38 million recorded in the third quarter of the FY 2017.

Among the exporting components, exports of leather and wool and medical seeds show upward trend, while food items and carpet and rugs shows downward trend during the quarter under review.

Export of leather and wool increased by 338 percent to a value of USD 13.37 million in the third quarter of the FY 2018 from a value of USD 3.05 million recorded in the corresponding quarter of the FY 2017.

Similarly, exports of medical seeds reported USD 127.18 million in the third quarter of the FY 2018 as against USD 87.66 million recorded in the previous corresponding period, reflecting 45 percent incline in the reference period.

On the contrary, exports of food items (fresh fruits, dry fruits and oil seeds) decreased by 25 percent to a value of USD 115.88 million in the third quarter of the FY 2018 from a value of USD 154.11 million recorded in the third quarter of the FY 2017.

Likewise, exports of carpet and rugs declined by 17 percent to a value of USD 5.45 million in the third quarter of the FY 2018 from a value of USD 6.56 million recorded in the third quarter of the previous year.

At the same time, aggregate imports slightly inclined by 3 percent to a value of USD 1,777.29 million in the reporting period compared to a value of USD 1,729.85 million recorded in the similar quarter of the previous year.

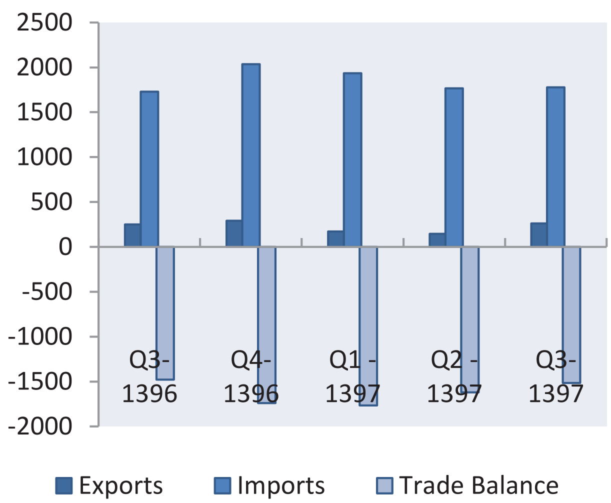
Over the same period of comparison, increases were registered in the value of two importing commodity divisions, in particular imports of consumer goods and imports of fuel and lubricants.

Imports of consumer goods significantly rose by 52 percent to a value of USD 1,049.64 million in the third quarter of the FY 2018 from a value of USD 690.56 million recorded in the third quarter of the FY 2017, imports of fuel and lubricants increased by 12 percent to a value of USD 251.34 million in the third quarter of the FY 2018 from a value of USD 225.33 million recorded in the third quarter of the FY 2017.

Unlike, imports of capital goods considerably decreased by 54 percent to a value of USD 265.35 million in the third quarter of the FY 2018 from a value of USD 578.83 million recorded in the third quarter of the FY 2017, and imports of industrial supplies dropped by 10 percent to a value of USD 210.96 million in the third quarter of the FY 2018 from a value of USD 235.13 million recorded in the third quarter of the FY 2017.

As a result, a significant change in the import structure in favor of industrial supplies and capital goods has been observed during the third quarter of the FY 2018. Industrial supplies mainly comprise metal productions, fertilizer and cement which are essentials for economic development. So, lower imports of such goods are an obvious evidence of slowing down of economic activities in the country especially in the industrial and construction sectors.

Figure 4.4: Trade Performance and Trade Balance



Source: NSIA/ DAB staff calculations

III. DIRECTION OF TRADE

The major trading partners of Afghanistan are Pakistan, Iran, India, China, and Common Wealth of Independence States (CIS).

Pakistan, India, Iran, China and CIS countries remained the largest export destinations for Afghanistan, While, major import origins are; Pakistan, India, Iran, Germany, China, USA, Japan and CIS countries.

2.1 Direction of Exports

According to the available merchandise trade statistics, **Pakistan continued to be the single largest buyer of Afghanistan's exports for a long period.** The share of Afghanistan's exports to Pakistan increased to 61 percent in the third quarter of the FY 2018 from 52 percent that was recorded in the same period of FY 2017, showing 23 percent growth in export earnings. Fresh and dry fruits, medical seeds, carpet and rugs and cotton products respectively accounted for 16 percent, 7 percent 2 percent and 2 percent of total exports to Pakistan.

India ranked the second largest buyer of Afghanistan's exports in the period under review. The share of Afghanistan's exports to India dropped to 30 percent in the review quarter from 34 percent recorded in the preceding and corresponding quarter of the previous year, registering 8 percent reduction in export earnings over the third quarter of the previous year. Fresh and dry fruits, medical seeds and saffron are the major exporting items to India which accounted 17 percent, 8 percent and 1 percent of total exports respectively.

China graded the third largest buyer of Afghanistan's exports in the third quarter of the FY 2018. The share of exports to China increased to 2.07 percent in the reference period from 1.01 percent recorded in the third quarter of the FY 2017, recording 113 percent growth in exports earning in the quarter under review. Wool and Animals Hair are the main exporting items to China which accounted for about USD 4.14 million of the total exports.

Iran ranked the last largest buyer of Afghanistan's exports in the third quarter of the FY 2018. The share of exports to Iran declined to 2 percent in the third quarter of the FY 2018 from 3 percent recorded in the previous corresponding period, registering 44 percent reduction in export earnings in the third quarter of the FY 2018 (Table 4.3 & 4.4 and Figure 4.5 & 4.6).

Figure 4.5: Direction of Exports (% share) in Q3, FY 2018

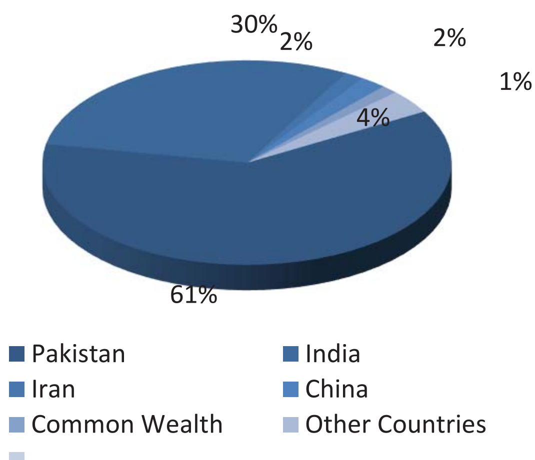
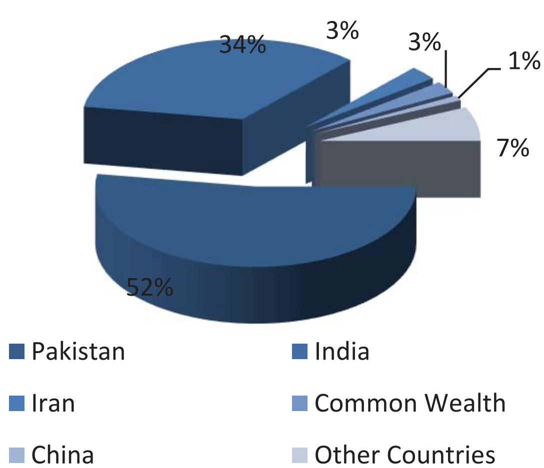


Figure 4.6: Direction of Exports (% share) in Q3, FY 2017



Source: NSIA/DAB staff calculations

2.2 Direction of Imports

CIS countries continued to be the single largest sources of imports for Afghanistan. During the quarter under review imports from CIS countries increased to USD 440.98 million with share of 25 percent in the third quarter of the FY 2018 from USD 489.05 million with share of 29 percent in the previous corresponding quarter, registering 10 percent reduction.

The main imported items from CIS countries are (flour and wheat flour, vegetable oil, petroleum oil, electricity, metal production, fertilizer and cement).

Iran ranked the second largest origin of imports for Afghanistan accounted for about 20 percent of total imports in the third quarter of the FY 2018. Aggregate Imports from Iran increased by 21 percent to USD 342.26 million in the third quarter of the FY 2018 from USD 283.65 million recorded in the corresponding period of FY 2017. The main imports from Iran were petroleum oil, metal production, cement, electricity, fertilizer, spare parts, and consumer goods.

China graded the third largest import origin to Afghanistan accounting for 16.5 percent of total imports in the third quarter of the FY 2018. Aggregate imports from China increased to USD 293.11 million in the third quarter of the FY 2018 from USD 282.06 million in the third quarter of the FY 2017, showing 4 percent growth in total imports during the quarter under review. The main imports from China were; spare parts, metal production, fertilizer, tire and tubes and consumer goods.

Pakistan was the fourth largest imports origin for Afghanistan in the third quarter of the FY 2018. Imports from Pakistan declined to USD 217.27 million in the third quarter of the FY 2018 from USD 268 million in the third quarter of the FY 2017, recording 19 percent reduction. This accounted for about 12.22 percent of Afghanistan's total imports.

Japan and India were the last largest imports sources for Afghanistan accountable for 6.40 percent and 4.37 percent of total imports respectively (Figure 4.7 & 4.8).

Figure 4.7: Direction of Imports (% share) in Q3, FY 2018-*

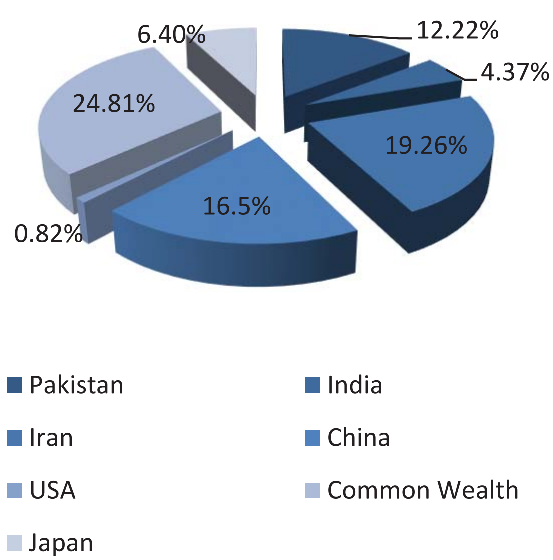
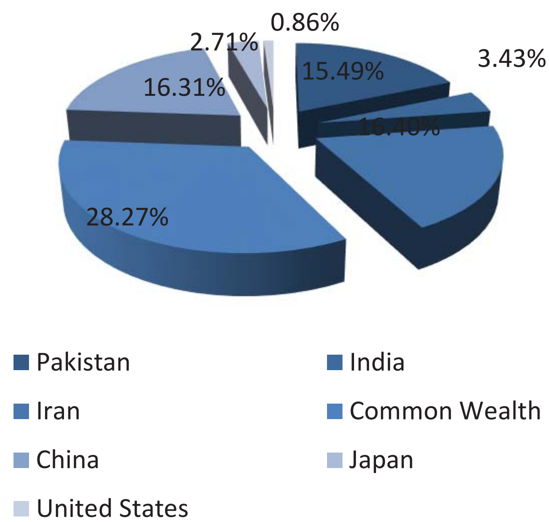


Figure 4.8: Direction of Imports (% share) in Q3, FY 2017



Source: NSIA/DAB staff calculations

IV. COMPOSITION OF TRADE

3.1 Composition of Imports

The composition of imports in the third quarter of FY 2018 indicates that;

- ✓ Imports of consumer goods had the largest share in the basket of imports which increased significantly to 59 percent in the third quarter of the FY 2018 from 40 percent recorded in the third quarter of the FY 2017.
- ✓ Expenditure on imports of such goods also increased by 52 percent to USD 1,049.64 million in the reference period from USD 690.56 million recorded in the same quarter of the previous year.
- ✓ The second largest share recorded for capital goods in the basket of imports during the third quarter of the FY 2018, although its share dropped to 14.9 percent in the third quarter of the FY 2018 from 33.5 percent recorded in the same quarter of the previews year.

- ✓ Expenditure on imports of capital goods also dropped by 54 percent to USD 265.35 million in the third quarter of the FY 2018 from USD 578.83 million recorded in the third quarter of the FY 2017.
- ✓ Imports of fuel and lubricants (petroleum oil) had the third largest share in the basket of Afghanistan's imports which is slightly declined to 14 percent in the third quarter of the FY 2018 from 13 percent recorded in the third quarter of the FY 2017.
- ✓ Expenditure on imports of fuel and lubricants in total imports increased by 12 percent to USD 251.34 million in the third quarter of the FY 2018 from USD 225.33 million recorded in the corresponding period of the previous year.
- ✓ Industrial supplies had the smallest share in the basket of Afghanistan's imports during the reporting quarter which decreased from 13.6 percent in the third quarter of the FY 2017 to 11.9 percent during the quarter under review.
- ✓ Expenditure on imports of industrial supplies also decreased by 10 percent, to USD 210.96 million in the third quarter of the FY 2018 from USD 235.13 million recorded in the third quarter of the FY 2017, (Table 4.2 and Figure 4.9-4.10).

Figure 4.9: Composition of Imports (% share) in Q3, FY 2018

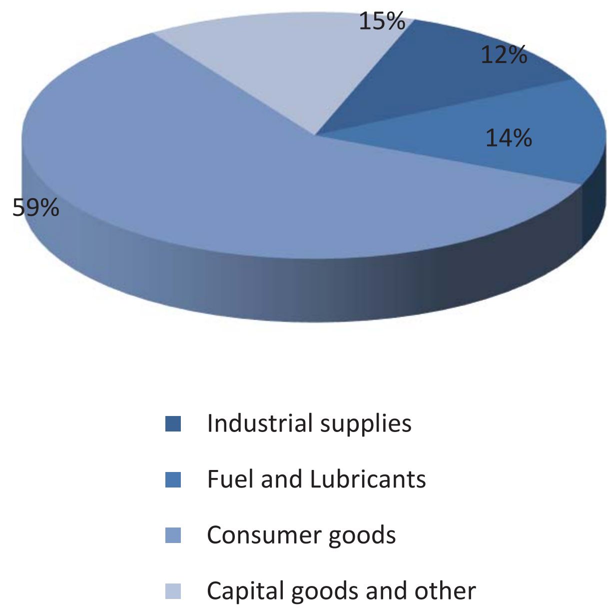
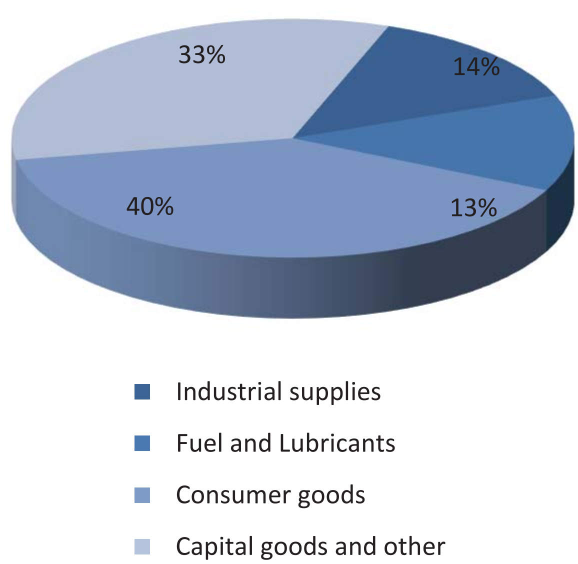


Figure 4.10: Composition of Imports (% share) in FY 2017



Source: NSIA/DAB staff calculations

3.2 Composition of Exports

The composition of exports in the first quarter of FY 2018 reveals that;

- ✓ Exports of medical seeds had the largest share in the basket of Afghanistan's exports which is increased to 48.6 percent in the reporting quarter from 35 percent recorded in the preceding and corresponding quarter of the FY 2017.
- ✓ Earnings from exports of medical seeds increased by 45 percent to USD 127.18 million in the third quarter of the FY 2018 from USD 87.66 million recorded in the same quarter of the previous year.
- ✓ The second largest share in total exports was recorded for food items food items (oil seeds, fresh and dry fruits), which declined to 44 percent in the third quarter of the FY 2018 from 61 percent recorded in the corresponding quarter of the previous year.
- ✓ Earnings from exports of food items decreased by 25 percent to USD 115.88 million in the third quarter of the FY 2018 from USD 154.11 million recorded in the preceding and corresponding of the FY 2017.
- ✓ Leather and wool products had the third largest share in the total exports. The share of leather and wool which recorded 1 percent in the third quarter of the FY 2017, increased to 5.1 percent during the quarter under review.
- ✓ Earning from exports of leather and wool increased to USD 13.37 million in the third quarter of the FY 2018 from USD 3.05 million recorded in the similar quarter of the previous year.
- ✓ Carpet and rugs which are considered the main component of Afghanistan's exports in the past decades had the smallest share in total exports, which declined to 2 percent in the review quarter from 3 percent recorded in the third quarter of FY 2017.
- ✓ Earnings from exports of carpet and rugs also declined by 17 percent to USD 5.45 million during the quarter under review from USD 6.56 million that was recorded in the same quarter of previous year. (Table 4.2 - Figure 4.11 and 4.12).

Figure 4.11: Composition of Exports (% share) in Q3, FY 2018

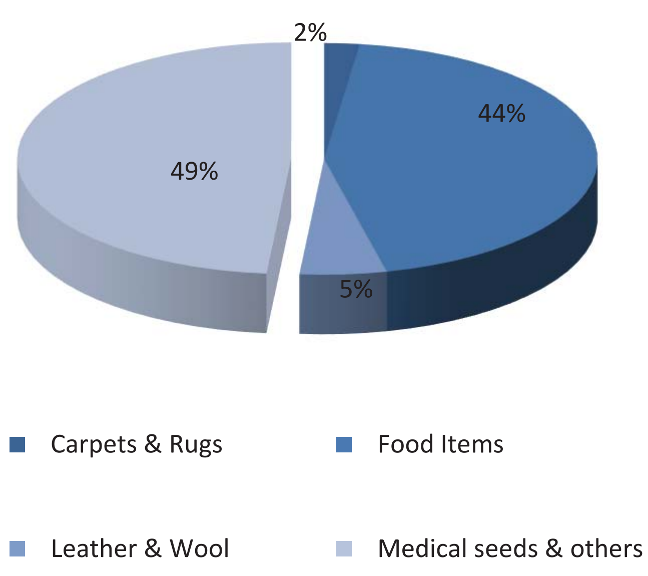
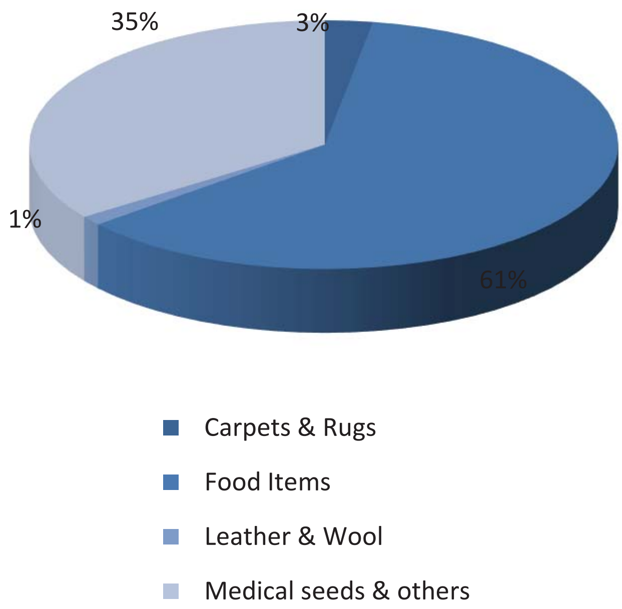


Figure 4.12: Composition of Exports (% share) in Q3, FY 2017



Source: NSIA/DAB staff calculations

V. EXTERNAL DEBT

Afghanistan's total external debt slightly increased by 1 percent to USD 2,210.97 million in the third quarter of the FY 2018 from USD 2185.77 million recorded in the similar quarter of the FY 2017, which shows about USD 25.2 million increase (Table 4.5 and Figure 4.13).

During the quarter under review, loan principal repayments made to the World Bank, Asian Development Bank, Islamic development bank and OPEC fund, while service charges were paid to the World Bank, Asian Development Bank and Islamic development bank.

World Bank and Asian Development Bank as major multilateral creditors to Afghanistan, made some debt release on principal during the quarter under review.

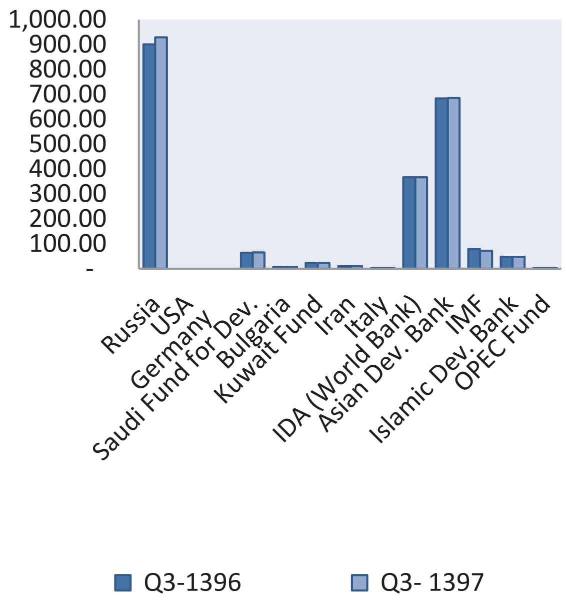
The total loan amounts payable to the Paris Club creditors in the third quarter of the FY 2018 stood at USD 929.44 million which is payable to Russian Federation.

In other words, Afghanistan's total debt from the Paris club members stands at about 42 percent of total current external debt which has decreased slightly by about 3 percent compared to the third quarter of the FY 2017.

Furthermore, total debt from Non-Paris Club members which are including (Saudi Fund for Development, Bulgaria, Kuwait Fund and Iran) increased by 2 percent to USD 107.49 million in the third quarter of the FY 2018 in comparison with USD 105.30 million recorded in the previous corresponding period.

On the other hand, total debt from multilateral creditors to Afghanistan slightly decreased to USD 1,174.04 million in the third quarter of the FY 2018 from USD 1,179.09 million which shows USD 5.03 million decline in the total debt during the quarter under review.

Figure 4.13: External Debt Comparisons for the FY 2018 and 2017 (in million USD)



Source: Debt Asset Management Unit, Ministry of Finance

VI. NET INTERNATIONAL RESERVES

According to the latest available data the net international reserves (NIR), increased by 4 percent, standing at USD 7,534.42 million in the third quarter of the FY 2018, up from USD 7,246.39 million recorded in the corresponding quarter of the previous year, (Table 4.6 and Figure 4.14).

The increase in the level of NIR was mainly due to the increase in the reserve assets which expanded by 3.1 percent to USD 8,241.90 million in the third quarter of the FY 2018 from USD 7994.81 million recorded in the corresponding quarter of the previous year.

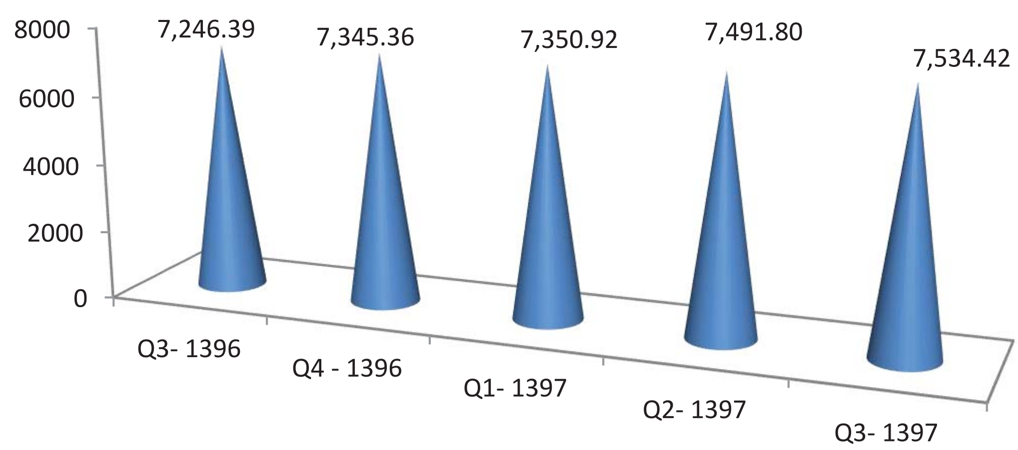
On the other hand, reserve liabilities decreased by 5 percent to USD 707.48 million in the third quarter of the FY 2018 from USD 748.42 million recorded in the third quarter of the FY 2017; this demonstrates that the reserve assets are higher than the reserve liabilities. The drop in reserve liabilities was mainly due to decline of commercial bank deposits in foreign currency which declined by 5 percent to USD 651.17 million in the third quarter of the FY 2018 from USD 688.49 million recorded in the same quarter of the previous year.

The reserve liability of nonresident deposits in foreign currency almost remained unchanged in the reporting quarter.

The increase in the Net International Reserves (NIR) could be attributed to significant inflows of foreign exchange to the government sector and personal home remittances.

The current level of net international reserve assets are able to support approximately 13 months of goods imports and also putting the country in a better position to withstand external shocks.

Figure 4.14: Net International Reserves from FY 2017-18 (in million USD)



Source: Monetary Policy Department, DAB

Table 4.1: Afghanistan Balance of Payments in million USD								
Items / Years	**Q1- 96**	**Q2- 96**	**Q3 - 96**	**Q4 - 96**	**Q1- 97**	**Q2- 97**	**Q3- 97**	**% change**
Current Account	**-1137.31**	**-1476.31**	**-833.60**	**-1171.38**	**-1349.22**	**-922.86**	**-1009.77**	**21%**
Credit	736.93	772.01	1111.00	1072.00	870.14	1070.94	1059.41	**-5%**
Debit	1874.24	2248.31	1944.60	2243.38	2219.36	1993.80	2069.18	**6%**
Goods and Services Account	**-1608.62**	**-1983.25**	**-1579.94**	**-1844.88**	**-1865.87**	**-1579.03**	**-1568.71**	**-1%**
Credit	213.70	230.54	334.67	368.78	320.49	363.70	438.06	**31%**
Debit	1822.32	2213.79	1914.61	2213.67	2186.36	1942.73	2006.77	**5%**
Goods Account	**-1462.74**	**-1804.27**	**-1374.75**	**-1611.78**	**-1669.02**	**-1501.28**	**-1388.62**	**1%**
Credit	*115.06*	124.17	251.37	293.36	172.45	146.81	261.88	**4%**
Debit	*1577.80*	1928.44	1626.12	1905.15	1841.47	1648.10	1650.51	**1%**
Services Account	**-145.88**	**-178.98**	**-205.19**	**-233.10**	**-196.85**	**-77.75**	**-180.09**	**-12%**
Credit	*98.64*	106.37	83.30	75.42	148.03	216.89	176.18	**111%**
Debit	*244.52*	285.35	288.49	308.52	344.89	294.63	356.27	**23%**
Primary Income Account	**17.17**	**34.91**	**19.25**	**24.79**	**21.78**	**43.22**	**91.53**	**376%**
Credit	*32.13*	47.18	30.77	37.13	32.23	54.75	102.22	**232%**
Debit	*14.96*	12.27	11.52	12.34	10.45	11.52	10.69	**-7%**
Secondary Income Account	**454.13**	**472.03**	**727.09**	**648.71**	**494.87**	**612.95**	**467.41**	**-36%**
Credit	*491.09*	494.28	745.56	666.08	517.43	652.49	519.13	**-30%**
Debit	*36.96*	22.25	18.47	17.38	22.56	39.55	51.72	**180%**
Current transfers	***432.51***	**422.42**	**659.61**	**566.00**	**414.48**	**538.13**	**411.58**	**-38%**
Workers' remittances	**50.40**	**55.16**	**76.53**	**86.79**	**91.92**	**96.60**	**95.42**	**25%**
Credit	*58.49*	*71.81*	*85.38*	*97.02*	*102.94*	*114.36*	*107.55*	**26%**
Debit	*8.08*	*16.65*	*8.84*	*10.24*	*11.02*	*17.76*	*12.13*	**37%**
Capital and financial account	**209.91**	**407.19**	**232.07**	**301.04**	**-49.11**	**122.58**	**257.66**	**11%**
Capital account	**222.08**	**415.02**	**541.96**	**554.39**	**40.49**	**206.88**	**461.96**	**-15%**
Credit	*222.08*	415.02	541.96	554.39	40.49	206.88	461.96	**-15%**
Debit	*0.00*	0.00	0.00	0.00	0.00	0.00	0.00	
Capital transfers	**222.08**	**415.02**	**541.96**	**554.39**	**40.49**	**206.88**	**461.96**	**-15%**
Credit	*222.08*	415.02	541.96	554.39	40.49	206.88	461.96	**-15%**
Debit	*0.00*	0.00	0.00	0.00	0.00	0.00	0.00	
Financial account	**12.2**	**7.8**	**309.9**	**253.35**	**89.61**	**84.30**	**204.30**	**-34%**
Direct investment	**5.01**	**13.89**	**9.79**	**12.05**	**39.15**	**48.41**	**12.02**	**23%**
Net acquisition of financial assets	-3.09	-3.27	-3.59	-0.84	3.78	3.78	-12.36	**244%**

Net incurrence of liabilities	8.10	17.16	13.39	12.89	35.36	44.63	24.38	**82%**
Portfolio investment	**36.62**	**-30.15**	**-11.57**	**-24.01**	**-54.02**	**18.22**	**24.37**	**-311%**
Net acquisition of financial assets	*36.62*	-30.15	-11.57	-24.01	-54.02	18.22	24.37	**-311%**
Net incurrence of liabilities	*0.00*	0.00	0.00	0.00	0.00	0.00	0.00	
Other investment	**12.37**	**25.59**	**-72.65**	**58.54**	**109.68**	**57.55**	**53.58**	**-174%**
Assets	*33.16*	5.36	-100.29	97.74	80.56	44.98	69.33	**-169%**
Liabilities	*20.79*	-20.23	27.64	39.20	-29.11	-12.57	-15.75	**-157%**
Reserve Assets	**-41.83**	**-1.50**	**384.32**	**206.77**	**-5.20**	**-39.88**	**114.34**	**-70%**
Net errors and omissions	**927.40**	**1069.11**	**601.53**	**870.34**	**1398.33**	**800.28**	**752.11**	**25%**

Source: NSIA/DAB staff calculations

Table 4.2: Merchandise Trade in million USD

Years	Q3- 2017		Q4- 2017		Q1 - 2018		Q2 - 2018		Q3- 2018	
	Total	***Share (%)***	***Total***	***Share (%)***	***Total***	***Share (%)***	***Total***	***Share (%)***	***Total***	***Share (%)***
Imports	**1,729.85**	**100%**	**2,035.14**	**100%**	**1,936.84**	**100%**	**1,766.96**	**100%**	**1,777.29**	**100%**
Industrial supplies	235.13	13.6%	253.40	12.5%	200.38	10.3%	194.14	11.0%	210.96	11.9%
Fuel and Lubricants	225.33	13.0%	242.65	11.9%	220.58	11.4%	214.21	12.1%	251.34	14.1%
Consumer goods	690.56	40%	836.82	41.1%	828.96	42.8%	687.54	38.9%	1049.64	59.1%
Capital goods and other	578.83	33.5%	702.27	34.5%	686.91	35.5%	671	38.0%	265.35	14.9%
Exports	**251.38**	**100%**	**293.34**	**100.0%**	**172.45**	**100%**	**146.81**	**100%**	**261.88**	**100%**
Carpets & Rugs	6.56	3%	5.41	1.8%	5.62	3.3%	5.7	3.9%	5.45	2%
Food Items	154.11	61.3%	193.61	66.0%	76.32	44.3%	47.30	32.2%	115.88	44%
Leather & Wool	3.05	1%	11.57	3.9%	7.11	4.1%	9.05	6.2%	13.37	5.1%
Medical seeds & others	87.66	35%	82.75	28.2%	83.41	48.4%	84.78	57.7%	127.18	48.6%
Trade Balance	**-1,478.47**		**-1,741.80**		**-1,764.38**		**-1,620.15**		**-1,515.41**	
Trade Balance as % of GDP	**0%**		**0%**		**0%**		**0%**		**0%**	

Table 4.3: Direction of External Trade Q3, FY 2018 (million USD)					
Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	159.11	61%	217.27	12.22%	-58.17
India	78.16	30%	77.74	4.37%	0.42
Iran	3.94	2%	342.26	19.26%	-338.32
Germany	0.82	0.31%	16.38	0.92%	-15.57
China	5.43	2.07%	293.11	16.5%	-287.68
England		0.00%	0.82	0.05%	-0.82
Saudi Arabia	1.27	0.48%		0.00%	1.27
USA		0.00%	14.64	0.82%	-14.64
Common Wealth	3.44	1.31%	440.98	24.81%	-437.54
Japan		0.00%	113.70	6.40%	-113.70
Other Countries	9.71	3.71%	260.37	14.65%	-250.66
Total	**261.88**	**100%**	**1,777.29**	**100%**	**(1,515.41)**

Table 4.4: Direction of External Trade Q3, FY 2017 (million USD)					
Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	129.75	52%	268.00	15.49%	-138.25
India	84.64	34%	59.32	3.43%	25.32
Iran	6.98	3%	283.65	16.40%	-276.67
Germany	3.52	1.40%	9.17	0.53%	-5.65
Common Wealth	6.19	2.46%	489.05	28.27%	-482.86
China	2.55	1.01%	282.06	16.31%	-279.51
Saudi Arabia	0.71	0.28%		0.00%	0.71
Japan		0.00%	46.87	2.71%	-46.87
England		0.00%	1.13	0.07%	-1.13
United States		0.00%	14.96	0.86%	-14.96
Other Countries	17.04	6.78%	275.64	15.93%	-258.60
Total	**251.38**	**100.00%**	**1729.85**	**100.00%**	**-1478.47**

Table 4.5: External Debt for the third quarter of the FY 2018 (in units indicated)		
	In million USD	Percent of total
Total external debt	**2,210.97**	**100.00**
Bilateral	1,036.93	46.90
Paris Club	**929.44**	**42.04**
Russian Federation	929.44	42.04
United States	-	0.00
Germany	-	0.00
Non-Paris Club	**107.49**	**4.86**
Multilateral	1,174.04	53.10
of which: IDA (World Bank)	367.80	16.64
Asian Development Bank	685.32	31.00
International Monetary Fund	71.67	3.24
Islamic Development Bank	47.51	2.15
OPEC Fund	1.74	0.08

Table 4.6: Net International Reserves (million USD)										
Changes on the previous quarter	**Q3-2017**	**% change**	**Q4 - 2017**	**% change**	**Q1 - 2018**	**% change**	**Q2 - 2018**	**% change**	**Q3 - 2018**	**% change**
Net international Reserves (million US Dollar)	**7,246.39**	23.22	**7,345.36**	1.37	**7,350.92**	0.08	**7,491.80**	1.92	**7,534.42**	4.0
Reserve Assets	7,994.81	22.71	8,159.01	2.05	8,131.13	-0.34	8,227.57	1.2	8,241.90	3.1
Reserve Liabilities	748.42	10.91	813.65	8.72	780.21	-4.11	735.76	-6	707.48	-5
Commercial bank deposits in foreign currency	688.49	4.00	750.66	9.03	722.88	-3.70	675.38	-7	651.17	-5
Nonresident deposits in foreign currency	0.14	-89.57	0.14	0.00	0.14	0.00	0.14	0.00	0.14	0.00
Use of Fund resources	59.80	17.53	62.85	5.10	57.19	-9.00	60.24	5	56.17	-6
Gross Intl. Reserves (in months of import)	**13.87**		**12.03**		**12.59**		**13.97**		**13.91**	
Net Intl. Reserves (in months of import)	**13**		**11**		**11**		**13**		**13**	

Source: NSIA/DAB staff calculations

5

Fiscal Developments

5

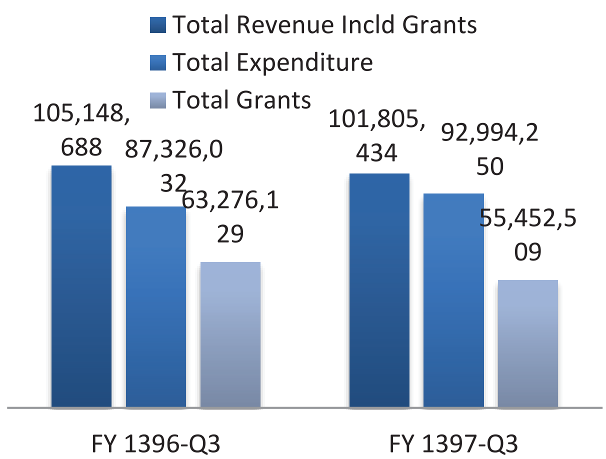
FISCAL DEVELOPMENTS

The key objective in the fiscal area is to achieve sustained increase in revenue collection and to permit the gradual takeover of externally financed operating & development spending and to ensure an expenditure allocation consistent with Afghanistan National Peace and Development Framework (ANPDF). The other goals include improvements in public expenditure management, fiscal policy formulation, efficiency in public enterprises, taxes and customs administration.

Similar to the other emerging and developing economies around the world, Afghanistan continuously faces budget deficit. The total core expenditure exceeds total domestic revenue in the third quarter of FY 2018 leading to AF 46.64 billion budget deficit, while including other revenue (grants) a budget surplus of AF 8.81 billion was observed comparably. Due to increment in income from sales of goods and services, extractive industry, income from capital property and a large difference between miscellaneous return, the total domestic revenue increased from AF 41.85 billion in the third quarter of FY 2017 to AF 46.34 billion in the review quarter that shows an increase of AF 4.50 billion leading to 11% growth in domestic revenue collection. In the meantime, increase in employees spending, capital expenditure and subsidies, grants contributions and pension expenditures resulted to raise the total core expenditure from AF 87.33 billion to AF 92.99 billion during the reference period showing an increase of AF 5.67 billion equivalents to 6.49% in expenditure compared to the same period of the previous year.

Furthermore, the total donor contribution (grants) allocated to operating and development expenditure represents a considerable decrease from AF 63.41 billion to AF 55.45 billion in the review quarter indicating AF 7.82 billion or 12.12% decline in the level of grants comparably. The decline is attributed to change in annual pledge, commitment and disbursement of main donor contributors which are ARTF, LOTFA, CSTC-A. Moreover, total core budget decreased from AF 429.41 billion in the corresponding period of FY 2017 to AF 377.19 billion in Q3, FY 2018 showing a crucial decrease of AF 52.22 billion or 12% decrease in total core budget accordingly. Also, operating budget decreased from AF 268.41 billion to AF 266.13 billion in the reference period, indicating 0.8% percent decline. Similarly, development budget showing a significant decrease from AF 161.00 billion Q3, FY 2017 to AF 111.06 billion in the review period representing 31% decrement as a result of low level of grants and budget allocation for the FY 2018 comparably.

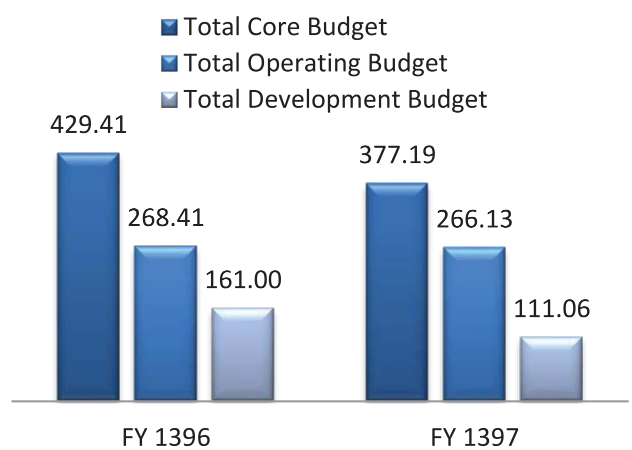
Figure 5.1: Comparison of Total Revenue, Expenditure, Budget and Grants Q3, FY 2017-Q3, 2018



I. BUDGET EXECUTION RATE

During the reference period, government spent 59 percent of the total AF 240.156 billion allocated budget, while comparing to 52 percent of the total AF 226.762 billion of allocated budget in the previous corresponding period representing 5.9 percent rise in overall budget execution rate relatively and it is attributed to several factors particularly timely processing and approval of expenses by the National Procurement Authority, security condition in provinces and improved performances by the budgetary units. Although there is decrease in annual approved budget from AF 429.41 billion in Q3, FY 2017 to AF 377.19 billion during the reference period leading to 12.16 percent decrease comparably. Operating budget execution rate indicates 1 percent incline from AF 172.64 billion to AF 174.41 in Q3, FY 2018. In addition, the total allocated core budget was AF 429.83 billion in Q3, FY 2017 and AF 385.09 billion in period under review. The development budget execution rate evidently represents increase of 21.5 percent comparing both AF 65.74 billion of the third quarter of FY 2018 and AF 54.12 billion in the corresponding period of FY 2017.

Figure 5.2: Comparison of Total Budget FY 2017 & FY 2018



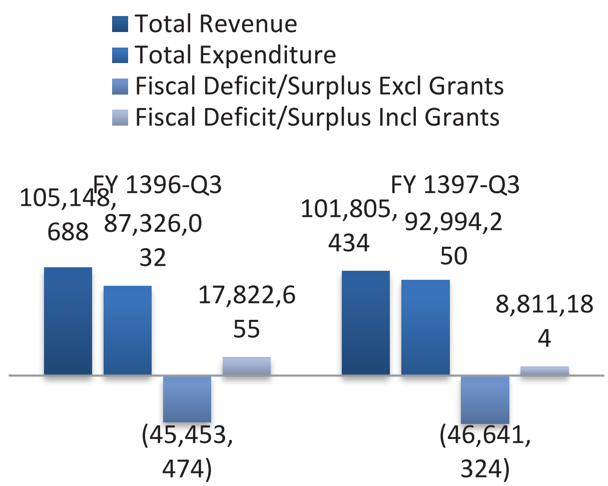
Source: Ministry of Finance/MPD calculations

II. CORE BUDGET (DEFICIT AND SURPLUS)

The overall budget prior to donor's contribution had a deficit of AF 46.64 billion in the reference period compared to AF 45.45 billion deficit in the third quarter of FY 2017 that shows AF 1.9

billion or 2.61 percent incline compared. Meanwhile, external amount of funding represents decline from AF 63.28 billion comparing to AFN 55.45 billion in the reference period. The total annual external planed funding amount in Q3, FY 2018 represents a decrease from AF 258.80 billion to AF 191.28 billion in the review quarter, indicating 26.09 percent decline in annual planed external source as a result of pledge, commitment and disbursement from the donor's contribution on annual basis.

Figure 5.3: Core Budget Deficit and Surplus FY 2017-18

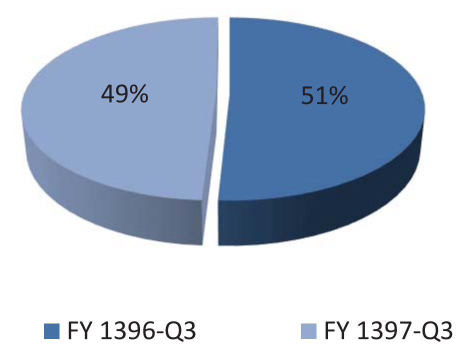


III. REVENUE COLLECTION

With reference period of Q3, FY 2018, total revenues including grants decreased significantly with total collection of AFN 101.80 billion in the review quarter compared to AFN 105.15 billion in the same corresponding period of FY 2018, presenting a mild decrease of AFN 3.34 billion or 3.2 percent as compared to the same quarter of the previous year.

Annual collection of planed domestic sources indicates AF 1.06 billion of increment from AF 160.56 billion to AF 161.62 billion in the reference period leading to 0.66 percent increase comparably. To meet FY 2018 budget deficit total domestic revenue & donor contribution play a vital role and revenue collection that steer to annual budget surplus.

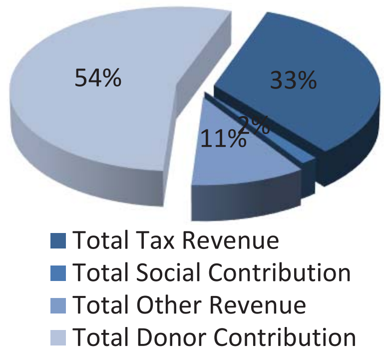
Figure 5.4: Contribution of Total Revenue FY 2017-18



Source: MoF/MPD Staff Calculations

Moreover, the positive gain in total revenue collection of FY 2018 was as a result of momentous improved in sales of goods and services, extractive industry. However, there had been decline in administrative fees, royalties and income from capital property during the year and negatively reflected retail activity from the low base previous year comprise of property tax, fixed tax and custom duties.

Figure 5.5: Total Revenue Contribution Q3, FY 2018



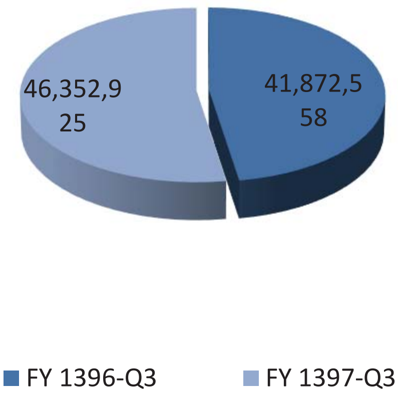
Source: MoF/MPD staff calculations

3.1 Domestic Revenue

The total collection of domestic revenue performance is enhanced in third quarter of fiscal year 2018. However, it was significantly sophisticated compared to the same period of FY 2017, while these measures are deemed sufficient by the government to ensure the achievement in terms of the GDP deficit in the FY 2018. The increment in domestic revenue collection was attributed to enhanced receipts from income, capital property, sales of goods and services, extractive industry and a notable change in miscellaneous revenue.

Total domestic revenue is increased from AFN 41.87 billion to AFN 46.35 billion in the review quarter showing an increase of AFN 4.48 equal to 10.7 percent growth in domestic revenue collection.

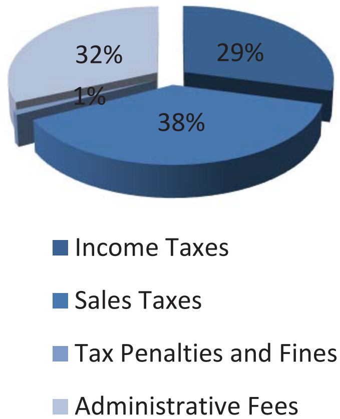
Figure 5.6: Total Domestic Revenue Comparison Q3, 2017- Q3, 2018



Source: MoF/MPD staff calculations

Besides, a breakdown of the total revenue collection showed a mild deceleration in various domestic revenue components such as fixed tax that shows a momentum decrease of 28 percent from AFN 5.68 billion to AFN 4.9 billion in the third quarter of FY 2018. The income tax shows decrease of 5.64 percent from AFN 7.98 billion to AFN 7.53 billion in the review quarter. Sales tax represents a significant decrease of 26.75 percent from AFN 13.51 billion to AFN 9.90 billion and customs and duties signify to have decreased 28.58 percent from AFN 17.17 billion to AFN 12.26 billion in the review quarter comparably.

Figure 5.7: Major Domestic Revenue Q3, 2018

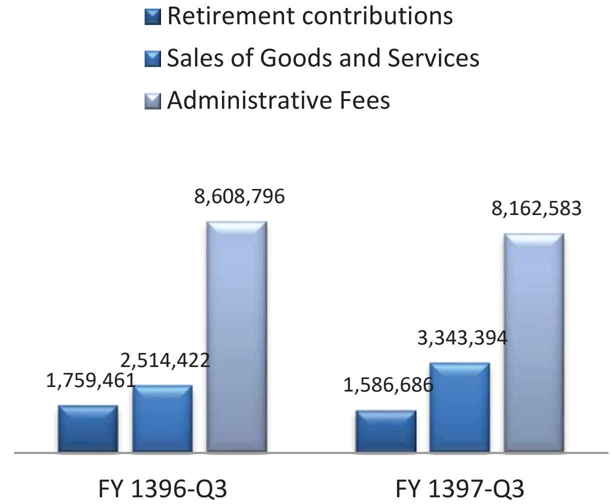


Source: Ministry of Finance/MPD calculation

3.2 Non-tax Revenues

One of the initial component of domestic revenues is non-tax revenues that represented a notable increase of 410.04 percent from AF 3.96 billion in the third quarter of FY 2017 to AFN 12.28 billion in the reference period showing a crucial increase of AFN 16.24 billion compared to same period of the previous year. This incline is caused by vital increase in income from capital property, sale of goods and services and a notable change in miscellaneous return.

Figure 5.8: Comparison of Major Components Total Non-tax Revenue Q3, FY 2017- Q3 FY 2018



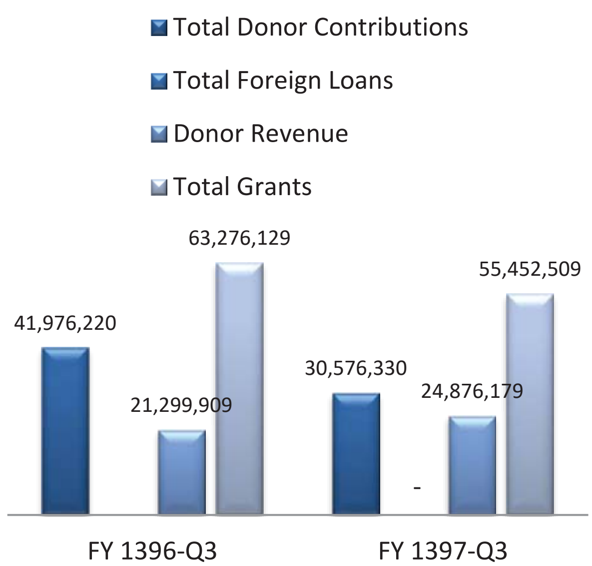
Source: Ministry of Finance/MPD calculation

The main contributors of the non-tax revenues are retirement contributions that decreased from AFN 1.76 billion to AFN 1.59 billion in the review quarter indicating 9.82 percent declination. Retirement contribution dedlined from AFN 8.61 billion to AFN 8.16 billion leading to 5.18 percent decrement and sales of goods and services from AFN 2.51 billion to AFN 3.34 billion showing 32.97 percent increase during the study period. However, non-tax fines and penalties decreased from 0.30 billion to 0.20 billion registering 32.89 percent decline in the review period. On the other hand, miscellaneous revenue increased from AFN -18.60 billion to AFN -2.90 billion in the reporting period.

IV.GRANTS

The donor contribution comprises an important part of the national budget. Meanwhile, donor grants finance major expenditure items in both operating and development budgets. Likewise, the government receives grants and occasional loans from various donors, trusts and international committees to finance variety of programs in both operating and development expenditures. Moreover, in Afghanistan's context, fiscal sustainability is defined as total domestic expenditure that should be financed by total domestic revenue where recently, it is being financed partially by external sources, foreign loans and the rest by domestic revenue.

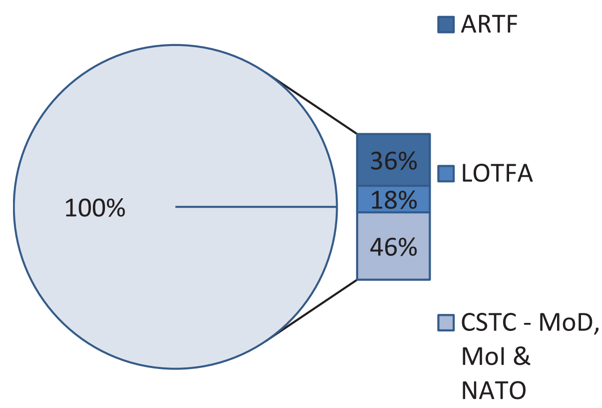
Figure 5.9: Total Annual Grants Analysis for the third quarter of FY 2017-18



Source: MoF/ MPD staff calculations

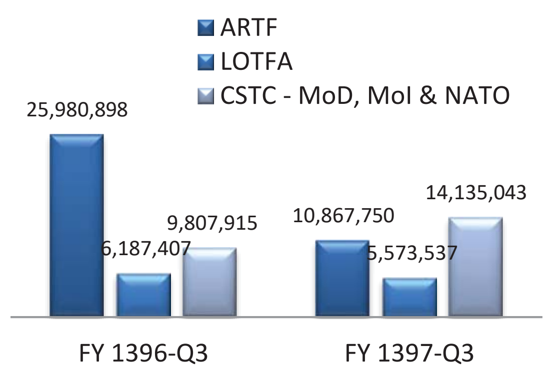
The total development and operating grants represent significant decrease of AFN 7.82 billion from AFN 63.28 billion in Q3, FY 2017 to AFN 55.45 billion, which clearly indicates a mild decrease compared to the same period of the previous year.

Figure 5.10: Components of Donor Contribution Q3, FY 2018



Source: MoF/MPD staff calculations

The main donor contributors to operating and development expenditures are grants from LOTFA that declined 58 percent from AFN 25.98 billion to AFN 10.87 billion in the reporting period and CSTC-A MoD, MoI & NATO contributed AFN 9.81 billion in the third quarter of FY 2018 that shows 44% increase compared to AFN 14.14 billion of the same quarter in FY 2017.



Source: MoF Financial Statement/MPD Staff Calculation

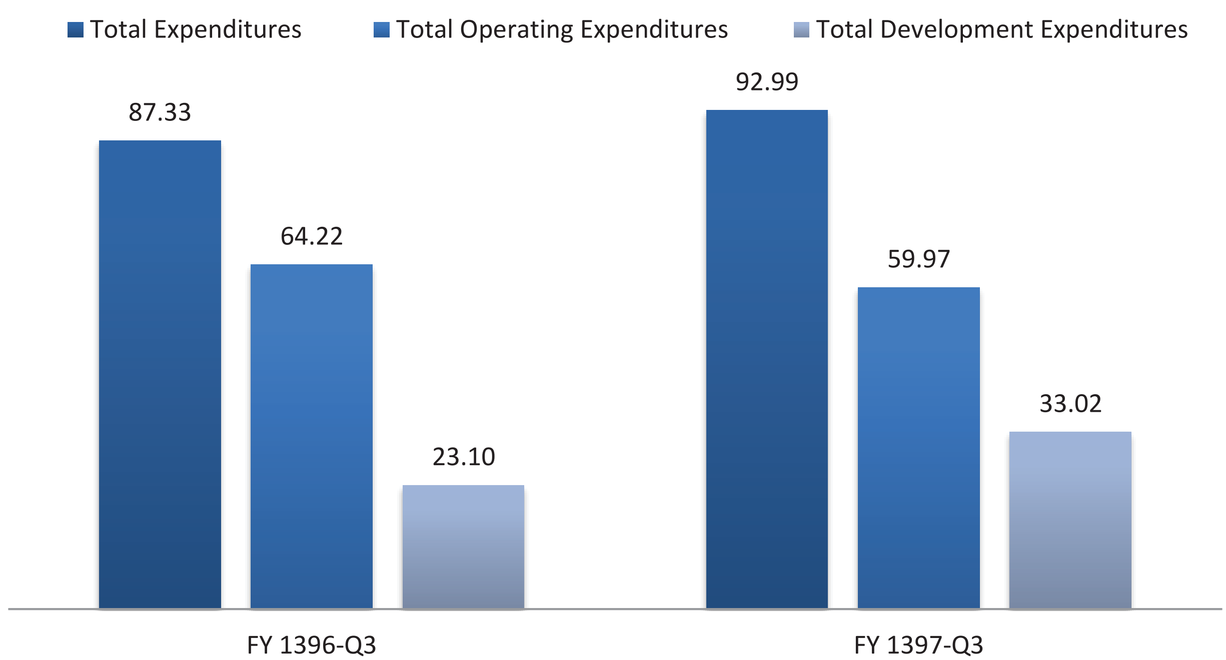
Figure 5.11: Comparison of Donor Contributions Q3, FY 2018

V. EXPENDITURE

The core expenditures are classified into development and operating expenditures which are allocated in eight different sectors such as security, governance, education, health, agriculture, social protection, infrastructure, and economic governance. Moreover, the sector wise expenditure is provided for both operating and development budget, while, increased expenditure on infrastructure, economic governance, and agriculture sectors are in line with the ANDS priority. Furthermore, total core expenditure presents 6.49 percent increase from AFN 87.33 billion to AFN 92.99 billion, indicating AFN 5.67 billion increase in overall development and operating expenditure compared to same period of previous year as a result of increase in employee expenditure, grants contribution and pensions and capital expenditure.

In addition, operating expenditure indicates 6.62 percent decline from AFN 64.22 billion to AFN 59.97 billion that apparently represents AFN 4.25 billion decrement in operating expenditure compared to same period of the previous year. Meanwhile, development expenditure shows 42.93 percent important incline from AFN 23.10 billion to AFN 33.02 billion indicating AFN 9.92 billion speeding up in development expenditure relative to the previous year. A minor increase in overall expenditure is indicated by increase in annual approved development budget as well as increase in core annual expenditure.

Figure 5.12: Comparison of Total Expenditure FY 2017-18



6

Banking System Performance

6

BANKING SYSTEM PERFORMANCE

The main financial indicators of banking sector demonstrated a fluctuating trend as some of them decreased while some others have grown over the last quarter. Total assets along with the total deposits attracted by the sector shows an upward trend while profit and capital have increased compared to the previous quarter (June 2018). Similarly, the banking sector is still beleaguered with low asset quality. Gross loans increased due to issuance of new loans, more overdraft utilization and increase in USD rate. Equity capital remained sufficient but declined as compared to the previous quarter as a result of decrease in the profitability of the banking sector.

• Asset base of the banking sector increased by 0.16 percent during the third quarter of 2018, standing at AFN 308.14 billion which is at slower pace against 4.26 percent growth in the same previous period. The increase in banking system assets was mainly powered by increase in deposits. Disaggregated analysis of total assets shows that most obvious increase was recorded in investment and mostly in net interbank claims; other contributed components include net loans, repossessed assets and net other assets. Whereas the Cash in vault and claims on DAB, intangible assets and premises and other fixed assets have decreased over the quarter.

• Total gross loan portfolio of the banking sector posted an increase of 2.80 percent over the quarter standing at AFN 43.30 billion. The increase in total gross loans is mainly attributed to issuance of new loans, overdrafts utilization and rise in USD rate.

• Deposits the main funding source in the banking sector stood at AFN 264,93 billion, comprising 97.22 percent of the total liabilities of the sector which increased by 0.62 percent against 5.22 percent growth in the period under review. The major increase in deposit base of the banking sector is attributed to demand deposits. Deposits were largely denominated in USD (64.95 percent) with Afghani denominated deposits lagging at 28.02 percent. Afghani denominated deposits indicated 2.33 percent decrease against 0.58 percent increase in the quarter of June 2018. USD denominated deposits increased by 2.78 percent against 0.10 percent decrease in the quarter of June 2018.

• The capital base of the banking sector fluctuated and decreased by 0.34 percent standing at AFN 35.64 billion. The decrease in capital base attributed to quarterly losses. The financial capital of one bank is below the set limits; however the capital adequacy of all banking institutions except two banks is above the minimum threshold (12 percent of risk-weighted assets). The Basel benchmark for capital to risk weighted is 8 percent. Capital adequacy ratio (CAR) of the banking sector recorded at 26.43 percent.• Banking sector incurred net profit amounting to AFN 353 million for the third quarter of 2018 against AFN 925 million net profits in the preceding quarter. Return on Assets (ROA) stands at 0.45 percent annualized and return on Equity (ROE) was recorded at 3.80 percent annualized. The decrease in profitability of the banking sector is mostly ascribed to increase in Credit Provision; other contributing factors include increase in Noninterest Expense and Salary Cost. It's worth mentioning that increase in Credit provision compared to the last quarter of current year has mostly impacted the sector's profitability. State-Owned Banks (SOB) along with branches of foreign banks (BFB) ended up with profit, while Private Banks (PB) ended up with loss in the review period.

I. ASSETS OF THE BANKING SYSTEM

The assets size of the banking sector increased by 0.16 percent in the period under analysis compared with 4.26 percent increase in the previous quarter. See Table 6.1.

The breakup of total assets reveals that the most obvious increase was registered in Net interbank Claims (AFN 4.36 billion or 5.29 percent of total assets); net-loans (AFN 906 million or 2.40 percent) and investment (AFN 2.81 billion or 13.22 percent). The decline in intangible assets and Fixed Assets were negligible. Cash in vault and Claims on DAB showed decrease of AFN 7.62 billion or 5.37 percent during the period under review.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (43.58 percent), interbank claims (28.22), net loans (12.55 percent), investments (7.81 Percent), "other assets" (4.51 percent) and fixed assets making 2.69 percent of the total assets. See Table 6.1.

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

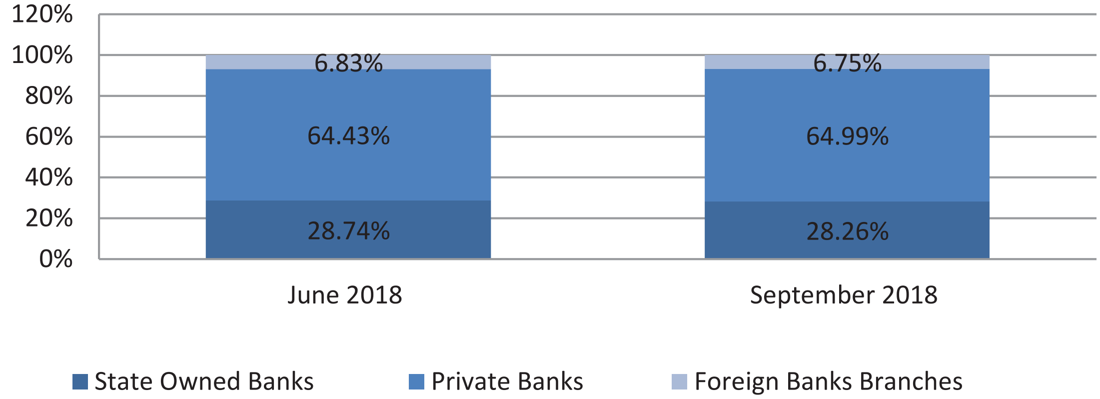


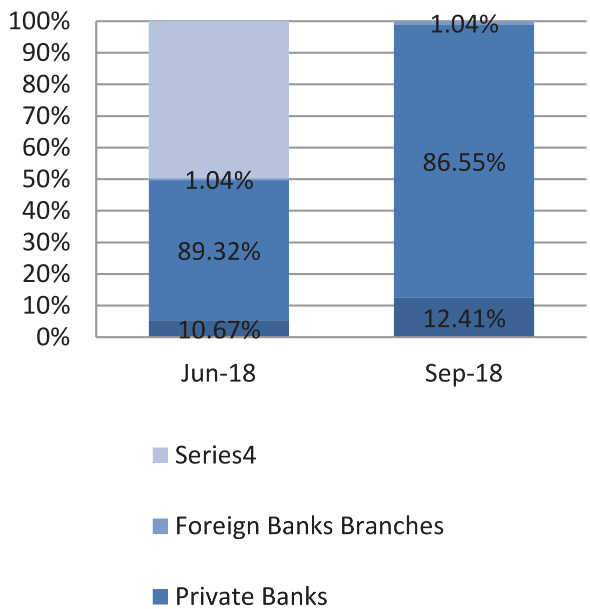
Table 6.1 Amount in million AFN	Jawza 1397 June, 2018	Mezan 1397 Sep, 2018	% of Total Assets/Liability	Growth
Assets				
Cash in vault and claims on DAB	141,928.48	134,302.95	43.58	-5.37
Interbank claims(Net)	82,598.29	86,966.90	28.22	5.29
Investments (Net)	21,266.21	24,077.56	7.81	13.22
Loans (Net)	37,772.75	38,679.22	12.55	2.40
Intangible assets	743.66	720.06	0.23	-3.17
Repossessed Assets	1,169.44	1,214.46	0.39	3.85
Fixed Assets	8,319.61	8,278.49	2.69	-0.49
Others	13,851.995	13,910.47	4.51	0.42
Total	307,650.43	308,149.10		0.16
Liabilities				
Deposits	263,304.51	264,936.17	97.22	0.62
Borrowings	2,670.81	2,552.10	0.94	-4.44
Subordinated Debt		-	-	-
Other	5,903.29	5,012.35	1.84	-15.09
Total	271,878.62	272,500.62		0.23
Financial Capital	35,771.81	35,648.48		-0.34

Source: Financial Supervision Department, DAB

1.1 Gross Loans

Total gross loans portfolio stands at AFN 43.30 billion, indicating AFN 1.81 billion or 2.80 percent incline since the previous quarter, constituting 14.05 percent of the total assets. The increase in total gross loans is mainly attributed to new issuance of loans, more overdraft utilization and increase in USD rate.

Figure 6.2: Share of Gross Loan Portfolio among banking group



Source: Financial Supervision Department

During the period under review, loan portfolio of nine banking institutions declined, whereas four banking institutions recorded increase in their loan portfolio and the remaining two banks did not participate in lending process.

Gross loan portfolio inclined only in one of the three state-owned banks, while among nine private banks, gross loan portfolio increased in five of them and four of them registered decline in their portfolios. In among the three branches of foreign banks, loan portfolio increased in one of them.. Private banks with 86.55 percent share in total portfolio posted 0.78 percent or AFN 289 million increase and state-owned banks holding 12.41 percent of the banking sector portfolio was up by 19.57 percent or AFN 880 million. While branches of foreign banks with 1.04 percent share depicted 2.78 percent or AFN 12 million increase during the period under review.

1.2 Loan Loss Reserves

While assessing the level of credit risk, banks must give due attention to credit risk mitigation tools within their risk mitigation framework. Banks are required to make both general reserves (on standard assets) and specific provisions (on non-standard assets) in order to mitigate their credit risk and according to revised asset classification and provisioning regulation. As per the new assets classification regulation, the creation of reserve for standard loans is optional.

By the end of September 2018, total provision cover of the system was 10.68 percent of total gross loans as opposed to

10.33 percent recorded in the previous quarter of FY 2018.

1.3 Distribution of Credit

In order to broad-based the loan portfolio and broaden the risk diversification and financial access besides new avenues of earning, DAB has diversified the sector wide distribution of other commercial loans to thirty sectors. The analysis of deployment of credit in different sectors indicate that the major portion of the loan portfolio is invested in trade sector (45.05 percent against 46.33 percent) mostly in petroleum and lubricant (11.01 percent); other main sectors include: services sector (23.06 percent against 22.72 percent) mainly in telecommunications (6.81 percent), manufacturing and industry sector (10.34 percent against 10.29 percent), commercial real estate and construction sector (8.91 percent against 7.15 percent), infrastructure sector (6.61 percent against 6.11 percent), agriculture sector (3.75 percent against 3.97 percent) and consumer sector (1.66 percent against 1.25 percent). Significant increases were observed in commercial real estate and construction sector, services sector, manufacturing, industry and infrastructure projects sectors, while the trade and consumer sectors were sectors which registered decrease over the reference quarter.. Loans designated to micro credit sector posted an increase of AFN 262 million currently standing at AFN 4.94 billion provided by three banks, while SME sector witnessed a decrease of AFN 19 million amounting to AFN 2.28 billion provided by four banking institutions. Concentration of loans to a few sectors of the economy would expose banks to credit risk in the event of crises situation associated to that sector, inversely affecting the overall banking sectors. Banks should closely monitor the potential risk associated with key sectors given the high NPL ratio. Disaggregated analysis shows that major portion of NPL originates from services sector constituting 34.74 percent of total banking sector's NPLs coming mainly from air transportation with 15.75 percent share of the banking sector's NPLs, while trade sector makes 24.08 percent of the banking sector's NPLs, mainly attributed to “cement and other construction material” with 14.02 percent share of the banking sector NPLs. Decreases were observed in trade sector, while “infrastructure projects”, “services” and “construction and building” sectors were among top increasing sectors. About 70.04 percent of the loans were designated in Kabul, while Balkh and Herat provinces are in the second and third places with Badghis and Kandahar provinces at fourth and fifth places respectively. The proportions of loans in other provinces were negligible. The designation of loans by sector, geography and institution is not adequately diversified, but it is expected that it will improve. It is desirable that all banks take active part in lending, so as to diversify lending services and properly perform their role in financial intermediation.

Table 6.2: Distribution of Loans Dec, 2014-Sep, 2018					
Sectors[1]	**Qaws, 1393 (Dec, 2014)**	**Qaws, 1394 (Dec, 2015)**	**Qaws, 1395 (Dec, 2016**	**Qaws, 1396 (Dec 2017)**	**Sunbula, 1397 (Sep, 2018)**
Commercial Real Estate and Construction					
Construction and Buildings	14.32%	9.44%	11.12%	8.70%	8.91%
Infrastructure Projects					
Power	0.35%	0.22%	0.38%	0.40%	0.13%
Road and Railway	2.41%	1.17%	0.64%	1.32%	2.14%
Dames	0.61%	0.09%	0.04%	0.00%	0.57%
Mines	0.08%	1.48%	0.52%	0.48%	0.50%
Other infrastructure projects	1.81%	2.44%	2.44%	3.46%	3.29%
Manufacturing and Industry					
Manufacturing &Products of Metal wood plastic rubber leather paper	2.477%	4.423%	3.469%	2.671%	3.42%
Manufacturing handmade and machine	4.187%	4.239%	3.743%	3.164%	3.19%
Cement and Construction Materials	2.864%	1.962%	1.274%	3.520%	3.73%
Trade					
Textile	2.59%	0.52%	0.72%	1.54%	2.5%
Wholesale	4.93%	9.89%	4.34%	4.67%	4.79%
Machineries	0.12%	0.25%	0.13%	0.09%	0.43%
Petroleum and lubricants	8.74%	9.80%	11.08%	10.78%	11.01%
Spare parts	0.24%	1.42%	0.26%	1.39%	1.74%
Electronics	1.40%	1.58%	1.91%	2.76%	3.10%
Cement and other construction material	1.87%	2.73%	2.35%	2.57%	5.22%
Food items	4.52%	8.24%	7.80%	7.27%	6.57%
All other items	5.72%	3.47%	4.17%	3.28%	7.07%
Retail trading	3.92%	3.28%	7.31%	8.15%	3.07%
Service					
Education	0.00%	0.00%	0.00%	0.00%	0.01%
Hotel and restaurant	1.20%	1.46%	1.33%	2.04%	2.09%
Telecommunication/scratch cards distributers	2.92%	5.70%	5.96%	5.52%	6.82%
Ground transportation	4.87%	5.31%	4.86%	1.86%	2.77%
Air transportation	4.18%	2.66%	2.35%	2.90%	2.79%
Health and hygienic	0.71%	1.16%	1.42%	1.73%	1.73%
Media, advertisements, printer	0.04%	0.04%	0.05%	1.18%	1.16%
All other services	6.19%	11.36%	13.22%	12.26%	5.70%
Livestock and farms					
Livestock and farming	0.043%	0.026%	0.059%	0.225%	0.57%
Agricultural Loans	2.61%	2.67%	3.20%	3.94%	3.76%
Consumer Loans	0.26%	0.30%	0.65%	0.86%	1.67%
Residential Mortgage Loans to Individuals	7.14%	2.68%	2.78%	0.71%	0.00%
All Other Loans	6.68%	0.00%	0.43%	0.57%	0.00%

[1] Revised and rearranged under specific sector heads.

II. CLASSIFICATION OF LOANS

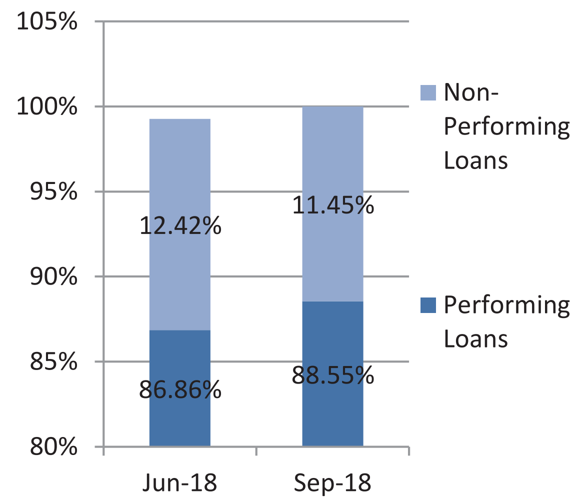
2.1 Non-performing loans

Banks should strengthen credit risk management measures to significantly reduce the high level of NPLs, which is not a favorable situation. Moreover, it can be inferred that quality of risk management in banks with poor credit performance shows weak performance. It is essential that banks with poor loan quality evaluate credit applications carefully, comply with all applicable laws, regulations, circulars, internal policies and procedures, and closely monitor financial condition of their borrowers to ensure that credit expansion will not pose a threat to the stability of the financial system.

In monetary terms, by the end of the third quarter of FY 2018, non-performing loans recorded AFN 4.95 billion or 11.45 percent of total gross loans and 15.56 percent of the system's regulatory capital against AFN 4.74 billion or 11.27 percent of the total gross loans in the previous quarter, showing a slight incline in monetary terms as well as percentage of total gross loans. Out of 11.45 percent NPL, 10.94 percent is related to four banks. These banks hold 10.94 percent of the system's gross loans and 14.86 percent of system's regulatory capital.

Financial Supervision Department (FSD) is closely working with banks with poor loan performance to design and implement plans to improve their asset quality. This situation requires regulatory oversight and prompt remedial action to improve governance of credit risk to avoid negative impact over the profitability and capital adequacy of the banks with poor credit quality.

Figure 6.3: Quality of Loan Portfolio



Source: Financial Supervision Department

2.2 Adversely-classified loans

Adversely classified loans (substandard, doubtful, loss)[2] depicted AFN 375 million decrease over the quarter, reaching AFN 7.33 billion, constituting 16.93 percent of the total gross loans and 23 percent of regulatory capital. Though decreased, but still requires strong board oversight and remedial actions by management to reduce the level of adversely classified loans to an acceptable level. In addition,

[2] Assets and advances for which the principal and/or interest remains outstanding for 61-120 days (Substandard). Default assets and advances for which the principal and/or interest remains outstanding for 121-480 days (Doubtful)- as per new Assets Classification and provision Regulation

more emphasis should be put on strengthening corporate governance in banks with poor credit quality, enhancing effectiveness and efficiency of internal controls, and adequately managing inherent and unsystematic risk. Management of the banks should take appropriate measures to address issues and weaknesses that have resulted in poor credit performance as per prudential regulations. Though systematic risk and economic downturn may have affected weak and systematically important bank's asset quality especially loans, banks management should have mechanisms to predict such risks, hedge their potential risk and take proper precautionary measures as per prudential regulations.

2.3 Loans classified Watch

Loans classified in the "watch"[3] category are AFN 5.48 billion, which makes 12.67 percent of total gross loans increased by 34 percent since the previous quarter. The increase is mostly attributed to three private commercial banks in the system. This category of loans require close monitoring as it may lead to more adversely classified loans (substandard, doubtful) and losses in the future.

2.4 Loans classified loss[4]

Loans charged off amounts to AFN 11 million comprising 0.03 percent of total gross loans and is attributed to one bank in the sector.

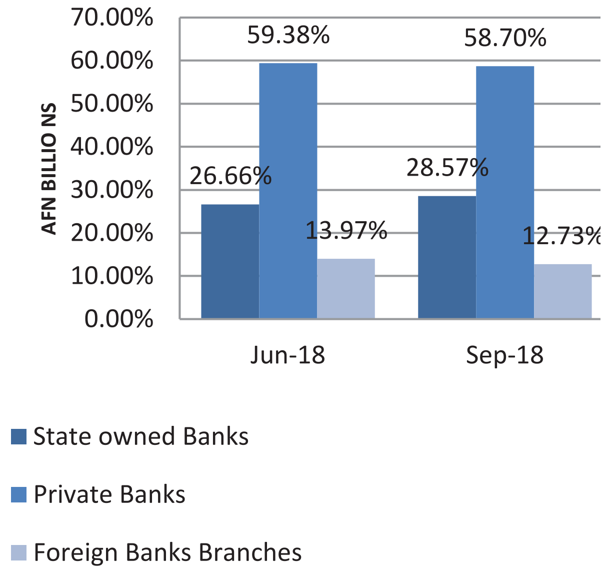
2.5 Inter-bank Claims

Gross interbank claims are the second largest among various asset categories currently comprising AFN 87.06 billion or 28.25 percent of total assets. Gross interbank claims registered AFN 4.37 billion or 5.29 percent incline in the review quarter compared to the previous quarter of FY 2018. The increase is mostly attributed to eight banking institutions, indicating that the banking sector has transferred a portion of its cash in vault and claims on DAB to interbank claims. With growth in the account of interbank claims, banks must not only appropriately measure risks associated with individual bank but should also measure risk in the countries in which they have placed funds. See figure 6.4.

Figure 6.4: Share of Inter-bank claims

[3] Assets and advances for which the principal and/or interest remains outstanding for 31-60 days (Watch)-new Assets Classification and provision regulation

[4] Assets on which the payment of principal or interest is due and remains unpaid for 540 day or more (Loss) as per Accounting Letter No. 03/92 dated 16/09/1392



Source: Financial Supervision Department

2.6 Investment

The net-investment[5] portfolio of the banking sector comprises of bonds, government securities and investment in associated companies. Investments increased by 13.22 percent or AFN 2.81 billion since June, 2018 standing at AFN 24.07 billion or 7.81 percent of total assets. The increase mostly came from nine banking institutions. Major part of the sector's investment took place outside Afghanistan. The investment portfolio is attributed to two state owned banks, five commercial banks and two branches of foreign banks.

[5] Investments include investment in bonds, securities, associated companies, in a subsidiary and in a bank

2.7 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the largest category making 43.58 percent of the total assets. This category decreased by AFN 7.62 billion, both in absolute as well as in percentage of total assets since the previous quarter currently standing at AFN 134.30 billion as of end of quarter three of FY 2018. The decreases were observed in overnight deposits accounts with DAB, correspondent account with DAB, capital notes and a minor decrease is in the cash in vault account.

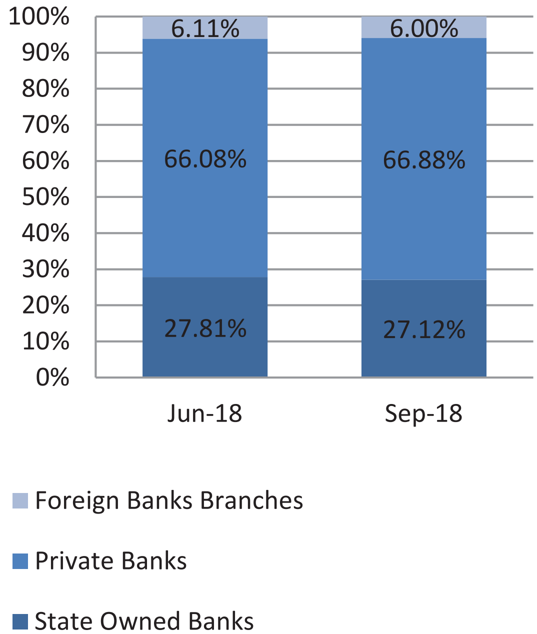
Banking sector is fully compliant with required reserves regulations and is deploying slowly and prudently the attracted funds into other types of assets.

III. LIABILITIES

Total liabilities of the banking sector increased by AFN 622 million or 0.23 percent standing at AFN 272.50 billion against AFN 271.87 billion in June, 2018. Among several components of total liabilities, total deposits have slightly increased, while other components have decreased over the period under review.

The majority of liabilities are made up of deposits (97.22 percent) with "other liabilities" at second and borrowings in third place. See Table 6.

Figure 6.5: Share of Liabilities among the banking group



Source: Financial Supervision Department

3.1 Deposits

Deposits being the main funding source amounted to AFN 264. 93 billion in the third quarter of FY 2018 showing an increase of AFN 1. 63 billion or 0.62 percent compared to the preceding quarter. Total deposits cover AFN 5.29 billion interbank and AFN 259. 64 billion customer deposits. The major increase in deposit base of the banking sector is attributed to customer deposits and occurred mainly in USD saving deposits, whilst deposits in AFN and other currencies registered a decrease in its position. Meanwhile, the interbank deposits indicated incline over the last quarter. Currency wise analysis shows that Afghani denominated deposits indicated 42.20 percent decline, accounting for 28.02 percent of total deposits, while US dollar denominated deposits increased 13.35 percent making 64.95 percent of the total deposits of the system.

Private banks attracted AFN 177. 27 billion deposits registering an incline of 2.03 percent making up 66.91 percent of the system's deposits.

The share of state-owned banks amounted to AFN 71.54 billion. It decreased by 2.23 percent since the previous quarter accounting for 27 percent of the system's deposits.

The deposit share of branches of foreign banks stands at AFN 16.12 billion that reduced by 1.62 percent making up 6.09 percent of total deposits of the system.

In terms of types of deposits, demand deposits accounted for 73.11 percent of the total deposit base, increased by 0.29 percent and saving deposits with 17.81 percent of total deposits was in the second place depicting 0.01 percent incline, while time deposits making up 10.02 percent of the total deposits portfolio was down by 0.01 percent since the previous quarter.

Figure 6.6: Afghani Denominated Deposits

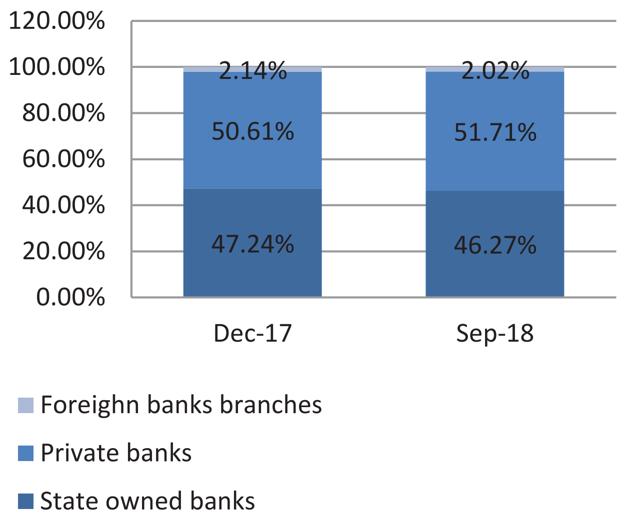


Figure 6.7: Currency Composition of Deposits

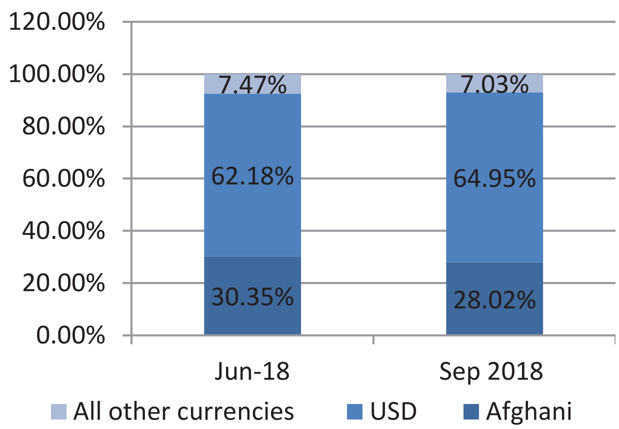


Figure 6.8: Deposits among banking group

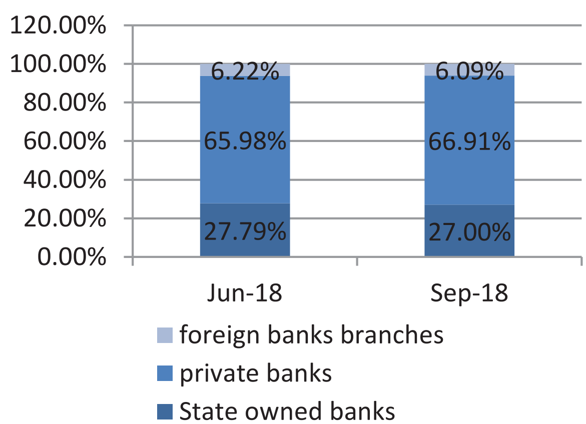
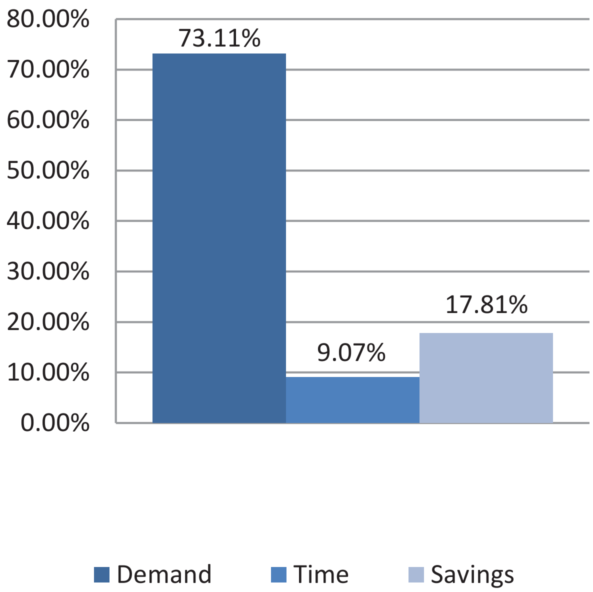


Figure 6.9: Breakdown of Deposits



Source: Financial Supervision Department, DAB

3.2 Borrowings

The share of borrowings in total funding structure of the system decreased by 4.44 percent standing at AFN 2.55 billion at the end of third quarter, making 0.94 percent of total liabilities. Reason for decrease in borrowing is repayment of some banks to lender institutions and impact of exchange rate. The current borrowing position is attributed to two banking institutions.

IV. LIQUIDITY

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

4.1 Liquidity Ratio (broad-based measure)

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

Generally, a surplus liquidity position was observed in the banking sector during the reference period. 71.91 percent of the sector's total assets are comprised of liquid assets. Ratio of the broad liquidity as a median for the whole system stood at 79.12 percent. All banking institutions were well above the minimum required level. See table 6.3.

Table 6.3: Key Financial Soundness Indicators of the banking Sector											
Ratio in %	**Mar, 2010**	**Mar, 2011**	**Mar, 2011***	**Mar, 2011**	**Dec, 2012**	**Dec, 2013**	**Dec, 2014**	**Dec, 2015**	**Dec, 2016**	**Dec, 2017**	**Sep, 2018**
Total Capital Adequacy Ratio	25.81	-14.46	30.39	23.06	21.84	26.34	26.46	19.94	27.68	29.81	26.43
Tier 1 Capital Adequacy Ratio	24.19	-14.51	30.29	23.98	19.97	24.65	26.09	19.66	22.93	28.17	25.67
Non-Performing Loan/Total Gross Loan	0.5	48.4	3.75	5.15	5.31	5.1	8.09	12.34	12.67	12.42	11.45
(ROA Cum Annualize)	1.41	-20.08	0.24	-1.21	-0.54	0.74	0.90	0.20	0.11	0.64	0.45
(ROE cum Annualize)	10.35	-520.66	1.9	-17.9	-7.17	10.03	7.35	1.69	1.08	3.38	3.80
liquidity Ratio (Broad Measure Median)	59.19	63.32	63.83	57.37	72.13	67.93	73.6	68.22	67.74	65.92	79.12
Liquidity Assets/Total Assets	0.38	40.58	47.01	55.82	63.75	73.18	73.28	75.05	71.98	73.95	71.91

*Excluding Kabul Bank Source: Financial Supervision Department/DAB

V. CAPITAL

The system is well capitalized. The capital fund of the banking sector stands at AFN 35.64 billion; declined by 0.34 percentage points or AFN 123 million over the last quarter. The decrease in total financial capital is mainly attributed to decrease in profitability.

On an aggregate basis, the capital adequacy ratio of the banking sector stands at 26.43 percent. See table 6.5.

Disaggregated analysis shows that the financial capital of one private bank is below the regulatory limits. However, the regulatory capital ratio of all banks except one private bank is above the set regulatory threshold (12 percent of the risk weighted assets). The Basel benchmark for capital to risk weighted is 8 percent.

VI. PROFITABILITY

On a cumulative base for the reference quarter, the banking sector obtained AFN 572 million profit against AFN 925 million net profits in the previous quarter, showing decline over the quarter. It's worth mentioning that the major part of the previous quarter net profits was from net interest income, other noninterest income and FX revaluation gain. In the previous quarter, the reintegration of provision was related to five banks, out of them two banks contain the major part of reintegration. In the review quarter, the reintegration of provision was related to 8 banks, out of them two banks contain the major part of reintegration.

The decrease in profitability of the banking sector as evident from the table 6.5 P/L is mostly ascribed to increase in net credit provision, increase in total operation cost (noninterest expense and salary) and other contributing factors such as decrease in FX Revaluation Gain. See table 6.5.

The returns on assets (ROA) shows how well a bank is being managed by conveying how much profit the bank earns per unit of its assets. ROA of the banking sector stands at 0.45 percent annualized, while the returns on equity (ROE), which measures shareholders return on their invested equity in a bank, was recorded at 3.80 percent annualized. The ROA of SOB[6] was recorded at 1.35 percent annualized, BOFB[7] at 1.58 percent, while PB[8] registered 0.41 percent annualized at end of third quarter of FY 2018.

On a cumulative basis, three banking institutions have incurred AFN 859 million net-losses during the quarter against AFN 1,00 billion net-losses posted by three banks in the previous quarter. On core income basis, eight banks ended with losses, against seven banks in the preceding quarter of June, 2018.

[6] SOB- Stated-Owned Banks
[7] BOFB- Branches of Foreign Banks
[8] PB- Private Banks

Group wise analysis reveals that state-owned banks and branches of foreign banks ended up with profits, while private banks registered loss in the period under analysis. See figure 6.10.

Major portion of the profitability of the banking sector is attributed to state- owned banks standing at AFN 351 million, branches of foreign banks profitability recorded at AFN 55 million, while private banks incurred AFN 53 million loss during the review.

Table 6.4: P/L Schedule

Items	Qaws 1395 (Dec., 2016)	Qaws 2017 (Dec., 2017)	%Change (Annual)
Interest income	1,814	1,938	6.84
Interest expense	262	283	8.02
Net interest income	1,552	1,655	6.64
Non-interest income	2,017	1,992	-1.24
Non-interest expenses	1,492	1,590	6.57
Salary cost	1,033	1,040	0.68
Credit provisions	12	559	4558.33
P/L before tax	1,032	457	-55.72
P/L after tax	925	353	-61.84

Source: Financial Supervision Department, DAB

Figure 6.10: Profitability of the Banking Sector

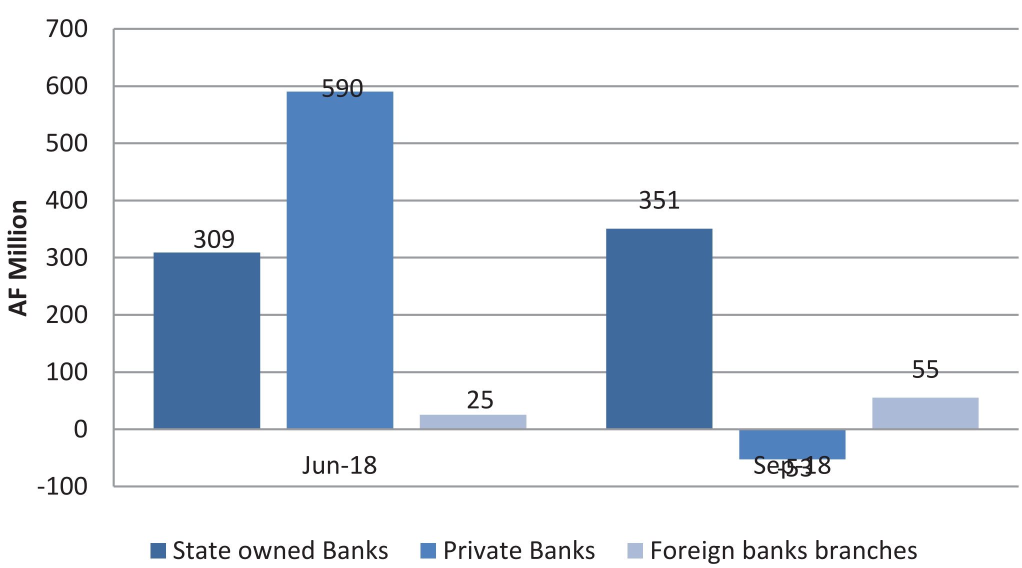


Figure 6.11: ROE and ROA of the banking system

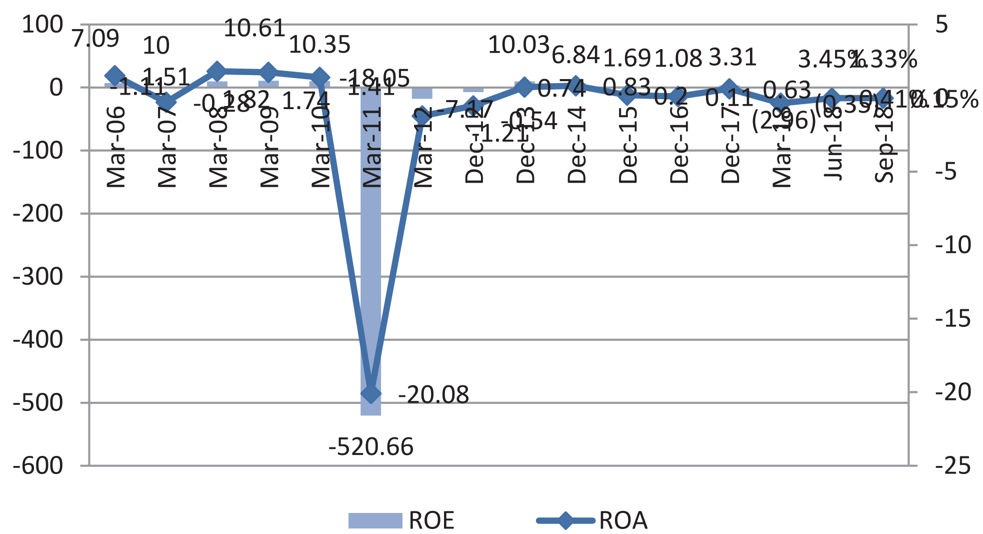
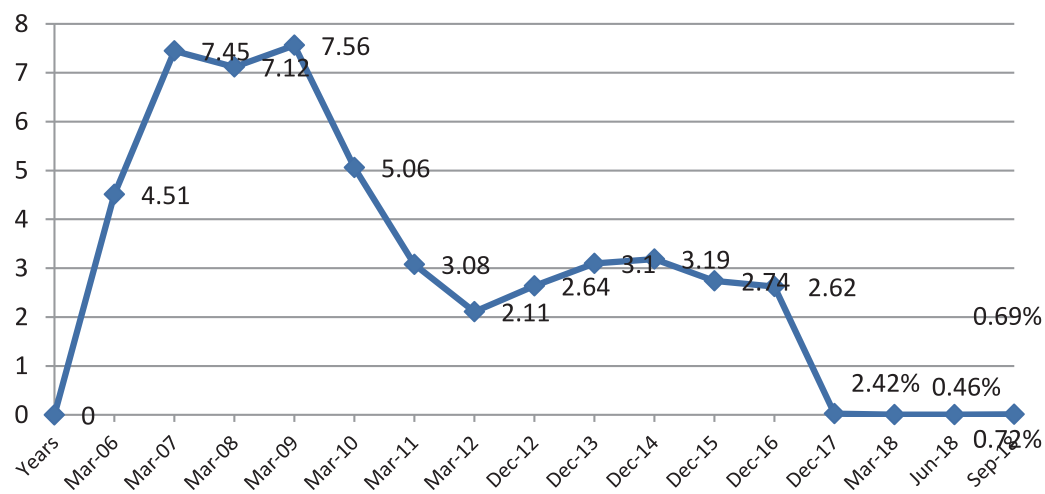


Figure 6.12: Net Interest Margin



Source: Financial Supervision Department, DAB

VII. Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for the overall open FX position, except for three banking institutions holding open FX positions on overall and on an individual currency (USD & Euro long position) basis that violated the limits. Those banks need to bring their FX positions under the set limit otherwise depreciation of US dollar can cause further loss.

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent appreciation in exchange rate would increase the regulatory capital of the system by AFN 1.65 billion and vice versa. Similarly, a four percent change would correspond to AFN 331 million increase and vice versa.

VIII. Interest Rate Risk

Overall the banking system is in an interest-rate sensitive position. However, calculations made from the Interest Rate Sensitivity Schedules of all banks reveal that the net-interest income of the system over the next 12 months may increase by AFN 841.81 million in the event of increase in the market interest rate (upward interest rate shock) by 3 percentage points. Conversely, if the interest rate decreases by 3 percentage points (downward interest rate shock), interest income will decline by AFN 841.81. For four banks, if the rate increases by 3 percentage points, their net interest income over the next 12 months will decrease.

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 banks, this situation makes the banks more vulnerable to a sudden decrease in the market rates.

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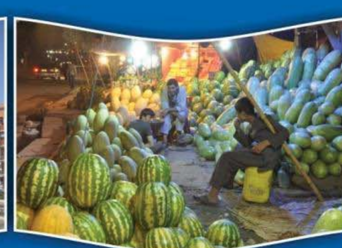

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