Da Afghanistan Bank

Central Bank of Afghanistan

Quarterly Economic and Statistical Bulletin

Second Quarter-1387

June 2008 - September 2008

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Data Notes

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

Afghanistan figures are in current Afghani unless otherwise specified.

Billion means 1,000 million

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LIST OF ABBREVIATIONS:

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

Message of the Governor

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

The second quarter of 1387 was characterized by turbulence in the global economy. After several years of rapid growth, the world economy faced serious challenges to maintain its robust growth. The sub-prime credit crisis in the United States, the persistence of large global imbalances and high oil and food prices threatened the sustainability of global economic growth with potentially significant impacts on Afghanistan's macroeconomic stability.

A combination of global economic shocks, regional food shortages and drought led Afghanistan to experience its sharpest inflationary surge in years, with price increase in the second quarter coming well above expectations. Headline inflation as measured by year-on-year percentage changes in Kabul CPI, increased to 35.7 percent in the quarter under review.

The increase in the CPI was mainly attributed to increases in the prices of food and oil. The food price index rose dramatically by 52.7 percent because of an increase in demand in the international markets and a shortage in the worldwide supply side. The increase in oil prices was mainly attributed by the recent developments in the international oil markets.

Monetary policy in the quarter under review remained cautious, underpinned by the broader objective of maintaining price stability while supporting the development of capital markets.

On the fiscal side, total operating expenditures at the end of second quarter of 1387 was AF 17,420 million or about 27 percent of total budget for the solar year 1387. Meanwhile, in development budget the expenditure was AF 11,065 million AF or 16 percent of the total development budget for the solar year 1387. On the revenue side, total domestic revenue at the end of the second quarter 1387 stood at AF 10,291 million (2 percent of GDP) about 13 percent increase compared to the same period last year.

The banking system continued to perform satisfactorily. Total assets of the banking system rose to AF 101.8 billion (USD 2.04 billion) at the end of second quarter 1387, up by 55 percent or AF 35.9 billion since September 2007. Loans amounted to AF 48.6 billion (USD 971.7

million) an increase of AF 17.4 billion (USD 347.6 million) or 55.7 percent since September 2007. Deposits stood at AF 79.6 billion (USD 1.6 billion) over the period under review; a 56 percent increase or an increase of AF 28.5 billion since September 2007. Deposits were largely denominated in USD (66 percent) with AF -denominated deposits lagging at 26 percent.

In the external sector, the trade deficit, the difference between exports and imports of goods, in the second quarter of 1387 stood at USD 490 million or approximately 4 percent of GDP. A comparison of merchandise trade in the second quarter of solar year 1387 with that in the second quarter of 1386 shows that imports declined by 3 percent to USD 595 million. Imports were dominated by industrial supplies (USD 202 million) such as petroleum and oil, metal products, fertilizer, chemicals and cement. Domestic exports increased by 4 percent to USD 105 million and were dominated by medical plants/seeds (USD 17 million) and food items (USD 27 million).

On an overall assessment, economic performance in the second quarter was broadly satisfactory notwithstanding concerns about the buildup of inflationary pressure and the potential for second-round effects on macroeconomic balance. On the positive side, international oil prices dropped to below USD 120 per barrel at the end of the quarter, the lowest in three months. The third quarter of the year is likely to be a challenging one for monetary policy as seasonal factors such as the increased demand for money due to Eid festivities and heavy demand for US dollars for the annual Hajj pilgrimage necessitate larger volumes of foreign currency auctions for sterilization purposes.

Foreseeable risks to the macroeconomic outlook remain. These risks include further increase in grain prices due to the wheat deficit and prolonged liquidity surge given steady foreign exchange inflows from remittances, the illegal opium trade and donor funds. Additional risks include the secondary effects of inflation on the banking sector and real estate values. Inflation will depress real returns to savings, bringing real (inflation-adjusted) deposit rates to negative levels. Negative real interest rates could lead to record high loan growth as bank struggle to maintain profitability. A negative interest rate scenario favors borrowers, and risks fuelling asset inflation and sparking a housing property bubble.

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank
(Central Bank)

1

THE INTERNATIONAL ECONOMIC ENVIRONMENT

SUMMARY

Most advanced economies were on the brink of recession as the quarter under review came to an end. Data for the third quarter of 2008 and forward-looking indicators suggest that the downturn in developed economies will continue to deepen into 2009 and 2010. Business and consumer confidence indicators for the United States and the Euro Zone are now close to those of the 2001/02 recession. Large emerging markets such as China and India also exhibited signs of weakness in aggregate demand and rising unemployment as export markets dried up. Small developing economies such as Afghanistan are vulnerable to the global slow-down as FDI, exports and official development assistance is rolled back putting stress on fiscal balances. On the positive side, the decline in inflationary pressure in Afghanistan as the pent up demand for food staples and weaker oil prices is passed through to households will be welcomed.

1. UNITED STATES

The United States faced an intensifying financial crisis and an economic downturn in the quarter under review. The US economy started contracting in the third quarter of 2008 with real GDP down by 0.1 percent compared to the second quarter. However, the percentage change in GDP compared with the third quarter of 2007 was positive with a growth rate of 0.8 percent. Since the summer of 2007 declining residential investment in the US has been a major drag on economic activity as business inventories have ballooned and private consumption has slowed.

Annual inflation increased in July 2008 reaching 5.6 percent but declined to 4.9 percent in September 2008. Despite the moderation in inflation it remained relatively high in the United States compared to the Euro Zone. Unemployment also hit record levels in the third quarter of 2008 at 5.9

percent up by 1.27 percentage points from the previous quarter.

The financial crisis continued to deepen in the third quarter of 2008 with major banks and government supported enterprises (Fannie Mae and Freddie Mac) bailed out by the government. Housing prices continued to decline at the fastest rate (varying from 5 to 17 percent) since the Great Depression. As a result more than 10 million households owed more on their mortgages than the market value of their homes. Confidence in financial institutions and markets in general has been affected by the financial crisis. Solvency concerns, bankruptcy risk, forced mergers and government interventions have pushed down consumer confidence, plunging the real economy into a downward spiral.

The US authorities have moved rapidly to stabilize the financial system by purchasing illiquid assets such as mortgage backed securities and credit default swaps from banks. Bank lending conditions and credit availability have been tight and are likely to remain so in the next quarter and through much of 2009.

In the fiscal sector, the stimulus package passed by the US Congress in April 2008 provided well-timed support, but the fiscal deficit continued to rise sharply and is now projected to reach 4.5 percent of GDP in 2009, the highest among G7 countries.

On an overall assessment economic activity is projected to decline in the final quarter of 2008 and to continue its downward spiral into the first quarter of 2009. Economic activity is then expected to stabilize in the second quarter of 2009 with the economy only returning to its full potential in 2010.

2. WESTERN EUROPE

The financial crisis has had a devastating effect on European economies. The transfer of risk aversion and financial stress to European countries has been rapid. The Euro Zone and the United Kingdom have been particularly hard hit by contagion effects from the US that weakened their economies and hobbled economic activity.

Economic activity in the Euro Zone and United Kingdom slowed significantly during the third quarter. Initially this was due to rising oil prices but later this was compounded by the global credit crunch. Economic growth turned negative with economic activity contracting by 0.2 percent and 0.5 percent in the Euro Zone and the United Kingdom, respectively.

The German economy also contracted in the second quarter with output declining by 0.5 percent, the most significant economic slowdown in the Euro Zone along with Italy. However, compared to the third quarter of the previous year, economic growth in the Euro Zone and the U.K. was up slightly by 0.7 and 0.3 percent respectively.

Headline inflation in the Euro Zone and the United Kingdom came in above expectations in the third quarter at 3.8 percent and 4.8 percent respectively compared to 2.1 percent and 2.3 percent in 2007.

Unemployment in the Euro Zone was also higher than analysts expected in the third quarter. The Euro Zone experienced an unemployment rate of 0.1 percent in August and 0.2 percent in September. The rate of unemployment in Spain was one of the highest in Europe at 11.5 percent followed by France with 7.9 percent.

While the surge in oil and food prices undercut real disposable incomes, financial conditions tightened quickly across the European continent. European banks struggled with a confluence of adverse shocks. They were exposed to losses on their holdings of US-mortgage-backed assets and deteriorating overall credit quality dating back to 2007 Concerns that initially focused on liquidity spread rapidly to bank solvency. Confidence in the sector weakened and highly-leveraged banks struggled to maintain funding in the face of rising creditor concerns about balance-sheet risk.

Central banks tried to ease liquidity pressures through provision of US dollar liquidity, and a number of governments (e.g. Belgium, France, Germany, Luxembourg, the Netherlands, and the United Kingdom) stepped in to provide solvency support to a number of major financial institutions (including Dexia and Fortis). Other emergency measures in response to the financial crisis in included raising deposit guarantee limits, extending state guarantees to creditors (for example Ireland) and providing explicit assurances to depositors (for example Germany and the United Kingdom).

Over the past six months changes in policy interest rates have been limited as central banks focused on providing liquidity to stressed markets. The European Central Bank increased interest rates by 25 basis points to 4.25 percent in July 2008. This was the first interest rate move since June 2007. In contrast the Bank of England has kept rates unchanged at 5 percent since April 2008. However, faced with the potential implosion of financial markets central banks changed their focus from increasing interest rate to stimulating the economy.

The fiscal condition of most western European countries remains precarious. The general government deficit for Euro

Zone countries averaged about 1.75 percent of GDP. However, fiscal deficits of some countries (France, Greece, Ireland, Italy, and Portugal) are still far from their medium-term objectives and in some cases are likely to exceed the Maastricht deficit limit of 3 percent of GDP in the near term.

3. JAPAN

The Japanese economy was not insulated from the turbulence in global financial markets. Real GDP contracted by 0.7 percent in the second quarter of 2008 indicating that Japan has already entered a recession along with other advanced economies. Weakening external demand, moderating private consumption and decreasing fixed investment account for the decline in economic activity. In addition, during the third quarter, rising input costs and diminishing profit expectations were weighing on corporate sentiment and companies' investment plans. Although the trade surplus deteriorated because of a higher bill for commodity imports, rising investment income helped keep the current account balance close to its long term level.

The annual inflation rate in the third quarter increased to 2.2 percent up from 1.3 percent in the second quarter. At the same time, the unemployment rate was at 4.1 percent, growing by 0.3 percentage point from the third quarter of 2007.

Given weakening domestic demand and low inflation pressures, the Bank of Japan kept the interest rate with a bias towards loosening. As to the fiscal sector, the public deficit excluding social security is expected to widen in 2008 and 2009. In late August, the Japanese government put forward an economic stimulus package in order to support economic growth, which also increased the public debt.

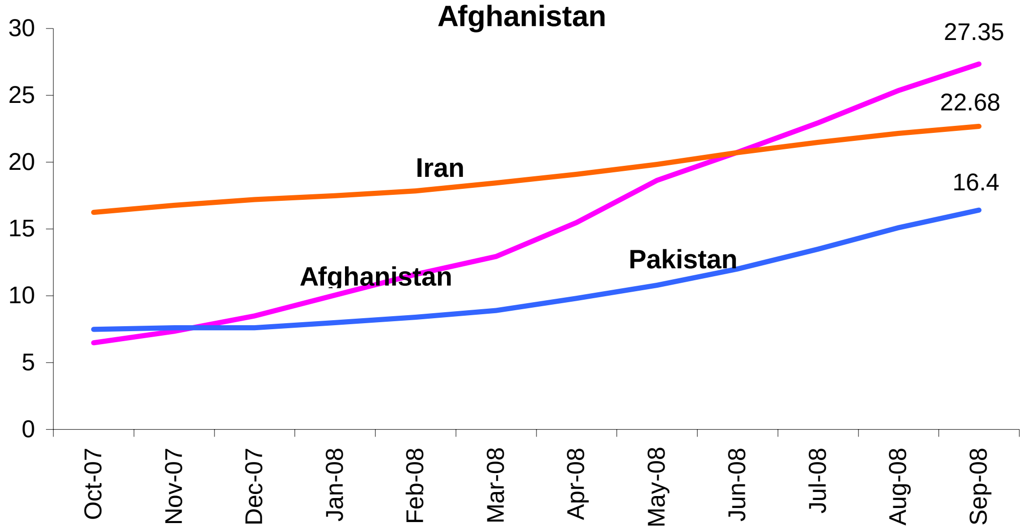
4 REGIONAL ECONOMIES

The global financial crisis spread to those South Asian economies that were deeply integrated into the international financial system. Most regional economies initially suffered declines in domestic demand as rising fuel and food prices started to weigh on consumption. However concerns shifted from the inflation front as foreign direct investment shrank and exports declined. The weakness in economic performance was observed in early 2008 and more weakness is expected because of slowing demand in western countries and growing strains in regional financial markets.

On the other hand, inflation has risen faster in this region than in any other part of the world. Iran had the highest inflation rate in the region with a period average inflation rate of 22.1 percent in the third quarter of 2008, up from 19.9 percent in the previous quarter. Pakistan had an inflation rate of: 16.4 percent (period average) in the third quarter up from 12 percent in the second quarter.

Regional financial markets have not been shielded from the turmoil in global markets. They showed considerable weakness in the third quarter, driven by negative sentiments of the global economic outlook and domestic concerns. The equity markets that experienced the largest run-up in prices in recent years (during 2005–07, prices more than quadrupled in China and tripled in India) have declined the most.

Figure 1.1: Period Average Inflation in Iran, Pakistan and Afghanistan



Source: Central banks of Iran, Pakistan and DAB

5. CHINA

China's GDP for the first three quarters showed a year-on-year increase of 9.9 percent, which was 2.3 percentage points lower than that of the same period last year. Although the growth rate of exports dropped by 4.8 percent, it was offset by the surge in foreign direct investment which increased during the first three quarters of 2008 by 29 percentage points compared with the same period last year. In the first three quarters of this year the consumer price index rose by 7 percent which was 2.9 percentage points higher than that in the same period last year. On a month-on month basis, inflation in September grew by 4.6 percent growth down by 0.3 percentage point. This indicates that inflationary pressures appear to be easing in line with concerns about the impact of the global slowdown on China's export industry.

6. INDIA

The Indian economy continued to record robust growth during the second quarter of 2008. However the rate of economic growth dropped by 0.2 percentage point to 7.7 percent in the third quarter. This represents a reduction in growth when compared to the previous five years when growth averaged 8.8 percent. The moderation in economic growth is partly due to a cyclical downturn nonetheless, the structural drivers of the growth process continued to be favorable during the first three quarters of 2008.

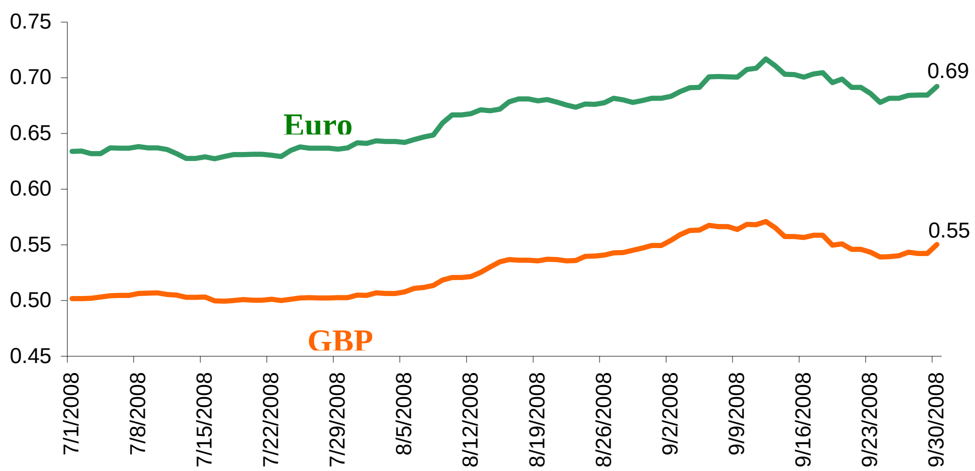
The overall performance of the agricultural sector was satisfactory. However growth in industrial production decelerated to 4.9 percent (year-on-year basis) in the second quarter compared to10 percent in the same quarter in the previous year. The services sector continued to performance well with double-digit growth for the fourteen consecutive quarters.

On the inflation front, India experienced 9 percent inflation in the third quarter on a year-on-year basis while the price change from the previous quarter was 4.1 percent in India.

7. GLOBAL EXCHANGE RATES

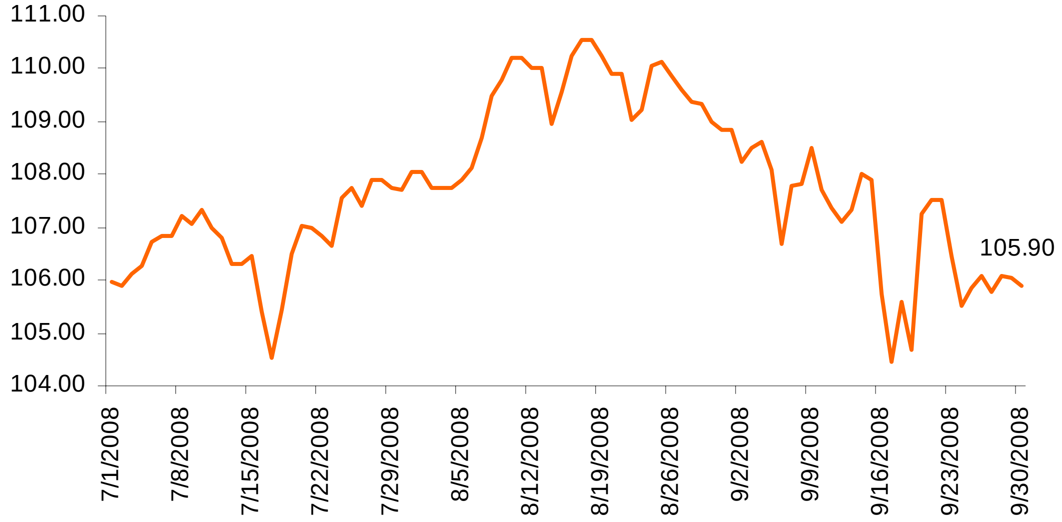
The US dollar appreciated significantly against other major currencies in the third quarter before ending the quarter mixed. The US dollar started to appreciate during the first week of August against the euro and pound and then experienced a slight depreciation in the second half of September. The volatility of the US dollar vis-à-vis the euro as measured by the standard deviation was quite low at 0.027. On the other hand, the Japanese yen fluctuated widely against the US dollar ranging from 104.43 to 110.56.

Figure 1.2: Nominal Exchange rate, USD daily average



Source: www.oanda.com

Figure 1.3: Nominal Exchange rate, USD/JPY



Source: www.oanda.com

Table 1.1: Exchange rates of selected currencies against the USD

	AF (Afghani)	INR (Indian Rupee)	IRR (Iranian Rial)	PKR (Pak. Rupee)
Average July	49.96	42.82	9037.50	70.12
Average August	49.94	42.93	9289.95	73.95
Average September	50.30	45.51	9501.31	76.76
Lowest rate Q3	49.98	42.05	8935.10	68.04
Highest rate Q3	50.63	47.35	9691.50	78.36

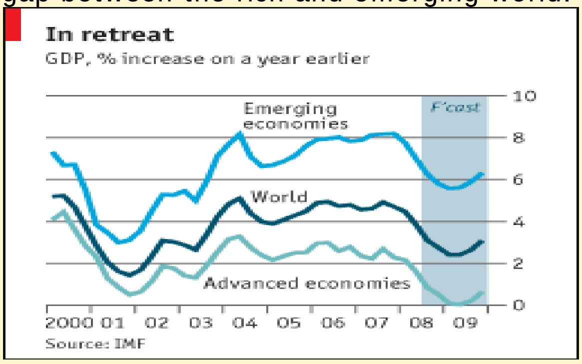
Box 1: The world economy is on the brink of recession

The world economy has been expanding since 2002 but now appears to be entering a major downturn in the face of the most dangerous shock to rich-country financial markets since the 1930s. The International Monetary Fund (IMF) expects global growth, measured on the basis of purchasing-power parity (PPP), to come down to 3% in 2009, the slowest pace since 2002 and on the verge of what it considers to be a global recession. While there is no commonly accepted definition of a global recession, the IMF regards periods when global growth is less than 3% to be global recessions. By this measure, three periods since 1985 qualify: 1990-1993, 1998 and 2001-2002.

The expansion of 2002-07 began with the bursting of the US technology stock bubble in 2000-01. To minimize the duration and depth of the ensuing recession, the Federal Reserve aggressively eased monetary policy. It lowered either the Federal Funds rate or the discount rate 27 times between January 2001 and June 2003, with the funds rate falling from 6.5 percent to 1.0 percent over that period. This expansionary monetary policy averted a deeper recession by stimulating a boom in the housing market, which soon turned into a housing bubble. Higher housing prices fueled a consumption boom, and the Fed's continued expansionary monetary policy kept the US economy awash in liquidity.

The first real sign that the US housing bubble was bursting, the mid-2007 crisis in the sub-prime mortgage market-- transmitted losses to a whole set of securitized financial products such as mortgage-backed securities. The drop in these assets dealt a blow to the balance sheets of many financial institutions. The sub-prime mortgage crisis thus became a full-fledged financial crisis, which in turn has led to a collapse in equity markets.

Although the full-fledged crisis struck first in the United States, the US is not alone in its vulnerability to shocks and collapses in consumer confidence. The rich world's economies were either shrinking, or close to it, long before September. The IMF expects the rich-world economies to grow by only 0.5% in 2009. Its forecast of 3% global growth depends on reasonably robust expansion in emerging economies. The fund expects developing countries, as a group, to grow by 6.1% in 2009, more slowly than their blistering 8% pace of recent years, but far from recession. That would imply an unprecedented growth gap between the rich and emerging world.

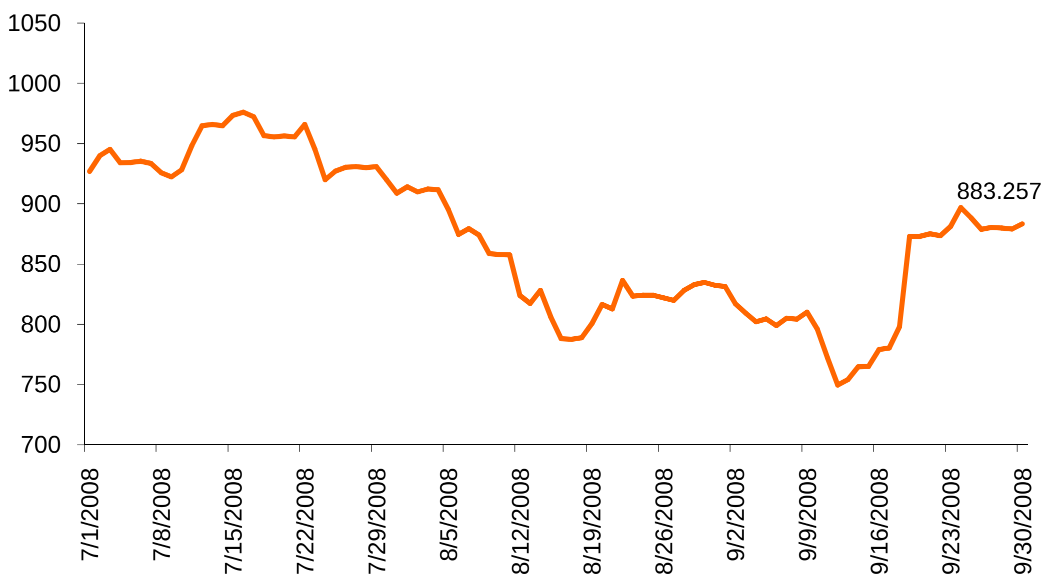


Source: International Monetary Fund, Economist, Financial Times (various issues)

8. GOLD PRICES DECREASED DURING THE SECOND QUARTER

During the quarter under review gold prices were on a declining trend, decreasing by 4.7 percent (Figure 1.4). The price of gold closed the quarter at USD 883.257/oz. and the volatility in gold prices was remarkable, ranging from USD975.801 to USD 749.574.

Figure 1.4: Gold Prices in USD



9. EQUITY MARKETS PERFORMANCE

Equity markets tumbled as risk aversion rose and investors sought safe and high quality assets. United States' equity markets were down by 8.88% during the third quarter; NASDAQ was down13.70 percent the Dow Jones Industrial Average was down 4.40 percent and S&P 500 was down 9 percent. Similar trends are observed in other major financial centres (Table 1.2).

Table 1.2: Country Performance of Stock Exchanges in Third Quarter 2008

	United States	United Kingdom	France	Germany	Japan	Hong Kong	China	India
Q3 % change	-8.88%	-12.86	-9.08%	-9.15%	-25.74%	-18.49%	-16.17%	-4.47%

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

SUMMARY

Monetary and capital market conditions remained buoyant in the quarter under review reflecting efforts by DAB to maintain liquidity at levels commensurate with overall economic activity. The DAB utilizes two separate sources of data to track monetary conditions: monetary program data and the monetary survey. According to the monetary program data, reserve money increased by 8 percent in the quarter under review from 5 percent in the first quarter, 1387. Reserve money is composed of bank deposits with the central bank (excess reserves, required reserves), currency in circulation and overnight deposit facility. Overnight deposits with the central Bank, a component of reserve money, increased by 34 percent in the second quarter 1387 reflecting stronger attempts by the banking sector to obtain higher yields on deposits.

According to the monetary survey, narrow money (M1) grew by 11.7 percent in the quarter under review down from 5.5 percent in the previous quarter reflecting tighter monetary conditions. Currency outside depository corporations, the other component of narrow money, grew by 6.2 percent in the quarter under review which was an identical rate to the previous quarter.

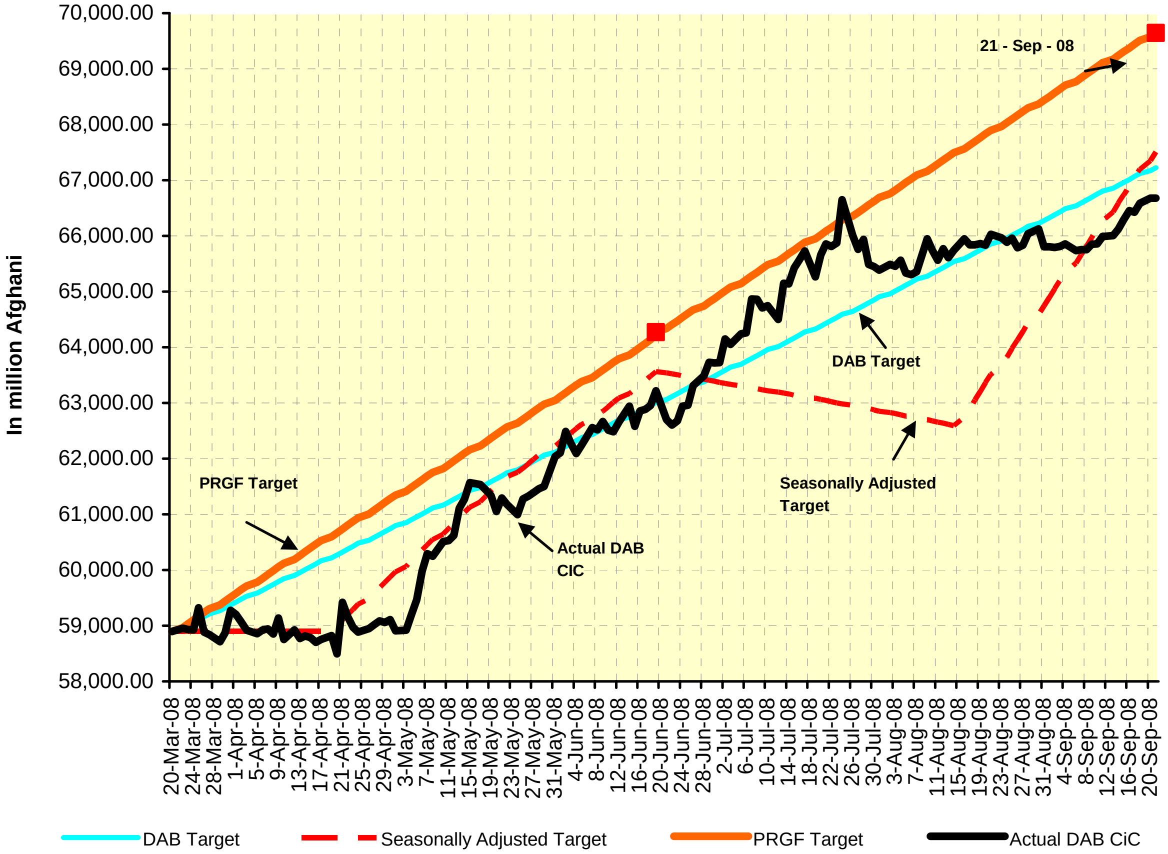
Quasi-money increased by 7.5 percent in the quarter under review from -1.2 percent in the previous quarter. Net domestic assets (NDA) increased by 11.6 percent in the second quarter, down from 17.1 percent in the first quarter 1387 while net foreign assets (NFA) increased by 6.77 percent in the quarter under review from 0.3 percent in the previous quarter.

1. PRGF MONETARY PROGRAM

Currency in circulation, the most liquid portion of money, remained on track in the quarter under review. Figure 2.1 shows the trends in daily currency in circulation was below the PRGF target at the end of the second quarter.

Reserve money increased by 8 percent in the second quarter from 5 percent in the first quarter 1387. This is due to an increase in commercial bank deposits with DAB which expanded from AF 5103 million to AF 6826 million which shows an increase of 34 percent in the quarter under review from -8 percent in the previous quarter.

Figure 2.1: Daily Currency in Circulation
(DAB Actual, Target and PRGF Ceiling) Second Quarter 1387



Source: Monetary Policy Department (DAB) and IMF Staff calculations

According to the monetary program data, which is shown in Table 2.1, net domestic assets declined by -8 percent in the quarter under review from -12 percent in the previous quarter which represents –a 1 percent deviation form the Monetary Program. This is mostly because of the other items net which declined by -6 percent in the quarter under review down from -66 percent in the previous quarter.

Net foreign assets increased by 8 percent in the second quarter down from 9 percent in the first quarter 1387. This is largely because of the category “other foreign assets” which increased by 12 percent in the quarter under review up from -16 percent in the previous. Another reason for increasing the net domestic assets is foreign liabilities which was AF -4,830 - million in the second quarter and AF -5,043 million in the first quarter 1387. It shows a percentage change of 4 percent in the quarter under review from -9 percent in the previous quarter.

Table 2.1: Performance of Afghanistan Monetary Program, Second Quarter 1387 (million AF)

	1386 Q4 Actual	1387 Q1 Actual	Quarter Change (Q4 -Q1)	1387 Q2 Target	1387 Q2 Actual	Quarter Change (Q1- Q2)	Deviation From Target
1. Net Foreign Assets (a+b)	**126,66**	**137,220**	**9%**	**149,055**	**148,248**	**8%**	**-1%**
(a) Foreign Assets (i+ii)	130,796	142,263	9%	155,009	153,078	8%	-1%
i. Foreign exchange reserve	120,754	133,872	11%	144,642	143,667	7%	-1%
ii. Other foreign assets	10,042	8,391	-16%	10,367	9,411	12%	-9%
(b) Foreign liabilities	-4,630	-5,043	-9%	-5,954	-4,830	4%	19%
2. Net Domestic Assets (a+b)	**-61,741**	**-69,362**	**-12%**	**-73,851**	**-74,839**	**-8%**	**1%**
(a) Domestic Assets (i+ii)	-35,070	-25,065	29%	-29,048	-27,956	-12%	4%
i. Net claims on general government	-35,070	-25,065	29%	-29,048	-27,956	-12%	4%
(b) Other Items Net	-26,671	-44,297	-66%	-33,625	-46,883	-6%	-39%
3. Reserve Money (a+b)	**64,426**	**67,858**	**5%**	**75,204**	**73,409**	**8%**	**-2%**
(a) Currency in Circulation	58,899	62,755	7%	69,644	66,582	6%	-4%
(b) Bank deposits with DAB	5,526	5,103	-8%	5,560	6,826	34%	23%

Source: International Monetary Fund, Central Statistical Office and DAB staff calculation

According to the monetary survey data, shown in Table 2.2, the supply of broad money (M2) expanded by AF 14,029 million in the quarter under review up from AF 126473 million AF in the previous quarter. This is a difference of AF 14557 million or 11.5 percent up from 5.2 percent in the previous quarter. The increase in broad money was driven by demand deposits and currency outside depository corporations. Demand deposits increased by 17.3 percent in the quarter under review up from 4.9 percent in the previous quarter and currency outside depository corporations increased by 6.2 percent in both the first and second quarters. Narrow money grew by 11.7 percent in the quarter under review from 5.5 percent in the previous quarter is a difference of AF 14,152 million.

Table 2.2: Monetary Aggregates, Second Quarter 1387 (In millions AF)

	1386 Q4 Amount	1387 Q1 Amount	Quarter Change (Q4-Q1)	Difference (Q4 - Q1)	1387 Q2 Amount	Quarter Change (Q1 - Q2)	Difference (Q1-Q2)
1- Narrow Money(M1)	**114,734**	**121,074**	**5.5%**	**6,340**	**135,225**	**11.7%**	**14,152**
Currency outside depository corporations	57,501	61,052	6.2%	3,552	64,850	6.2%	3,798
Demand Deposits	57,233	60,021	4.9%	2,788	70,375	17.3%	10,354
2- Quasi Money	**5,467**	**5,399**	**-1.2%**	**-68**	**5,804**	**7.5%**	**405**
In Afghani	2,013	2,614	29.9%	601	2,633	0.8%	20
In Foreign currency	3,454	2,785	-19.4%	-669	3,171	13.8%	385
3- Broad Money(M2)	**120,201**	**126,473**	**5.2%**	**6,272**	**141,029**	**11.5%**	**14,557**
Determinants							
1- Net Foreign Assets	**159,652**	**159,186**	**-0.3%**	**-467**	**169,963**	**6.77%**	**10,778**
(a) Foreign Assets	167,988	165,098	-1.7%	-2,890	175,445	6.3%	10,348
DAB Foreign exchange reserves	144,435	138,672	-4.0%	-5,762	149,529	7.8%	10,857
Other foreign assets	23,553	26,425	12.2%	2,872	25,916	-1.9%	-509
(b) Foreign Liabilities	8,335	5,912	-29.1%	-2,423	5,482	-7.3%	-430
2. Net Domestic Assets	**-39,451**	**-32,713**	**17.1%**	**6,738**	**-28,934**	11.6%	**3,779**
(a) Net Domestic Credit	1,497	12,993	767.8%	11,495	14,715	13.3%	1,723
Net Claim on General Government	-41,478	-31,867	-23.2%	9,611	-35,748	12.2%	-3,881
Claims on other Sectors	42,975	44,859	4.4%	1,884	50,463	12.5%	5,604
(b)Other Items Net	10,591	-40	-100.4%	-10,632	3,221	-8056.9%	3,261
(c) Capital Accounts	51,540	45,665	-11.4%	-5,874	46,870	2.6%	1,205

Source: Monetary Policy Department DAB

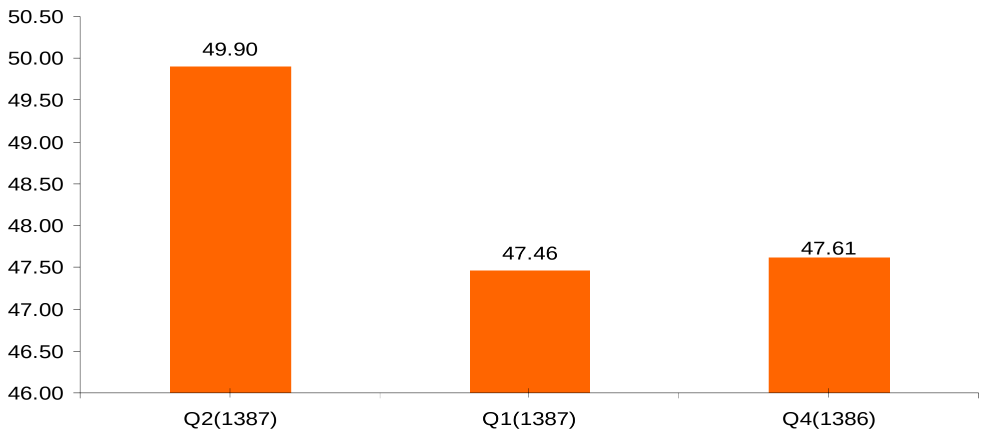
Quasi-money which is a component of M2, increased by 7.5 percent in the quarter under review from (-1.2) percent in the previous quarter. This is due to an increase in foreign currency which increased by 13.8 percent in the second quarter 1387 from minus 19.4 percent in the first quarter 1387.

Net domestic assets, which is a determinant of monetary growth, increased by 11.6 percent in the quarter under review. This was less than 17.1 percent growth in the previous quarter; a difference of AF 3779 million. This is mostly motivated by net domestic credit which increased by 13.3 percent in the quarter under review less form 767.8 percent in the previous quarter which shows a difference of AF 1723 million.

The 13.3 percent increase in the net domestic assets is mostly driven by the net claims on general government which increased by 12.2 percent in the quarter under review form -23.2 percent in the previous quarter which shows a difference of AF -3881 million. Claims on “other sectors”, which is another component of net domestic assets grew by 12.5 percent in the quarter under review from 4.4 percent in the previous quarter.

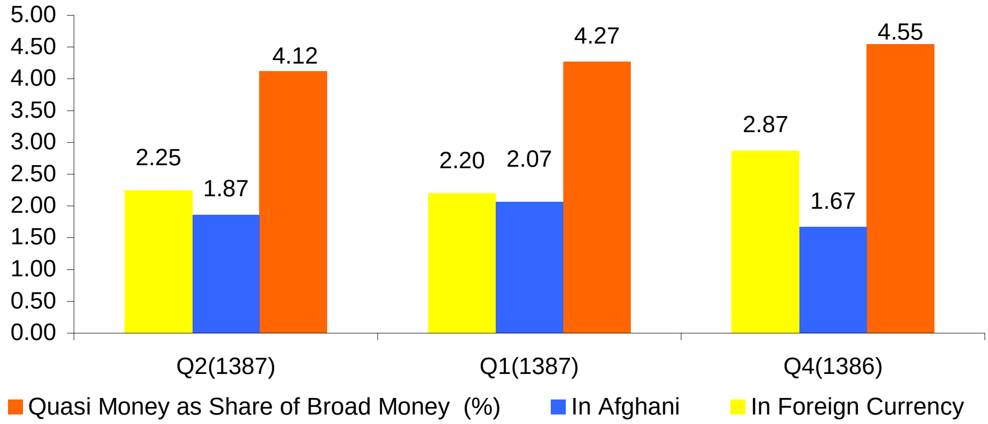
According to Figure 2.2, bank deposits as share of broad money grew by 49.90 percent in the second quarter 1387 from 47.46 percent in the first quarter 1387. This is due to increase in foreign currency which is shown in the below Figure 2.3. Foreign currency grew by 2.25 percent in the second quarter 1387 from 2.20 in the first quarter of 1387.

Figure 2.2: Bank Deposits as Share of Broad Money (%)



Source: Monetary Policy Department, DAB

Figure 2.3: Quasi Money as Share of Broad Money (%)



Source: Monetary Policy Department, DAB

2. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

2.1 Capital Note Auctions

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

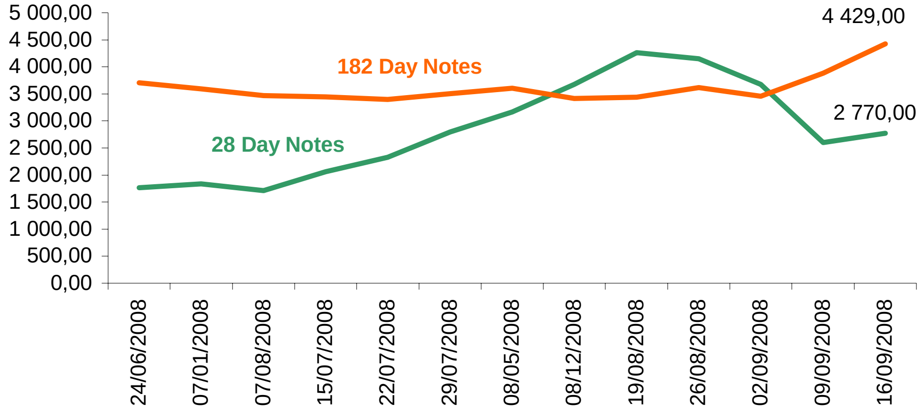
The amount to be auctioned is announced every Monday to the banks electronically. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase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

The amounts awarded in the quarter under review fluctuated between AF 120 million and AF 1.53 billion for 28 day notes and between zero bids accepted and AF 700 million for the 182 day notes. The amounts announced for both 28 day and 182 day notes were AF 200 million and AF 100 million respectively.

The outstanding stock of 28 day notes recorded a significant increase of AF 2.5 billion which caused the amount outstanding to increase to AF 4.25 billion in the quarter under review. The outstanding stock of 28 day notes dropped to AF 2.7 billion at the end of second quarter of 1387. On the other hand, the outstanding stock of 182 day notes did not increase during the first two and half months of this period then increased by AF 1 billion at the end of the quarter.

The total outstanding stock of both maturities stood at AF 7.2 billion at the end of the reporting period. (Figure 2.4).

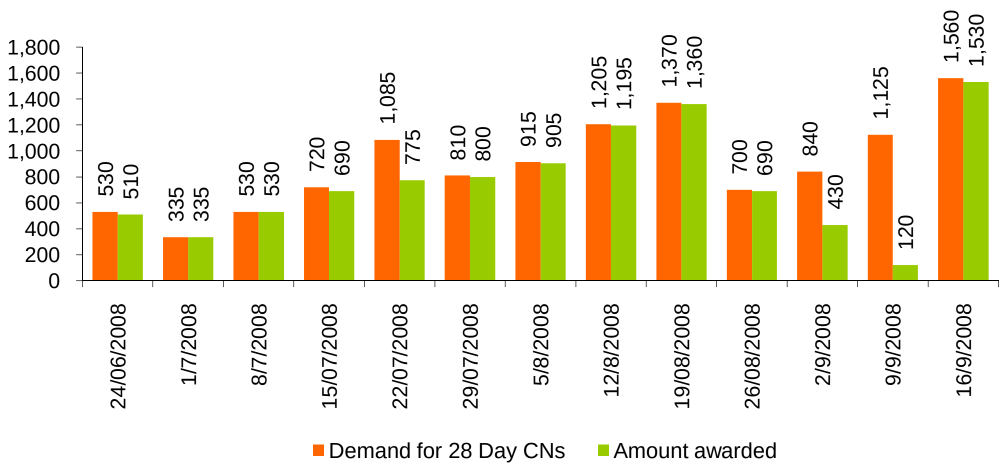
Figur 2.4: Capital Notes Stock outstanding (million AF)



Source: Market Operations Department, DAB.

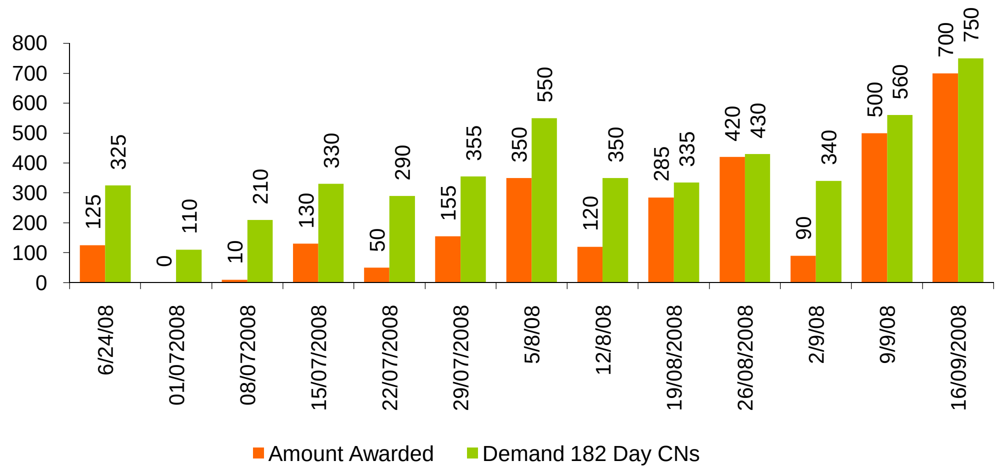
The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the bid amount for 28 days notes was AF 902 million and amount awarded was AF 759 million for a cover ratio of 1.18. The bid amount for 182 day note was AF 380 million and amount awarded was AF 226 million for a cover ratio of 1.68 Comparing the cover ratio in the second quarter to that in the previous quarter, the cover ratio for the 28 day note was 3.36 and for 182 day note it was 1.41 reflecting increased supply of CNs which was matched by increased demand from commercial banks. (Figure 2.5 for 28 day CNs and Figure 2.6 for 182 day CNs).

Figure 2.5: Demand and amount awarded for 28 Capital Notes (million AF)



Source: Market Operations Department, DAB

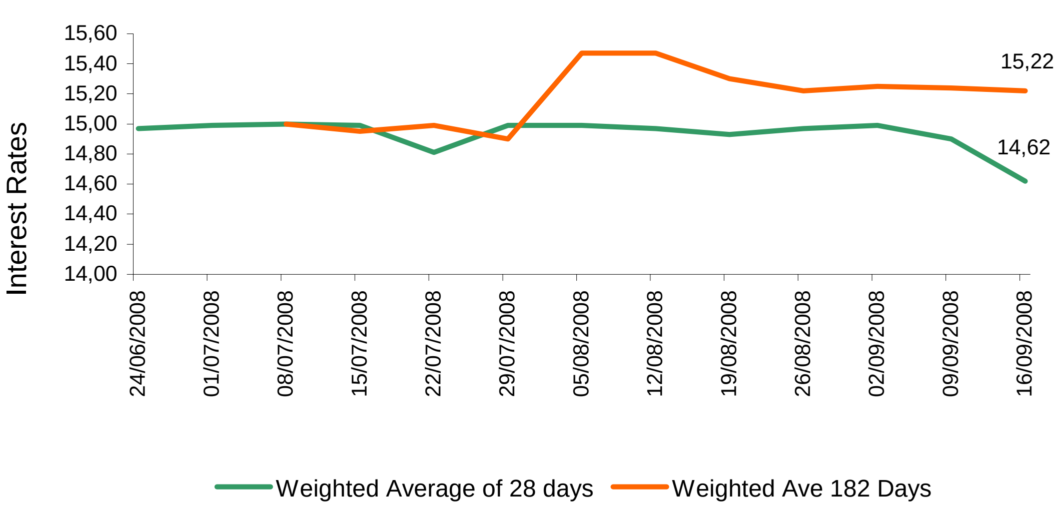
Figure 2.6: Demand and Awarded amount for 182 CNs
(million AF)



Source: Market Operations Department/ DAB

The weighted average interest rate for 28 day maturity ranged between 14.49 percent and 15.98 percent; and 16.26 percent to 14.99 percent for 182 day maturity. The weighted average interest rates in the previous quarter were 8.20 percent to 15.06 percent; and 9.38 to 18.00 percent respectively (Figure2.7).

Figure 2.7: Weighted Average of 28 day and 182 Day Capital Notes Interest rates



Source: Market Operations Department, DAB

2.2 Term Structure of Interest Rates

The term structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity on a security. The yield of the capital notes is the annualized percentage increase in the value of the CN. The yield curve for September 20, 2008 is positive.

Figure 2.8: Term Structure of Interest Rates (Yield Curve)

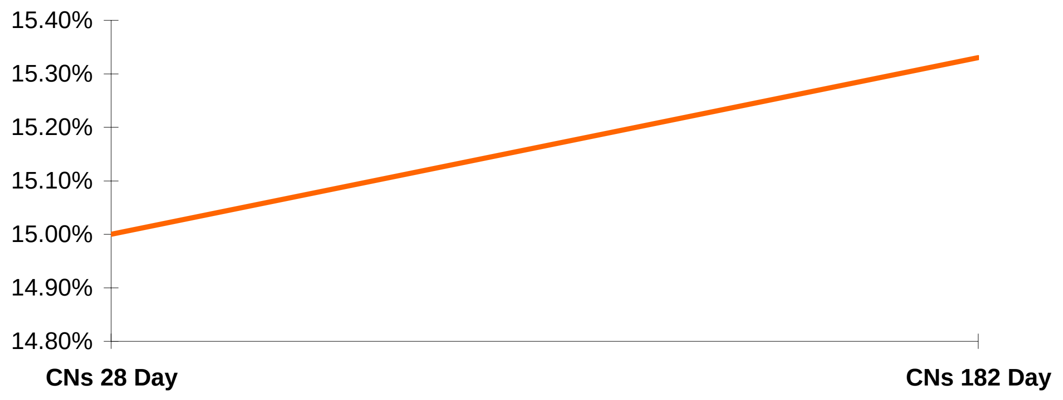
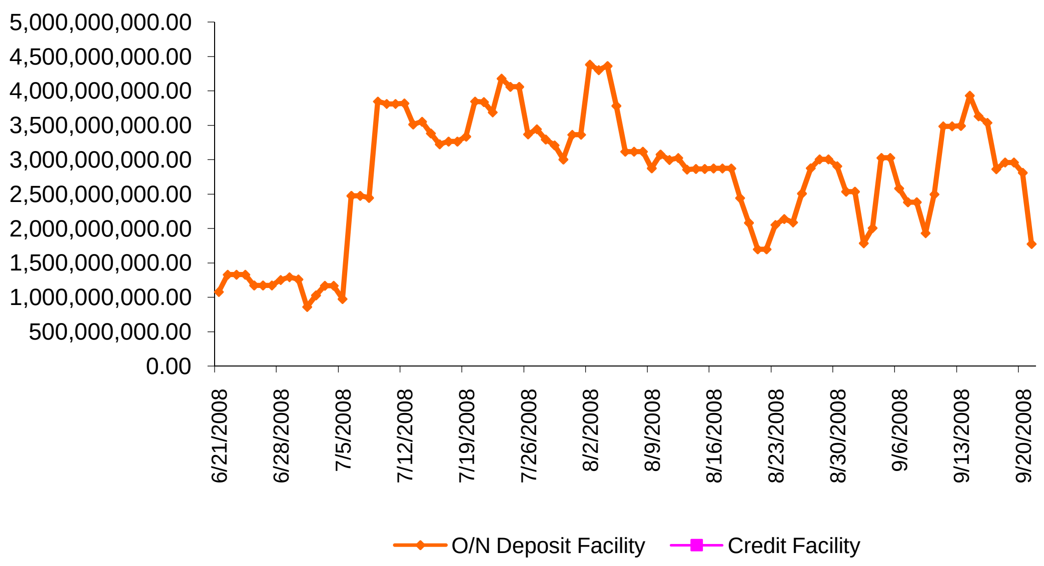


Figure 2.9: O/N Deposit Balances (in AF)



Source: Market Operations Department, DAB

2.3 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted towards required reserves. The interest rate on the overnight deposit facility is now 350 basis points below 28 auction cut-off rate (based on a circular to all banks approved by DAB Supreme Council on Feb 27, 2007). The outstanding amount of deposit facility balances fluctuated between AF 1.00 billion and AF 4.5 billion. The quarter under review ended with stock outstanding amounting to AF 1.7 billion.

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

It is worth mentioning that none of the banks benefited from the facility during this period. During the quarter, required reserves averaged AF 255,659,470.00 per bank, while excess reserves (including overnight deposits) averaged AF 264,580,076.27 per bank. These figures were AF 335,629,290.00 and AF 105,119,600.00 respectively during the previous quarter.

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

Figure 2.10: Excess Reserves (Deposit Facility not included) (Thousand AF)

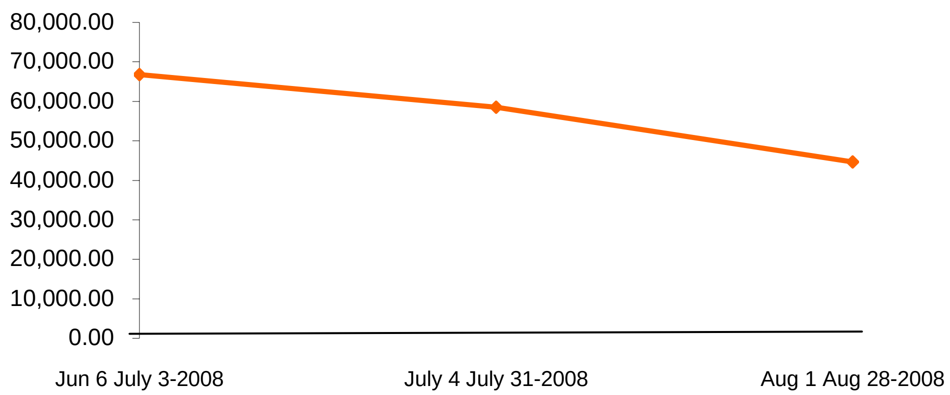


Table 2.3: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	No. Winning Bids	No. of total bids	Cut of Rate	Low Bid	Weighted Average
24-Jun-2008	200	510	530	5	5	15,04%	14,90	14,97
1-Jul-2008	200	335	335	4	4	15,04%	14,89	14,99
8-Jul-2008	200	530	530	5	5	15,04%	14,94	15,00
15-Jul-2008	200	690	720	6	6	15,02%	14,94	14,99
22-Jul-2008	200	775	1 085	5	6	15,00%	14,50	14,81
29-Jul-2008	200	800	810	5	5	15,00%	14,97	14,99
5-Aug-2008	200	905	915	5	6	15,00%	14,94	14,99
12-Aug-2008	200	1 195	1 205	7	7	15,00%	14,80	14,97
19-Aug-2008	200	1 360	1 370	7	7	15,00%	14,75	14,93
26-Aug-2008	200	690	700	6	6	15,00%	14,50	14,97
2-Sep-2008	200	430	840	5	6	14,99%	14,94	14,99
9-Sep-2008	200	120	1 125	1	7	14,90%	14,90	14,90
16-Sep-2008	200	1 530	1 560	6	6	14,84%	14,25	14,62

Table 2.4: Auction of 182 Day Capital Notes

Date	Auction Amount	Amount Awarded	Total Bid Amount	No. Winning Bids	No. of Total bids	Cut of Rate	Low Bid	Weighted Average
24-Jun-2008	100	125	325	2	3	15,50%	15,00	15,16
1-Jul-2008	100 not awarded		110	0	2			
8-Jul-2008	100	10	210	1	2	15,00%	15,00	15,00
15-Jul-2008	100	130	330	1	2	14,95%	14,95	14,95
22-Jul-2008	100	50	290	1	3	14,99%	14,99	14,99
29-Jul-2008	100	155	355	3	4	15,50%	14,99	14,90
5-Aug-2008	100	350	550	3	4	15,60%	15,10	15,47
12-Aug-2008	100	120	350	2	3	15,60%	15,30	15,47
19-Aug-2008	100	285	335	2	2	15,30%	15,30	15,30
26-Aug-2008	100	420	430	3	3	15,30%	15,00	15,22
2-Sep-2008	100	90	340	1	3	15,25%	15,25	15,25
9-Sep-2008	100	500	560	2	2	15,24%	15,23	15,24
16-Sep-2008	100	700	750	2	3	15,23%	15,20	15,22

3. FOREIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates:

The daily trends in the AF/USD exchange rate for the second quarter 1387 are shown in Figure 2.11. Overall, the AF/USD exchange rate moved in a relatively narrow corridor of AF 49.85 to 50.68 to the USD throughout the quarter under review. On an end quarter basis the AF/USD depreciated by 1.3 percent from AF 49.82 per USD at the beginning of the quarter to AF 50.47 per USD at the end of the quarter under review. On an annual basis the Afghani depreciated slightly by 0.58 percent in the quarter under review (AF 50.15 per USD) from the same quarter a year ago (AF 49.86 per USD).

On an annual basis, the Afghani appreciated against the Pakistani rupee (Pk.Rs) by 16.1 percent, but depreciated against the euro by 11.59 percent in the quarter under review.

Figure 2.11: Daily Average Exchange Rate (AF/USD): Q2 1387
(March 22, 08 to Sep 13, 08)

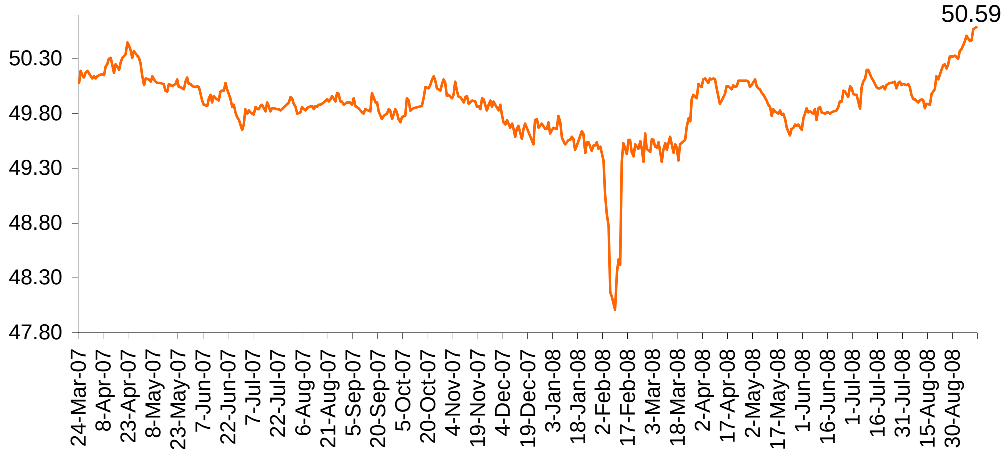
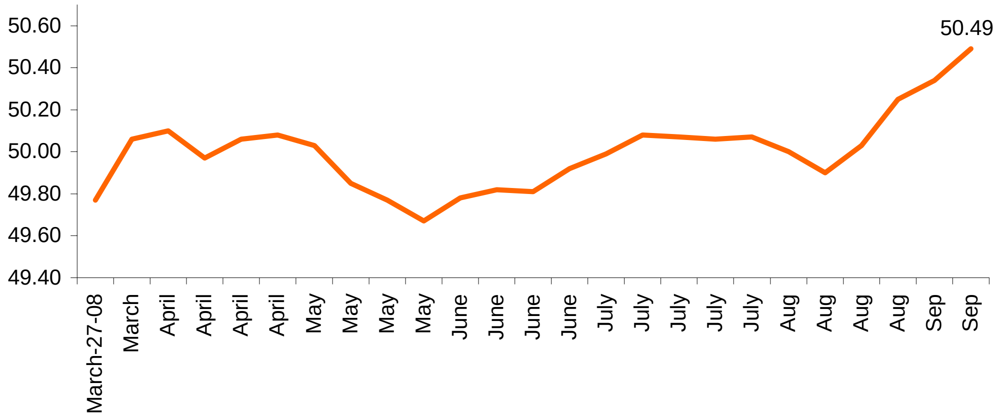


Table 2.5: Exchange Rate against selected currencies Q2 1387

Period	USD	Pk.Rs	EURO
Average for Q2 1387	50.15	0.688	75.8
Average for Q2 1386	49.86	0.82	67.93
% Appreciation (-) or depreciation(+) of AF against respective currency	**0.58**	**-16.1**	**11.59**
Closing rate on Sep 20, 08	50.47	0.65	72.61
Closing rate on June 19, 08	49.82	0.73	77.22
% Appreciation (-) or depreciation(+) of AF against respective currency	**1.3**	**-10.96**	**-5.97**

Source: Monetary Policy Department/ Market operations Department/ DAB

Figure 2.12: Weekly Average Exchange Rate AF/USD



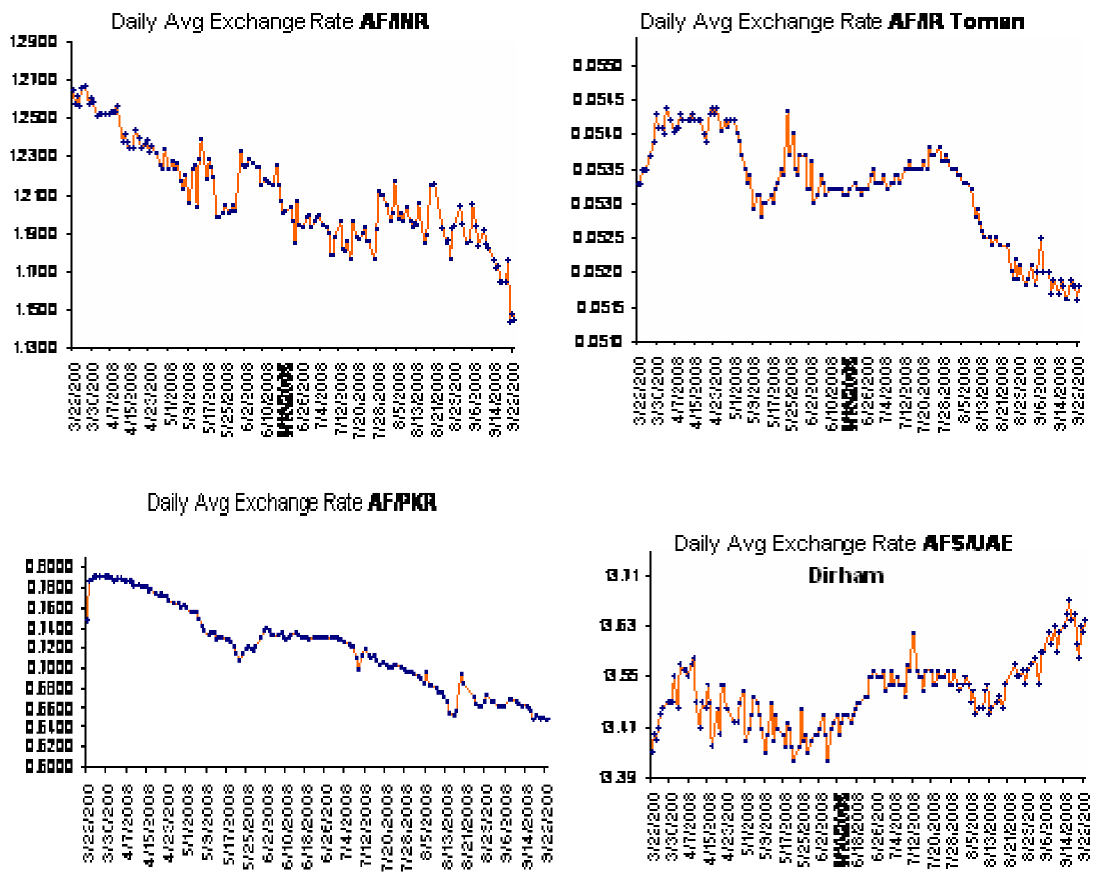
Source: Monetary Policy Department/ Market operations Department/ DAB

Weekly exchange rate movements are shown in Figure 2.12. As can be seen from the Figure 2.12, the Afghani started appreciating slightly *vis-à-vis* USD from mid-July 2008, which continued up to mid-Aug 08, from AF50.08 per USD to AF49.9 per USD, but Afghani started depreciating at the quarter under review reaching 50.49 at the end of the quarter under review.

The standard deviation of the exchange rate for the second quarter 1387 stood at 0.18 compared with the 0.06 in the Q2 1386. The slight difference in standard deviation between two quarters shows that exchange rate of Afghani against USD has been more volatile in the quarter under review.

A comparison of the daily average exchange rate of Afghani against other major currencies for Q2 1387 (March 22, 08 to Sep 21, 08) is shown in Figure 1.13

Figure 2.13: Daily Exchange Rates of some regional currencies



Source: Monetary Policy Department/ DAB

3.2 Foreign Exchange Auction

Foreign exchange auctions are a key instrument used by the central bank to smooth fluctuations in the exchange rate and to control the growth of the money supply. Da Afghanistan Bank (DAB) has maintained its bi-weekly sterilization policy to mop up extra liquidity arising principally from government expenditures and foreign peace keeping forces. The foreign exchange auction size is determined by a liquidity forecasting framework, which takes into account money demand on the one hand and the currency growth ceiling agreed between the DAB and the IMF on the other.

Table 2.6 summarizes the results of DAB foreign exchange auctions during the period June 24, 2008 to Sep 20, 2008.

In the quarter under review DAB intervention reached a total of USD 540 million. The weighted average of the entire 27 awarded auctions rate (sale price of the USD) was 50.1, covering June 24, 2008 to Sep 23, 2008. The total number of awarded bidders was 591, compared with the previous quarter in which there were 25 auctions of USD 279.3 million. The weighted average was 49.85 with the participation of 604 bidders

Table 2.6: Auction summary

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Mid-Rate	Amount Announced	No of Awarded Bidders
24/06/08	39	49.99	49.88	49.47	49.91	10.00	11
28/06/08	39	50.01	49.91	49.99	49.95	10.00	12
01/07/08	40	50.01	49.30	49.92	49.98	10.00	32
05/07/08	39	50.00	49.92	49.99	49.98	10.00	16
08/07/08	41	50.17	50.03	50.13	50.11	10.00	25
12/07/08	49	50.13	49.98	50.10	50.13	25.00	33
15/07/08	40	50.01	49.90	49.99	50.04	25.00	19
19/07/08	38	50.05	49.92	50.00	50.05	25.00	38
22/07/08	39	50.11	49.90	50.07	50.07	25.00	16
26/07/08	34	50.05	49.91	49.94	50.03	25.00	30
29/07/08	41	50.10	50.00	50.05	50.09	25.00	29
02/08/08	43	50.06	49.93	50.02	50.07	25.00	21
05/08/08	40	49.98	49.88	49.91	49.97	25.00	6
08/08/08	42	49.86	49.71	49.83	49.90	25.00	24
12/08/08	42	49.90	49.71	49.80	49.92	25.00	36
16/08/08	37	49.89	49.34	49.85	49.88	20.00	21
19/08/08	39	50.06	49.75	49.99	50.02	20.00	23
23/08/08	39	50.20	50.00	50.13	50.20	20.00	26
26/08/08	42	50.25	50.00	50.22	50.21	20.00	25
30/08/08	38	50.38	50.23	50.35	50.32	20.00	21
02/09/08	39	50.32	50.21	50.30	50.33	20.00	15
06/09/08	37	50.55	50.11	50.50	50.46	20.00	16
09/09/08	37	50.49	50.30	50.46	50.46	20.00	19
13/09/08	39	50.69	50.56	50.66	50.59	20.00	15
16/09/08	39	50.56	50.20	50.54	50.57	20.00	26
20/09/08	36	50.48	50.25	50.46	50.47	20.00	17
23/09/08	34	50,47	50,32	50,4410	50,48	20,00	19
Total amount sold in million USD						**540.00**	**591**

Source: Market Operations Department (DAB)

3

INFLATION TRENDS AND OUTLOOK

SUMMARY

Afghanistan is currently experiencing its sharpest inflationary surge in years as a result of exogenous shocks from regional and international markets and drought conditions in the northern parts of the country.

Headline consumer price index (CPI) inflation, the broadest measure of the rise in the general level of prices, for Kabul stood at 194.2 at the end of the second quarter 1387 representing an inflation rate of 35.7 percent up from 12.1 percent in the same period a year ago.

The sharp rise in the CPI was mainly attributed to increases in the prices of food and oil. The food price index rose dramatically by 52.7 percent because of an increase in demand in international markets.

Core inflation as calculated by the trimmed mean methodology also increased by 13 percent in the quarter under review up from 6.3 percent in the same quarter a year ago. The high and accelerating rate of core inflation remains a concern for monetary policy.

1. INFLATION CONTINUED TO INCREASE IN THE SECOND QUARTER

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation, as measured by year-on-year percentage changes in Kabul CPI, increased to 35.7 percent in the second quarter of 1387 up from 12.1 percent in the same quarter a year ago. The CPI measures the average price of a fixed set (or basket) of goods. The basket of goods is intended to reflect all the items a typical family buys to achieve some minimum standard of living in some base period (currently 2004). The CPI does not count the price of each item equally but weights each according to its share of total household expenditures in the base period, so that changes in the index from one period to the next are broadly reflective of changes in a representative household's current cost of living.

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

	Weight	1385				1386				1387	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2*
Headline	**100**	**5.5**	**5.4**	**3.5**	**4.8**	**8.1**	**12.1**	**17**	**20.7**	**33.3**	**35.7**
Food and Beverages	**61.3**	**2.9**	**3.8**	**2.8**	**6.3**	**11.8**	**15.8**	**25.6**	**30.6**	**48.6**	**52.7**
Bread and Cereal	28	0.7	-0.2	-3.1	3.6	13	21.5	42.6	51.8	91.4	91.9
Meat	6	3.3	6.6	5.3	4.2	1.1	-5.9	-0.8	4.1	5.9	11
Oil and Fat	5.3	-1.2	2.6	6.9	17	43	36.7	42.5	45.2	20.2	27
Vegetables	4.9	14.2	16.6	22	21.4	4	13.2	8.8	6	27.6	28.4
Tea and beverages	2	4	7	5.6	4.4	3.4	3.5	1.5	3.9	13.3	15.7
Non – Food	**38.7**	**9.4**	**7.6**	**4.4**	**2.5**	**3**	**7.1**	**5.4**	**6.9**	**10.3**	**10.8**
Construction materials	3.2	1.8	-5.4	-11.9	-11.3	-5.3	8.7	17.1	17.9	15.6	17.3
Fuel and Electricity	6.8	19.4	24.7	54.8	51.4	52.8	58.4	9.5	7.5	11.9	9.5
Transportation	2.3	23.7	27	16.5	31.2	16	8.5	14.6	23.9	40.5	25.9
Health	2	15.4	12.1	10	7.2	4.4	4.3	3.8	3.3	7.8	19.2
Core (Headline Excl Housing)		**4.2**	**5.1**	**3.6**	**4**	**4.2**	6.3	5.6	5.9	9.5	13.5

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

The breakdown of Kabul headline CPI inflation is presented in Table 3.1 and illustrated in Figure 3.1. The increase in Kabul headline CPI to 35.7 percent in the second quarter of 1387 from 12.1 percent in the same quarter a year ago was the result of increases in the following four sub-indices.

First, the food sub-index which accounts for 61.3 percent of the CPI basket increased. This price index rose sharply by 52.7 percent as a result of recent developments in international markets. The supply of wheat and other staples in international markets decreased while demand increased in some major emerging market countries such as China and India. Bio-fuel production is one of main contributor to the decline in supply of food staples. On the demand side, population growth and increasing income levels in some emerging countries, such as China and India is the major contributor to increase in this sub-index.

Within Afghanistan, agricultural production has been badly affected by the drought especially in the central, northern and some parts of the south and east of the country. In addition, Pakistan and Tajikistan banned private wheat exports to Afghanistan. Overall, the upward trend in the food sub-index began in February 2007 and has continued its upward trend reaching a peak of 66.1 percent in May 2008. The food sub-index was volatile in the first six months of 1387 and decreased to 52.7 percent in the quarter under review.

Second, the bread and cereals sub-index which accounts for 28 percent of the CPI increased. This price index rose dramatically by 91.9 percent in the quarter under review from 21.5 percent in the same quarter a year ago. The increase is attributed to recent developments in international markets including drought in major grain producing countries which was exacerbated by drought conditions in Afghanistan.

Third, the non-food sub-index which accounts for 38.7 percent of the CPI basket increased. This sub-index rose by 10.8 percent in the quarter under review compared to 7.1 percent in the same quarter a year ago. The main drivers of the increase are construction material, transportation and health sub-indexes.

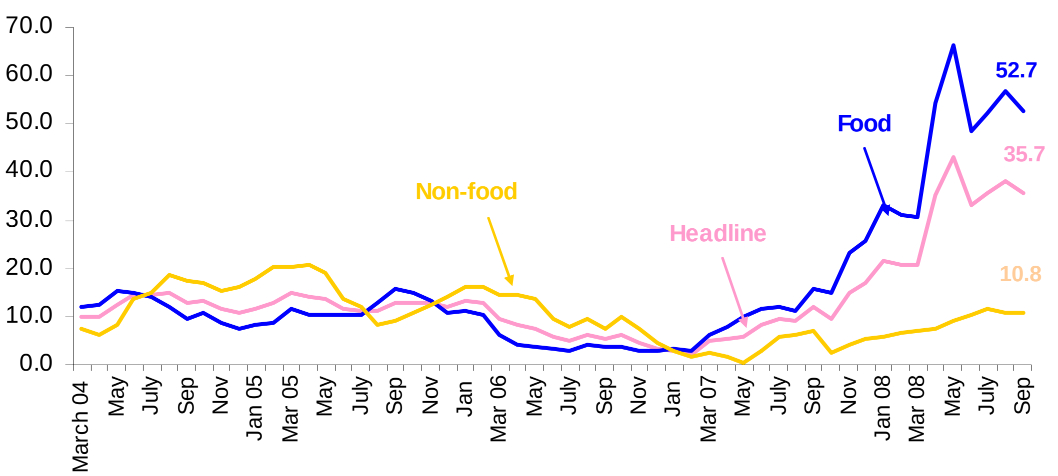
Fourth, the construction materials sub-index which accounts for 3.2 percent of the CPI basket increased. This sub-index rose by 17.3 percent in the quarter under review, compared to 8.7 percent in the same quarter a year ago as a result of the boom in new construction projects, as well as developments in oil prices, which has led to an increase in transportation costs. Repatriation of Afghan refugees from neighboring countries such as Iran and Pakistan also led to increased demand for housing pushing up the rent sub-index.

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

First, the fuel and electricity sub-index which accounts for 6.8 percent of the CPI basket declined. This sub-index declined by 9.5 percent in the quarter under review, compared to 58.4 percent in the same quarter a year ago.

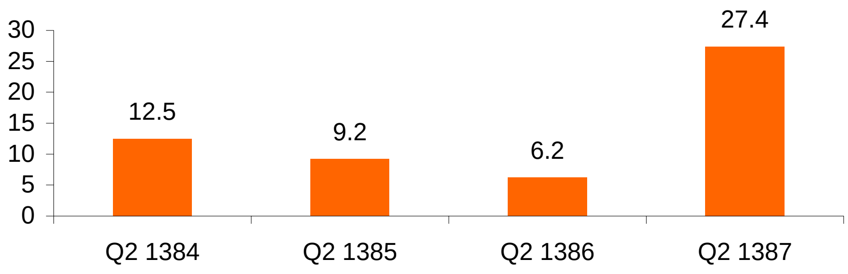
Second, the oil and fat sub-index which accounts for 5.3 percent of CPI basket declined. This sub-index fell by 27 percent in the second quarter of 1387 compared to 36.7 percent in the same quarter a year ago.

Figure 3.1: Inflation Trend: Kabul CPI



Source: Central Statistics Office and DAB staff calculations.

Figure 3.2: Period Average: Kabul Headline CPI
(end of quarters)



Source: Central Statistics Office and DAB staff calculations.

The volatility of Kabul inflation as measured by the standard deviation was 1.4 percent in the second quarter of 1387, down from 1.7 percent in the same quarter a year ago.

The analysis of inflation trends includes a measure of core inflation because comparing one period's price statistics with another period gives a crude measure of inflation (if the general level of prices has risen). In particular, such measures of inflation do not discriminate between relative price changes and inflation, so an increase in the price of a single item, such as food, may cause the price index to rise. For this reason, a measure of core inflation, which is obtained by excluding the most extreme items in the CPI basket, is used. The trimmed mean method of calculating core inflation eliminates the items with the greatest positive and negative fluctuations from the CPI basket and recalculates a more robust inflation measure which is not subject to criticism of standard core inflation indicators that exclude the same item (e.g. oil) from the CPI. Trimmed mean inflation stood at 13.5 percent in the second quarter of 1387 up from 6.3 percent in the same quarter one year ago.

Figure 3.3: 25%Trimmed Mean Inflation (Sept 2008)

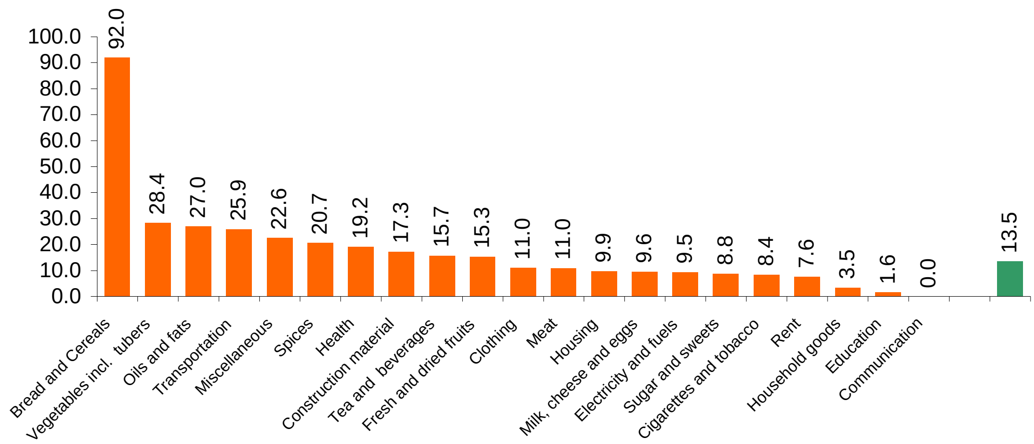
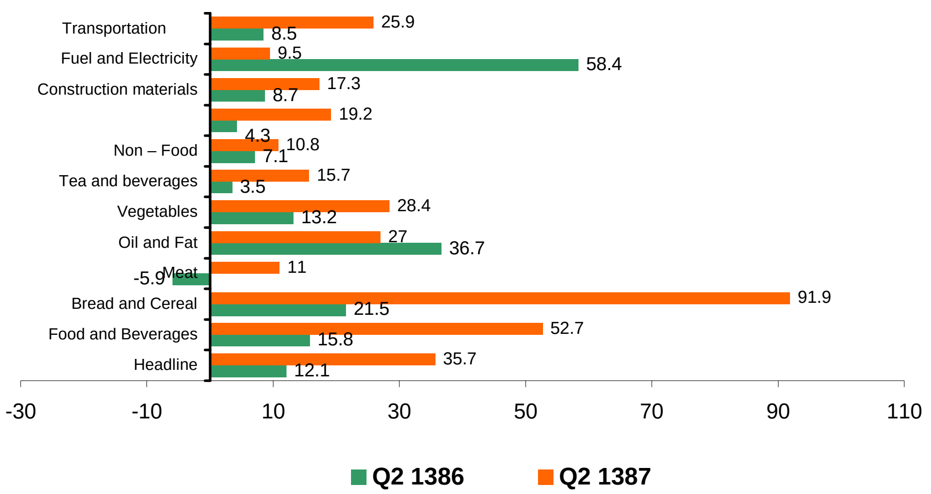


Figure 3.4: Contribution to Kabul CPI inflation



Source: Central Statistics Office and DAB staff calculations

1.2 Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis. Headline inflation, as measured by year-on-year percentage changes in national CPI increased by 38.8 percent in the second quarter of 1387 from 14.9 percent in the same quarter a year ago. The breakdown of national CPI into its respective components is presented in Table 3.2 and illustrated in Figure 3.6

Table 3.2: Breakdown of National Headline CPI

(percent changes year on year)

Consumer Price Index

(March 2004 = 100)

	Weight	1385				1386				1387	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	100	**5.7**	**5.3**	**3.4**	**3.8**	**9.6**	**14.9**	**20.5**	**24.3**	**41.5**	**38.8**
Food and Beverages	61.3	**4.1**	**4.1**	**3.5**	**4.9**	**13**	**16.8**	**27.1**	**31.9**	**57.9**	**56.6**
Bread and Cereal	28	2.3	1.2	-1.1	3	16.2	20.8	41.8	50	100.4	97.4
Milk and cheese	5.6	7.9	6.6	7.1	6.6	10.9	15.1	14.7	15.6	14.8	13.7
Oil and fat	5.3	2.5	-0.2	4.9	3.2	24.5	40.3	42.2	52.3	40.6	27.3
Non – Food	**38.7**	**8**	**7**	**3.6**	**2.2**	**4.4**	**11.9**	**11**	**12.2**	**4.6**	**10.5**
Housing	17.2	8.9	5.1	1.5	-1.5	3.7	15	12.1	13.3	13.9	9.5
Rents	7.1	3.3	-4.2	-14.7	-20	-12.8	-3.7	4.7	11.7	9.1	3.5
Fuel and Electricity	6.8	17.9	21.8	26.1	25.3	28.6	40.4	18.6	14.8	18.7	14.3
Transportation	2.3	25.2	31.8	11.9	21.1	11.7	11.1	20.5	27.9	36.4	27.9
Core Inflation		**4.9**	**5.3**	**4.1**	**11.7**	**12.4**	**10.8**	**10.2**	**10.4**	**6.3**	**3.7**

Source: CSO and DAB staff calculations.

The figures reported in the Q columns are y-o-y changes at the end of that quarter.

The increase in the national CPI inflation to 38.8 percent in the second quarter of 1387 from 14.9 percent in the same quarter a year ago was the result of increases in the following four sub-indices.

First, the bread and Cereals sub-index which accounts for 28 percent of the CPI basket increased. This sub-index rose sharply by 97.4 percent at the end of quarter under review from 20.8 percent at the end of the same quarter a year ago. The main reasons behind this increase are thought to be the decline in supply and an increase in demand in international markets. The production of food in major food producing countries, such as USA, Canada, and Australia declined sharply due to poor weather conditions. In addition, the conversion of food grains into bio-fuels also contributed to the decline in global supply. On the demand side, population growth and increasing income levels in some emerging countries, such as China and India put upward pressure on this sub-index.

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

Second, the transportation sub-index which accounts for 2.3 percent of the CPI basket increased. This sub-index rose by 27.9 percent at the end of the second quarter of 1387 from 11.1 percent at the end of the same quarter a year ago. The main reason behind this increase is recent developments in international oil prices.

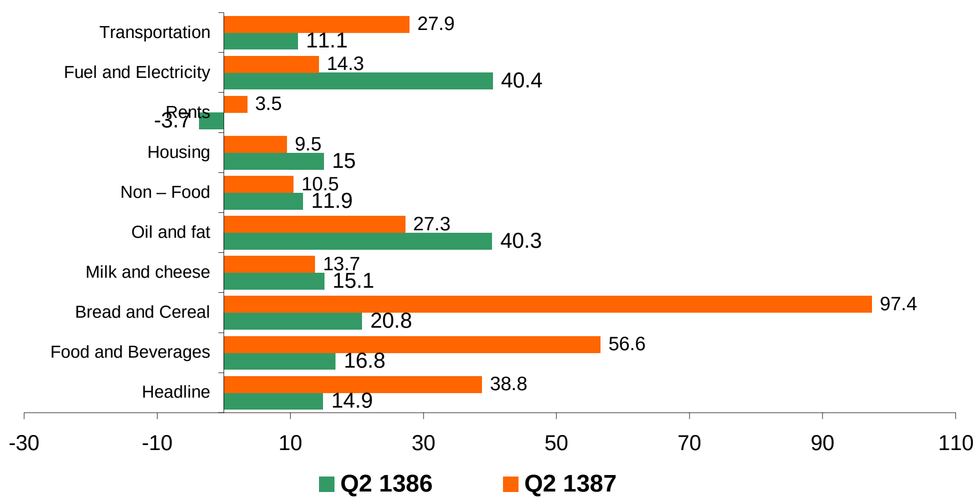
On the other hand some categories of the national CPI posted declines:

First, the oils and fats sub-index accounts for 5.3 percent of the CPI basket declined This sub-index declined by

27.3 percent at the end of second quarter of 1387 from 40.3 percent in the same quarter a year ago.

Second, the fuel and electricity sub-index accounts for 6.8 percent of the CPI basket declined. This sub-index declined by 14.3 percent at the end of the quarter under review from 40.4 percent at the end of the same quarter a year ago. The breakdown of national CPI is presented in Figure 3.5.

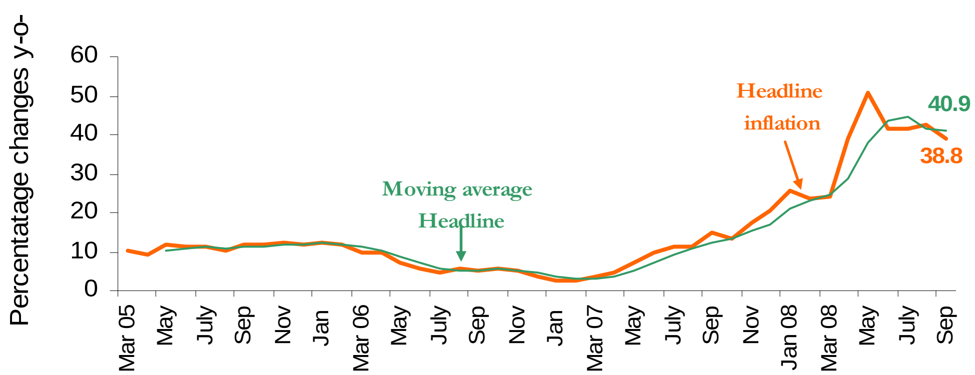
Figure 3.5: Contribution to national CPI inflation



Source: Central Statistics Office and DAB staff calculations.

The volatility of inflation for national CPI as measured by the standard deviation in the second quarter of 1387 was 1.9 percent, down from 2.1 percent in the same quarter a year ago. The low rate volatility of inflation is good point for monetary policy. Figure 3.6 presents inflation trend for national CPI.

Figure 3.6: Headline Inflation: National CPI



Source: Central Statistics Office and DAB Staff calculations

Box 2: Wheat loan to ease food shortage

The United Nations World Food Program (WFP) and the government of Pakistan have finalized an agreement to loan 50,000 tons of wheat for pre-winter food aid operations in Afghanistan. The loan will enable WFP to begin importing wheat over two months and pre-position it in areas where access is difficult in winter. The loan will help WFP to remedy immediate funding delays in emergency food aid for about five million Afghans hit by high food prices and drought. Upon receiving funds from donors WFP will repay the loan.

UN agencies and the Afghan government jointly appealed on 9 July, 2008 for USD 404 million to deal with the food crisis resulting from high prices and drought. The joint appeal included WFP's request for USD 185 million, which it will use to procure 230,000 tons of food to be distributed through August 2009.

The UN has reiterated calls for vital funding to avert a possible crisis this winter amid donors' slow and insufficient response to the joint appeal. WFP said it had received up to 25 percent of its appeal by 3 September, 2008. The WFP noted that the 100,000 tons of wheat would be sufficient for its winter pre-positioning program. In addition, the US Agency for International Development (USAID) pledged 50,000 tons of wheat which was due to be delivered by early December 2008.

The hike in food prices has prompted Pakistan to impose a ban on food exports to neighboring Afghanistan, which relies particularly on Pakistani wheat flour. Earlier this year Pakistan agreed to sell 50,000 tons of wheat to the Afghan government to ease its domestic food shortages. "Over 12,000 tons of the wheat procured from Pakistan have been imported to the country and the process is ongoing," according to a Pakistan government statement on 2 September. "The imported wheat will be offered at a subsidized price", the Pakistan government said. The statement also said separate agreements signed with the Russian Federation and Ukraine would allow the country to import about 80,000 tons of wheat.

According to Afghanistan's National Risk and Vulnerability Assessments, 42 percent of the Afghan population (approximately 12 million people) lives below the poverty line, on 45 US cents per day or less.

Source: *IRIN news*

1.3. Quarterly changes in Kabul headline CPI

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

The Kabul headline CPI in the second quarter of 1387 fell by 8 percent from 13.1 percent in the first quarter of 1387. The decline in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: This sub-index fell by 8.1 percent in the quarter under review from 19.1 percent in the first quarter 1387 with a contribution of 8.6 percent by bread and cereals.

Non-food: This sub-index rose by 7.7 percent in the quarter under review form 2.5 percent in the first quarter of 1387, with a contribution of 13.2 percent by construction materials, 13.9 percent by fuel and electricity and 1.4 percent by health sub-indexes. Transportation fell by 0.3 percent in the quarter under review from 18.8 percent in the first quarter of 1387. The reason behind the decline is believed to be the slowdown in the world economy as a result of which the price of crude oil fell below USD 100 per barrel in international markets.

Table 3.3 presents price indicators for quarter-on-quarter changes in Kabul CPI

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

(percent changes quarter on quarter)
Consumer Price Index
(March 2004 = 100)

	Weight	1385				1386				1387	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**100**	**-0.7**	**2.2**	**1.6**	**1.7**	**2.4**	**6.0**	**5.9**	**5.0**	**13.1**	**8.0**
Food and Beverages	**61.3**	**-0.4**	**1.6**	**0.8**	**4.2**	**4.7**	**5.3**	**9.4**	**8.3**	**19.1**	**8.1**
Bread and Cereal	28	-3.1	0.7	-0.3	6.5	5.7	8.2	17.0	13.4	33.3	8.6
Meat	6	0.5	2.6	-0.3	1.5	-2.6	-4.6	5.1	6.6	-1.0	0.0
Oil and Fat	5.3	0.7	3.5	3.9	8.2	23.0	-1.1	8.3	10.2	1.8	4.5
Vegetables	4.9	10.1	2.4	4.3	3.2	-5.7	11.5	0.2	0.6	13.5	12.2
Tea and beverages	2	2.3	2.2	0.5	-0.7	1.4	2.3	-1.5	1.7	10.6	4.5
Non – Food	**38.7**	**-1.2**	**3.0**	**2.5**	**-1.7**	**-0.7**	**7.1**	**0.8**	**-0.3**	**2.5**	**7.7**
Construction materials	3.2	-2.7	-2.9	-6.3	0.1	3.9	11.5	0.9	0.9	1.8	13.2
Fuel and Electricity	6.8	-4.8	12.3	47.2	-3.7	-4.0	16.4	1.7	-5.4	-0.1	13.9
Transportation	2.3	18.0	19.8	-4.2	-3.1	4.3	12.0	1.3	4.3	18.8	0.3
Health	2	2.8	0.8	0.5	3.0	0.1	0.7	0.0	2.5	4.5	11.4
Core Inflation		**4.4**	**5**	**3.6**	**4**	**4.2**	**6.3**	**5.6**	**5.9**	**9.5**	**13.5**

Source: Central Statistics Office and DAB staff calculations

1.4. Quarterly changes in national headline CPI

This section analyzes quarter-on-quarter changes in national headline CPI. The national headline CPI fell by 5.2 percent in the quarter under review from to 18.2 percent in the first quarter 1387. The decrease in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: This price index decreased by 5.0 percent in the second quarter of 1387, compared with 26.7 percent in the first quarter of 1387. Bread and cereals sub-index fell by 5.3 percent and oil and fat by 1.5 percent respectively, while Milk and cheese sub-index rose by 4.4 percent from 3.1 percent in the first quarter of 1387.

Non Food: This sub-index rose by 5.6 percent with the housing sub-index increasing by 8.5 percent, rents 3.2 percent, fuel and electricity 14.2 percent, while transportation fell by 4.6 percent compared with 12.6 percent in the first quarter of 1387.

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

Table 3.4: Quarter on Quarter changes in National CPI

(percent changes year on year)

Consumer Price Index

(March 2004 = 100)

	Weight	1385				1386				1387	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	100	**-1.7**	**2.2**	**1.9**	**1.3**	**3.8**	**7.2**	**7.0**	**4.4**	**18.2**	**5.2**
Food and Beverages	61.3	**-1.8**	**2.3**	**1.1**	**3.3**	**5.8**	**5.8**	**10.0**	**7.2**	**26.7**	**5.0**
Bread and Cereal	28	-4.0	2.9	-0.7	4.9	8.3	6.9	16.7	11.0	44.7	5.3
Milk and cheese	5.6	-0.2	1.6	4.0	1.1	3.9	5.4	3.6	1.9	3.1	4.4
Oil and fat	5.3	-4.6	-0.5	7.1	1.5	15.2	12.0	8.5	8.7	6.4	1.5
Non – Food	**38.7**	**-1.5**	**2.2**	**3.1**	**-1.5**	**0.6**	**9.5**	**2.3**	**-0.4**	**2.8**	**5.6**
Housing	17.2	-4.9	1.8	5.1	-3.3	0.2	13.0	2.5	-2.3	0.7	8.5
Rents	7.1	-6.3	-1.6	-7.4	-6.3	2.1	8.7	0.6	0.0	-0.3	3.2
Fuel and Electricity	6.8	-5.5	8.5	24.2	-1.6	-3.1	18.6	5.0	-4.8	0.2	14.2
Transportation	2.3	14.5	12.1	-1.3	-4.4	5.6	11.5	7.0	1.5	12.6	4.6
Core Inflation		**4.9**	**5.3**	**4.1**	3.7	6.3	10.4	10.2	10.8	12.4	11.7

Source: CSO and DAB staff calculations.

2. INFLATION OUTLOOK

Afghanistan is suffering from imported inflation caused by higher global commodity prices, regional food supply constraints and domestic-demand inflation caused by excess demand driven for food staples as a result of drought during the previous planting season. The poor rains were concentrated in the North of the country during the last planting season, which is likely to continue to negatively affect domestic agriculture. As a result, wheat production is projected to register a deficit of 1.9 million tons out of 5 million ton demand in SY 1387. Regional dynamics have also exacerbated the situation with Pakistan and Tajikistan banning private wheat exports to Afghanistan. This has put upward pressure on prices in the short-run. However, the overall inflationary outlook will depend on the extent and duration of higher oil prices as well as grain prices.

2.1 Risks to inflation

In the foreseeable future significant risks to inflation remain. These risks include further increases in grain prices, a prolonged liquidity surge due to foreign exchange inflows from remittances the illegal opium trade and donor funds. Additional risks include the secondary effects of inflation on housing and real estate prices. If inflation continues at the current high rate it will depress real returns to saving, drive real (inflation-adjusted) deposit rates to even greater negative levels. Negative real interest rates could lead to record high loan growth as banks struggle to maintain profitability. A negative interest rates scenario favors borrowers, and can fuel asset inflation ultimately sparking a housing property bubble.

Box 3: What is deflation and what can central banks do about it?

Having started the year worrying about inflation central bankers and international institutions have now said the risk of deflation is rising, even though it is still small. Deflation refers to a persistent and generalized falls in prices. In other words, the underlying consumer price index (CPI) would enter negative territory. It is the opposite of inflation, when prices rise, and should not be confused with disinflation, which merely describes a slowdown in the rate of inflation. The Figure below shows the monthly percentage change in the CPI and includes periods of deflation, inflation, and disinflation in consumer prices.

Two brief periods, the first from approximately mid-1949 to mid-1950, and the second, approximately from the fall of 1954 to the summer of 1955, shown in the Chart, indicate brief periods of deflation in the consumer price index. Other than these two brief periods, the CPI Index shows inflation in consumer prices over nearly the entire 1947 to 1999 periods. The period from mid-1980 to mid-1983 indicates a period of disinflation, a period when the rate of inflation was declining from month to month.

However, whether deflation is a good thing or not depends on the circumstances in which it occurs. Lower prices are good for consumers as they increase the purchasing power of their income, but not if they are associated with falling wages, rising unemployment and falling asset prices. For example, in the 1930s and more recently in Japan, deflation reflected economic collapse and rising unemployment made worse by the combination of high debt levels and falling asset prices (‘bad deflation’).

However not all deflation is bad. In the 1870-1895 period in the US, deflation occurred against a background of strong economic growth, reflecting rapid productivity growth and technological innovation (‘good deflation’). Falling prices for electronic goods are an example of good deflation.

Bad deflation is worrisome for central banks because it is hard to shake off and is self-reinforcing. Put simply, unless it is stopped early, deflation can breed deflation, leading to what is known as a deflationary spiral.

When an economy has fallen into bad deflation, demand from businesses and consumers to buy products dries up because they expect to pay less later as prices fall. But as producers struggle to sell and go bust, unemployment rises, reducing demand further. That causes deflation to become more pronounced.

As prices fall, the value of each unit of money increases. This makes it more expensive to service existing debts. This is as true of governments as it is for consumers.

As debt becomes more expensive to pay off, the risk of default and bankruptcy rises too, making banks more wary of lending. This reduces demand and further exacerbates the deflationary problem.

Potential drivers of deflation

Right now, given the global economic slump, high household debt levels in key countries and falling asset prices, the main concern is that we will see a bout of ‘bad deflation’. The past few months have seen headline inflation rates fall sharply. US inflation has fallen from a peak of 5.6% over the year to July to just 1.1% over the year to September. Chinese inflation has fallen from a peak of 8.5% in April to 2.4% in September. In Afghanistan inflation dropped from 43.2 percent in May to 35.7 percent in September. Similarly, inflation is likely to fall in other countries leading to deflation worries next year. There are two key drivers:

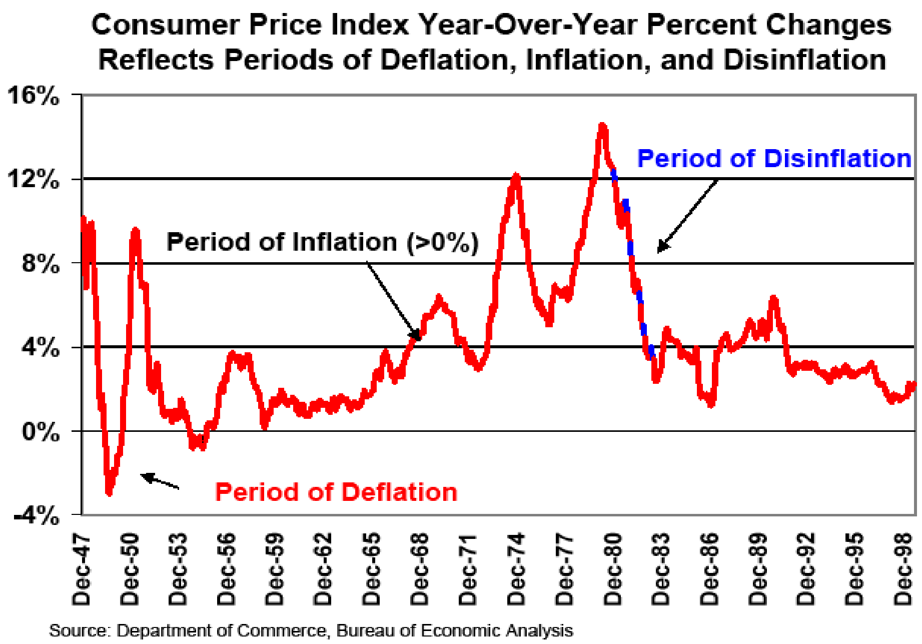
Firstly, the slump in commodity prices is cutting inflation via lower petrol prices and indirectly via lower raw material prices.

Secondly, underlying inflation pressures will fall in normal lagged response to the global recession. This is because the recession will lead to global spare capacity and this leads to discounting putting downward pressure on prices. Excess capacity in Chinese factories will also see China return to its position of exporting deflation to the rest of the world in order to help keep its exports up. The US recessions of the mid-1970s, early 1980s and early 1990s were associated with falls in US inflation excluding food and energy of six, nine and 2.5 percentage points respectively. A 2.5 percentage point fall in US core inflation from its recent peak would take it to zero.

How has deflation been tackled in the past?

"Bad" deflation is extremely dangerous because it is self-reinforcing. In other words, deflation creates more deflation. Several different strategies have been used in the past with varying degrees of success. These include:

-- Tax cuts to boost demand from consumers and businesses
-- Lowering central bank interest rates to encourage economic activity
-- Printing more currency to boost money supply
-- Capital injections into the banking system
-- Increase government spending on projects that boost the return on private investment



4

FISCAL DEVELOPMENTS

SUMMARY

The overall fiscal position was mixed in the quarter under review with some indicators showing solid performance while others did not meet expectations.. On the positive side, the core budget deficit showed marked improvement relative to the previous quarter coming in at about AF 1.6 billion which was significantly lower than the AF 66 billion deficit recorded in the first quarter of SY 1387.The lower budget deficit was principally due to higher grant revenues which more than compensated for the increase in government spending.

On the negative side, total revenue collection for the second quarter was AF 9.96 billion which was below expectations. Total revenues exceeded the quarterly target of AF 133.2 million, on a year-to-date basis it was below the target by AF 149.7 million or by 1 percent.

Poor customs revenues in the quarter under review were the main culprit for the weak performance of total revenues The massive decline in customs revenues and import duties were attributed to low fuel imports from Uzbekistan and the abolition of duties on wheat, flour and rice imports to mitigate the impact of higher imported prices. This measure was taken to reduce food insecurity in vulnerable households and avert a potential humanitarian crisis.

However, fiscal discipline was not maintained as spending did not decline in line with the shortfall in revenues. Instead total expenditures were AF 29 billion in the quarter under review, nearly a 100 percent increase over the previous quarter. The sharp increase was largely due to higher wages and salaries and increased development spending.

At the end of the second quarter, total operating expenditures stood at AF 17,420 million or about 27 percent of the total budget for the solar year 1387. Expenditure of the development budget stood at AF 11,065 million or 16 percent of the total development budget.

Official development assistance and grants from doors, a major component of the core budget stood at AF 17.2 billion in the second quarter bringing the year-to-date total to AF 18.3 billion. Of the AF 17.2 billion, AF 9.6 was allotted to operating grants whilst AF 8.6 billion was allotted to development projects.

1. REVENUES

Total domestic revenue is composed of domestic taxes, customs duties, non-tax revenues and other taxes (Table.4.1). Total revenues (excluding grants) in the second quarter 1387 stood at AF 9.96 billion against a target of AF 9.83 billion. This was 21 percent higher than the previous quarter and 1 percent above target. Tax and non-tax revenue exceeded their targets by 15 and 5 percent respectively. However, customs revenues fell short of target by 20 percent.

Table 4.2 shows major sources of revenues by type and offices of domestic revenue collection. Key contributors to tax revenues in the quarter under review were the Large Taxpayer Office (LTO) and Medium Tax Payer Offices (MTO) which are located in Kabul. This reflects the high concentration of tax payers in the capital city with over 50 percent of domestic tax revenues collected from Kabul.

In terms of geographical distribution of customs revenues, the top five provinces of Heart, Balkh, Kandahar, Nangarhar and Nimroz collectively accounted for about 80 percent of total customs revenues in the quarter under review.

Revenues from customs duties in the quarter under review reached about AF 1.3 billion against a target of AF 3.9 billion. The revenue shortfall in the quarter under review was 20 percent below target. The poor performance of customs revenue collection was attributed to two main factors.

First was the abolition of wheat, flour and rice import tariffs to mitigate steep increases in food import prices. This was an emergency response to a looming humanitarian crisis as vulnerable households in drought stricken areas faced severe food insecurity.

Second was the two month freeze on petroleum imports from Uzbekistan which severely hit Balkh's customs collections.

Non-tax revenues for the quarter under review performed relatively well with revenues of AF 2.55 billion. This was above the target of AF 2.06 billion. The good performance of non-tax revenues was attributed to robust collection of administrative fees which registered a 40 percent increase above target. The reason for this was largely because of revenues and license fees paid to the Ministry of Communication and over-flight charges paid to the Ministry of Transport.

Social contributions collected in the second quarter of the year amounted to AF 210 million which was well above the AF 132 million target. Social contributions are revenues collected to support social programs such as retirement pensions and payments to martyrs and the disabled.

In the quarter under review, grants totaled AF 17.2 billion most of which was allotted to ARTF, LOFTA and the combined Security Transitional Command – Afghanistan (CSTC-A)

Table 4.1: 1387 Second Quarter Revenues

Core (in million of Afghani)		1386 Qtr 2 Actual YTD	1386 Qtr 2 YTD/ Actual Target	1387 Qtr 1 Prelim	1387 Qtr 2 Prelim	1387 Qtr 2 Prelim YTD	1387 Qtr 2 Target YTD
1	**REVENUES INCLUDING GRANTS**	**31,738.8**		**9,295.9**	**27,174.8**	**36,470.7**	
1-19	**REVENUES EXCLUDING GRANTS**	**15,881.8**	**44.5**	**8,238.1**	**9,961.1**	**18,199.2**	**18,354.0**
11	**Tax Revenues**	**5,722.0**	**40.2**	**3,654.3**	**4,011.0**	**7,665.3**	**6,501.4**
111	Fixed Taxes	940.3	190.3	837.1	814.1	1,651.2	1,514.4
112	Income Taxes	1,258.9	24.8	1,024.5	1,218.9	2,243.4	1,367.9
113	Property Taxes	37.8	32.0	25.6	37.4	62.9	56.9
114	Sales Taxes	3,054.5	42.0	1,447.2	1,583.4	3,030.7	3,102.6
116	Other Taxes	296.3	27.3	239.6	238.0	477.6	308.2
117	Tax Penalties and Fines	134.1	67.0	80.3	119.2	199.5	151.4
12	**Customs Duty, Import Taxes**	**6,434.6**	**42.2**	**3,268.5**	**3,109.0**	**6,377.5**	**7,219.2**
13	**Non Tax Revenue**	**4,100.0**	**72.5**	**1,807.9**	**2,559.7**	**4,367.6**	**3,853.6**
131	Income from Capital Property	607.1	225.7	69.3	92.2	161.5	238.0
132	Sales of Goods and Services	944.0	40.8	453.3	606.1	1,059.4	1,054.6
133	Administrative Fees	2,456.9	83.7	1,237.3	1,818.6	3,055.9	2,453.1
134	Royalties	19.1	39.0	7.6	11.6	19.2	20.1
135	Non Tax Fines and Penalties	72.9	85.8	40.3	31.2	71.5	87.9
14	**Miscellaneous Revenues**	**-511.0**	**-202.8**	**-583.4**	**71.2**	**-512.2**	**534.0**
17	**Social Contribution**	**136.1**	**39.4**	**90.9**	**210.2**	**301.1**	**245.7**
19	**Grants**	**15,857.0**		**1,057.8**	**17,213.7**	**18,271.5**	
191-2	Foreign governments	7,679.3		196.8	9,904.3	10,101.1	
193-4	International Organization	8,177.7		860.9	7,309.4	8,170.3	
195-6	Other Government Units	0.0		0.0	0.0	0.0	

Source: FPU using AFIMS data downloaded on the 18 Nov. 2008, and Central Statistics Office for GDP data
1/ Revenues exclude proceeds from the sale of fixed assets (150). This items are included under financing.

Table 4.2: Sources of revenue

Revenue Office	Percentage of total revenue collected, H1
Large Taxpayers Office, Kabul	38%
Medium Taxpayers Office, Kabul	14%
Mustufiats (including Kabul STO)	36%
Customs ((inc. fixed tax on imports)	9%
Others	2%

Source: Revenue Department, Ministry of Finance

2. EXPENDITURES

Spending pressures were evident in the quarter under review as the authorities found little space for fiscal maneuver with a higher wage bill and a lower revenue inflow. Almost all components of the total core budget experienced sharp increase. Total core budget expenditures are composed of the operating and development budgets. Total gross expenditures for the quarter under review were AF 28.8 billion which represents a 100 percent increase on the first quarter of the year. Expenditures in the quarter under review rose sharply due to heavy expenditures in critical line ministries: Ministry of Education was up by 15.29 percent, Ministry of Defense was up by

10.95 percent, Ministry of Interior Affairs was up by 10.38 percent, Ministry of Ministry of Energy and Water was up by 7.64 percent and Ministry of Labor and Social Services was up by 3.61 percent (Table 4.3).

Recurrent expenditures also grew sharply in the quarter under review. Recurrent expenditures are classified into the following five categories (a) compensation of employees, (b) goods and services, (c) interest payments (d) subsidies and grants, (e) acquisition of non-financial assets.

Expenditure on compensation of employees in the second quarter of the year was AF 12.1 billion which was above the quarterly target of AF 10.3 billion. The increase in compensation is attributed to an increase in wages and salaries which saw an increase from AF 1.2 billion in the first quarter of the year to AF 2.2 billion in the second quarter. The main reason for the sharp increase was the increase in food allowances for security personnel.

Expenditure on goods and services was AF 11.1 billion in the quarter under review, almost a 99 percent increase from the previous quarter. The main reason for the sharp increase in this category was the increase in payments for contracted services.

Expenditures on interest payments was AF 52 million in the quarter under review, of which AF 43 million was paid to the World Bank whilst AF 8.5 million was paid to the IMF for the PRGF loan.

Expenditures on subsidies, grants and social transfers reached AF 1,935 million in the quarter under review.

The development budget experienced less dramatic increases in spending. The total development budget for Solar Year 1387 is AF 69,408 million (USD 1,388 million) as shown in Table 4.2. However at the end of the first quarter of 1387 total development expenditures stood at AF 3,157 million (5 percent of the total budget). This represents an increase of one percentage point compared to the same period last year. Overall, there has only been a modest two percentage point increase in expenditures in the second quarter 1387.

Development expenditures are heavily concentrated in the provinces outside the capital reflecting the wide disparity in household incomes between Kabul and the provinces Faryab province recorded the highest spending in both the first and second quarters of the year. In Faryab province, the highest spending project has been the Asian development Bank funded Qaisar-Andhkoy road which involves upgrading and sealing 210 km of highway at a cost in SY 1387 of AF633 million. Faryab province was followed by Balkh province which also had a major works program in the building of the northern road link between Mazar-e-Sharif and Herat.

Figure 4.1: Expenditure in core budget as of second quarter 1387

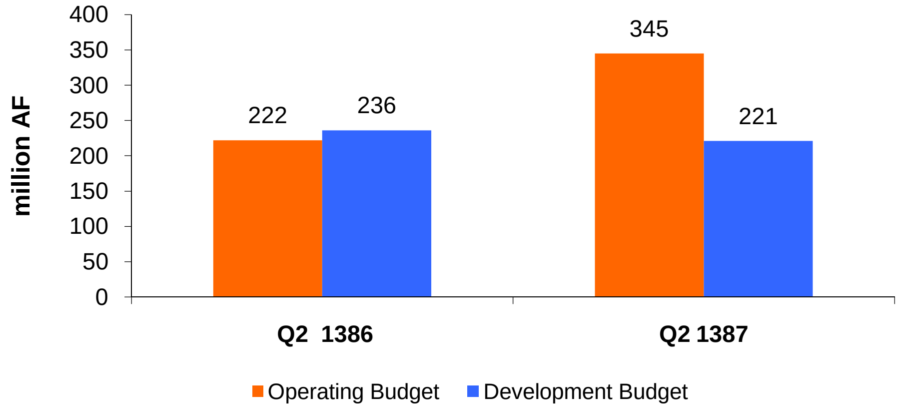


Table 4.3: Integrated Core Budget Gross Expenditures by Ministries second quarter 1387

(In million AF)

Ministries	Expenditure	As Total Expenditures (%)
Ministry of Education	4,766	15.29
Ministry of Defense	3,414	10.95
Ministry of Interior Affairs	3,236	10.38
Directorate of National Security	375	1.20
Ministry of Foreign Affairs	512	1.64
Ministry of Public Health	954	3.06
Ministry of Finance	528	1.69
Ministry of Labor and Social	1126	3.61
Ministry of Higher Education	591	1.89
Ministry of justice	307	0.98
Ministry of Agriculture	501	1.61
President Office	281	0.90
Ministry of Energy and water	2380	7.64
Local Government	412	1.32
Others	11789	37.82
Total	**31171.1**	**100**

Source: MOF and DAB staff Calculation

Table 4.4: 1387 Second Quarter Expenditures

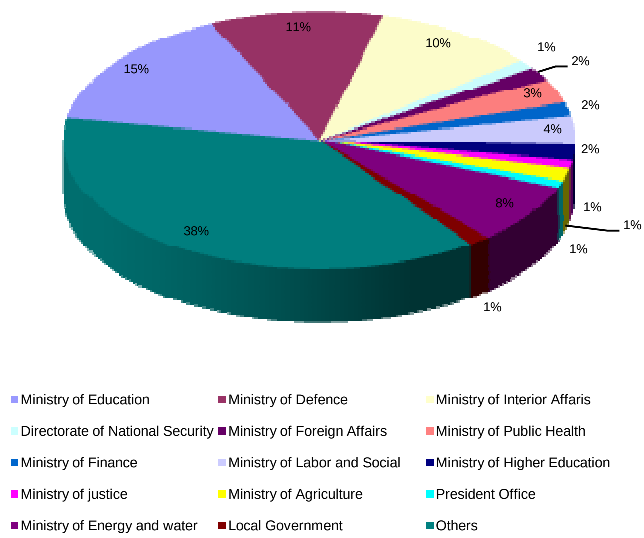
	Core (in million of Afghani)	1386 Qtr 2 Actual YTD	1386 Qtr 2 Actual YTD	1386 Qtr 2 Actual YTD	1386 Qtr 2 Actual YTD
2	**TOTAL GROSS EXPENDTURES**	**34,267.3**	**15,372.1**	**28,792.1**	**44,164.2**
2*	**TOTAL NET EXPENDITURES**	**34,226.5**	**15,363.3**	**28,780.2**	**44,143.5**
2-25	**RECURRENT EXPENDITURES**	**24,376.1**	**13,426.9**	**20,231.6**	**33,658.6**
21	**Compensation of Employees**	**14,159,4**	**8,924.1**	**12,074.4**	**20,998.4**
	of which operating budget	**14,137.2**	**8,922.2**	**12,076.3**	**20,998.4**
211-3	Wages and Salaries	13,981.2	8,838.2	11,977.4	20,815.6
214-5	Social Benefits	178.3	85.9	97.0	182.8
22	**Use of Goods and Services**	**8,814.8**	**3,680.1**	**6,993.8**	**10,673.9**
	of which operating budget	**4,029.4**	**2,139.9**	**4,158.4**	**6,298.3**
221	Travel	415.4	254.0	305.8	559.9
222	Communications	187.6	100.4	119.6	220.0
223	Contracted services	3,804.8	1,201.5	2,359.9	3,561.5
224	Repairs and Maintenance	1,046.5	356.6	515.9	872.5
225	Utilities	275.1	110.9	219.7	330.6
226	Fuel	725.0	416.2	597.1	1,013.2
227-9	Other use of Goods and Services	2,360.5	1,240.4	2,875.8	4,116.2
23	**Interest** 1/	**81.4**	**0.0**	**51.7**	**51.7**
24	**Social Transfers**	**1,320.4**	**822.8**	**1,111.8**	**1,934.6**
242	Subsidies	0.7	0.4	1.8	2.2
245	Grants	1.0	6.0	0.9	6.9
247	Social Securities	1,063.5	688.5	933.2	1,621.7
248-9	Other Social Transfers	255.2	127.9	176.0	303.9
25	**Gross Acquisition of Nonfinancial Assets**	**9,891.1**	**1,945.1**	**8,560.5**	**10,505.6**
	of which operating budget	**326.0**	**329.9**	**268.3**	**598.1**
25*	**Net Acquisition of Nonfinancial Assets** 2/	**9,850.4**	**1,936.3**	**8,548.6**	**10,484.9**

Source: FPU using AFIMS data downloaded on the 18 Nov. 2008, and Central Statistics Office for GDP data

1/ Interest Only Does not include loan principal payments

2/ Proceeds from sale of fixed assets are net off from the total

Figure 4.2: Integrated Core Budget Gross Expenditures by Ministries in Second quarter 1387



3. FINANCING THE CORE BUDGET

With revenues growing faster than expenditures, financing the core budget will be a major challenge for the rest of the year. Total expenditures exceeded total revenues by AF 1.6 billion in the quarter under review, bringing the year to date financing requirement to AF 7.7 billion. Of this amount, about AF 7.7. billion has been borrowed from foreign sources, with the remaining being drawn down from government deposits in the Treasury Single Account (TSA) at the central bank.

At the end of the second quarter, funds in the TSA were down by an alarming AF 6 billion from the beginning of the year. The drawdown of the TSA was not evenly distributed in the first two quarters of the year. The largest amount was withdrawn in the first quarter of the year and only AF 300 million was withdrawn in the second quarter of the year. This was largely because of the receipt of several large grants in the second quarter which temporarily bolstered the fiscal position.

However the fiscal outlook remains worrisome because liabilities (including invoices to contractors and the PRGF loan repayments) have risen sharply and discretionary savings fell to only AF 1.1 billion at the end of the second quarter. In the short term the fiscal outlook depends heavily on receipt of AF 4 billion in respect of the Aynak mining concession an increase in customs revenue collection and greater fiscal discipline.

5

BANKING SYSTEM PERFORMANCE

SUMMARY

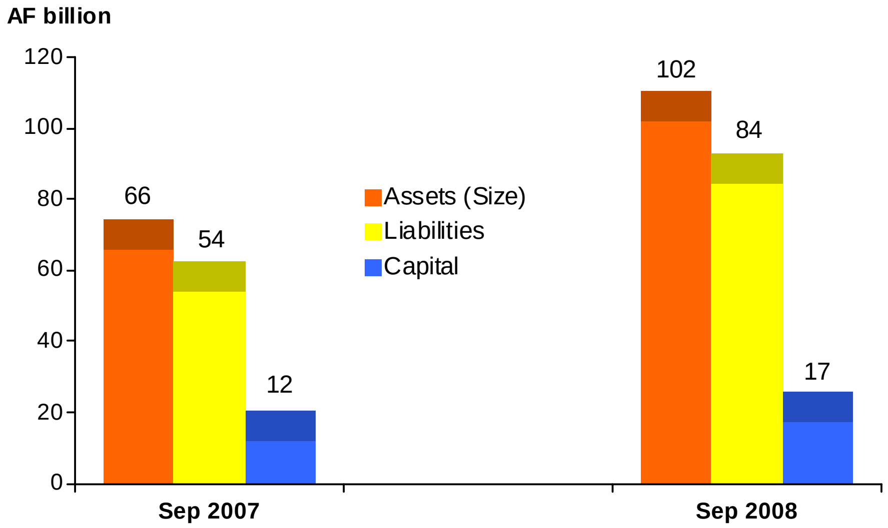
The banking sector continued to perform satisfactorily in the quarter under review. Total assets of the banking system rose to AF 101.8 billion (USD 2.04 billion) at the end of the second quarter of 1387, up by 55 percent or AF 35.9 billion from September 2007. Loans amounted to AF 48.6 billion (USD 971.7 million) an increase of AF 17.4 billion (USD 347.6 million) or 55.7 percent from September 2007. Deposits stood at AF 79.6 billion (USD 1.6 billion) over the period under review; a 56 percent increase or and increase of AF 28.5 billion since September 2007. Deposits were largely denominated in USD (66 percent) with AF -denominated deposits lagging at 28 percent. Total capital of the banking system stood at AF 17.3 billion (USD 345.6 million).

Overall the banking sector was profitable, earning a year-to-date net profit of AF 1.2 billion (USD 23.6 million) compared to the same period in the previous year for an overall return on assets (ROA) of 3.88 percent which was higher than previous year (0.89 percent). The main causes for the improvement in ROA are significant increases in interest income and non-interest income which more than completely offset notable increases in overhead expenses. State-owned banks are among the top six profitable banking institutions as measured by ROA.

1. ASSETS OF THE BANKING SYSTEM

The banking system continued to grow at a brisk rate in the quarter under review. Total assets (the size) of the banking system at the end of the second quarter 1387 stood at AF 101.8 billion (USD 2.04 billion), up by 55 percent or AF 35.9 billion (USD 720 million) from September 2007 (Figures 5.1 and 5.2). The major contributors to this increase was the increase in loans of AF 17.4 billion) and cash in vault/claims on DAB of AF 13.9 billion). The remaining portion is made up of other asset categories such as claims on financial institutions, “other assets except interest receivable” and “net due from” (NDF). The most important components of the banking system’s total asset portfolio are loans that comprise 48 percent, claims on financial institutions 14 percent, cash in vault/claims on DAB 24 percent, NDF 6 percent, and other assets except interest receivable (5 percent). Other components of total assets are negligible. The rapid increase in the relative importance of loans can be traced to immediate deployment of attracted funds into new loans (61 percent), while the remaining portion was mainly retained in the form of liquid assets.

Figure 5.1: Banking System's Growth Rate
Growth Rate = 55 percent or AF 36 billion



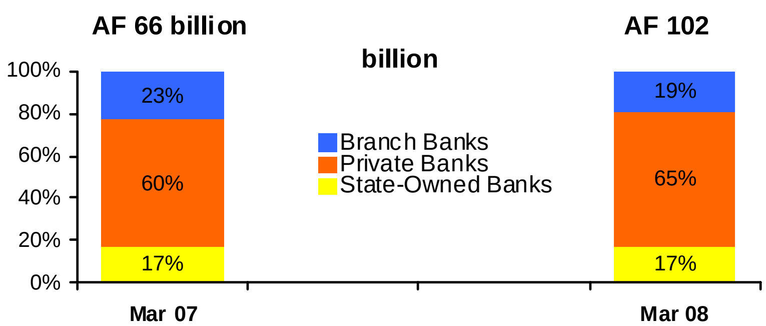
Source: Financial Supervision Department/DAB

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

1.1 Claims on Financial Institutions

Claims on financial institutions are the third largest among various asset categories, currently comprising AF 13.8 billion – a 17 percent increase since September 2007 indicating that the banking sector channeled a portion of its attracted funds as deposits in other financial institution, when credible borrowers were not found. Later on, if needed for liquidity purposes or after getting

Figure 5.2: Size of Banking Sector (total assets)
Increased by 55 percent or AF 36 billion



loan application from low-risk borrowers, these assets are then substituted for higher income earning assets.

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

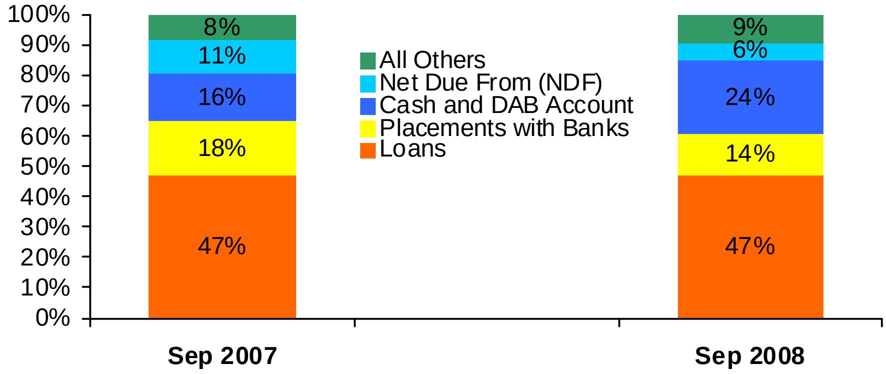
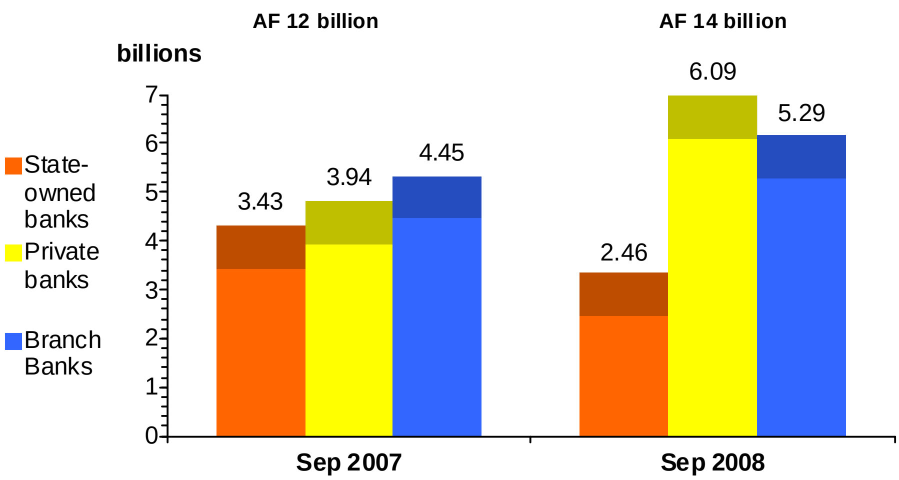


Figure 5.4: Claims on Financial Institutions



Source: Financial Supervision Department/DAB

1.2 Net Loans

The loan portfolio continues to grow, totaling AF 48.6 billion (USD 972 million) as of September 30, 2008 – a 71 percent increase since September 2007 – or 48 percent of total assets; the highest amount as well as share percentage in total assets among different asset categories. The increase occurred in the gross loan portfolio; loss reserves as percentage of gross loans also changed to 2.34 percent. Increases in lending were observed at all but 80 percent of the growth is still attributable to private bank's group; and 56 percent to one banking institution.

Private banks are the leading creditors, having increasing their portfolio both in absolute terms as well as when measured as a percentage of total loans, currently at AF 39 billion or 80 percent of total loans. Developments in state-owned banks and branches of foreign banks' share and amount were insignificant.

By far, the major component of loan portfolio is "other commercial loans (89.5 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend. Thus, lending is picking up, but still not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture.

Figure 5.5: Currency Composition of Loans

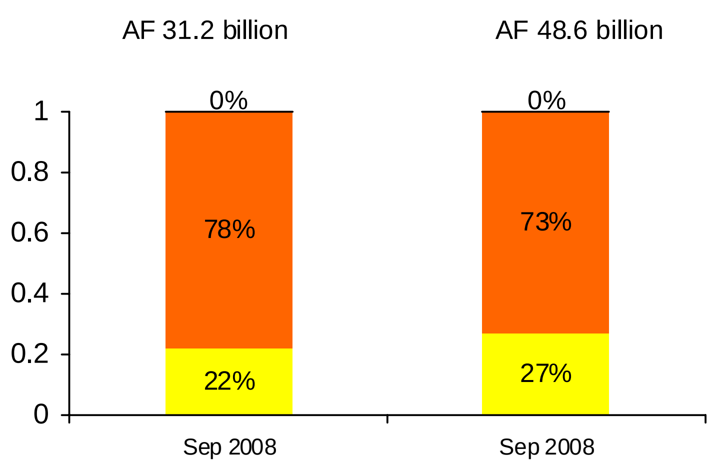
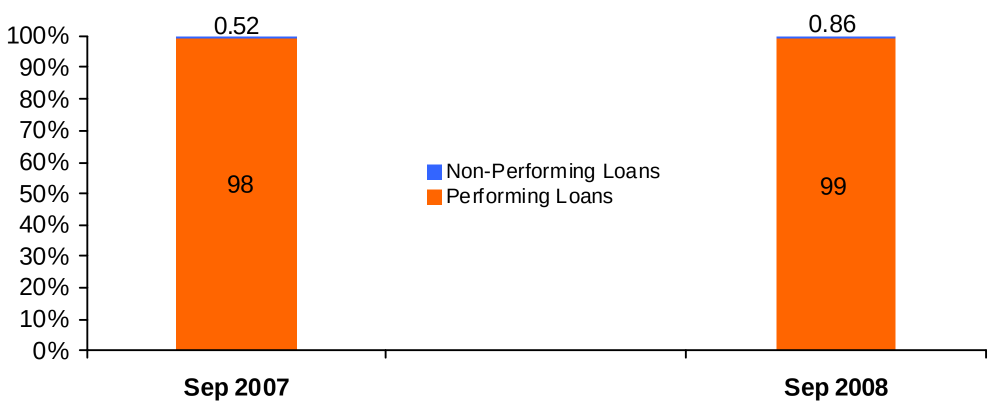


Figure 5.6: Quality of Loan Portfolio



Source: Financial Supervision Department/DAB

1.3 Non-performing loans

The banking system's non-performing loans stood at 0.86 percent of gross loans an increase by 259 million since September 2007. The low NPL is a positive indicator of the quality of the banks portfolio but on the other had it is a concern for regulatory authorities that the banks are unable to recover their loan repayments from customers.

1.4 Adversely-classified loans

Adversely-classified loans increased to AF 1.82 billion from AF 569 million at the end of September 2007. However, their share in total loans significantly increased to 3.25 percent. Loans under "Watch" category contribute 5.89 percent of total gross loans and compared to the second quarter of 1386 have increased by 3.14 percentage points which is alarming. This trend should be monitored closely, to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative.

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

1.5 Cash in Vault and Claims on DAB

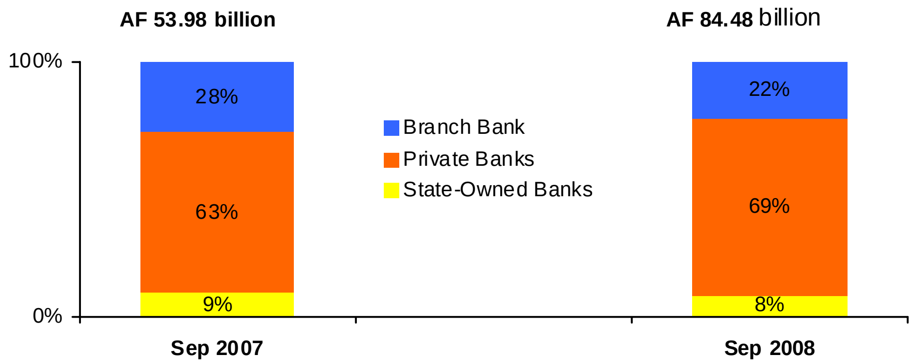
Cash in vault and claims on DAB remains the second largest category, increasing both in absolute as well as in percentage of total assets. The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

2. LIABILITIES

Total liabilities of the banking sector were AF 84.5 billion, up by 57 percent from September 2007. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Figure 5.7: Liabilities Increased by AF 30.5 billion or 57 percent

Breakdown of Liabilities as percentage of total liabilities



2.1 Deposits

Deposits are the major component of liabilities, currently equal to AF 79.6 billion, a 56 percent or AF 28.5 billion increase since September 2007. Private banks attracted AF 55.3 billion more deposits, 69.8 percent of the total increase. Total deposits increased in absolute terms as well as percent of total liabilities. Total deposits of private banks also increased according to both indicators. Deposits of state-owned banks and branches of foreign banks have also increased in absolute terms as well as percentage of total deposits compared to September 2007.

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

Figure 5.8: Major Liability Categories

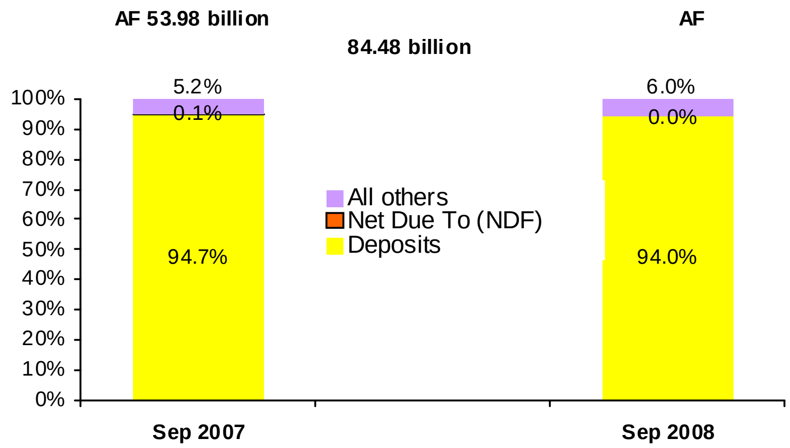
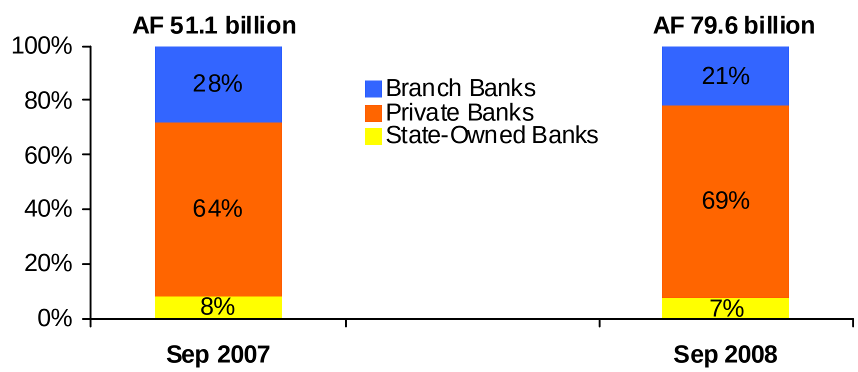


Figure 5.9: Deposits Increased by AF 28.5 billion or 56 percent



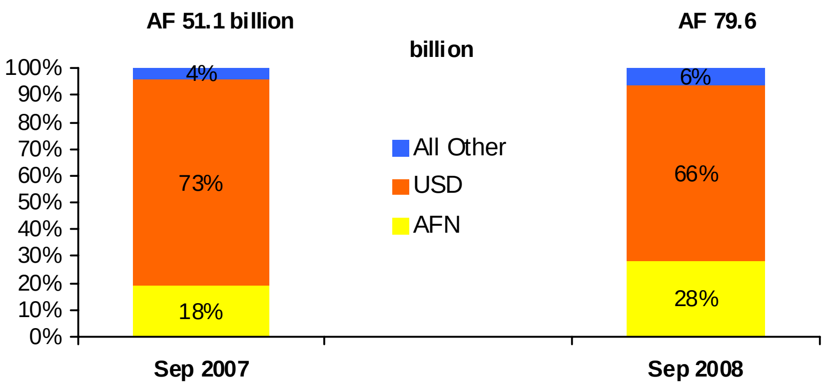
Other liabilities except Interest Payable remain the second major component of liabilities up by 74.5 percent since September 2007. Other liabilities comprise 4 percent of total liabilities.

2.2 Capital

The banking system, as a whole, is well capitalized. Total financial capital at full-fledged banks is AF 17.3 billion, up by 46 percent since September 2007. If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 17.3 billion consists 17 percent of AF 101.8 billion, which is slightly below the benchmark, while total assets of the full-fledged commercial banks are AF 82.9 billion.

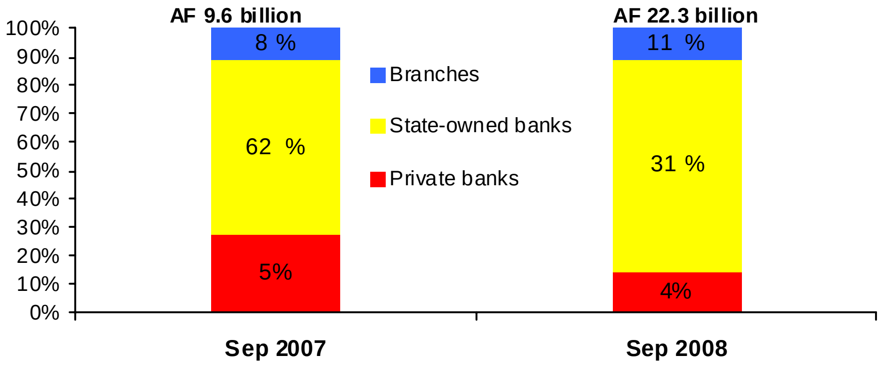
Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the "Net Due To Related Depository Institutions" (NDT), primarily the home office and other branches of the same bank, while the closest analogue to negative capital is the net due from related depository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

Figure 5.10: Currency Composition of Deposits



The NDT position has increased to AF 120 million from AF 61 million in September 2007 and NDF position has decreased both in absolute terms as well as a percentage of total assets. So, two banks are in a favorable NDT position, much smaller number than the relatively large, unfavorable NDF positions for the remaining three banks. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted. They are simply sending their acquired funds to their international networks. The largest NDF position by a branch of foreign bank was AF 4.44 billion, down by 0.04 percent compared to the same quarter in 1386.

Figure 5.11: Afghani Denominated Deposits as Percentage of Total Deposits



2.3 Profitability

The banking system in general is profitable. Total net profit of the banking sector during the second quarter of 1387 is AF 1.2billion. This is an overall return on assets (ROA) of 3.88, up by 125 percent compared to the second quarter of 1386,

Private banks are the most profitable group of banks accounting for 56 percent of the total net profit of the banking system. State-owned banks were next accounting for 24 percent while foreign branches accounted for 20 percent of the total net profit of the banking system. Only one bank was not profitable with total negative net profit of 35 million.

The major component of income was net interest income (NII) which amounted where total net profit amounted to AF 525 million or an overall return on assets (ROA) of 1.75.

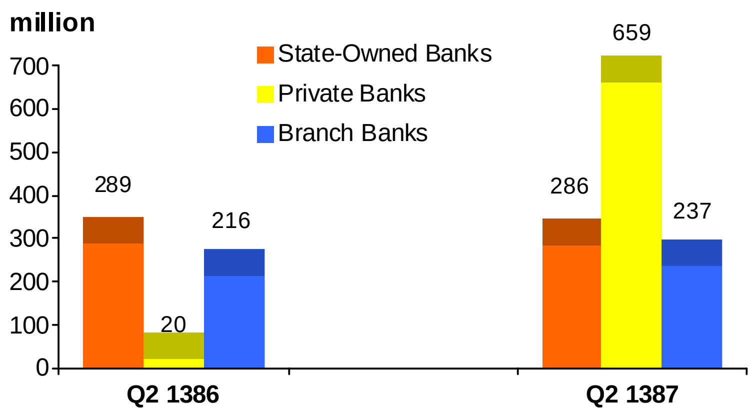
The main contributors to the increase in ROA are significant increases in net interest income, non-interest income, and gains on FX revaluation which more than completely offset notable hikes in overhead expenses. to AF 3.6 billion, up by 82.6 percent since September 2007.

The second major component of income is other non-interest income (ONII) which totaled AF 795 million, a 25.7 percent increase since September 2007.

The most important component of expenses is the non-interest expense (NIE), currently equal to AF 2.6 billion, a 45.7 percent increase compared to the second quarter of previous year.

The efficiency ratio, (*net interest income* + *trading account gain/loss* + *other non-interest income* **divided** *by operating expenses*) of the system as a median stands at 1.64, slightly up by 0.005 percentage point since the second quarter of last year. Six banking institutions ended up with lower efficiency ratios compare to the median of the banking system.

Figure 5.12: Profitability



2.4 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is within the limits established by the DAB. However, four banks are non-compliant with limits set for individual currency open FX position, among them one is slightly above the maximum threshold. All the three banks (holding open FX position in USD, except one bank, which is holding its position in British pound), are above the maximum regulatory threshold. The number of banks in violation of regulatory limits has decreased since second quarter 1386, but still warrants prompt corrective action by DAB. Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch.

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by 3.88 percent or AF 645 million and vice versa. Similarly, a 4 percent change would correspond to 0.78 percent or AF 129 million.

2.5 Interest Rate Risk

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

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

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

6

EXTERNAL SECTOR DEVELOPMENTS

SUMMARY

The external sector faced significant challenges against the backdrop of turmoil in the global economic environment. The trade deficit, the difference between exports and imports of goods, in the second quarter of 1387 stood at USD 490 million or approximately 4 percent of GDP a reflection of the low savings in the economy and high investment requirements for post-conflict reconstruction.

A comparison of merchandise trade in the second quarter of solar year 1387 with that in the second quarter of 1386 shows that imports increased by 3 percent to USD 595 million.

Imports were dominated by industrial products such as petroleum and oil, metal products, fertilizer, chemicals and cement. Exports declined by 6 percent to USD 105 million and were dominated by medical plants/seeds (USD 17 million) and food items (USD 27 million).

With respect to the direction of trade, Pakistan remained Afghanistan's major export destination with a 53 percent share of total exports, followed by the Commonwealth of Independent States (CIS), with 14 percent share of total exports in the second quarter of 1387.

In the quarter under review, NIR increased from USD 2,209 million in the second quarter of 1386 to USD 2,766 million; a 25.2 percent increase. The increase in NIR was driven largely by inflows of donor grants, US Army financing and foreign direct investment (FDI). Reserve liabilities increased by 59 percent from USD 85 million to USD 135 million in the period under review. This can be attributed to receipt of PRGF disbursement of USD 95 which accounted for about 70 percent of total liabilities.

1. MERCHANDISE TRADE

At the end of the second quarter of 1387 the trade deficit stood at USD 490 million or 4 percent of GDP. At this pace, the trade deficit is projected to be approximately equivalent to the second quarter of 1387. Table 6.1 shows merchandise trade by its main categories, percent changes and the trade deficit as a percentage of GDP from 1384 up to second quarter of 1387. Imports of USD 595 million were dominated by industrial supplies and materials (USD 202 million). Exports of USD 105 million were dominated by medical plants/seeds (USD 17 million) and food items (USD 48 million).

Table 6.1: Merchandise Trade (in million USD)

Years	1384		1385		Q2 1386		Q2 1387	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**2,471**	**100.00**	**2,744**	**100.00**	**577.6**	100.00	**595.03**	**100.00**
Industrial supplies	541	21.90	68	2.48	152.5	26.40	202.55	34.0
Capital goods & others	1,207	48.83	1,133	41.29	282.0	48.83	226.75	38.1
Fuel & lubricants	245	9.90	354	12.90	5.6	0.98	26.4	4.4
Exports	**384**	**100.00**	**416**	**100.00**	**112.03**	**100.00**	**105.10**	**100.00**
Carpets & Rugs	207	53.93	187	44.80	69.2	61.77	28.6	27.2
Food items	104	27.13	165	39.66	29.93	26.72	47.5	45.2
Leather & Wool	37	9.51	31	7.39	1.21	1.08	11.9	11.3
Medical seeds & others	36	9.42	34	8.16	11.69	10.43	17.1	16.3
Trade Balance	**-2,087.02**		**-2,327.73**		**-465.53**		**-489.93**	
Trade Balance as % of GDP	**31.28**		**-28.19**		**-4.79**		**-3.81**	

Source: Central Statistics Office and DAB staff calculations

2. DIRECTION OF TRADE

Tables 6.2 and 6.3 compare the direction of trade in the second quarter of 1386 with the second quarter of 1387. Pakistan remained Afghanistan's largest export destination with a 53 percent share of total exports in the second quarter of 1387 compared to 64 percent in the second quarter of 1386. Exports to Pakistan have decreased significantly by 22 percent from USD 72 million in the second quarter of 1386 to USD 56 million in the second quarter of 1387. India is the second major export destination for Afghan products. Exports to India decreased by almost 27 percent from USD 20 million in the second quarter of 1386 to USD 15 million in the second quarter of 1387. Finally, CIS retained their position as major export destinations for Afghanistan. In the second quarter of 1386 exports with the Ex-soviet commonwealth were USD 6 million compared to USD 14 million in the second quarter of 1387: an increase of 136 percent.

Table. 6.2: Direction of External Trade for 2nd Quarter of 1386 (million USD)

Country Name	Exports		Imports		Trade Balance
	Millions of USD	% share	Millions of USD	% share	
Pakistan	71.68	63.98	107.08	18.54	-35.40
India	19.84	17.71	35.37	6.12	-15.53
Iran	0.40	0.36	33.27	5.76	-32.87
Japan	0.00	0.00	17.77	3.08	-17.77
China	0.00	0.00	88.76	15.37	-88.76
Ex-soviet Common Wealth	5.77	5.15	182.64	31.62	-176.87
European Countries	3.91	3.49	12.83	2.22	-8.92
England	0.00	0.00	2.09	0.36	-2.09
Saudi Arabia	0.98	0.87	0.00	0.00	0.98
Other Countries	9.45	8.44	97.75	16.92	-88.30
Total	**112.03**	**100.00**	**577.56**	**100.00**	**-465.53**

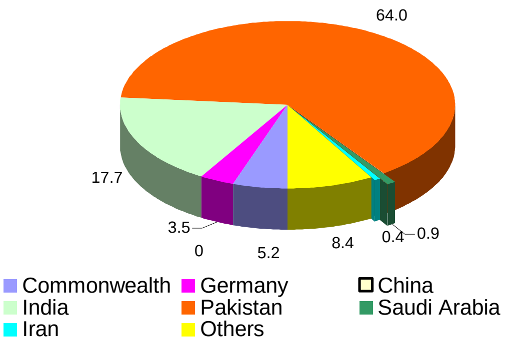
Source: CSO and DAB staff calculations

Table. 6.3: Direction of External Trade for 2nd Quarter of 1387 (millions USD)

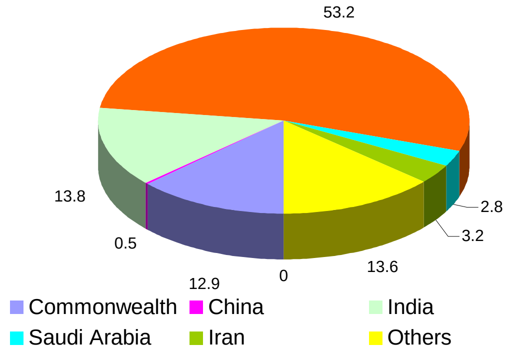
Country Name	Exports		Imports		Trade Balance
	Millions of USD	% share	Millions of USD	% share	
Pakistan	55.90	53.19	108.21	18.19	-52.31
India	14.50	13.80	21.23	3.57	-6.73
Iran	3.40	3.24	48.35	8.13	-44.95
Japan	0.00	0.00	27.60	4.64	-27.60
China	0.50	0.48	85.95	14.44	-85.45
Ex-soviet Common Wealth	13.60	12.94	177.40	29.81	-163.80
European Countries	0.00	0.00	5.25	0.88	-5.25
England	0.00	0.00	1.80	0.30	-1.80
Saudi Arabia	2.90	2.76	0.00	0.00	2.90
Other Countries	14.30	13.61	119.24	20.04	-104.94
Total	**105.10**	**100.00**	**595.03**	**100.00**	**-489.93**

Source: CSO and DAB staff calculations

Figure 6.1: Direction of Exports (share %) in Q2 - 1386



Fiqure 6.2: Direction of Exports (share%) in Q2 - 1387

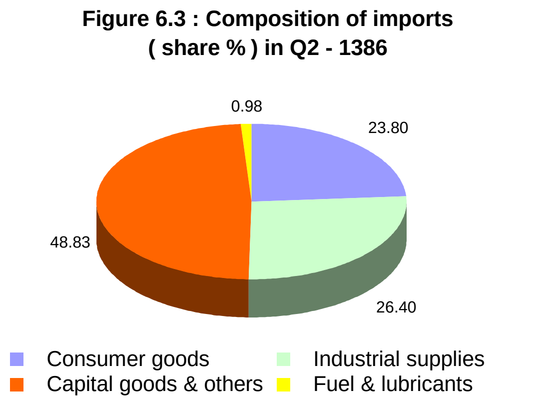


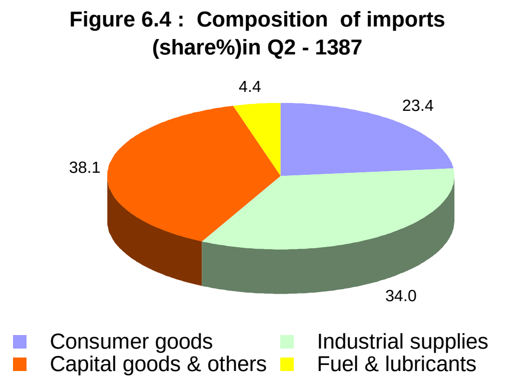
Source: CSO and DAB staff calculations

2.1 Composition of Trade

Figures 6.3 and 6.4 present the composition of total imports for the second quarter of 1386 up to the second quarter of 1387.

The composition of imports in the second quarter of 1387 shows that imports of capital goods had the largest share at 49 percent followed by industrial supplies with 26 percent, consumer goods such as textile, cloths, footwear and so on stood at 24 percent. Fuel and lubricants stood at about 1 percent of total imports to Afghanistan.



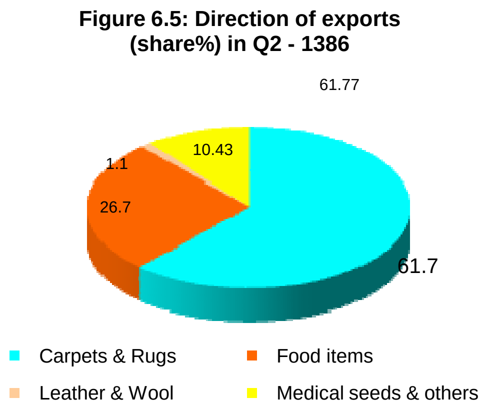


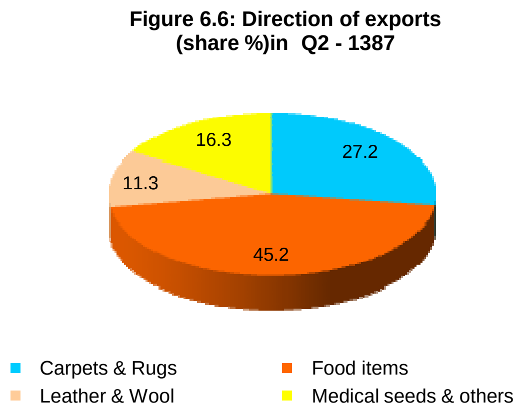
Source: CSO and DAB staff calculations

Comparing imports for the second quarter of 1386 with that of the second quarter of 1387 shows that the composition of imports has changed significantly. There was no significant change in the share of capital goods in the second quarter of 1387 compared to the second quarter of 1386. The second biggest item in the second quarter was industrial supplies which increased to 34 percent up from 26 percent in the second quarter of 1386. On the other hand, the share of consumer goods which was 24 percent during the second quarter of 1386 decreased slightly to 23 percent in the second quarter of 1387. There was also an increased in fuel & lubricants in the second quarter of 1387 to 4 percent from 1 percent in the second quarter of 1386.

Figures 6.5 and 6.6 compares the composition of total exports for the second quarter of 1386 with the second quarter of 1387. The largest export category was carpets and rugs with 62 percent followed by food items with 27 percent of total exports, medical plants/seeds with 10 percent, and leather and wool with 1 percent.

Figure 6.6 shows the composition of total exports for the second quarter of 1387 by main commodities and products. The category carpet and rugs accounted for 27 percent of total exports, followed by food items with 45 percent of total exports, medical plants/seeds with at 16 percent, and leather and wool with 11 percent.





Source: CSO and DAB staff calculations

Comparing the composition of exports for the second quarter of 1387 with that of the second quarter of 1386 it is clear that the composition of exports remained approximately the same. There were only minor changes in the share of carpets and rugs category which decreased to 27 percent in the second quarter of 1387 from 62 percent in the second quarter of 1386. On the other hand, the share of medical plants/seeds and others increased in the second quarter of 1387 to almost 16 percent from 10 percent in the second quarter of 1386. In addition, the share of leather and wool increased to 11 percent in the second quarter of 1387 up from 2 percent in the second quarter of 1386. Also the share of food items increased to 45 percent in the second quarter of 1387 up from 27 percent in the second quarter of 1386.

2.2 External Debt

Afghanistan's public and publicly guaranteed external debt prior to the application of traditional debt relief mechanisms is estimated at USD 11,939.4 million in nominal terms as of March 20, 2006 (Table 6.5). Afghanistan's external debt strategy continues to focus on providing a stable foundation for debt sustainability over the long term. The mechanism through which external debt sustainability is currently being pursued is under the HIPC (Highly Indebted Poor Country) initiative. On July 19, 2007 the group of major official creditors known as the Paris Club reached agreement on significant debt reduction with the Government of Afghanistan. The cancellation of approximately USD 10 billion in external debt amounts to a 92 percent reduction in Afghanistan's debt to its three Paris Club creditors, Germany, the Russian Federation and the United States.

The three creditors intend to cancel the remaining debt under the enhanced Heavily Indebted Poor Country (HIPC) initiative. The Paris Club agreement also calls for comparable treatment from Afghanistan's other bilateral creditors. Afghanistan's debt to the U.S. is approximately USD 108 million.

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

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

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

Source: Data provided by Afghan authorities; and IMF staff estimates.
1/ Before up-front 80 percent discount on Russian debt
2/After up-front 80 percent discount on Russian debt priority the application of traditional debt relief.

2.3 Net International Reserves

The level of Afghanistan's net international reserves (NIR) is an important determinant of the overall performance of the external sector and a key quantitative performance criterion under the PRGF program. Developments in the level of NIR reflect trends in export earnings, foreign direct investment and disbursements by donors and multi-national forces stationed in Afghanistan. NIR is defined as the difference between reserve assets and reserve liabilities. Reserve assets are defined as the sum total of monetary gold, IMF reserve position, holdings of Special Drawing Rights, Foreign Exchange Reserves and other claims.

In the quarter under review, NIR increased from USD 2,209 million to USD 2,766 million; a 25.2 percent increase, see Table 6.5 & Figure 6.7 below. The increase in NIR was driven largely by inflows of donor grants, US Army financing and foreign direct Investment (FDI).

Reserve liabilities increased by 59 percent from USD 85 million to USD 135 million in the period under review. This can be attributed to receipt of PRGF disbursement of USD 95 million which accounted for about 70 percent of total liabilities.

Another key indicator, the monthly import cover, increased from 11 months in Q2 of 1386 to 14 months in the quarter under review. This is well above the NIR floor in the PRGF program of 5 months and indicates that the country can comfortably maintain the necessary external liquidity to support the balance of payments.

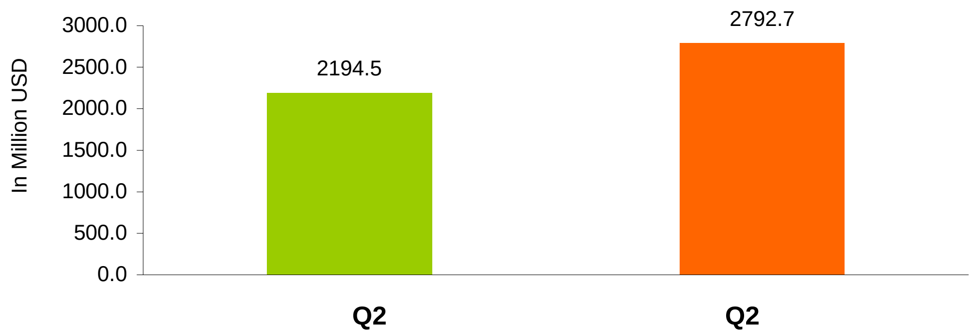
Table 6.5: Net International Reserves, First and second quarters SY 1386 and 1387

(Million of USD)

Changes on the previous quarter	1386				1387			
	Q1	% change	Q2	% change	Q1	% change	Q2	% change
Net international Reserves (million US Dollar)	**1,970.5**	16	**2,208.6**	27.4	**2,595.1**	31.7	**2,766.1**	25.2
Reserve assets	**2,040.9**	18.2	**2,293.4**	29.2	**2,703.4**	32.5	**2,901.2**	26.5
Reserve Liabilities	**70.4**	154.5	**84.9**	106.2	**108.3**	53.9	**135.1**	59.2
Commercial bank deposits in foreign currency	**28.7**	23	**30.2**	-15.3	**30.3**	5.6	**38.3**	26.9
Nonresident deposits in foreign currency	**6.1**	40.1	**2.6**	-52.7	**1.2**	-79.9	**1.6**	-38.6
Use of Fund resources	**35.6**	0	**52.1**		**76.8**	115.4	**95.2**	82.8
Gross Intl. Reserves (in months of import)	**9**		**12**		**13**		**15**	
Net Intl. Reserves (in months of import)	**9**		**11**		**12.8**		**14**	

Source: Da Afghanistan Bank

Figure 6.7:Net International Reserves 2nd quarter 1386 and2nd quarter 1387



Source: Da Afghanistan Bank

2.4 Foreign Direct Investment

Afghanistan has a long and distinguished history of facilitating trade and investments through the historical Silk Road. However, after several decades of war and civil strife, much needs to be done to encourage foreign direct investment. Foreign direct investment (FDI) has the potential to be a powerful weapon of economic development, especially in the current global context. It enables a capital-poor country like Afghanistan to build up physical capital, create employment opportunities, develop productive capacity, enhance skills of local labor through transfer of technology and managerial know-how, and helps integrate the domestic economy with the global economy.

The economic impact of FDI on the level of economic activity has been widely investigated in recent years across different countries. Empirical studies have shown that there is a high positive correlation between FDI inflows and aggregate exports and imports. Some results suggest that the inflow of FDI can 'crowd in' or 'crowd out' domestic investment depending on specific circumstances. However, the consensus appears to be that overall, FDI has a positive impact on economic growth but the magnitude of the effect depends on the availability of complementary resources, especially on the domestic stock of human capital.

With respect to its impact on the external sector, FDI inflows (which are recorded in the capital and financial accounts of the BOP) play an important role in determining the surplus/deficit in the capital and financial account of the BOP.

There are at least two competing effects of FDI on the balance of payments. On the one hand, after setting up capital machineries, the FDI-financed companies will begin to export their products as most of these companies are export-oriented. This is because FDI-financed firms tend to export a greater proportion of their output than their local counterparts as these firms usually tend to have a comparative advantage in their knowledge of international markets, efficiency of distribution channels, and their ability to adjust and respond to the changing pattern and dynamics of international markets.

On the other hand, empirical research in several countries suggests that the initial inflow of FDI tends to increase the host country's imports. One reason for this is that FDI companies have high propensities to import capital and intermediate goods and services that are not readily available in the host country. However, if FDI is concentrated in import substituting industries, then it is expected to affect imports negatively because the goods that were imported earlier would now be produced in the host country by foreign investors.

In conclusion it is likely that the initial impact of an inflow of FDI on Afghanistan's BOP is positive but the medium term effect could become either positive or negative as the investors increase their imports of intermediate goods and services, and begin to repatriate profit.

Notwithstanding the impact of FDI on the balance of payments there is a broad consensus that FDI brings net benefits to Afghanistan. These benefits are important for integrating the domestic economy with the global economy and in the area of technology and skill transfer. Therefore, Afghanistan urgently needs to undertake effective promotion measures to convince potential foreign investors that their involvement in business activities in the country is valued, they would be facing friendly regulations, and they can enjoy investment incentives that are competitive with those offered by other countries in the region and the developing world. The country also needs to move forward through implementing investment friendly policies, simplifying regulatory practices, and removing inefficient bureaucratic procedures. Several policy areas to promote FDI include:

Quality of bureaucracy and governance: Appropriate reform measures are needed in the country's administrative system. The bureaucracy needs reorganization in order to bring about a perceptible improvement in its efficiency and productivity. Bureaucratic control and interference in business and investment activities should be minimized on a priority basis

Improvement of law and order: The law and order situation needs to be improved through appropriate reforms in law enforcement and introducing other measures. A social consensus is needed to establish the rule of law, avoid political confrontation, terrorism and reduce corruption.

Development of infrastructure and human resources: Both the government and private sector need to come forward to invest in infrastructure development. For this purpose, appropriate policies are needed such that the private sector can smoothly operate in providing infrastructure services. Similarly, both public and private universities should come forward in introducing courses/programs that produce graduates with technical and management skills required in modern industrial and other activities. In this context, if the government and the private sector work together to implement effective economic reforms in a successful manner, Afghanistan stands a good chance of being able to participate in the prosperity and growth that has swept some parts of the developing world in recent years.

Privatization and further reforms: The privatization program of the state owned enterprises needs to be geared up to stimulate domestic and foreign investments. Several financial institutions and some of the public utilities may be privatized in order to ensure better and more efficient services. The policies should encourage private sector participation in several key sectors like agricultural processing, manufacturing, infrastructure including transportation, telecommunication, power, and in the production of high value added products.

Modernization of business law: It is important for Afghanistan to modernize and revamp all laws relating to business and investment keeping in view the international practices and requirements of globalization.

Setting up of industrial parks in all major cities: The development of new industrial parks can help in creating a favorable environment for foreign investment. The availability of ready infrastructure along with secure and enabling investment climate can act as a powerful catalyst in attracting foreign investors for investment in profitable ventures.

Improving the country's image abroad: Positive developments regarding the country's economy, society, and future prospects, including the hospitable investment climate existing in the country and the facilities available to foreign investors, should be projected abroad in an effective manner, especially among the potential investors. Such 'image building' efforts would be crucial to dispel the negative images that have persisted for long and discouraged the investors to come forward. In addition to the above, maintaining consistency in policies and actions is important so that no 'wrong signal' is conveyed to the investors.

Economic and commercial diplomacy: Strengthening economic and commercial diplomacy is a key factor in attracting FDI in the present world characterized by rapid globalization and increasing competition. In this respect, improved bilateral relations with potential investor countries can act as a catalyst to increasing FDI inflows to Afghanistan. Moreover, it is important not only to improve relations with countries that have already invested in Afghanistan, but also to identify potential investors in other countries and undertake appropriate measures to attract them to invest in the country.

Box 4: Aynak Cooper Mine and Afghan Telecoms to attract FDI

Afghanistan has awarded a state-owned company in China with the right to develop a large copper field to the south of Kabul, following two years of bidding. China Metallurgical Group agreed to invest about USD 3 billion in the project and related infrastructure development -- including the construction of a coal-fired electrical power plant and what would be Afghanistan's first freight railway. This is one of the biggest foreign direct investment projects in the history of Afghanistan. By the estimates of some geologists, deposits at Afghanistan's Aynak copper field in Logar province make it the world's largest undeveloped copper field. The deal gives China Metallurgical Group the right to extract high-quality copper from the area south of Kabul.

About USD500 million will be invested in building an electrical power plant. And a large amount of money will also be invested in building a railroad. The coal-fired power plant to be built near the copper field would generate up to 400 megawatts of electricity which is more than enough electricity to run the mine. The excess electricity would be routed to Kabul, where most residents now have electricity for only a few hours per day -- if at all. Another 5,000 people -- mostly Afghan workers led by a few Chinese experts -- are expected to be employed in the mining operations and as construction workers on the railroad.

Latest estimates suggest there is at least 13 million tons of copper waiting to be mined from the Aynak field. With further exploration, those estimates could rise to 20 million tons before full-scale mining operations begin. And at current prices, the value of copper at Aynak could be about USD 30 billion.

The government has also announced plans for the privatization of Afghan Telecom Corporation. The Ministry of Communications and IT released a Request for Expressions of Interest (REI) in the sale of 80 percent of the shares of the company, in what it says will be the most ambitious privatization project in Afghanistan to date. Afghan Telecom currently operates a fixed wireless CDMA network in 110 districts, with coverage expanding to 365 districts. The company also plans to introduce village communications network that will connect 5,000 villages to telecoms services.

Source: Ministry of Mines, Ministry of Communications and IT