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Combined Issue 1384 (2005-06)

**Da Afghanistan Bank
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LIST OF ABBREVIATIONS

GOA	Government of Afghanistan
EMA	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 Afghans



FOREWORD

It gives me great pleasure to present this combined issue of the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank for 1384 (2005-06).

The Bulletin reviews overall economic developments, as well as progress in financial sector reform and developments in formulation of monetary policy besides fiscal and external sector developments in the Afghanistan economy.

On this occasion, I would like to express my thanks and indeed, admiration for Dr. Narendra Jadhav for these painstaking efforts in bringing out this combined issue in a thoroughly revised and comprehensive format and that too, within a record time. I would also like to place on record my appreciation for the Monetary Policy Department of Da Afghanistan Bank in general and to Mr. Aziz Babakarkhail in particular, for their untiring efforts. Thanks are also due to other colleagues especially John Ewald, Glenn Tasky and Davis Bunting.

This edition of Bulletin is richer and broader than our previous issues. It would be our endeavor to continue the efforts to improve the coverage, quality and timeliness of the Quarterly Bulletin in future as well.

Noorullah Delawari

Governor

Da Afghanistan Bank

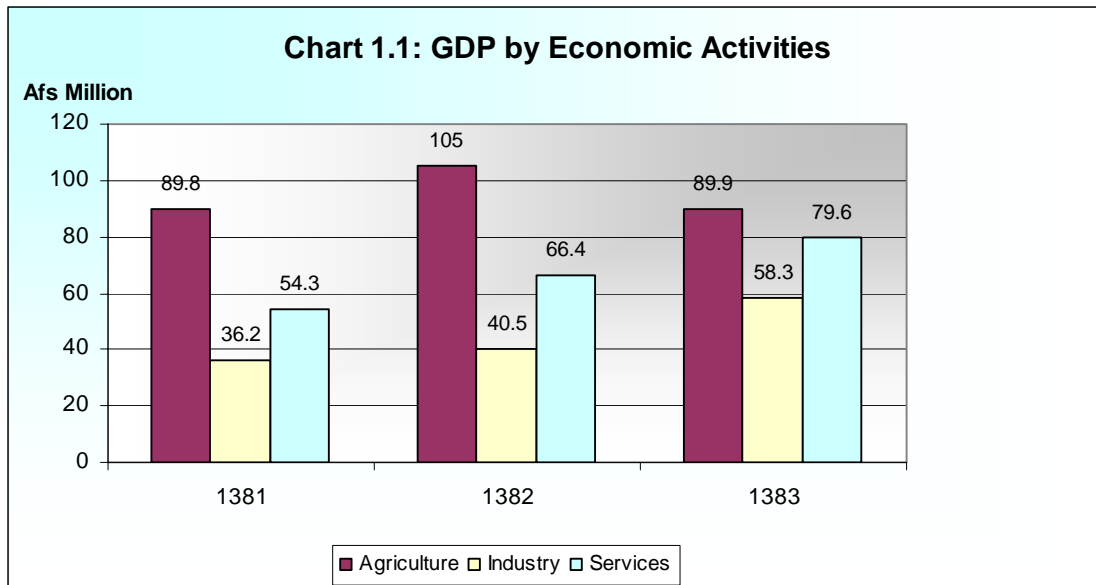
I- Macroeconomic Overview

1.1 Economic Growth

Afghanistan economy is well on its way to sustained growth and development¹. In view of the devastation caused by the prolonged war, the economic activity was severally depressed until the year 1380 (i.e., 2001/02). When the recovery began, the economy rebounded strongly posting real GDP growth rates of 28.6 per cent in 1381 (i.e., 2002/03) and 15.7 per cent in 1382 (i.e., 2003/04). In the year 1383 (i.e., 2004/05), despite a severe drought and consequent adverse effect on agricultural production, the overall real GDP growth rate was maintained at an impressive level of 8 per cent. Going by available indications, the real GDP growth rate is expected to have continued its momentum in the year 1384 (i.e., 2005/06) as well.

Structure of Production

The structure of production in Afghanistan as illustrated in Chart 1.1 provides a break-up of GDP by economic activities for the three year period 1381 (i.e., 2002/03) through 1383 (i.e., 2004/05).



¹ In Afghanistan, the Central Statistical Office (CSO) compiles data on GDP and other related macroeconomic aggregates in accordance with the UN System of National Accounts (SNA1993). Afghanistan Statistical Yearbook 2005 (Issue 26, December 2005) provides the GDP data from the year 2002-03 up to 2004-05 (estimates).

As is evident from the Chart, while the industry and services have been recording steady growth, the agricultural sector has exhibited considerable year-to-year fluctuations which are not surprising given its dependence on weather conditions.

Agriculture

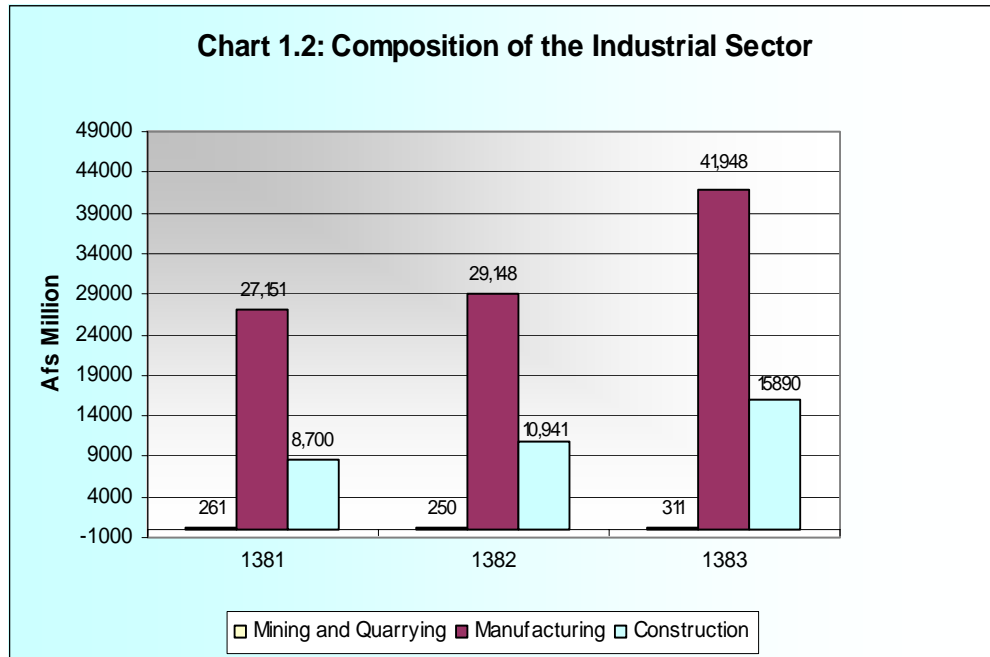
Afghanistan is primarily an agrarian economy—with agriculture contributing to around 35 per cent of GDP (in 1383) and 80 per cent of population living in rural areas. There was a major setback to agriculture in the year 1383 (i.e., 2004/05) on account of a severe drought. The maximum impact of the drought was in the case of wheat – the main staple, whose production declined by as much as 31 per cent in 1383 (i.e., 2004/05). Other cereals (i.e., rice, barley, maize and millet) were not affected. In fact, the rice production increased by 35 per cent during the year. Nevertheless, given the dominance of wheat in cereals production in Afghanistan, the overall cereals production in the country declined by around 20 per cent. Among other crops, while potatoes and sugarcane were adversely affected by the drought, nuts and olives showed moderate increase. Livestock productions, especially meat, milk and skin also registered modest improvement during the year 1383 (i.e., 2004/05). In the year 1384 (i.e., 2005/06), the agricultural sector is expected to have bounced back aided by favourable weather conditions.

Industry

The industrial sector in Afghanistan consists of the following sub-sectors:

- a. Mining and quarrying
- b. Manufacturing
- c. Electricity, gas and water
- d. Construction.

Relative shares of these sub-sectors within the industrial sector for the period 1381 (i.e., 2002-03) through 1383 (i.e., 2004-05) are illustrated in Chart 1.2



As can be seen from the Chart, the manufacturing sub-sector constitutes the bulk of the value added in industry, while the construction sub-sector has been making significant strides in the recent years.

During the year 1383, the industrial sector recorded an exceptionally strong growth of 44 per cent attributable mainly to manufacturing which grew by 44 per cent and construction which grew by 45 per cent. Within the manufacturing sector, the impressive growth in the year was attributed especially to the “food, beverage and tobacco” group (47.8 per cent growth), chemicals and chemical production, coal, rubber and plastic group (17.3 per cent growth) and textile, wearing apparel and leather group (12 per cent growth). As far as the construction activities are concerned, the demand for housing has remained very strong in both urban and rural areas on account of the return of around 3.5 million refugees since the end of the war in December 2001. Moreover, public construction has got a big boost since roads, highways, bridges, schools, hospitals and airports are being built with the help from the donors. The rest of the industrial sector i.e., electricity, gas and water sub-sector recorded a growth rate of 14.7 per cent during the year 1383 (i.e., 2004/05). Within this sector, hydro power electricity declined by around 13 per cent due to unusually dry weather conditions in most part of the country. This decline was, however, more than compensated by private electricity generation.

Services

The services sector in Afghanistan which contributes around one-third of GDP, is dominated by “transport and storage” (37.9 per cent of value added in services in 1383), wholesale and retail trade (28.7 per cent of value added in services in 1383) and “producers of Government services (16.2 per cent of value added in services in 1383). “Financial Services” sub-sector contributed barely 0.23 per cent of value added in services in the year 1383.

During the year 1383 (i.e., 2004/05), the services sector grew by around 20 per cent, aided mainly by “wholesale and retail trade, restaurants and hotels” (30 per cent growth), transport and communication (24 per cent growth) and financial services (11 per cent growth).

Projections for 1384 (2005/06)

The estimates of real GDP growth for the year 1384 (i.e., 2005/06) have not been made available by the Central Statistical Office (CSO) as yet. Nevertheless, going by the available indications, the growth momentum achieved by the Afghanistan economy is likely to be maintained during the year 1384 (i.e., 2005/06) as well.

There are several reasons for this favourable outlook. First, the weather related setback to agriculture witnessed last year does not seem to have repeated itself in 1384. It is important to remember that the economy grew by 8 per cent last year despite the severe drought. In the year 1384, that adverse factor pulling the overall growth rate down does not seem to exist. Secondly, for the same reason, hydro–electricity generation is not likely to be adversely affecting the overall growth rate as it did the last year. Thirdly, the country seems to be enjoying the “peace dividend” in terms of the return of 3.5 million refugees and the consequent boost to the construction sector besides the added purchasing power driving the aggregate demand in the economy and promoting a range of industrial activities and services.

In sum, during the year 1384 (i.e., 2005-06), the agricultural sector is expected to have returned to its trend; construction activity, telecommunications, trade and transport seem to have provided further impetus to growth. Accordingly, there is a strong

likelihood of the Afghanistan economy achieving the targeted real GDP growth of 14 per cent in 1384.

1.2 Inflation

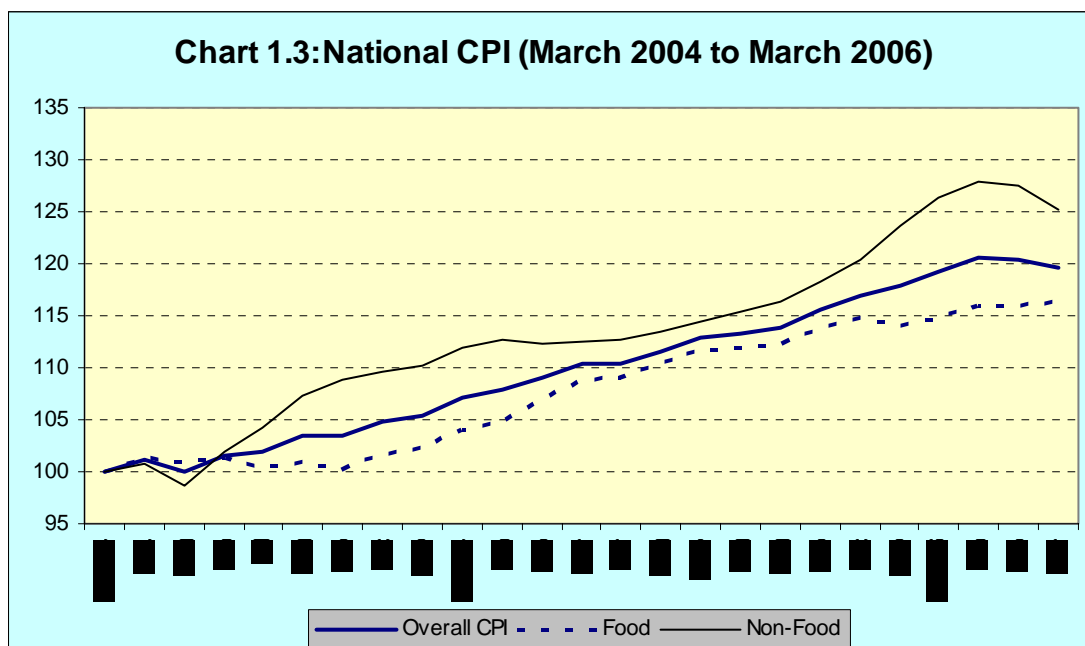
Until recently, inflation in Afghanistan was measured exclusively in terms of Kabul-based Consumer Price Index (Kabul CPI) with the base December 2002=100. In a welcome move, the Central Statistical Office (CSO) has now started publishing Consumer Price Index for the nation as a whole (National CPI) with the base March 2004 (i.e., the first month of the year 1383) = 100. The national CPI includes CPI for six major cities representing the regions of Kabul, Herat, Kandahar, Jalalabad, Mazar-e-Sharif and Khost.

Inflation Based on National CPI

National Consumer Price Index (NCPI) data on monthly basis from March 2004 to March 2006 are presented in Table 1.1 and illustrated in Chart 1.3.

Table 1.1: National CPI

	Overall CPI	Food	Non-food
Mar. 04	100.00	100.00	100.00
Apr.	101.20	101.40	100.80
May	100.00	100.90	98.60
Jun	101.50	101.30	101.90
Jul	101.90	100.40	104.30
Aug	103.50	101.00	107.40
Sep	103.50	100.20	108.80
Oct	104.90	101.80	109.60
Nov	105.40	102.40	110.20
Dec. 04	107.10	104.00	112.00
Jan	107.90	104.90	112.60
Feb	109.10	107.00	112.40
Mar	110.30	108.90	112.50
Apr	110.40	109.00	112.70
May	111.60	110.40	113.40
June	112.80	111.80	114.40
July	113.30	112.00	115.40
Aug	113.90	112.30	116.40
Sep	115.50	113.80	118.20
Oct	117.00	114.80	120.30
Nov	117.80	114.10	123.60
Dec. 05	119.30	114.80	126.40
Jan	120.60	116.00	127.80
Feb	120.40	115.90	127.50
Mar	119.70	116.30	125.10



A comparative picture of inflation during the last two years 1383 (i.e., 2004-05) and 1384 (i.e., 2005-06) is presented in Table 1.2.

Table 1.2: National Inflation in Afghanistan (per cent)

Year	Overall	Food	Non-food
1383 (i.e., 2004-05)	10.3	8.9	12.5
1384 (i.e., 2005-06)	8.5	6.8	11.2

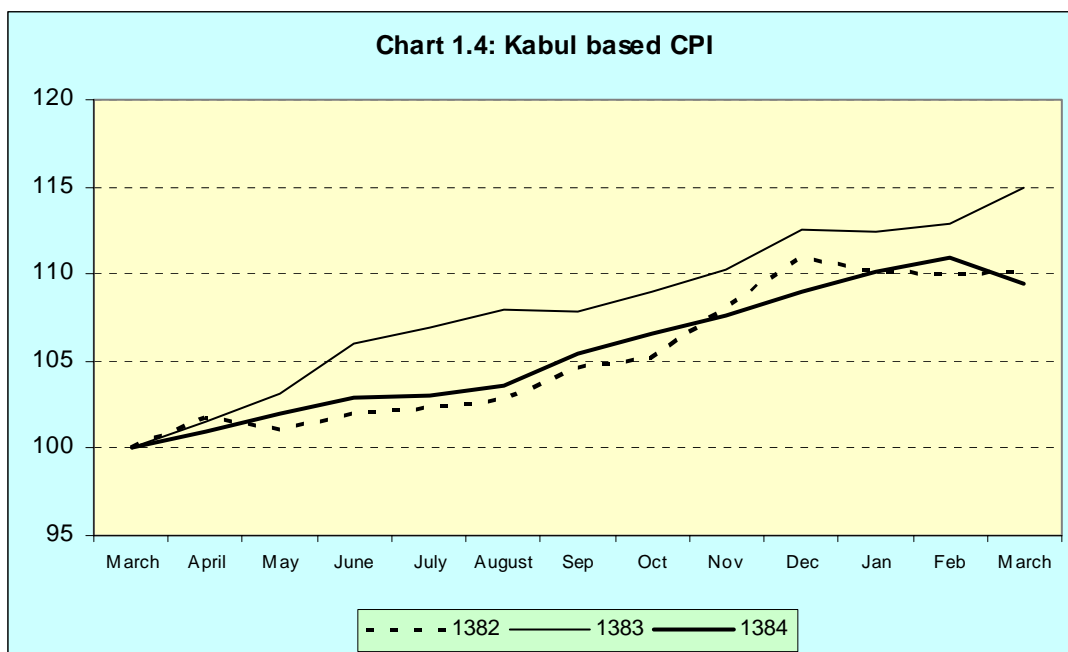
As can be seen from the Table:

1. National inflation in Afghanistan has come down from a double digit rate (10.3 per cent) in 1383 to single digit one (8.5 per cent) in 1384.
2. Food price inflation has distinctly decelerated in 1384 (2005-06).
3. Non-food prices inflation continues to remain in double digit (11.2 per cent in 1384), but has come down from its level in the preceding year.

Even with the introduction of National CPI, the Kabul-based CPI remains important. Monthly data on Kabul-based CPI from March 2004 to March 2006 are presented in Table 1.3 and Chart 1.4.

Table 1.3: Kabul-based CPI

Period	Overall Index	Food, Beverages & Tobacco	Non Food Items
Mar 03	96.0	95.9	96.3
Apr	97.7	97.7	97.7
May	97.0	96.2	98.3
June	97.9	97.0	99.3
July	98.3	97.1	100.2
Aug	98.7	97.0	101.4
Sep	100.5	97.5	105.1
Oct	101.0	98.6	104.7
Nov	103.8	102.1	106.5
Dec	106.5	106.1	107.3
Jan-04	105.7	105.8	105.5
Feb	105.6	107.1	103.3
Mar	105.7	107.3	103.3
New Series : March 2004 =100			
March	100.00	100.00	100.00
April	101.50	102.20	100.30
May	103.10	103.50	102.60
June	106.00	103.90	109.30
July	106.90	103.80	111.70
August	108.00	102.40	116.60
Sep	107.90	100.60	119.20
Oct	109.00	103.00	118.30
Nov	110.30	104.60	119.00
Dec	112.50	106.90	121.10
Jan 05	112.40	107.00	120.70
Feb	112.90	108.60	120.40
March	114.90	111.60	120.20
Mar	114.90	111.60	120.20
Apr	116.00	112.90	121.00
May	117.20	114.00	122.30
June	118.20	114.40	124.10
July	118.40	114.20	125.10
August	119.00	114.30	126.30
Sep	121.10	115.50	130.00
Oct	122.40	116.70	131.40
Nov	123.70	117.20	134.00
Dec. 05	125.20	117.60	137.40
Jan 06	126.60	118.60	139.30
Feb	127.50	119.80	139.60
Mar	125.80	118.50	137.50



A disaggregated picture of Kabul-based inflation during the last three years is presented in Table 1.4.

Table 1.4: Kabul-based Inflation

Year	Overall	Food	Non-Food	Rents	Fuel	Transportation
1382	10.10	11.89	7.27	9.42	15.13	13.70
1383	14.90	11.60	20.20	75.30	0.10	20.35
1384	9.49	6.18	14.39	24.81	25.07	7.81

These results imply the following:

1. There is a notable success in containing inflation in 1384 (i.e., 2005-06). Overall inflation rate came down to a single digit aided by deceleration in both – food as well as non-food inflation, as in the case of national CPI.
2. The deceleration in food price rise, as expected, was on account of the agriculture resuming its normal trend.

3. The deceleration in non-food price rise on the other hand, was on account of the deceleration in rents. Rents which have a weight of 6.8 per cent in the index, had risen phenomenally by 75.3 per cent in the year 1383, which had caused a spurt in that year's overall inflation rate. With the rents rising at a relatively moderate pace of 24.8 per cent in 1384, there was some favourable dampening effect on the non-food inflation. However, to some extent this was neutralized by the acceleration in fuel prices reflecting the oil price shock.

1.3 Medium Term Challenges

Table 1.5 presents details relating to consumption (private and Government), gross domestic savings, gross fixed investment and the resultant resource gap in Afghanistan for the last three years, 1381 (i.e., 2002-03) through 1383 (i.e., 2004-05)

Table 1.5: Saving – Investment Balance in Afghanistan (as % of GDP)

Items	1381(i.e., 2002-03)	1382 (i.e., 2003-04)	1383 (i.e., 2004-05)
1. Private Consumption	111.6	127.2	120.5
2. Government Consumption	8.5	8.1	9.8
3. Consumption (1+2)	120.1	135.3	130.3
4. Gross Domestic Savings [100-(3)]	-20.1	-35.3	-30.3
5. Gross Fixed Investment	13.3	15.8	20.2
Resource Gap [(4)-(5)]	-33.4	-51	-50.3
Memo Item GDP (Afs million, at current prices)	182,862	223,629	254,487

Source: Afghanistan Statistical Yearbook 2005

The Table reveals the following:

1. The average private consumption in Afghanistan over the three year period was as high as 119.8 per cent of GDP. The average Government consumption during the same period works out to around 8.8 per cent of GDP. Thus, the average

annual consumption expenditure in Afghanistan amounted to 128.6 per cent of GDP over the last three years.

2. In turn, this implies that the average gross domestic saving in Afghanistan over the three year period averaged (-28.6) per cent of GDP or dissaving of around 28.6 per cent of GDP per year.
3. Combined with the private fixed investment at an average annual rate over the three year period of around 16.4 per cent of GDP, this implies a resource gap as large as 45 per cent of GDP per year.
4. While the enlargement of private fixed investment from 13.3 per cent of GDP in 1381 (i.e., 2002-03) to around 20.2 per cent of GDP in 1383 (i.e., 2004-05) is symptomatic of growing confidence in re-building the economy, the resource gap in Afghanistan is exceptionally large in comparison with other developing countries. Illustratively, the resource gap as percentage of GDP was -1 per cent in Turkmenistan, +7 per cent in Uzbekistan, +2 per cent in Iran, 0 per cent in Pakistan and -3 per cent in India in recent years.

In sum, the prevailing economic structure in Afghanistan reflects a unique demand-driven, donor-funded paradigm which is understandable given the excessive damages inflicted by a prolonged war. Yet, this pattern cannot be sustained for too long. Over the medium term, this clearly underscores the imperative need for

- a. Boosting domestic savings for fostering private investment;
- b. Augmenting revenue collection for enlargement of public investment ,
and,
- c. Promoting the production of tradable goods and services (i.e., exports and import substitutes).

This would pave the way for consolidating the growth momentum achieved so far and for achieving self sustaining economic growth over the medium term, thereby improving the standard of living of the people in Afghanistan.

II - Monetary Policy and Market Operations

Monetary policy in Afghanistan has been focused on expanding money supply so as to facilitate rapid economic growth by meeting the desire of individuals to hold Afghani as cash balances while containing inflationary pressures and maintaining relative exchange rate stability. In view of the inadequate depth in financial markets, the DAB's monetary program is centred primarily on the sterilization of excess liquidity through weekly and more recently bi-weekly foreign exchange auctions.

2.1 Currency in Circulation

Currency in circulation (i.e., bank notes and coins issued minus cash holding in DAB vaults) is the main operating target for monetary policy in Afghanistan. Quarterly data on currency in circulation in Afghanistan are presented in Table 2.1 and Chart 2.1

Table 2.1 : Currency in Circulation, Monetary Base, and Forex Reserves

Period	Currency in Circulation (Million Afs)	Monetary Base (Million Afs)	Gross International Reserves (Million US Dollar)
Mar-03	20,676	20,676	426.1
Mar-04	28,801	31,124	815.9
Jun-04	30,172	31,759	950.2
Sep-04	35,054	36,015	1093.3
Dec-04	37,116	38,953	1285.1
Mar-05	38,763	41,063	1261.3
Jun-05	40,084	42,247	1345.8
Sep-05	42,997	44,538	1458.7
Dec-05	43,012	45,210	1581.7
Mar-06	44,028	49,541	1719.8

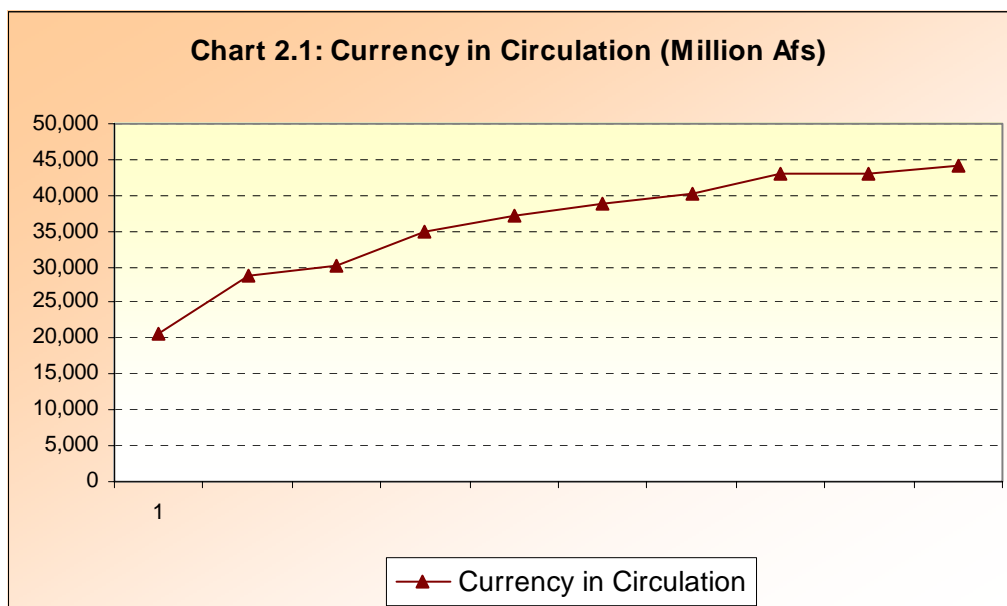


Chart 2.1 illustrates the actual movements of currency in circulation for the years 1382, 1383 and 1384. Throughout this period, the DAB has succeeded in holding the actual currency expansion well within the targets agreed with the IMF. Based on the target for real GDP growth of 14 per cent and projected inflation rate of 10 per cent, the monetary program for the year 1384 (i.e., 2005-06) was formulated. The year 1384 has also been marked by success in meeting the agreed target.

2.2 Monetary Base

Monetary base or Reserve Money, or Primary Liquidity as it is variously referred to comprise currency in circulation outside the central bank plus reserves of the commercial banking system plus commercial banks investment in central bank instruments including the capital notes. Quarterly data on monetary base in Afghanistan are also provided in Table 2.1.

As can be seen from the Table, at end 1382 (March 2003), currency in circulation was the same as the monetary base. With the re-emergence of the banking system and introduction of Capital Notes, a wedge has been driven between currency in circulation and Monetary Base, as was expected. In fact, currency in circulation as a proportion of Monetary Base has declined during the year 1384 (i.e., 2005-06) from 94.4 per cent at the beginnings of the year to 88.8 per cent by the end of the year. While this is symptomatic

of financial sector development, the prevailing dominance of currency in circulation in the Reserve Money (88.8 per cent at end -1384) implies continued validity of using the currency in circulation as the main operating target for monetary policy.

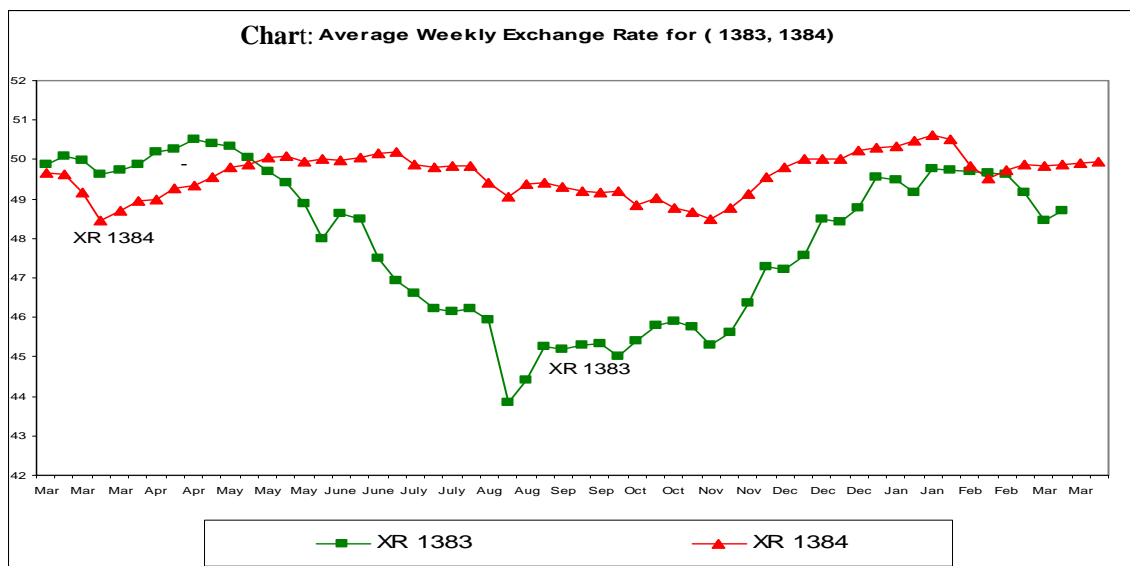
2.3 Foreign Exchange Reserves

Gross international reserves in Afghanistan have been rising steadily. During the year 1384 (i.e., 2005-06), the central bank added US dollars 459 million to its reserves, taking the level of the gross international reserves to around US\$1720 million. During the previous year, 1383 (i.e., 2004-05), the central bank had added US dollars 445 million to its reserves.

Interestingly, despite the steady expansion of currency in circulation, the ratio of gross international reserves to currency in circulation has constantly been above 100 per cent and has been rising in the recent years. In other words, the Afghani has been backed more than 100 per cent by foreign exchange reserves which is healthy.

2.4 Exchange Rate Movements

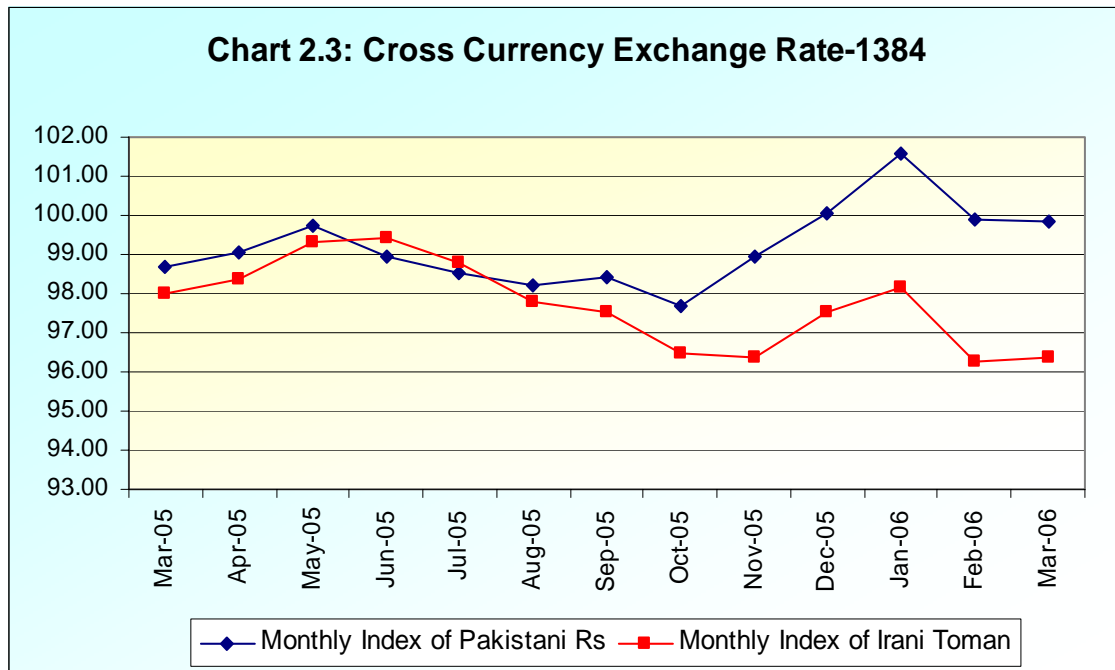
Chart 2.2 presents a snapshot of exchange rate movements in Afghanistan as measured by variations in bilateral exchange rate of Afghani *vis a vis* the US dollar (on weekly average basis) over the last two years.



It is evident from the Chart that the Afghani- US dollar exchange rate exhibited a remarkable degree of stability during the year 1384 (i.e., 2005-06) in comparison with the

preceding year. In the year 1383 (i.e., 2004-05), the Afghani appreciated quite sharply in the first half of the year (especially between April and August 2004), reaching the level of 44 Afs per US dollar. In the second half of the year, especially during November 2004 to January 2005, there was an equally sharp depreciation of the Afghani taking the Afghan-US dollar rate once again in the neighbourhood of Afs 50 per US dollar. In contrast, during the year 1384 (i.e., 2005-06), the Afghani generally moved in a narrow range between Afs 48 to Afs 50 per US dollar, occasionally exceeding the Afs 50 per US dollar level but only briefly.

Cross currency exchange rates of Afghani *vis a vis* Pakistani Rupee and Iranian Toman during the year 1384 are presented in Chart 2.3.



As can be seen from the Chart, Afghani’s exchange rate with both Pakistani Rupee as well as Iranian Toman has been fairly stable throughout the year 1384.

2.5 Foreign Exchange Auctions

With a view to maintain relative stability in the Afghani–US dollar rate, the DAB has adopted the policy of periodic intervention in the foreign exchange market in the form of

weekly foreign exchange auctions. These auctions are intended to smoothen the fluctuations in the exchange rate while modulating the monetary expansion on a trajectory consistent with policy targets in respect of inflation and economic growth.

Table 2.2 presents details of forex auctions conducted during the year 1384 (i.e., 2005-06).

Table 2.2: Foreign Exchange Auctions

Auction Date	Price Offered		Price Sold	Amount Awarded	No. of Awarded
	High	Low		in Million US \$	Bidders
28 March 05	49.10	48.80	49.10	10.00	39
4 April 05	48.80	48.48	48.80	10.00	25
11 April 05	49.35	49.00	49.35	8.00	40
19 April 05	49.37	49.20	49.37	5.00	42
24 April 05	49.38	49.18	49.38	5.00	42
2 May 05	49.80	49.50	49.80	8.00	49
9 May 05	49.98	49.75	49.98	10.00	21
16 May 05	50.02	49.20	49.95	7.85	33
23 May 05	49.80	49.70	49.80	12.00	45
30 May 05	49.90	49.50	49.90	12.00	34
6 June 05	50.00	49.65	50.00	12.00	34
13 June 05	50.19	50.00	50.15	12.00	40
20 June 05	50.09	49.90	50.09	12.00	29
27 June 05	50.20	50.03	50.20	12.00	50
4 July 05	49.96	49.80	49.96	12.00	20
11 July 05	50.00	49.75	49.92	10.00	21
18 July 05	49.80	49.60	49.80	9.75	30
24 July 05	49.83	49.45	49.77	10.55	30
31 July 05	49.70	49.50	49.63	9.40	28
7 August 05	48.95	48.45	48.92	8.25	18
14 August 05	49.27	49.00	49.22	6.25	21
21 August 05	49.42	49.22	49.37	9.60	26
28 August 05	49.35	49.22	49.29	11.85	36
4 September 05	49.12	48.95	49.10	11.05	20
11 September 05	49.17	49.05	49.13	11.45	27
19 September 05	49.17	49.05	49.14	11.80	30
25 September 05	49.27	49.17	49.24	12.25	31
2 October 05	48.88	48.65	48.80	10.65	30
9 October 05	48.90	48.13	48.77	5.55	12
16 October 05	48.94	48.67	48.88	9.75	29
23 October 05	48.85	48.45	48.64	8.65	28

29 October 05	48.53	48.10	48.40	7.25	24
7 November 05	48.50	48.38	48.46	2.85	8
13 November 05	49.14	48.80	49.08	9.95	24
20 November 05	49.33	49.20	49.31	7.70	21
27 November 05	49.87	49.60	49.80	13.20	29
4 December 05	50.15	49.70	50.05	10.55	20
11 December 05	50.07	49.92	50.03	12.60	24
18 December 05	50.07	49.90	50.05	12.20	26
25 December 05	50.20	49.90	50.15	10.50	25
1 January 06	50.40	50.22	50.34	13.60	32
15 January 06	50.45	50.20	50.31	11.20	29
21 January 06	50.65	50.40	50.60	13.15	29
29 January 06	50.70	50.50	50.64	12.30	31
5 February 06	49.97	49.80	49.90	7.10	22
11 February 06	49.27	49.00	49.27	3.50	14
14 February 06	49.45	49.25	49.42	6.60	12
19 February 06	49.75	49.00	49.61	7.20	18
21 February 06	49.74	49.55	49.70	6.20	15
25 February 06	49.92	49.70	49.86	9.85	24
28 February 06	50.00	49.70	49.84	5.45	14
4 March 06	50.05	49.70	49.86	5.50	20
7 March 06	49.86	49.70	49.83	8.00	24
11 March 06	49.86	49.50	49.83	6.50	18
14 March 06	49.91	49.70	49.88	6.15	15
18 March 06	50.14	49.50	50.06	11.10	28
Average rate and total dollar sales			49.60	524.85	

Source: Market Operations Department, DAB

As can be seen from the Table 2.2, 56 auctions were conducted during the year 1384 (i.e., 2005-06). (The weekly auctions were made bi-weekly with effect from February 2006). During the year 1384 (i.e., 2005-06), roughly US dollars 525 million were sold (i.e., around US dollar 9.4 million per auction on average). This aggregate amount was roughly 67.2 per cent of the currency in circulation at the beginning of the year. The average sale price of the US dollar in the course of these 56 auctions works out to Afs 49.6 per US dollar.

2.6 Capital Notes

The Da Afghanistan Bank (DAB) introduced a short term financial instrument in the form of Capital Notes with effect from September 19, 2004. The central bank has been auctioning Overnight Capital Notes (on a daily basis) and 30 day Capital Notes (on a weekly basis) to the commercial Banks.

Details of these auctions are presented in Appendix Tables A and B. During the year 1384 (i.e., 2005-06), Overnight Capital Notes for Afs 12,684 million were auctioned at weighted average rates ranging between 0.9 per cent to 2.67 per cent. During the same period, through 47 weekly auctions 30 Day Capital Notes for Afs 3,920 million were auctioned at weighted average rates ranging between 3.7 per cent to 6.16 per cent.

2.7 Reserve Requirements

On December 11, 2005, the Supreme Council of Da Afghanistan Bank adopted modifications to the reserve requirements for monetary policy purposes. The objective of the rule changes was to improve the effectiveness of the reserve requirement as a tool of monetary policy. The changes included the following:

1. The Afghani-denominated DAB capital note was eliminated from the list of eligible assets.
2. The existing requirement of 8 per cent was reaffirmed.
3. The penalties for non-compliance are clarified and strengthened.
4. DAB will begin paying interest on the amount of Afghani-denominated current account at DAB that is required to meet the 8 per cent minimum. No interest will be paid on excess reserves.

The elimination of capital notes from the definition of eligible assets is expected to improve the effectiveness of the capital notes as a tool of monetary policy by enabling them to be issued and withdrawn from the market as needed, in order to influence the aggregate amount of banking organizations' Afghani-denominated current account at DAB, and therefore the monetary base².

² The function of the Capital Note in this context is similar to that of government securities in more highly-developed financial markets, although the effect on the central bank's own balance sheet differs. When DAB sells a Capital Note to a banking organization, it debits the bank's current account at DAB and credits

DAB will also begin paying interest on required reserves (but not on excess reserves) by means of a formula to be announced by circular, and then retroactively crediting the appropriate amount to the banking organization's current account at DAB at the end of each reserve maintenance period.

Subsequently, on 8th January, 2006, a Supervisory Circular was issued by the DAB to banks along with the revised version of regulation, announcing penalties for non-compliance and late filing of required reports. The Supervisory Circular also pointed out the necessity for the banks of entering in to Supervisory Agreement with DAB on time table for coming into compliance within limited period of time.

Appendix Table A: Overnight Auctions

Date	Amount Awarded	Total Bid Received	Participants	Weighted Average
3/21/2005	50,000,000	100,000,000	2	1.00
3/22/2005	50,000,000	100,000,000	2	1.00
3/23/2005	50,000,000	111,000,000	3	1.00
3/24/2005	50,000,000	110,000,000	3	1.19
3/26/2005	50,000,000	50,000,000	1	1.20
3/27/2005	50,000,000	50,000,000	1	1.30
3/28/2005	50,000,000	50,000,000	1	1.30
3/29/2005	41,000,000	41,000,000	2	1.50
3/30/2005	39,000,000	39,000,000	2	1.50
3/31/2005	45,000,000	45,000,000	1	1.45
4/2/2005	50,000,000	50,000,000	1	1.50
4/3/2005	50,000,000	50,000,000	2	1.50
4/4/2005	50,000,000	50,000,000	1	1.60
4/5/2005	50,000,000	50,000,000	1	1.60
4/6/2005	50,000,000	50,000,000	1	1.70
4/7/2005	50,000,000	50,000,000	1	1.70
4/9/2005	50,000,000	50,000,000	1	1.70
4/10/2005	50,000,000	50,000,000	1	1.80
4/11/2005	50,000,000	50,000,000	1	1.80
4/12/2005	50,000,000	50,000,000	1	1.80
4/13/2005	35,000,000	35,000,000	1	1.90

Capital Notes (a liability of DAB). The monetary base declines. When a central bank sells a government security to a bank, it debits the bank's current account at DAB and credits its holdings of government securities (an asset of that central bank). The monetary base declines in this instance, too. These declines in the monetary base promote declines in the broader monetary aggregates, and in the supply of credit in the economy.

4/14/2005	50,000,000	50,000,000	1	1.90
4/16/2005	50,000,000	50,000,000	1	1.90
4/17/2005	50,000,000	110,000,000	3	1.60
4/18/2005	50,000,000	110,000,000	3	1.50
4/19/2005	50,000,000	50,000,000	1	1.60
4/20/2005	40,000,000	40,000,000	2	1.95
4/23/2005	35,000,000	35,000,000	1	1.80
4/24/2005	35,000,000	35,000,000	1	1.80
4/25/2005	50,000,000	50,000,000	1	1.90
4/26/2005	50,000,000	50,000,000	1	1.90
4/27/2005	50,000,000	59,000,000	2	1.90
4/30/2005	50,000,000	50,000,000	1	1.90
5/1/2005	50,000,000	50,000,000	1	2.00
5/2/2005	50,000,000	50,000,000	1	2.00
5/3/2005	50,000,000	50,000,000	1	2.00
5/4/2005	50,000,000	62,000,000	2	1.97
5/5/2005	50,000,000	62,000,000	2	1.97
5/7/2005	50,000,000	105,000,000	3	1.90
5/8/2005	50,000,000	68,000,000	3	1.97
5/9/2005	50,000,000	112,000,000	4	1.89
5/10/2005	50,000,000	110,000,000	4	1.96
5/11/2005	50,000,000	110,000,000	4	1.98
5/12/2005	50,000,000	94,000,000	3	1.90
5/14/2005	50,000,000	123,000,000	4	1.89
5/15/2005	50,000,000	123,000,000	4	1.90
5/16/2005	50,000,000	128,000,000	4	1.50
5/17/2005	50,000,000	127,000,000	4	1.57
5/18/2005	50,000,000	74,000,000	3	1.53
5/19/2005	50,000,000	77,000,000	3	1.49
5/21/2005	50,000,000	116,000,000	3	1.40
5/22/2005	50,000,000	78,000,000	3	1.44
5/23/2005	50,000,000	127,000,000	4	1.10
5/24/2005	50,000,000	112,000,000	3	1.05
5/25/2005	50,000,000	95,000,000	4	1.42
5/26/2005	50,000,000	134,000,000	5	1.17
5/28/2005	50,000,000	80,000,000	2	1.08
5/29/2005	50,000,000	262,000,000	4	1.07
5/30/2005	50,000,000	277,000,000	4	1.00
5/31/2005	50,000,000	70,000,000	3	1.00
6/1/2005	50,000,000	62,000,000	2	1.10
6/2/2005	50,000,000	74,000,000	3	1.05
6/4/2005	50,000,000	97,000,000	3	1.04
6/5/2005	50,000,000	219,000,000	4	0.99
6/6/2005	50,000,000	74,000,000	3	0.90
6/7/2005	50,000,000	72,000,000	3	0.98
6/8/2005	50,000,000	70,000,000	3	1.00
6/9/2005	50,000,000	60,000,000	2	1.00

6/11/2005	50,000,000	62,000,000	2	1.00
6/12/2005	50,000,000	60,000,000	2	1.00
6/13/2005	50,000,000	160,000,000	4	1.00
6/14/2005	50,000,000	165,000,000	4	1.00
6/15/2005	50,000,000	141,000,000	5	1.06
6/16/2005	50,000,000	91,000,000	3	1.04
6/18/2005	50,000,000	80,000,000	2	1.00
6/19/2005	50,000,000	80,000,000	2	0.90
6/20/2005	50,000,000	79,000,000	2	0.94
6/21/2005	50,000,000	129,000,000	3	0.94
6/22/2005	50,000,000	54,000,000	2	1.02
6/23/2005	50,000,000	10,000,000	1	1.00
6/25/2005	38,000,000	38,000,000	2	1.00
6/26/2005	50,000,000	129,000,000	4	1.00
6/27/2005	50,000,000	120,000,000	4	1.01
6/28/2005	50,000,000	91,000,000	3	1.01
6/29/2005	5,000,000	5,000,000	1	1.50
6/30/2005	4,000,000	4,000,000	1	1.10
7/2/2005	50,000,000	55,000,000	2	1.69
7/3/2005	4,000,000	4,000,000	1	1.20
7/4/2005	17,000,000	17,000,000	2	1.14
7/5/2005	18,000,000	18,000,000	2	1.07
7/7/2005	25,000,000	25,000,000	1	1.00
7/9/2005	50,000,000	58,000,000	2	1.00
7/10/2005	35,000,000	35,000,000	2	1.17
7/11/2005	25,000,000	25,000,000	2	1.24
7/12/2005	50,000,000	59,000,000	2	1.16
7/13/2005	35,000,000	35,000,000	2	1.43
7/14/2005	25,000,000	25,000,000	2	1.42
7/16/2005	30,000,000	30,000,000	2	1.45
7/17/2005	50,000,000	70,000,000	2	1.42
7/18/2005	50,000,000	69,000,000	2	1.40
7/19/2005	50,000,000	60,000,000	2	1.48
7/20/2005	25,000,000	25,000,000	2	1.49
7/21/2005	10,000,000	10,000,000	1	1.43
7/23/2005	50,000,000	87,000,000	2	1.27
7/24/2005	50,000,000	80,000,000	2	1.39
7/25/2005	50,000,000	85,000,000	2	1.30
7/26/2005	40,000,000	40,000,000	1	1.20
7/27/2005	22,000,000	22,000,000	2	1.43
7/28/2005	42,000,000	42,000,000	1	1.38
7/30/2005	38,000,000	38,000,000	2	1.40
7/31/2005	50,000,000	60,000,000	2	1.48
8/1/2005	50,000,000	50,000,000	2	1.58
8/2/2005	35,000,000	35,000,000	1	1.70
8/3/2005	30,000,000	30,000,000	2	1.60
8/4/2005	32,000,000	32,000,000	2	1.71

8/8/2005	32,000,000	32,000,000	2	1.64
8/9/2005	32,000,000	32,000,000	2	1.67
8/10/2005	31,000,000	31,000,000	2	1.71
8/11/2005	10,000,000	10,000,000	1	1.90
8/13/2005	50,000,000	79,000,000	2	1.82
8/14/2005	50,000,000	77,000,000	2	1.93
8/15/2005	50,000,000	80,000,000	2	1.88
8/16/2005	50,000,000	95,000,000	2	1.65
8/17/2005	50,000,000	75,000,000	2	1.75
8/18/2005	20,000,000	20,000,000	1	1.65
8/20/2005	50,000,000	70,000,000	2	1.99
8/21/2005	50,000,000	120,000,000	3	1.88
8/22/2005	50,000,000	118,000,000	3	1.93
8/23/2005	50,000,000	118,000,000	3	1.98
8/24/2005	50,000,000	45,000,000	2	1.88
8/25/2005	50,000,000	108,000,000	3	1.90
8/27/2005	50,000,000	108,000,000	3	1.92
8/28/2005	50,000,000	120,000,000	3	1.55
8/29/2005	50,000,000	120,000,000	3	1.50
8/30/2005	50,000,000	100,000,000	2	1.49
8/31/2005	50,000,000	20,000,000	1	1.55
9/1/2005	50,000,000	50,000,000	1	1.49
9/3/2005	50,000,000	100,000,000	3	1.50
9/4/2005	50,000,000	50,000,000	1	1.60
9/5/2005	50,000,000	108,000,000	3	1.54
9/6/2005	50,000,000	110,000,000	3	1.60
9/7/2005	15,000,000	15,000,000	1	1.57
9/8/2005	40,000,000	40,000,000	1	1.90
9/10/2005	50,000,000	40,000,000	1	2.10
9/11/2005	20,000,000	20,000,000	1	2.20
9/12/2005	37,000,000	37,000,000	2	2.13
9/13/2005	50,000,000	65,000,000	2	2.67
9/14/2005	10,000,000	10,000,000	1	3.00
9/15/2005	50,000,000	75,000,000	3	1.86
9/17/2005	50,000,000	106,000,000	2	1.90
9/19/2005	50,000,000	130,000,000	3	1.92
9/20/2005	50,000,000	97,000,000	2	1.87
9/21/2005	27,000,000	27,000,000	3	1.70
9/22/2005	50,000,000	80,000,000	3	1.72
9/24/2005	50,000,000	75,000,000	2	1.79
9/25/2005	50,000,000	83,000,000	2	1.74
9/26/2005	50,000,000	50,000,000	1	1.69
9/27/2005	50,000,000	70,000,000	2	1.72
9/28/2005	25,000,000	25,000,000	2	1.72
9/29/2005	45,000,000	45,000,000	2	1.70
10/1/2005	50,000,000	70,000,000	2	1.69
10/2/2005	50,000,000	80,000,000	2	1.68

10/3/2005	50,000,000	62,000,000	2	1.70
10/5/2005	50,000,000	60,000,000	2	1.67
10/6/2005	25,000,000	25,000,000	2	1.54
10/8/2005	50,000,000	65,000,000	2	1.58
10/9/2005	50,000,000	75,000,000	3	1.39
10/10/2005	50,000,000	76,000,000	3	1.28
10/11/2005	50,000,000	88,000,000	3	1.45
10/12/2005	50,000,000	58,000,000	2	1.54
10/13/2005	50,000,000	70,000,000	3	1.36
10/15/2005	50,000,000	52,000,000	3	1.52
10/16/2005	50,000,000	51,000,000	3	1.43
10/17/2005	40,000,000	40,000,000	2	1.50
10/18/2005	32,000,000	32,000,000	2	1.53
10/20/2005	27,000,000	27,000,000	2	1.58
10/24/2005	42,000,000	42,000,000	2	1.67
10/25/2005	50,000,000	50,000,000	2	1.68
10/26/2005	8,000,000	8,000,000	1	1.80
10/27/2005	15,000,000	15,000,000	1	1.80
10/29/2005	50,000,000	65,000,000	2	1.74
10/30/2005	40,000,000	40,000,000	1	1.80
10/31/2005	35,000,000	35,000,000	1	1.90
11/1/2005	43,000,000	43,000,000	1	2.00
11/2/2005	7,000,000	7,000,000	1	2.00
11/7/2005	50,000,000	50,000,000	1	2.00
11/8/2005	50,000,000	50,000,000	1	2.00
11/9/2005	32,000,000	32,000,000	2	1.88
11/10/2005	50,000,000	65,000,000	2	1.62
11/12/2005	30,000,000	30,000,000	1	2.00
11/13/2005	50,000,000	112,000,000	2	1.95
11/14/2005	50,000,000	110,000,000	2	1.50
11/15/2005	50,000,000	142,000,000	2	1.43
11/16/2005	50,000,000	105,000,000	2	1.40
11/17/2005	50,000,000	100,000,000	2	1.40
11/18/2005	50,000,000	100,000,000	2	1.40
11/19/2005	50,000,000	100,000,000	2	1.40
11/20/2005	50,000,000	100,000,000	2	1.40
11/21/2005	50,000,000	100,000,000	2	1.20
11/22/2005	50,000,000	100,000,000	2	1.20
11/23/2005	15,000,000	15,000,000	1	1.25
11/24/2005	9,000,000	9,000,000	1	1.50
11/26/2005	9,000,000	9,000,000	1	1.50
11/27/2005	3,000,000	3,000,000	1	2.00
11/30/2005	35,000,000	35,000,000	2	1.55
12/1/2005	17,000,000	17,000,000	1	1.90
12/3/2005	17,000,000	17,000,000	1	1.90
12/4/2005	50,000,000	50,000,000	1	1.90
12/5/2005	50,000,000	50,000,000	1	1.90

12/6/2005	50,000,000	90,000,000	2	1.69
12/8/2005	16,000,000	16,000,000	1	1.99
12/10/2005	50,000,000	70,000,000	2	1.65
12/11/2005	50,000,000	85,000,000	2	1.82
12/12/2005	50,000,000	75,000,000	2	1.75
12/13/2005	50,000,000	85,000,000	2	1.82
12/14/2005	50,000,000	50,000,000	1	1.85
12/15/2005	50,000,000	70,000,000	2	1.90
12/17/2005	50,000,000	76,000,000	2	1.84
12/18/2005	50,000,000	80,000,000	2	1.75
12/20/2005	50,000,000	85,000,000	2	1.75
12/21/2005	5,000,000	5,000,000	1	1.50
12/22/2005	50,000,000	50,000,000	2	1.50
12/24/2005	50,000,000	50,000,000	1	1.50
12/25/2005	30,000,000	30,000,000	1	1.70
12/26/2005	50,000,000	50,000,000	1	1.80
12/27/2005	50,000,000	100,000,000	2	1.50
12/28/2005	50,000,000	90,000,000	2	1.52
12/29/2005	50,000,000	50,000,000	1	1.60
12/31/2005	50,000,000	50,000,000	1	1.60
1/1/2006	50,000,000	70,000,000	2	1.70
1/2/2006	50,000,000	100,000,000	2	1.56
1/3/2006	50,000,000	70,000,000	2	1.62
1/4/2006	50,000,000	100,000,000	1	1.50
1/5/2006	50,000,000	70,000,000	1	1.70
1/8/2006	50,000,000	80,000,000	2	1.50
1/14/2006	20,000,000	20,000,000	1	1.50
1/15/2006	20,000,000	20,000,000	2	1.45
1/16/2006	50,000,000	100,000,000	2	1.50
1/17/2006	50,000,000	100,000,000	1	1.40
1/18/2006	50,000,000	50,000,000	2	1.32
1/19/2006	50,000,000	70,000,000	2	1.32
1/21/2006	50,000,000	70,000,000	2	1.30
1/22/2006	50,000,000	100,000,000	2	1.00
1/23/2006	50,000,000	100,000,000	2	0.99
1/24/2006	50,000,000	50,000,000	1	0.99
1/25/2006	10,000,000	10,000,000	1	1.00
1/26/2006	50,000,000	50,000,000	1	1.00
1/28/2006	50,000,000	50,000,000	1	1.00
1/29/2006	50,000,000	100,000,000	2	0.99
1/30/2006	50,000,000	50,000,000	1	1.00
1/31/2006	50,000,000	50,000,000	1	1.00
2/1/2006	50,000,000	90,000,000	2	1.00
2/2/2006	50,000,000	80,000,000	2	1.15
2/4/2006	50,000,000	95,000,000	2	1.01
2/5/2006	50,000,000	80,000,000	2	1.08
2/6/2006	30,000,000	30,000,000	1	1.20

2/7/2006	30,000,000	30,000,000	1	1.30
2/8/2006	10,000,000	10,000,000	1	1.40
2/11/2006	44,000,000	44,000,000	1	1.40
2/12/2006	50,000,000	50,000,000	1	1.50
2/13/2006	50,000,000	80,000,000	2	1.38
2/14/2006	50,000,000	50,000,000	1	1.30
2/15/2006	50,000,000	50,000,000	2	1.25
2/16/2006	50,000,000	100,000,000	3	1.20
2/18/2006	50,000,000	100,000,000	3	1.75
2/19/2006	50,000,000	130,000,000	4	1.13
2/20/2006	50,000,000	100,000,000	2	1.12
2/21/2006	50,000,000	100,000,000	2	1.00
2/22/2006	20,000,000	20,000,000	1	1.00
2/23/2006	20,000,000	20,000,000	1	1.20
2/25/2006	45,000,000	45,000,000	1	1.20
2/27/2006	50,000,000	100,000,000	3	1.31
2/28/2006	50,000,000	85,000,000	3	1.31
3/1/2006	34,000,000	34,000,000	2	1.30
3/2/2006	50,000,000	72,000,000	4	0.98
3/4/2006	50,000,000	115,000,000	4	1.22
3/5/2006	50,000,000	65,000,000	2	1.00
3/6/2006	50,000,000	70,000,000	2	1.00
3/7/2006	50,000,000	90,000,000	4	0.99
3/8/2006	50,000,000	65,000,000	2	1.00
3/9/2006	50,000,000	50,000,000	1	1.00
3/11/2006	50,000,000	50,000,000	1	1.00
3/12/2006	50,000,000	50,000,000	1	1.00
3/13/2006	50,000,000	50,000,000	1	1.00
3/14/2006	50,000,000	50,000,000	1	1.00
3/15/2006	20,000,000	20,000,000	1	1.00
3/16/2006	50,000,000	50,000,000	2	1.79
3/18/2006	50,000,000	90,000,000	2	1.50
3/19/2006	50,000,000	90,000,000	2	1.40
3/20/2006	50,000,000	100,000,000	2	1.00
	12,684,000,000			1.49

Appendix Table B: 30 day Note Auctions

3/23/2005	100,000,000	100,000,000	1	5.00
4/6/2005	90,000,000	90,000,000	2	5.00
4/13/2005	125,000,000	150,000,000	2	5.02
4/20/2005	125,000,000	130,000,000	2	5.01
4/27/2005	70,000,000	70,000,000	1	6.00
5/4/2005	50,000,000	50,000,000	2	5.60
5/18/2005	125,000,000	200,000,000	3	5.76
5/25/2005	125,000,000	310,000,000	3	5.02
6/1/2005	125,000,000	235,000,000	4	4.80
6/8/2005	125,000,000	175,000,000	3	5.39
6/15/2005	90,000,000	90,000,000	3	5.54
6/22/2005	125,000,000	120,000,000	3	5.68
6/29/2005	45,000,000	45,000,000	2	5.78
7/6/2005	125,000,000	200,000,000	2	5.20
7/13/2005	125,000,000	260,000,000	3	5.00
7/20/2005	100,000,000	100,000,000	2	5.10
7/27/2005	40,000,000	40,000,000	2	5.80
8/3/2005	80,000,000	80,000,000	2	4.94
8/10/2005	100,000,000	100,000,000	1	5.10
8/17/2005	25,000,000	25,000,000	1	5.00
8/24/2005	30,000,000	30,000,000	1	5.99
8/31/2005	50,000,000	50,000,000	1	6.00
9/7/2005	50,000,000	50,000,000	2	6.08
9/14/2005	125,000,000	330,000,000	4	4.00
9/21/2005	125,000,000	180,000,000	4	4.90
9/28/2005	60,000,000	60,000,000	1	4.20
10/5/2005	45,000,000	45,000,000	1	4.30
10/12/2005	70,000,000	70,000,000	2	4.26
10/26/2005	125,000,000	125,000,000	2	5.28
11/2/2005	40,000,000	40,000,000	1	6.00
11/9/2005	50,000,000	50,000,000	2	6.16
11/23/2005	50,000,000	50,000,000	1	5.80
12/7/2005	50,000,000	50,000,000	1	6.00
12/14/2005	30,000,000	30,000,000	1	6.00
12/21/2005	30,000,000	30,000,000	1	6.00
12/28/2005	50,000,000	50,000,000	1	6.00
1/4/2006	125,000,000	125,000,000	3	4.50
1/18/2006	125,000,000	125,000,000	3	5.76
1/25/2006	115,000,000	115,000,000	2	4.40
2/1/2006	110,000,000	110,000,000	1	4.99
2/8/2006	125,000,000	200,000,000	1	6.00
2/15/2006	125,000,000	180,000,000	2	4.90
2/22/2006	125,000,000	140,000,000	2	5.50
3/1/2006	50,000,000	50,000,000	2	3.70
3/8/2006	125,000,000	125,000,000	1	6.00
3,920,000,000				5.30

III - Financial Sector Developments

3.1 Banking Sector

Following over two decades of war which ended in December 2001, Afghanistan has made considerable progress in rebuilding its social and economic infrastructure. A critical component of this reconstruction and reform efforts relate to the financial sector in general and the banking system in particular.

Afghanistan had virtually no functioning banking sector until 2002. Two commercial banks and four specialized banks did exist, but only on paper. In fact, the Taliban regime had explicitly prohibited even basic banking facilities interest payment on saving accounts, such as deposit and loans. Not surprisingly, several competing currencies circulated. After the fall of Taliban, the new Government took the historic step of introducing a new currency i.e. “The new Afghani” as the legal tender throughout the country. The central bank of the country i.e. Da Afghanistan Bank (DAB) successfully managed the conversion of the old Afghani into new Afghani at the rate of 1000:1 according to the Presidential Decree. Subsequently, the adoption of the central bank law (i.e., Da Afghanistan Bank Law) and Banking law (i.e., Law on Banking in Afghanistan) paved the way for re-emergence of the banking system. Under the set of regulations for banking licence/ permits, duly approved by the Supreme Council of DAB, a number of commercial banks have now become functional.

Size and Composition of the banking system

The banking system in Afghanistan comprises three broad groups:

- (a) State-owned Banks.
- (b) Private Banks³, and
- (c) Branches of Foreign Banks.

There are three State-owned Banks (i.e., Bank Millie Afghanistan, Pashtany Tejaraty Bank and Export Promotion Bank). In addition there are four Private Sector Banks (i.e., Kabul Bank, Afghanistan International Bank, First Microfinance Bank and Arian Bank). Finally there are branches of five Foreign Banks i.e., Standard

³ These are full-fledged banks with the participation of foreign capital.

Chartered Bank, Punjab National Bank, National Bank of Pakistan, Habib Bank Ltd and Bank Alfalah Ltd.

Latest available data on the size and composition of Afghan banking system are presented in Tables 3.1.

Table 3.1: Afghanistan Banking System-Size and Composition (Afs million)

Bank Group	End-1383	End Q1-1384	End Q2-1384	End Q3-1384
State-owned Banks	10,515.1 (54.4)	11,133.7 (49.3)	11,407.0 (46.4)	11,674.0 (40.3)
Private Banks	4,051.1 (21.0)	5,708.4 (25.3)	7,639.0 (31.1)	10,763.0 (37.2)
Branches of Foreign Banks	4,736.2 (24.6)	5,730.2 (25.4)	5,527.0 (22.5)	6,548.0 (22.5)
Total	19,302.4 (100.0)	22,572.3 (100.0)	24,573.0 (100.0)	28,985.0 (100.0)

Several observations are in order here:

1. The overall size of the Afghan banking system is still very small. Illustratively, the total assets of the banking system placed at around Afs 29 billion at the end of third quarter of 1384 (i.e. December 2005) as a percentage of nominal GDP for the year 1383 (i.e. 2004-05) estimated at around Afs 254 billion was only about 8.8 per cent. The banking assets to GDP ratio in India is as high a 69 per cent whereas for the European Union as a whole it is around 230 per cent!

The low banking assets to the GDP ratio in Afghanistan is not surprising given the fact that Afghanistan is a late starter on economic reforms. For several former communist countries which embarked on economic reforms in the 1990s, the banking assets to GDP ratio is in the low 30s. While the limited depth of financial intermediation in Afghanistan is understandable, it also shows that the Afghanistan banking system has a long way to go.

2. While the size of Afghan Banking System is still small, the picture is changing rapidly. It is important to note that the size of the Afghan Banking system expanded during the first three quarters of 1384 from Afs 19.3 billion to AFS 29 billion-a rise

of over 50 per cent in nine months yielding an annualized rate of around 66 per cent, which is certainly most encouraging.

3. While the Afghan banking system continues to be dominated by the State-owned Banks as a group, the Private Sector Banks are catching up very fast. At the end of year 1383, the share of the State-owned Banks in the assets of the overall banking system was as high as 54.5 per cent. During the three quarters of the year 1384 however, this share has steadily declined reaching 40.3 per cent at end Q3, 1384 (i.e. December 2005). Over the same period, Private Banks gained at the expense of the State-owned Banks with their share increasing from 21 per cent at end 1383 to as much as 37.2 per cent at the end Q3, 1384. The share of Branches of Foreign Banks during this period fluctuated between 22 to 25 per cent.

Consolidated Balance Sheet of the Banking System

The evolution of the consolidated Balance Sheet of the Banking System in Afghanistan covering the period end-1383 (i.e., March 2005) through end Q3, 1384 (i.e., December 2005) is presented in Table 3.2

Table 3.2: Consolidated Balance Sheet of Afghan Banks (Afs millions)

A	Liabilities	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Capital	8,883.4	9,418.6	9,370.0	9,579.0
2	Deposits				
	Afghani	1,860.3	2,080.0	2,350.0	2,865.0
	US Dollar	6,641.4	9,267.0	10,405.0	12,556.0
	Other Currencies	593.4	615.0	682.0	803.0
	Subtotal Deposits	9,095.1	11,962.0	13,437.0	16,224.0
3	Borrowings	82.6	84.9	140.0	105.0
4	Other Liabilities				
	excluding interest payable				
	Afghani	228.3	153.4	444.0	784.0
	US Dollar	454.0	651.8	595.0	1,703.0
	Other Currencies	56.0	44.0	30.0	30.0
	Subtotal	738.3	849.2	1,069.0	2,517.0
5	Other Liabilities	503.0	267.7	557.0	560.0
	Capital plus Liabilities	19,302.4	22,582.4	24,573.0	28,985.0

B	Assets	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Cash in Vault and claims on DAB	3,031.0	3,437.4	3,284.0	4,087.0
2	Claims on Financial Institutions				
	Afghani	9.0	10.0	10.0	19.0
	US Dollar	6,334.0	6,409.0	7,988.0	7,432.0
	Other Currencies	1,236.0	1,162.0	1,289.0	1,320.0
	Subtotal	7,579.0	7,581.0	9,287.0	8,771.0
3	Investments	785.0	983.5	735.0	738.0
4	Loans				
	Afghani	673.0	821.5	998.0	1,108.0
	US Dollar	2,264.0	3,463.3	4,574.0	5,912.0
	Other Currencies	0.0	0.0	0.0	0.0
	Subtotal	2,937.0	4,284.8	5,572.0	7,020.0
	Less Loan Loss Reserves	72.0	103.5	128.0	168.0
	Net Loans	2,865.0	4,181.3	5,444.0	6,852.0
5	Other Assets	5,042.4	6,399.2	5,823.0	8,537.0
	Total Assets	19,302.4	22,582.4	24,573.0	28,985.0

Analyzing these balance sheets, several observations can be made:

1. On the liabilities side, other than capital, the most prominent component is deposits. At end Q3-1384, deposits constituted 56 per cent of total size of the balance sheet (i.e., total assets or total liabilities plus capital). In fact, the share of deposits in total size of the Consolidated Balance Sheets of the Banking System has steadily grown from 47.1 per cent at end 1383 to 53 per cent at end Q1, 1384 and 54.7 per cent at end Q2, 1384 before peaking at 56 per cent by end Q3-1384.

2. Within the category of deposits, the most dominant ones are deposits denominated in US dollars. At end-1383, the proportion of US dollar denominated deposits was as high as 73 per cent of total deposits. In the first three quarters of the year 1384, the proportion of US dollar denominated deposits stabilized at even higher level around 77.4 per cent of total deposits. As far as the Afghani denominated deposits are concerned, their proportion in total deposits at the end of the year 1383 was relatively small at 20.5 per cent. During the course of the year 1384, so far, the proportion of Afghani deposits in the total appears to have stabilized at even lower level of around 17.5 per cent. These facts are contrary to the expectation of “Afghanization”.

3. On the asset side of the Consolidated Balance Sheet of the Banking System there are two important components: Loans and Claims on Financial Institutions (i.e., inter-bank deposits).

Loans

At the end Q3, 1384, loans (net of loan loss reserves) at Afs 6.85 billion constituted 23.6 per cent of the total size of the Consolidated Balance Sheet of the Banking System. Notably, an increasing trend in the share of loans to total assets/ liabilities is clearly discernible. In fact, the share of loans in the total size of the Consolidated Balance Sheet of the Banking System which was only 14.8 per cent at the end-1383 rose steadily through the three quarters of 1384 (i.e., 18.5 per cent, 22.1 per cent and 23.6 per cent, respectively).

It may be noted however, that the bulk of these loans are made in US dollars rather than in Afghani. For example, at end Q3, 1384 (i.e., December 2005), for the Banking System as a whole, as much as 84.2 per cent of loans were denominated in the US dollar while the remaining 15.8 per cent of loans were extended in Afghani. Even more disturbing is the fact that the proportion of loans denominated in US dollar has actually increased in the last nine months - from 77.1 at end-1383 to 81.8 per cent at end Q1, 1384, 83.1 per cent at end Q2, 384 and finally to 84.2 per cent at end Q3, 1384. This again is against the expectation of “Afghanization”.

Inter-Bank Deposits

Claims on Financial Institutions (which are primarily inter-bank deposits), are mainly in US dollars or in other foreign currencies and not in Afghani.

At end Q3, 1384 (i.e., December 2005), inter-bank deposits of the Consolidated Banking System at Afs 8.8 billion were around 30.3 per cent of the total size of the Banking System. As much as 84.7 per cent of such deposits were denominated in the US dollars.

Consolidated Banking Sheets of Bank Groups

Consolidated balance sheets of the three banking groups viz, State-owned Banks, Private Banks and Branches of Foreign Banks are presented in Tables 3.3, 3.4 and 3.5.

Table 3.3: Consolidated Balance Sheet of State - owned Banks
(Afs Millions)

A	Liabilities	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Capital	7,598.5	8,035.4	7,931.0	7,949.0
2	Deposits				
	Afghani	1,601.4	1,785.2	1,853.0	2,035.0
	US Dollar	634.5	675.1	767.0	781.0
	Other Currencies	108.5	104.4	101.0	80.0
	Subtotal Deposits	2,344.4	2,564.7	2,721.0	2,896.0
3	Borrowings	82.6	85.0	84.0	85.0
4	Other Liabilities				
	excluding Interest Payable				
	Afghani	131.4	100.5	334.0	332.0
	US Dollar	329.0	326.1	314.0	383.0
	Other Currencies	11.6	9.9	9.0	9.0
	Subtotal	472.0	436.5	657.0	724.0
5	Other Liabilities	17.5	12.2	14.0	18.0
	Other Capital plus Liabilities	10,515.0	11,133.8	11,407.0	11,672.0

B	Assets	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Cash in vault and Claims on DAB	1,469.8	1,526.9	1,243.0	1,184.0
2	Claims on Financial Institutions				
	Afghani	9.8	9.9	10.0	9.0
	US Dollar	3,533.6	3,959.0	4,219.0	4,134.0
	Other Currencies	959.2	886.4	942.0	914.0
	Sub Total	4,502.6	4,855.3	5,171.0	5,057.0
3	Investments	784.9	983.5	734.0	737.0
4	Loans				
	Afghani	641.6	775.5	945.0	995.0
	US Dollar	474.4	518.1	706.0	857.0
	Other Currencies	0.0	0.0	0.0	0.0
	Subtotal	1,116.0	1,293.6	1,651.0	1,852.0
	Less Loan Loss Reserves	64.6	60.3	63.0	77.0
	Net Loans	1,051.4	1,233.3	1,588.0	1,775.0
5	Other Assets	2,706.3	2,534.8	2,671.0	2,919.0
	Total Assets	10,515.0	11,133.8	11,407.0	11,672.0

Table 3.4: Consolidated Balance Sheet of Private Banks

(Afs millions)

A	Liabilities	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Capital	1,285.0	1,383.2	1,439.0	1,629.0
2	Deposits				
	Afghani	137.5	137.5	288.0	582.0
	US Dollar	2,087.1	3,581.7	5,267.0	6,551.0
	Other Currencies	308.8	279.2	300.0	328.0
	Subtotal Deposits	2,533.4	3,998.4	5,855.0	7,461.0
3	Borrowings	0.0	0.0	56.0	20.0
4	Other Liabilities				
	excluding interest payable				
	Afghani	86.7	15.2	54.0	393.0
	US Dollar	101.5	287.6	215.0	1,240.0
	Other Currencies	44.5	33.8	20.0	21.0
	Subtotal	232.7	336.6	289.0	1,654.0
5	Other Liabilities	0.0	0.0	0.0	0.0
	Capital plus Liabilities	4,051.1	5,718.2	7,639.0	10,764.0

B	Assets	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Cash in Vault and claims on DAB	787.4	782.8	886.0	1,500.0
2	Claims on Financial Institutions				
	Afghani	0.0	0.0	0.0	10.0
	US Dollar	1,235.8	1,732.2	2,904.0	2,176.0
	Other Currencies	275.6	274.0	346.0	393.0
	Subtotal	1,511.4	2,006.2	3,250.0	2,579.0
3	Investments	0.0	0.0	0.0	0.0
4	Loans				
	Afghani	31.80	46.00	53.00	108.00
	US Dollar	1521.10	2,595.10	3,065.00	4,719.00
	Other Currencies	0.0	0.0	0.0	0.0
	Subtotal	1,552.9	2,641.1	3,118.0	4,827.0
	Less Loan Loss Reserves	1.0	37.0	57.0	90.0
	Net Loans	1,551.9	2,604.1	3,061.0	4,737.0
5	Other Assets	200.4	325.1	442.0	1,948.0
	Total Assets	4,051.1	5,718.2	7,639.0	10,764.0

Table 3.5: Consolidated Balance Sheet of Branches of Foreign Banks (Afs millions)

A	Liabilities	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Capital *	0.0	0.0	0.0	0.0
2	Deposits				
	Afghani	121.4	157.2	210.0	248.0
	US Dollar	3,919.8	5,010.0	4,371.0	5,223.0
	Other Currencies	176.1	231.8	280.5	394.7
	Subtotal Deposits	4,217.3	5,399.0	4,861.5	5,865.7
3	Borrowings	0.0	0.0	0.0	0.0
4	Other Liabilities				
	excluding Interest Payable				
	Afghani	10.2	37.8	56.0	59.0
	US Dollar	23.5	38.0	65.0	81.0
	Other Currencies	0.0	0.4	0.0	0.0
	Subtotal	33.7	76.2	121.0	140.0
5	Other Liabilities	485.3	255.0	544.2	539.0
	Capital plus Liabilities	4,736.3	5,730.2	5,526.7	6,544.7

B	Assets	End-1383	End Q1, 1384	End Q2, 1384	End Q3, 1384
1	Cash in vault and Claims on DAB	775.5	1,127.8	1,154.0	1,403.0
2	Claims on Financial Institutions				
	Afghani	0.0	0.0	0.1	0.0
	US Dollar	1,564.3	718.1	866.0	1,121.0
	Other Currencies	1.0	1.9	0.4	14.0
	Subtotal	1,565.3	720.0	866.5	1,135.0
3	Investments	0.0	0.0	0.0	0.0
	Loans				
	Afghani	0.08	0.05	0.10	5.00
	US Dollar	267.9	350.1	804.0	336.0
	Other Currencies	0.04	0.03	0.08	0.00
	Subtotal	268.0	350.2	804.2	341.0
	Less Loan Loss Reserves	6.00	6.10	6.02	2.00
	Net Loans	262.00	344.08	798.20	339.00
5	Other Assets	2,133.50	3,538.32	2,708.00	3,667.70
	Total	4,736.30	5,730.20	5,526.70	6,544.70

* Branches of Foreign Banks have no capital of their own.

Analyses of these balance sheets reveal the following salient features:

Deposits

The deposit base of the State-owned Banks is mainly Afghani whereas the deposit base of Private Banks and Branches of Foreign Banks is mainly the US dollar. For example, at end Q3, 1384 (i.e., December, 2005), 70.2 per cent of deposits in the State-owned Banks were denominated in Afghani whereas only 27 per cent of their deposits were denominated in the US dollars. In contrast, in respect of Private Banks, only 7.8 per cent deposits were denominated in Afghani while 87.8 per cent of deposits were denominated in the US dollars.

The absence of “Afghanization” is even more pronounced in Branches of Foreign Banks where Afghani-denominated deposits constituted barely 4.2 per cent of deposits at end Q3, 1384 whereas 89 per cent of deposits were denominated in the US dollar. A similar pattern prevailed throughout the nine months period from end-1383 through end Q3, 1384.

Loans

As far as loans are concerned, the US dollar denominated portion is quite striking. Even for the State-owned Banks wherein only 27 per cent of deposit base was denominated in the US dollar at end Q3, 1384, 46.3 per cent of the loans were denominated in the US dollar. The proportions of US dollars denomination were phenomenally higher in other banks 97.8 per cent in respect of Private Banks and as much as 98.5 per cent in respect of Branches of Foreign Banks.

Banking Operations

A. Credit-Deposit Ratios

Credit-deposit ratios for Afghan Banking system as whole, as well as separately for the Bank-Groups during the period, end-1383 through end Q3, 1384 are presented in Table 3.6.

Following salient features are revealed:

1. Credit- deposit ratio⁴ for the banking system as a whole is quite low by international standards which are understandable given the nascent stage of development of the financial sector in Afghanistan. It is noteworthy however that credit-deposit ratio has increased quite sharply in the last nine months from 30.7 per cent at end-1383 to as much as 43.3 per cent by end Q3, 1384. This is symptomatic of the growing reach of the banking system.

Table 3.6: Credit – Deposit Ratios (Per cent)

Banking-Group		End-1383	End Q3 1384
1	State-owned Banks	42.1	63.9
2	Private Banks	61.2	64.7
3	Branches of Foreign Banks	6.1	5.8
Banking System		30.7	43.3

2. Disaggregated analysis by the Bank Groups shows that the overall credit-deposit ratio for the banking system is being held down by an exceedingly poor performance of Branches of Foreign Banks in extending credit. In fact, the credit –deposit ratio for the foreign Banks has been as low as around 6 per cent throughout the course of the year 1384,so far.
3. Credit- ratios of the State-owned Banks and Private Banks at around 64 per cent by end Q3, 1384 are quite impressive. What is even more striking is the fact that there has been a significant improvement in the credit-deposit ratio of the State-owned Banks—from 42.1 per cent at end-1983 to 63.9 per cent by end Q3, 1384 which is comforting.

B. Liquidity of Bank Assets

Liquid assets to bank assets for the Afghan banking system as a whole, as well as separately for the Bank Groups during the period, end-1383 through end Q3, 1384 are presented in Table 3.7. It turns out that all individual Bank-Groups as well as the banking

⁴ Credit-deposit ratio of banks essentially reflects the extent of financial intermediation in terms of credit extended in relation to their deposit liabilities.

system as a whole is highly liquid by international standards. This indicates reluctance on the part of Bank-Groups towards commercial lending operations. Fortunately, there is a welcome decline in liquidity of all bank-groups during the year 1384 which signifies growing willingness towards commercial lending.

Table3.7: Liquid Assets to Total Assets Ratio (Per cent)

Banking-Group		End-1383	End Q3 1384
1	State-owned Banks	56.8	53.5
2	Private Banks	38.8	37.9
3	Branches of Foreign Banks	49.4	38.8
Banking System		54.3	44.3

Note: Liquid assets include highly liquid assets such as cash in vault, balances in current account with DAB, and holdings of DAB capital notes besides other liquid assets such as claims on financial institutions.

C. Financial Soundness

Capital

The Afghan banking system is well capitalized. Branches of Foreign Banks do not have separate capital. For the other two Bank-Groups i.e, State-owned Banks and Private Banks, the combined capital at end 1383 was around Afs 8.9 billion which rose during the year 1384 to reach Afs 9.6 billion by end Q3, 1384. Going by the internationally accepted norm of capital / assets ratio of 20 per cent, the capital stock of Afs 9.6 billion at end Q3, 1384 could have supported total assets of Afs 48 billion whereas the actual stock of assets of these Bank-Groups at that point of time was around Afs 22.7 billion only, signifying healthy capitalization.

Asset Quality

Asset quality of loan portfolio is measured typically by the incidence of non-performing loans (NPL), defined generally as the sum of loans past due, 91 days or more.

The asset quality of the loan portfolio of Afghan banks may be deemed to be quite satisfactory. Until Q2, 1384 the NPLs of the Afghan banking system were below 2.5 per cent of gross loans. In the latest quarter i.e, Q3 1384 however, the NPL ratio deteriorated

to 6.5 per cent of gross loans. By international standards, even at the currently elevated level of 6.5 per cent, NPLs in the Afghan banking system remain satisfactory.

Profitability

The Afghan banking system has consistently been profitable in the recent past. In fact, the annualized return on assets (ROA) in the Afghan banking system ranged between 2.2 per cent to 2.9 per cent during the course of three quarters of the year 1384 which compares well with the prevailing international evidence-India (1.2 per cent), Malaysia (1.4 per cent), Thailand (1.3 per cent), Brazil (1.8 per cent), and Mexico (1.5 per cent) in 2004.

Risk Management

The Afghan banking system is on a learning curve as far as sophisticated risk management techniques and mechanisms are concerned. A specific cause of concern there is the foreign exchange risk. Accordingly to DAB regulations, the overall long open foreign exchange position in all foreign currencies is not supposed to exceed 40 per cent of the relevant bank's regulatory capital. Yet, for most domestic banks, the long open foreign exchange position is well above this limit, which has prompted enforcement actions by the central bank.

3.2 Non-Bank Financial Sector

In any country there are several financial intermediaries in addition to the commercial banking system. These typically include:

- Microfinance institutions,
- Corporate no-depository institutions (i.e., Finance Companies, Mortgage Companies, and Leasing Companies),
- Insurance Companies
- Private Pension Plans
- Foreign Exchange Dealers
- Payment System Operations
- Money Service Providers

- Securities Service Providers (i.e., those covering underwriting, brokerage, dealing, operating a securities exchange, investment companies (mutual funds etc.).

Of these, the DAB Law and Banking Law provide the central bank exclusive authority over the licensing, supervision and regulation of the following: Microfinance Depository Institutions, Foreign Exchange Dealers, Payment System Operators, Money Service Providers and Securities Service Providers. Thus, the existing legislation gives the DAB a considerable authority over the financial sector⁵.

At end-January 2006, Afghanistan had 13 non-bank credit institutions grouped into six categories. These institutions, their loans outstanding and required ownership are illustrated in Table 3.8

Table 3.8: Non-bank Credit Institutions

<i>Type of institution</i>	<i>Number existing</i>	<i>Total loans outstanding (Afs million)</i>	<i>% agg loans</i>	<i>Required ownership structure</i>
Leasing company	1	0	0	Corporation registered in Afghanistan
Microfinance Institutions				
Credit union (members are individuals and single proprietors, member-only savings deposits)	7	500	7	Non-distributive corporation (proposed)
Cooperative bank (members are partnerships, organizations, and corporations, members-only deposits)	0	0	0	Non-distributive corporation (proposed)
Class A microfinance institution (no savings deposits, total assets greater than AFN 250 million)	1	422	6	Non-distributive corporation (proposed)
Class B microfinance institution (no savings deposits, total assets between AFN 50 and 250 million)	0	0	0	Non-distributive corporation (proposed)
Class C microfinance institution (no savings deposits, total assets less than AFN 50 million)	4	77	0	Non-distributive corporation (proposed –perhaps more flexibility)
Total		999	13	

Note: Data are as of 30 November 2005.

⁵ Finance Companies, Mortgage Companies, Leasing Companies, Microfinance non-depository Institutions, insurance Companies and Private Pension Plans are not covered in any legislation in force.

IV- Fiscal Sector Developments

4.1 Budgetary System

In Afghanistan, the fiscal year starts on March 21 and ends on March 20 of the following year. There are three types of budgets to be dealt with each fiscal year:

1. Operating or Ordinary Budget ;
2. Development Budget (under the control of the Government) ;
3. Development Budget (also called external budget, which is not under the control of the Government).

The operating budget is partly financed by the Government domestic revenues and partly by two specific donor funded accounts of ARTF and LOTFA, which are two means of supporting the operating budget of the Government. The development budget under the control of the Government is totally financed by donor money. There is a multiyear allocation of donor money by the Government, which is being implemented by the line ministries of the Government. Finally the third type is external budget or development budget which is controlled and implemented by the donors and the Government has little or no role in that. This budget is in the form of economic projections of donor inflows by the Government. Recently, in the London Conference a pledge of around US dollars 10 billion was made to Afghanistan; 50 per cent of this money is supposed to be provided directly to the Government while the remaining 50 per cent is to be injected through the NGOs and other international organizations.

4.2 Fiscal Trends – 1384 (i.e., 2005-06)

Table 4.1 provides actuals for 1383, budgeted amounts for 1384 and actuals in the first three quarters of 1384.

Table 4.1: Afghanistan Operating Budget : Execution for the First Three Quarters of 1384 (Mn US\$)

	Annual Budget 1384	Actuals			Months (Actuals) 1384			YTD	% of Annual Budget 1384
		1381	1382	1383	Q1	Q2	Q3		
Donor Revenue	1,059.40	255.10	257.30	312.70	141.10	218.40	83.70	443.20	41.84
Operating Budget	0.00				37.50	139.60	50.30	227.30	
Development Budget	0.00				103.60	78.90	33.50	215.90	
Domestic revenue	333.00	131.90	209.80	252.30	98.10	82.40	135.80	316.30	94.98
Taxation	253.10	91.10	160.30	210.10	55.30	61.60	63.10	180.00	71.11
Income tax	0.00				1.00	1.10	0.20	2.30	
Profit taxes legal entities	0.00				0.40	2.50	3.80	6.80	
Income and profit taxes	0.00				1.80	2.00	1.80	5.60	
Taxes on immovable property	0.00				0.50	0.50	0.40	1.50	
Sales tax	0.00				0.00	0.00	0.00	0.00	
Taxes on gross receipts	0.00				2.20	4.40	3.80	10.40	
Taxes on specific services	0.00				0.10	0.10	0.10	0.30	
Motor vehicle taxes	0.00				2.40	1.80	1.30	5.50	
Other taxes good and services	0.00				0.50	0.80	0.80	2.20	
Custom duties and taxes imports	0.00				45.60	47.30	50.10	143.00	
Custom duties and taxes exports	0.00				0.60	0.80	0.10	1.50	
Other taxes	0.00				0.10	0.40	0.60	1.10	
Other Revenues	79.90	40.80	49.50	42.20	42.80	20.70	72.80	136.30	170.57
Retirement contributions	0.00				0.90	1.00	1.00	2.90	
Interest	0.00				0.00	0.00	0.00	0.00	
Investment revenue private sector	0.00				0.00	0.00	0.00	0.00	
Revenue from state owned enterprises	0.00				0.10	1.10	0.20	1.40	
Depreciation from state owned enterprises	0.00				0.20	0.40	0.40	1.00	
Rent - immovable properties	0.00				0.40	0.60	1.10	2.10	
Rental - shop markets	0.00				0.00	0.00	0.00	0.00	
Sale of agricultural products	0.00				0.10	0.20	0.10	0.50	
Sale of services	0.00				4.90	10.80	10.90	26.50	
Sale of second hand confiscated	0.00				0.00	0.50	0.40	0.90	
Rent of movable properties	0.00				0.00	0.00	0.00	0.10	
Revenue from sale of documents	0.00				6.00	4.10	6.50	16.70	
Revenue from sale of licenses	0.00				21.00	1.50	42.20	64.70	
Legal services	0.00				2.20	2.50	2.10	6.80	
Revenue from fines	0.00				0.40	0.40	0.30	1.10	
Voluntary assistance - domestic	0.00				0.00	0.00	0.00	0.00	
Balance of tax on imports	0.00				0.00	0.00	0.00	0.00	
Revenue from previous years	0.00				0.00	0.00	0.00	0.00	
Other misc revenue	0.00				6.20	-2.30	7.30	11.10	
Returns - advance payments	0.00				0.20	-0.10	0.00	0.10	
Sale of land and building	0.00				0.00	0.10	0.10	0.20	
Revenue - natural resources	0.00				0.10	0.10	0.10	0.30	
Total Government Expenditure	1,392.40	348.80	456.70	535.10	214.90	271.90	232.50	719.20	51.65
Economic classification (Development Budget)	714.40	0.00	0.00	0.00	78.30	105.80	78.70	262.80	36.79
Salaries and allowance	0.00				2.60	1.00	1.30	4.90	
Goods and services	0.00				47.10	75.30	44.50	166.80	
Pension payments	0.00				0.00	0.00	0.00	0.00	
Grants	0.00				0.70	2.40	0.00	3.10	
Capital expenditure	0.00				27.90	26.80	32.90	87.60	
Interest payments	0.00				0.00	0.30	0.10	0.40	
Economic classification (Operating Budget)	678.00	348.80	456.70	535.10	136.60	166.00	153.70	456.40	67.32
Salaries and allowance	400.80				83.10	109.60	102.20	294.90	
Goods and services	206.40				28.40	38.20	33.90	100.60	
Pension payments	30.10				7.70	8.20	10.50	26.40	
Grants	16.40				0.00	0.20	0.10	0.40	
Capital expenditure	16.00				16.10	9.10	6.00	31.20	
Interest payments	8.30				1.30	0.70	1.00	3.00	
Operating Budget Balance	-345.00	-216.90	-246.90	-282.80	-38.60	-83.70	-17.90	-140.10	40.62
Overall Balance	0.00	38.20	10.40	30.00	24.30	28.90	-12.90	40.30	

Sources: Ministry of Finance (Website); Da Afghanistan Bank.

Domestic Revenue

Domestic revenue in Afghanistan flows in through the collection of direct and indirect taxes and duties, licenses, sale and utilization of the Government owned properties etc. This classification was made in 1381 and used through 1383. For 1384, the Ministry of Finance has changed it to a large number of categories, which includes the recently implemented income tax as well.

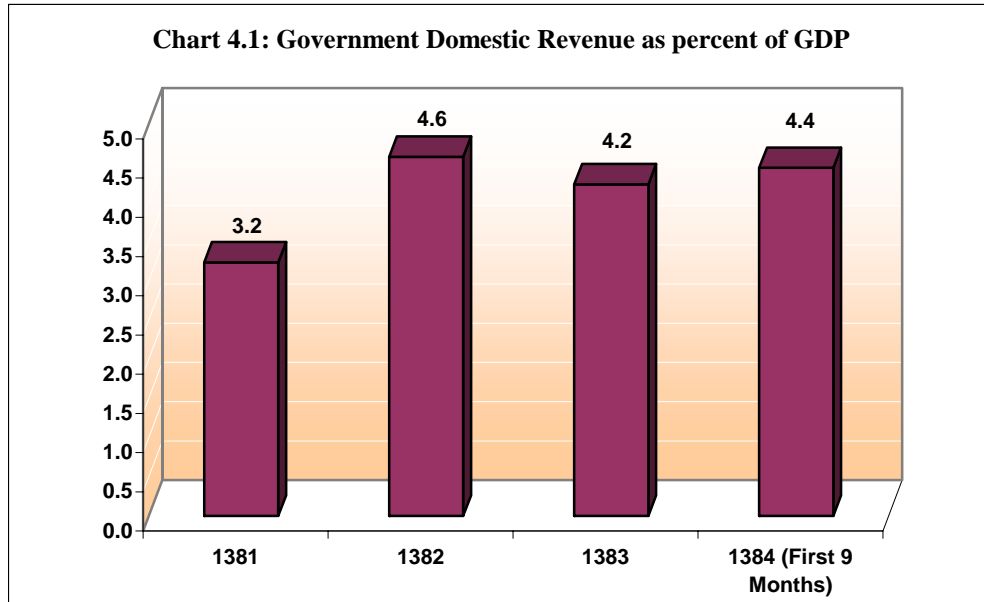
Domestic revenues are projected to be US\$ 333 million during the 1384 (i.e., 2005-06) fiscal year. As against that the actual domestic revenue collection during the first nine months of the fiscal year 1384 (i.e., 2005-06) was US\$316.3 million, almost 95 per cent of total domestic revenue budgeted.

The Government is committed to cover all, or most, of its operating expenditures through domestic revenue. It has done well, in terms of domestic revenue collection, during first nine months of 1384.

It is important for the Government to meet its revenue targets and increase revenues as share of GDP in the coming years. The targets are rather low compared to the international standards. Although new schemes of income tax are implemented by the Government, it is still short of revenue, which constrains the expenditure level. Revenue raising schemes would have to be developed in order to meet at least the basic international standards.

The foreign donors are not likely to remain committed to pump money to cover the Government operating expenditures forever. Private sector consumption has been exceeding the GDP during past few years, after the political and economic turmoil. In contrast, the Government revenue and expenditure have remained largely unchanged (as per cent of GDP), within a few percentage points.

Chart 4.1 depicts the domestic revenue to nominal GDP ratio for the four year period, 1381 (i.e., 2002/03) through 1384 (i.e., 2005/06).



Source: Ministry of Finance and IMF/DAB estimates.

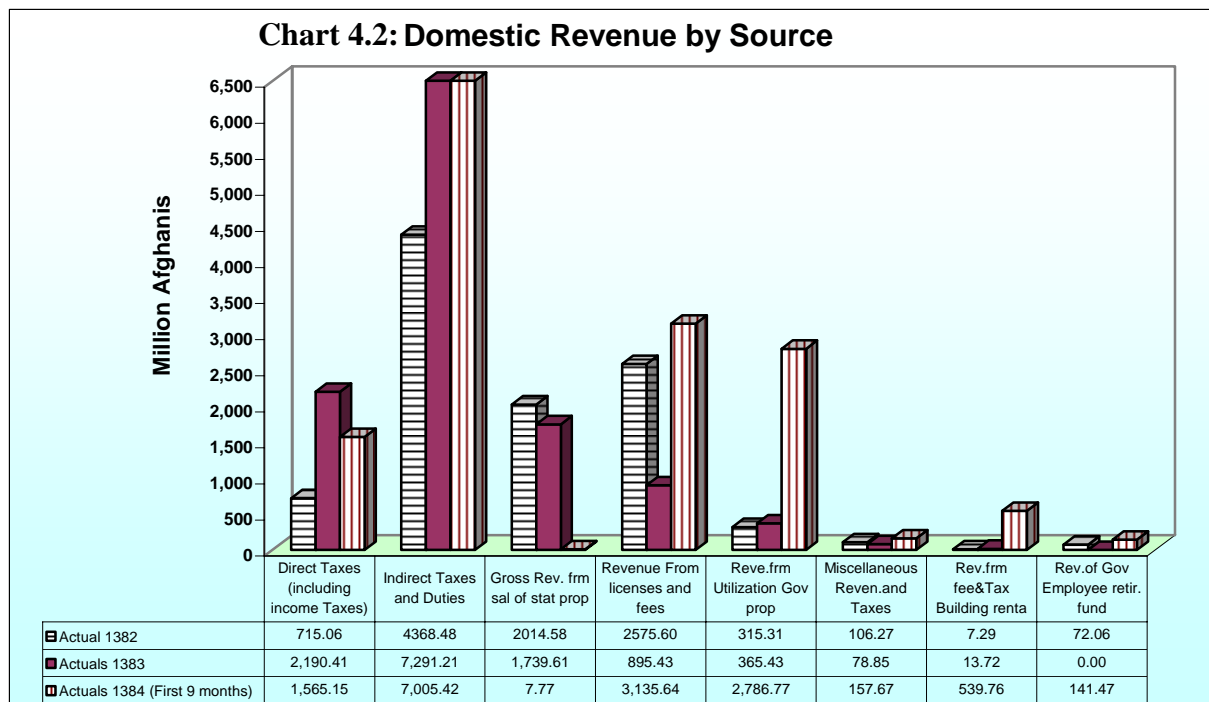
During 1381 (i.e., 2002-03) total domestic revenue was 3.3 per cent of nominal GDP, which was perhaps the lowest in the world. During 1382 (i.e., 2003-04) domestic revenue was 4.6 per cent of nominal GDP - slightly higher than in 1381. There was a dip in these exceedingly low levels in 1383 (i.e., 2004/05). The latest data however, shows some improvement with domestic revenue placed at 4.4 per cent of nominal GDP. Nevertheless, the ratio still remains lower than in the year 1382.

As a percentage of nominal GDP, domestic revenue in Afghanistan is among the lowest in the world. It is widely recognized that the minimal level of domestic revenue should be in the range of 12 to 15 per cent of nominal GDP in developing countries. Domestic revenue collection in Afghanistan is thus rather weak and requires concerted efforts to come up to the standards for other developing countries. Tax reforms to raise domestic revenue are currently underway in Afghanistan and will hopefully raise the revenue level to at least 10 per cent of nominal GDP in the next few years.

During the first nine months of 1384, the Government has achieved its target. It is expected that the domestic revenue will increase much more than what was forecast. Currently available data show that it is about 4.4 per cent of GDP and will increase by the

end of the year to a higher level. This improvement is mostly because of implementation of the income tax.

Chart 4.2 shows the Government’s actual domestic revenue collection by source comparing the two previous years with the figures currently available for the first nine months of 1384. Comparing these three sets of data, it appears that the Government is doing well in collection of indirect taxes and duties-the main source of domestic revenue. However, in the other areas progress has been somewhat slow. The income tax collection has started from September 2005. So far it has contributed around US\$ 2.3 million to the domestic revenue through December 2005.

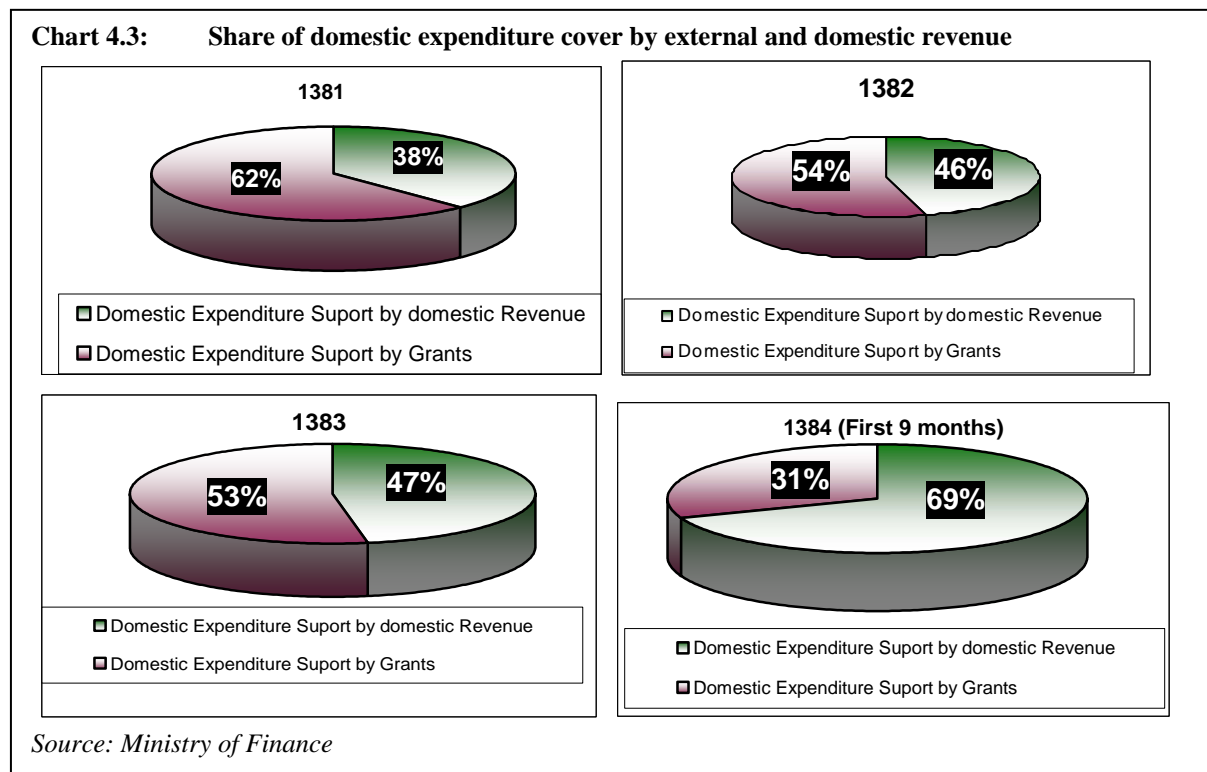


Source: Ministry of Finance

Budget Support from Abroad

The “no overdraft” rule initiated at the beginning of the new political scenario of Afghanistan, still remains in force. Large portion of fiscal deficit is being financed through foreign assistance. The Government is aiming to limit the external dependency of the operating budget within the next few years. Currently available data show that during the first nine months of 1384, about 69 per cent of total operating expenditures are

covered through the domestic revenues, and the rest has been covered through the donor assistance. This signifies a distinct improvement. As illustrated in Chart 4.3, the share of external support in the operating budget during 1381(i.e., 2001-02) was 62 per cent of total actual operating expenditure. It then declined to 54 per cent during 1382 (i.e., 2002-03). It was anticipated to further decline during 1383 (i.e., 2003-04), i.e. to about 49 per cent. But that target was not achieved. During that year it turned out to be around 53 per cent of total actual expenditures.

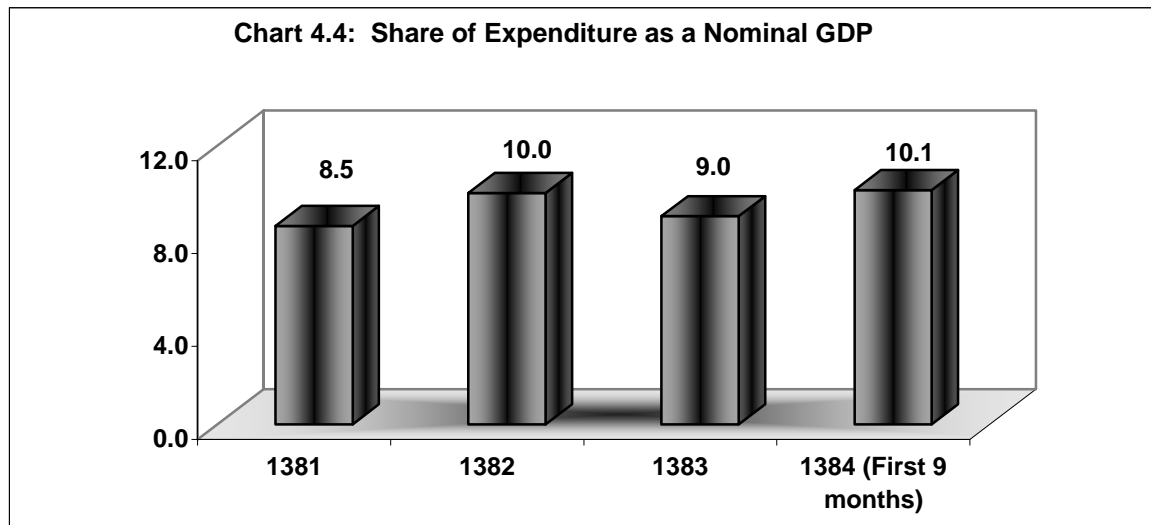


Domestic Expenditure

Expenditure incurred by the general Government can be divided into two types: The first type is operating expenditure (including capital expenditures) and the second type is development expenditure. Operating expenditure of the general Government is projected on a yearly basis. It is partly financed by domestic revenue and partly through external support. In 1383 almost 49 per cent of the operating budget was projected to be financed by donations from abroad. The Government is striving not to go for overdrafts under any

circumstances. Therefore, the Government has not financed any of its operating expenditure through external or domestic debt. Over the years since 2002 when the interim administration took over the political power, the Government operating budget has been in surplus and it is aiming to have at least zero budget deficit (balanced budget including donor revenues) during the upcoming years. Development expenditure on the other hand, is multiyear projection of the Government, and is almost entirely funded by donors.

Chart 4.4 illustrates share of Government expenditure on nominal GDP for the four years period, from 1381 through 1384 (first nine months).



Source: Ministry of Finance

Current data reveal that US\$ 535.08 million were spent by the Government in 1383, which was 82 per cent of total projected expenditure. Total operating expenditure as a per cent of nominal GDP was 8.6 per cent, 10 per cent and 9 per cent, respectively, during the fiscal years 1381 (i.e., 2002-03), 1382 (i.e., 2003-04) and 1383 (i.e., 2004-05). For the nine months of 1384, the total expenditure of the Government as per cent of nominal GDP has increased to a level of 10.1 per cent. This level is higher than the full year expenditures for the previous three years. It is clear that during the fiscal year 1384 the Government is aiming at a much larger expenditure than in the previous three years.

V- External Sector Developments

5.1 Merchandise Trade

Merchandise trade statistics for Afghanistan are compiled officially by the Central Statistical Office (CSO) which collects trade data from the custom offices throughout the country. A substantial share of the country's imports and exports are not in the record of the custom offices. As such the amounts that are in the records of customs and get enumerated are underestimated. Thus the CSO figures tend to understate the Afghan trade. It is recognized however that the figures reported by CSO, which come from the customs administration, do reflect the underlying trends.

Official trade statistics do not mention the active smuggling activities along the Iranian, and more importantly, the Pakistan borders. The actual dimensions are still unknown but based on the unrecorded trade survey conducted by the DAB Statistical Unit and the discussions held with the IMF missions, it is estimated at around 20 per cent of recorded imports are re-exported; smuggled exports are estimated to be equal to 30 per cent of recorded exports; and that smuggled imports are estimated to be roughly 30 per cent of recorded imports.

The IMF also estimates the merchandise trade data using GDP growth, consumption patterns as well as corresponding data with the trading partners. It turns out that recorded and unrecorded trade figures of the IMF are typically much higher than the CSO and DAB estimates.

Efforts are now underway to improve the capacity of the CSO through the implementation of a large-scale Statistical Master Plan and through more intensive communication between the CSO, DAB and the IMF. Clearly, improving the CSO methodology is the best long term solution for getting more accurate numbers regarding the trade. In the meantime, the Monetary Policy Department of DAB (Balance of Payment Section) is moving ahead with a program to conduct surveys. As the CSO's coverage capacity improves, the statistical base of the external sector of the country is expected to improve over time. Progress along these lines will be noted in future issues of this bulletin.

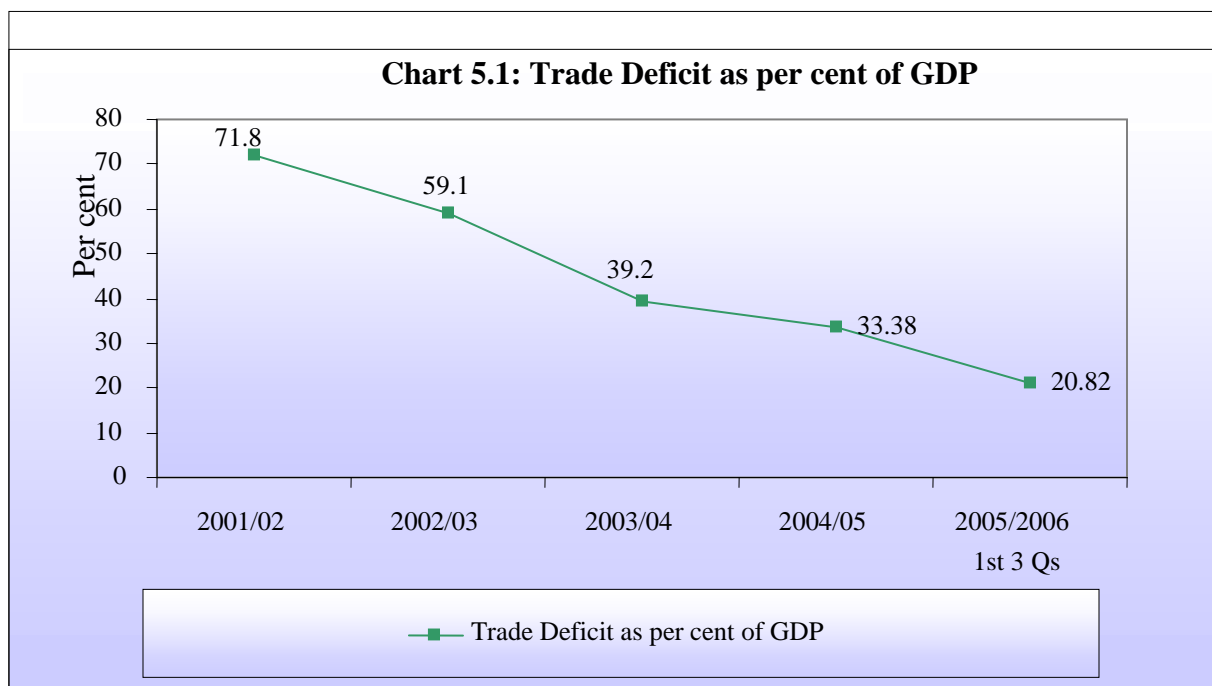
Merchandise trade data for Afghanistan covering the period 1380 (i.e., 2001-02) through the first three quarters of 1384 (i.e., 2005-06) are presented in Table 5.1.

Table 5.1: Merchandise Trade (in US\$ million)

		1380	1381	1382	1383	First 3 Qs of 1384
Imports:	(from previous period)	2,374.00	3,250.90	2,846.80	2796.20	2109.15
	Recorded Imports	1695.70	2322.10	2101.00	2150.90	1622.42
	Consumer goods	872.40	767.50	903.40	383.30	283.82
	Industrial supplies & materials	245.00	807.80	399.20	667.40	366.80
	Capital goods & others	562.30	724.40	777.40	1034.00	774.10
	Fuel and lubricants	16.00	22.40	21.00	66.20	197.70
	Unrecorded	678.00	928.80	745.80	645.30	486.73
Exports:		604.20	836.70	815.00	826.40	630.97
	Domestic	68.20	100.10	144.00	304.80	235.76
	Re-exports & shuttle trade	536.00	736.60	617.00	521.60	395.21
Trade balance:		-1769.80	-2414.00	-2031.80	-1969.80	-1478.17
Trade Balance as per cent of GDP		71.80	59.10	44.30	33.40	15.81

As is evident from Table 5.1, while the level of imports is broadly maintained in the year 1384 (i.e., 2005-06) so far *vis a vis* 1383, (i.e., 2004-05), exports have been somewhat subdued in 1384 in comparison with the last three years.

Importantly, the trade deficit has been shrinking – both in absolute terms as well as in terms of proportion of GDP, as can be seen from Chart 5.1

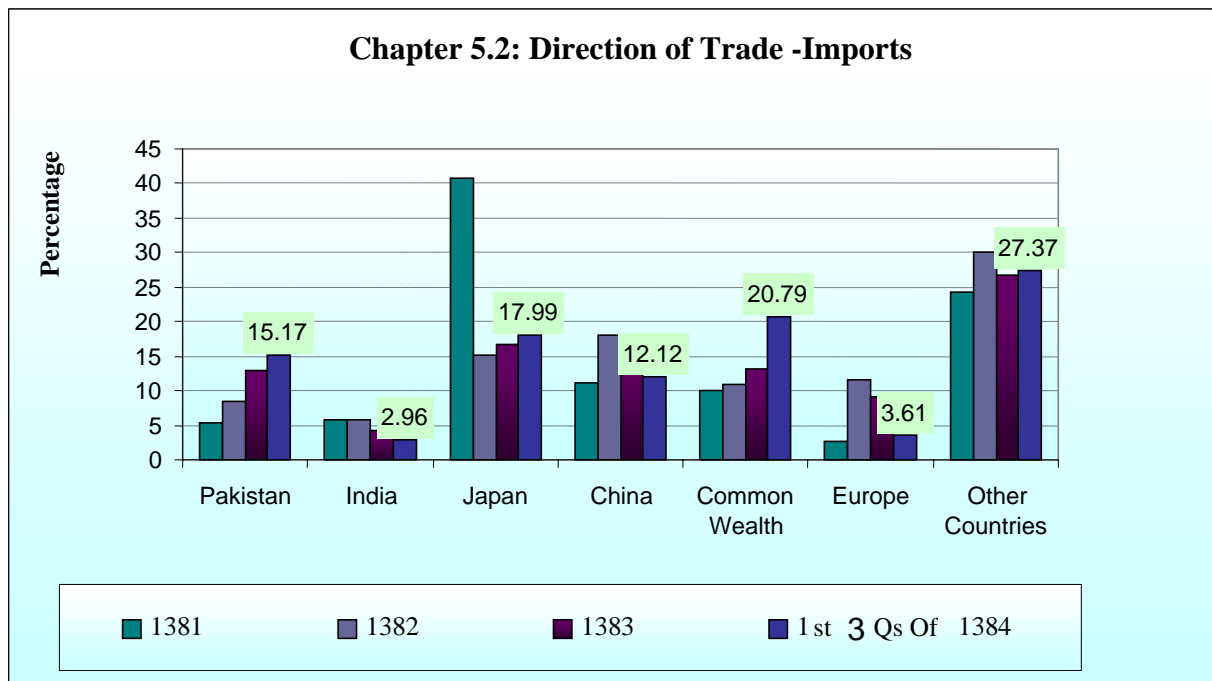


The IMF team in Afghanistan is supporting the CSO and DAB to improve the underlying balance of payments statistics in the coming years. In forthcoming issues of this Bulletin progress on improving the statistical base of the external sector will be reported.

While the trade deficit as a ratio of GDP appears to be somewhat large in relation to other developing countries, this is certainly not unexpected for a post-conflict developing economy that is in the process of rebuilding its productive capacity after decades of war and destruction. In any case, the trade deficit has been declining quite rapidly and at the prevailing levels, it is sustainable given the continued support to Afghanistan from the global community.

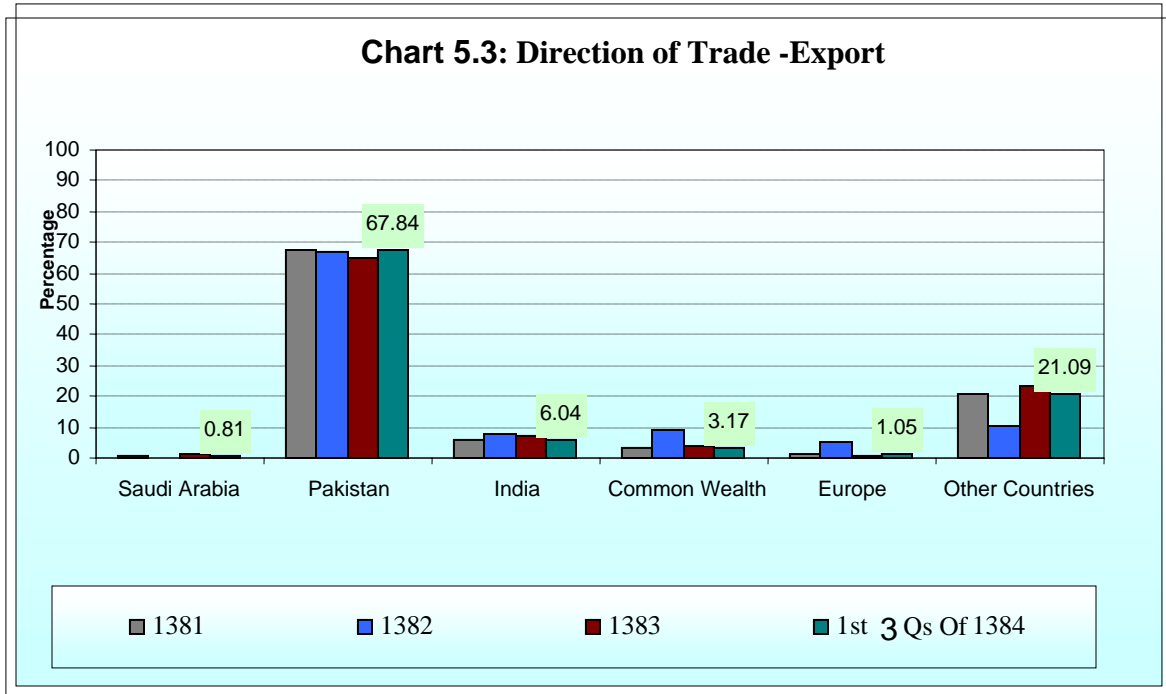
5.2 Direction of Trade

Chart 5.2 and 5.3 indicate the direction of trade, for both imports and exports, for Afghanistan during the period 1383 to the first three Quarters of 1384 (March 21st to December 22nd 2005). Japan remained the largest single country source of imports in to Afghanistan with a share of 18 per cent followed by Pakistan with 15.2 per cent of total imports. China was placed at about 12.2 per cent, Europe with 3.6 per cent, and India with 3.0 per cent.



Source: CSO

In the arena of exports, Pakistan remained Afghanistan’s largest customer by a large margin. Pakistan’s share in total exports from Afghanistan increased for the 1st three Quarters 1384 (March 21st to December 22nd 2005) to 67.84 per cent, India was at 6.04 per cent part of Afghanistan’s customers with the share of total exports, Europe with 1.05 per cent and at last Saudi Arabia with 0.81 per cent



Source: CSO

5.3-Composition of Trade

As far as the composition of imports in to Afghanistan is concerned, during the first three Quarters 1384 (March 21st to December 22nd 2005), imports of “Transportation and Other Equipment” had the largest share (26.62 per cent) followed by “Machinery & Equipments” (22.5 per cent), “Construction Material” (12.4 per cent), “Fuel” (11.85 per cent) “Textile Clothing & Footwear” (11.46 per cent), and “Food Items” (11.32 per cent) as illustrated in Chart 5.4.

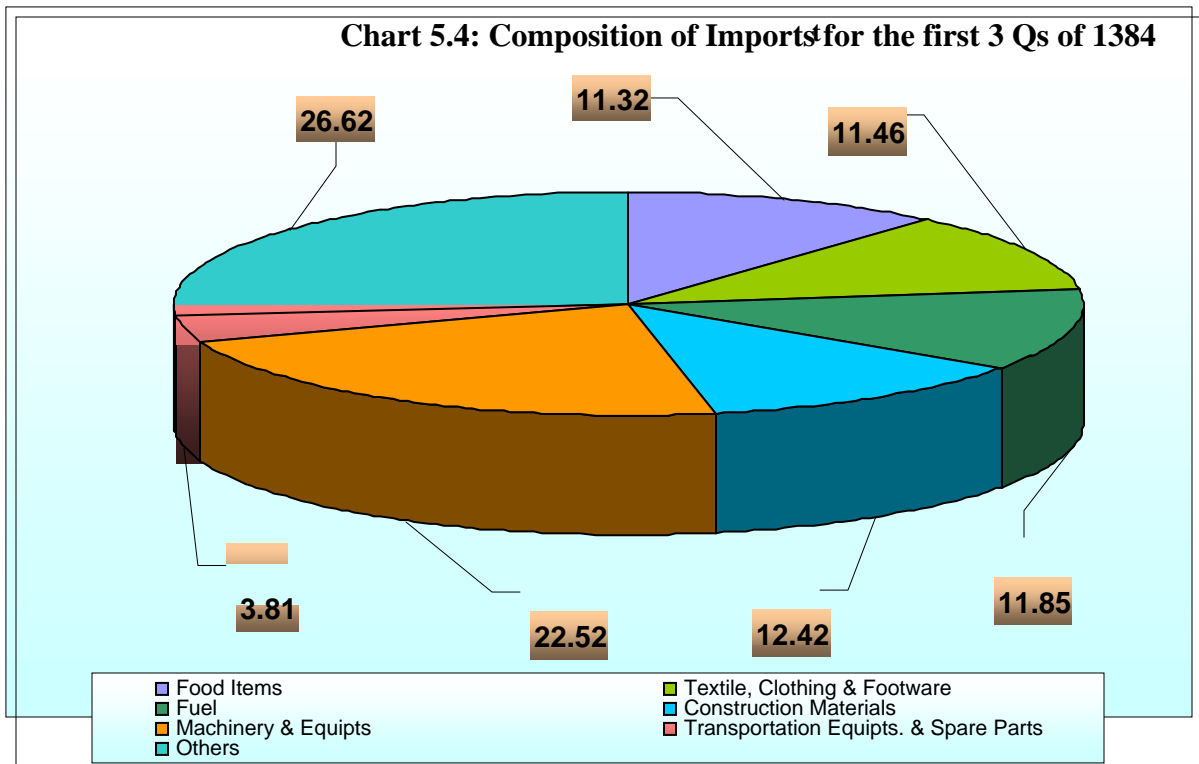
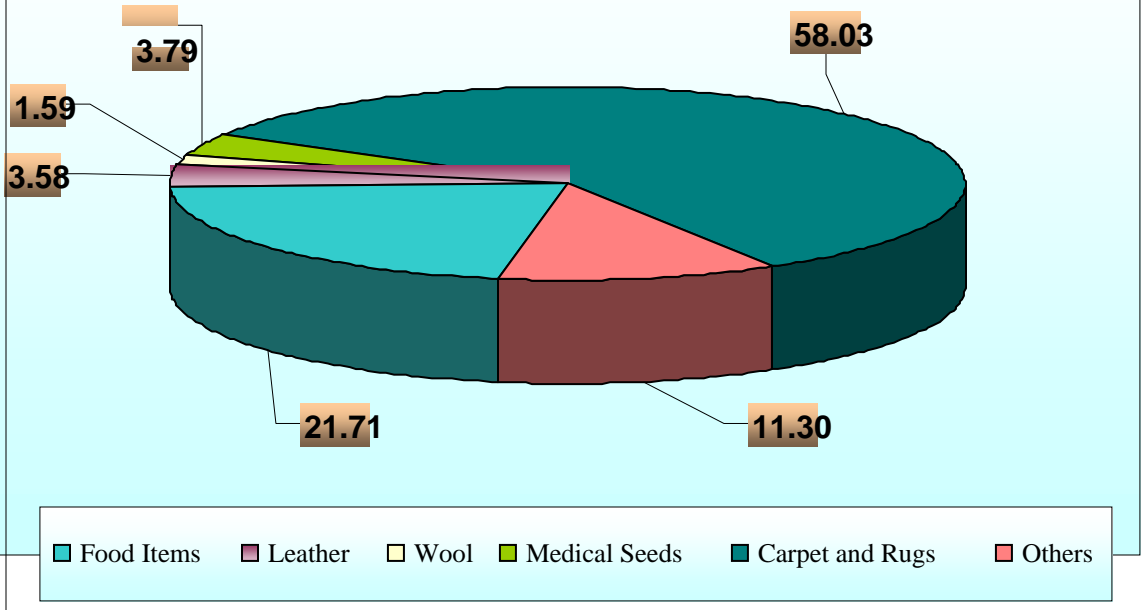


Chart 5.5 presents details of composition of exports for the first three quarters of 1384.

As can be seen from the Chart 5.5 “Carpet & Rugs” (58.03 per cent), “Food Items” (21.71 per cent) led the pack followed by Medical Seeds (3.79 per cent), “Leather” (3.58 per cent) and Wool (1.59 per cent).

Chart 5.5: Composition of Exports for the first 3 Qs of 1384



Special Feature

Currency Conversion in Afghanistan*

Historically, several countries in different parts of the world – advanced economies as well as developing countries have been subjected to high or hyper inflation greatly reducing the value of their currencies. Afghanistan is no exception. Afghanistan's problems were in some respects, even more daunting than those in the other countries. Three versions of its domestic currency were circulating in the country during the days of the Taliban. There was the official Afghani, which had been issued prior to the Taliban rule by previous regimes, as well as the government in exile. Additionally, two other versions of the currency issued by private individuals were also in circulation. The uncontrolled and excessive printing and issuing of these currencies had greatly eroded its value and the values of all deposits and contracts denominated in Afghani.

A single currency was needed to be established as quickly as possible so as to gain control and stabilize its value and to facilitate recovery and economic growth. After careful consideration and detailed discussions between the Da Afghanistan Bank (DAB) and Ministry of Finance (MoF), it was proposed to the then Transitional Government to approve the conversion of the old Afghani bank notes into new Afghani bank notes. A program for printing and introducing the new currency was announced on September 04, 2002 and was made effective from October 07, 2002 (by Decree No 142, dated October 06, 2002).

In order to ensure proper control over the supply of the new currency and thus of its value, the transitional government followed the practice of other countries and gave the central bank i.e., DAB a full authority over the issuance of currency. This ended the problem of multiple issuers.

Since the value of the old Afghani had been seriously eroded by inflation—the largest denomination (Afs10, 000) was worth about 25 US cents--and people had to carry around large bundles of cash for even small purchases, it was decided that one new Afghani would replace 1,000 old ones. This would make transactions much simpler, end

*Based on a draft prepared by Abdul Samad Stanakzai, Technical National Advisor, Monetary Policy Department, DAB.

the need to carry around bundles of bills to buy basic goods, and would set the stage for the central bank's effective control of the money supply.

Several countries that have dropped zeros from their currencies have generally introduced the title “New” before the name of their new currency. On the other hand, those countries that had to remove zeros many times due to hyperinflation seem to have preferred to introduce different names in order to avoid the possible confusion between old and new currency units. In the case of Afghanistan, under the assumption that there will be no further need to drop zeros in the long run, the expression “New” was deemed to be appropriate to precede the name of the national currency for a temporary period of time. The New Afghani was converted at a ratio of 1 to 1000 of the old Afghani. Since the conversion, the Afghani has remained remarkably stable and the economy has rebounded. The conversion has also improved DAB's ability to formulate monetary policy and reduced the risks of counterfeiting. The exchange rate has remained for most part in the range 49 or 50 Afghanis per U.S. dollar since the currency conversion.

Replacing all banknotes in a post-conflict country like Afghanistan within a fairly short period posed tremendous logistical challenges. Many parts of the country are isolated due to the mountainous terrain and a poor road system. Extraordinary preparations and allowances for the currency exchange were needed, such as air-lifting cash by helicopter to remote exchange points, and allowing sufficient time for all Afghans to bring in old bills and exchange them for the new currency. Careful preparations were also needed to ensure that the old currency, once exchanged, was secured and destroyed so that it did not find its way back into the exchange process.

The total amount of old Afghanis collected and burned in the conversion process was Afs 19 trillion: Afs 14 trillion in regular old notes were exchanged at face value and Afs 3.4 trillion of notes were converted at 50 per cent of value. An additional Afs 1.8 trillion was absorbed through the foreign exchange auctions during October-January of 2002. All in all, Afs 15.6 billion in new Afghanis was issued through the conversion process. By early 2003, the amount of all new currency in circulation was in excess of Afs 20 billion, reflecting both the currency conversion and Government payments made in the new currency.

In order to avoid re-emergence of inflationary pressures and stabilize the value of the new Afghani, DAB carefully limits the rate of growth of the new currency in relation to the growth in the economy's output and demand for currency. The DAB has stopped all lending to the Government (which creates money) and all new currency is issued in exchange for foreign currency. As a result of these sound monetary (and fiscal) policies, the value of the new currency has rapidly stabilized (as measured by consumer prices and the exchange rate) despite the serious difficulties being experienced in the economy.

The most important benefits of the new currency discarding the three zeros have been as under:

- Eliminating the circulation of multiple regional currencies in the country.
- Better aligning the value of the new currency (after dropping three zeros) with Afghanistan's major trading partners and neighbouring countries, specifically Pakistan and India.
- Bringing a general simplification in expressing and recording the monetary values which has been exceedingly useful for practical reasons, For example, bread now costs (6-12) Afs and a kilo of rice now costs (30-45) Afs.
- Eliminating technical and operational problems arising from the use of figures with multiple zeros.

In macroeconomic sense, the major benefits of stabilizing and preserving the value of the new currency by prudently limiting the growth in its supply may be recounted as follows:

- Stabilizing the value of the currency improves the ability of economic agents to evaluate options and thus promotes greater economic efficiency and growth.
- Stabilizing the value of the currency better preserves the value of wealth held in monetary form and thus promotes savings.
- Transition to moderate levels of inflation helps restore the credibility of the Afghani both locally and in world markets.

The dropping of three zeros has created some controversy and in some quarters, there has been some misunderstanding about its implications. Some people mistakenly

think that dropping three zeros has reduced the value of their claims denominated in Afghani. However, the old Afghani of 2002 had already lost considerable value on account of high inflation well before the three zeros were removed. Some have argued that deposits they made many years ago or contracts they entered into many years ago lost value because of the conversion to the new Afghani. Actually this is not the case. Value was lost, but it was as a result of too many people printing too much currency. It was lost because of the inflation that had taken place before the introduction of the new Afghani. This is lamentable. However, it would be very unfair, as well as financially infeasible, to restore the value lost to inflation to selected groups of people. Everyone holding old Afghanis or claims denominated in old Afghanis suffered losses equally as a result of earlier inflation, and the DAB is committed to avoiding such situations in the future.

The zeros-removal operation is not expected to have either favourable or an unfavourable effect on exchange rates or interest rates, apart from its positive impact on expectations, since the main factors determining the general level of exchange rates and interest rates are the economic fundamentals and the currency stabilization programs. Experience from around the world supports this conclusion. About 49 countries have removed zeros from their currencies so far. Brazil deleted 18 zeros in 6 operations, Argentina 13 zeros in 4 operations, Israel 9 zeros in 4 operations, Poland 4 zeros in 1 operation, Greece 3 zeros in 1 operation. Note that very few countries have eliminated fewer than 3 zeros in any currency conversion program. Recently, New Turkish Lira was introduced (effective January 1, 2005) dropping as many as six zeros! Transition to new currency units in these countries has been performed along with a stabilization program in general, usually with successful results in terms of reduced inflation, more rapid growth, and greater exchange rate stability. The currency conversion signals that the failed old policies are definitively ended and stable, pro-growth policies are being put in place. In sum three zeros is typically the minimum level of currency change in the conversion process. There is nothing unusual or extreme in what was done in Afghanistan. All prices, currency denominations, and contractual agreements were impacted, equally and symmetrically so that there was no loss in value at the time of replacing 1.000 old Afghanis with one new one. The currency conversion was one of the

most successful programs implemented by the new Government and along with a prudent monetary policy to limit new inflation it is the basis for the remarkable economic progress achieved in recent years.

Speeches

1. Da Afghanistan Bank (DAB) Monetary Policy *

Since the Bonn agreement came into effect, the DAB has undergone multidimensional changes in all its functional aspects, introducing reforms to meet the challenges of the economy in transition. In a modern economic system, the central bank as an independent institution plays various important roles in shaping economic events in the society. I am not here to elaborate on all various roles a central bank can play. However, I would like to stress importance of the monetary policy role to Afghanistan National Development Strategy (ANDS).

Let me first point out a few important reforms, which have been made to enhance the general functions of the Da Afghanistan Bank. Prior to the currency reform in Afghanistan, 2/3 of the currency in circulation had been issued by various local power entities, while the Da Afghanistan Bank had controlled only 1/3 of the currency in circulation.

The single currency reform, which was implemented in 2002, has brought about stability and confidence in the economy. In addition, the Da Afghanistan Bank (central bank) law and banking law have been enacted. This fact, along with other desirable outcomes, has resulted in embodying the independent status of the central bank as granted by the constitution. Likewise, it has led to the establishment of 12 commercial banks, a first step forward in creating the financial sector in the country.

Furthermore, having passed laws to combat money laundering and financing of terrorism, in full conformance with international standards, DAB is home to the newly created Financial Intelligence Unit. This unit is a critical component in Afghanistan's desire to combat money laundering and terrorist financing at both national and international levels. Moreover, this unit will help to maintain and enhance overall financial sector integrity

* Speech delivered by Governor Noorullah Delawari at London Conference (January 28-February 02, 2006)

DAB's primary objective is to achieve and maintain domestic price stability, to foster the liquidity and solvency, and to avoid volatility in exchange rate. In addition, DAB tries to promote economic growth consistent with DAB overall monetary policy objectives.

Moreover, DAB strives to keep stability and promote prudent growth in the financial market. Because, in order for businesses to grow, the economy should have a functional financial market, wherein capital formation, as well as its channelling to profitable investment take place. DAB continues to play a pivotal role in developing and deepening the capacity of market and in supervising the financial intermediaries. Furthermore, DAB continues to maintain public and investors' confidence in the economy as the investors need to know there is a reasonable degree of macroeconomic stability in the economy. It is, among other factors, largely contingent on economic policy performance. The DAB has fortunately to date met all policy benchmarks set by IMF. Efforts have been underway to further improve both the design and implementation of our monetary policy. We once again praise the generosity of donors and IMF for providing DAB staff with training and technical assistance in this regard, and look forward to continued success with their support.

Our monetary policy framework consists of an ultimate objective (controlling inflation), an intermediate target (currency in circulation), and an operating target (weekly foreign currency auction). We reduce inflationary pressure and maintain exchange rate stability through weekly foreign currency auctions. An additional monetary policy instrument has also been introduced, namely capital notes. The introduction of the capital notes functions both as means and an end in itself; it serves the purpose as an end in that it is a measured step in creating a securities market, which will strengthen the performance of financial market.

In consultation with IMF, we have achieved the objectives of stabilizing the price level to the extent that our policy can influence it through the monetary policy transmission mechanism. There are of course other structural factors, which are beyond the scope of the DAB that contribute to increase the price level. Even so, the story of economic growth in Afghanistan is rather encouraging. Since the beginning of first

administration of H.E President Karzai, the Afghan economy has experienced unprecedented economic growth, with GDP increase of an average of 17 percent per annum.

The exchange rate has been stable over the past two years. We are indeed grateful to donors and international community respectively for the inflow of aid and their presence in Afghanistan; their demand for domestic currency has made the central bank a net buyer of foreign currency. This provides the DAB with a useful monetary policy instrument, which in turn helps the DAB achieve the aforementioned monetary policy objectives, and contributes to the development of necessary national reserves.

We believe in a vibrant private sector and its development has been described as key objective in the National Development Strategy plan. It will function as an engine to pull our economy along the track of economic growth. The DAB through its policy implementation is committed to provide a sound environment for the development of private sector.

2. Development of Microfinance and SME Lending in Afghanistan*

The rapid development of microfinance and lending to small and medium-sized enterprises (SMEs) in Afghanistan is proceeding hand in hand with the rapid development of the financial sector in general, after many years of stagnation. So let's begin by discussing the regulatory framework and the characteristics of the microfinance sector as it currently exists, and show how it is complementing the commercial banks in filling a gap and lending to an underserved market.

The emerging role of microfinance institutions in the regulated financial sector

Microfinance institutions (MFIs) fit well into the expanding financial sector. We are happy to report that there are now 12 MFIs in Afghanistan, and I'll return to their activities in a moment.

From a regulatory point of view, there are two types of MFIs: those that accept savings deposits from their members, such as credit unions, and those that do not. It is clear that a more intensive regime of supervision is needed for the deposit-taking MFIs, and the Banking Law enacted in 2003 already authorizes DAB to apply whatever portions of the Law that is necessary to protect these MFI depositors. Accordingly, DAB is developing a "tiered" regulatory regime, in which the supervision becomes more "bank-like" as the MFI more resembles a commercial bank. Regulations have been drafted and are in the public comment stage to bring depository MFIs (DMFIs) fully into the regulatory framework, with internationally-accepted prudential standards of corporate governance, capital adequacy, liquidity, and loan-loss provisioning.

The proposed regulation embodies the concept that DMFIs should be oriented towards profit, although they may not necessarily be profitable. It also states that DMFIs must be "non-distributive corporations" – that is, corporations with shareholders who participate in losses of the DMFI, but cannot participate in any profits. All profits of the

* Speech delivered by Governor Noorullah Delawari at the SAARCFINANCE Governors' Symposium on Micro credit (February 15-16, 2006) at Dhaka Bangladesh.

DMFI, if any, must be reinvested in the DMFI. If a DMFI with positive capital is liquidated, the net assets will accrue to another DMFI, not to the shareholders.

DAB recognizes that the differences between DMFIs and banking organizations in the nature and size of their business and the origin of their resources necessitates a simplified licensing, regulatory, and supervision regime, and that is what we are developing. In particular, the restricted activities of DMFIs means that a variety of risks to which commercial banks are subject is not present

Of course, MFIs that do not take savings deposits require less prudential supervision. Their supervision will be limited to a registration and reporting requirement, with periodic spot checks to ensure that they are not accepting deposits. Along with finance companies, mortgage companies, leasing companies, and other non-depository credit institutions, these MFIs will most likely be regulated by DAB under future legislation.

Current activity of MFIs in Afghanistan

The motivation behind all of these legislative and regulatory efforts is that DAB regards MFIs as an integral part of the financial sector of Afghanistan, with a distinct emphasis on serving low-income and rural communities. And indeed they are: twelve MFIs currently have nearly 130,000 active borrowers throughout Afghanistan, with an average active loan size of \$150. These outstanding loans currently represent over 13 percent of the total credit market in Afghanistan in monetary volume. In addition to that, 105,000 active savers have deposited a total of \$2.6 million in the 5 MFIs that are currently functioning as credit unions.

Facts and figures on lending and deposit-taking can sometimes conceal the unique role that is played by MFIs in Afghanistan. For example, women make up 78 percent of all borrowers. And these female entrepreneurs are not just active in traditional businesses such as crafts: more than half of the outstanding loans are to retail, trading, and small agricultural enterprises such as poultry and livestock. This orientation sharply distinguishes MFI lending from traditional commercial bank lending.

Although MFIs in Afghanistan provide similar services to similar communities as MFIs in other countries, their organization and orientation are strikingly different. Because MFIs did not exist in Afghanistan under previous regimes, the advent of the new

order of peace and stability in late 2001 gave policymakers and donors a “green field” on which to promote the growth of this activity in a relatively organized and controlled fashion.

There are some very distinctive characteristics of the MFIs that have sprung up in Afghanistan in recent years. First of all, MFIs supported by the major donor agencies through the Microfinance Investment Support Facility for Afghanistan (MISFA) are required to be organizationally distinct from the non profit associations (such as CARE and Mercy Corps) that set them up. This means that they are required to have their own corporate governance, own accounting, and own reporting.

Next, these MFIs are required to have an orientation toward profit. This does not mean that they will always be profitable, of course, but that they are expected to operate efficiently and prudently manage their risks. The fact that they are expected to account for and report on their activities separately from their founding organizations supports this goal, since it enables their performance to be measured against international norms and against the performance of other types of credit institutions, such as banks, finance companies, and leasing companies. It is worth mentioning, as an aside, that these expectations are the same that would be applied by any responsible bank supervisor to commercial banks.

It is recognized that the application of the “business model” to microfinance might strike some observers as inconsistent with the aim of microfinance, which is to help the poor. These observers may fail to see the merit of the cold-hearted application of allocated costs, loan-loss provisioning, calculation of rates of return on invested funds, and other concepts of sound financial management.

In Afghanistan, a different mode of thought is required. Afghanistan is one of the poorest countries of the world, and one of the largest per capita recipients of donor assistance. The policy of the Afghan government is that it is imperative that donor assistance, as well as the hard-earned savings of MFI members, not be squandered because of a lack of attention to risk, excessive costs, or improper or non-transparent transactions between the MFI and its founding or sponsoring organization.

And, if MFIs adopt this profit orientation early in their operations, it will help them grow in size and scope – maybe even to the point where they would eventually qualify

for a full-fledged commercial banking license. Indeed, there is already one commercial bank whose operations grew out of a previously-existing MFI. This bank has plans to expand to more provinces around Afghanistan, making larger loans to support small and medium-sized enterprises, without losing its original focus on microfinance.

To summarize, Afghanistan's relative inexperience with microfinance gives it an advantage – the nation can choose the best aspects of models that have been in place in other countries, while continuing to innovate on its own – as it has already done.

Conclusion

The government of Afghanistan, together with its partners in the international community and relying on the enormous energy and nascent entrepreneurial talent of the private sector, is committed to creating an environment conducive to economic growth. Making that commitment is not easy. As you know, this country is emerging from 25 years of war, multiple regime changes, economic collapse, and a disintegration of the social fabric that is almost unprecedented in human history. With the help of the international community, Afghanistan is now stabilizing – but it is not yet stable. Many more years of hard work will be required to rebuild the institutions of a stable, just, benevolent, and prosperous society.

3. Money Laundering and Terrorist Financing*

It is my immense pleasure to welcome all the delegates and participants to this important event organized by the Da Afghanistan Bank in collaboration with World Bank and US Treasury Department. I would like to thank the World Bank and US Treasury for financing this valuable and most important event in Afghanistan for the first time.

If the international community wants to fight money laundering and terrorist financing, then the financial institutions are required to transmit sound financial information for sound investigation. The financial institutions should share the information. The cooperation between the public and private sector should be built on mutual trust and this requires an effective exchange of information. But I should say that the circle of investigation is becoming very narrow, focused on the terrorists.

Since it is becoming more difficult for terrorists to raise monies from other sources, terrorists are evolving and have moved into the money laundering space. Terrorists are now working with drug traffickers and criminals to make and launder the proceeds of crime like fraud, prostitution, intellectual property theft, smuggling - this is now routine for them. Terrorists use low value but high volume fraud activity to fund their operations. Some of the most experienced groups are using legitimate businesses such as hotels, pubs and taxi operators to launder money and fund political activities. Even beyond, terrorists are buying out/controlling front-end businesses especially cash-intensive businesses including in some cases money services businesses to move monies. Bulk cash smuggling and placement through cash-intensive businesses is one typology. They are now also moving monies through the new online payment systems. They also use trade linked schemes to launder monies. Nonetheless, the older systems have not given way. Terrorists also continue to move monies through Hawalas, and through international ATM transactions.

* Speech delivered by Samiullah Ibrahimi, First Deputy Governor at workshop on “Building Financial Market Integrity in Afghanistan” organized by DAB, World bank and the US Treasury (April 16,2006).

Suspicious activity

Operation Green Quest is the US multi-agency task force set up in October 2001 to combat terrorist financing and had developed a checklist of suspicious activities. The following patterns of activity indicate collection and movement of funds that could be associated with terrorist financing:

1. Account transactions that are inconsistent with past deposits or withdrawals such as cash, cheques, wires, etc.
2. Transactions involving a high volume of incoming or outgoing wire transfers, with no logical or apparent purpose that come from, go to, or transit through locations of concern, that is sanctioned countries, non-cooperative nations and sympathiser nations.
3. Unexplainable clearing or negotiation of third party cheques and their deposits in foreign bank accounts.
4. Structuring at multiple branches or the same branch with multiple activities.
5. Corporate layering, transfers between bank accounts of related entities or charities for no apparent reasons.
6. Wire transfers by charitable organisations to companies located in countries known to be bank or tax havens.
7. Lack of apparent fund raising activity, for example a lack of small cheques or typical donations associated with charitable bank deposits.
8. Using multiple accounts to collect funds that are then transferred to the same foreign beneficiaries
9. Transactions with no logical economic purpose, that is, no link between the activity of the organisation and other parties involved in the transaction.
10. Overlapping corporate officers, bank signatories, or other identifiable similarities associated with addresses, references and financial activities.
11. Cash debiting schemes in which deposits in the US correlate directly with ATM withdrawals in countries of concern. Reverse transactions of this nature are also suspicious.

12. Issuing cheques, money orders or other financial instruments, often numbered sequentially, to the same person or business, or to a person or business whose name is spelled similarly.

It would be difficult to determine by the activity alone whether a particular act was related to terrorism or to organised crime. For this reason, these activities must be examined in their proper context along with other factors in order to determine a terrorist financing connection. Simple transactions can be found to be suspect and money laundering derived from terrorism will typically involve instances in which simple operations had been performed (retail foreign exchange operations, international transfer of funds) revealing links with other countries including FATF blacklisted countries. Some of the customers may have police records, particularly for trafficking in narcotics and weapons and may be linked with foreign terrorist groups. The funds may have moved through a state sponsor of terrorism or a country where there is a terrorism problem. A charity may be a link in the transaction.

Bank processes

In addition to normal AML controls, banks must focus on the CFT angle with renewed vigor and knowledge derived from the extensive databank of case studies now available. Banks must focus on not just name matching with sanctions databases but also with other know your customer (KYC) high-risk databases of good third party vendors. They must use technologies like link analysis to establish second and third level links that identify transactions as potentially suspicious from a CFT perspective. Focus on preventing identity theft is an integral part of any CFT program. Detection rules designed to capture the suspicious activity list given above, should be evaluated. Any bank that is used for terrorist financing will suffer tremendous reputational damage and also a real business impact in terms of share price and expensive fines.

The future of terrorist financing

Looking into the near future, if terrorist groups are replaced by smaller, decentralized groups, the premise that terrorists need a financial support network may become

outdated. Moreover, some terrorist operations do not rely on outside sources of money and may now be self-funding, either through legitimate employment or low-level criminal activity, for example, the 7/7 London terrorists. Some experts argue that for anti-terrorism, disruption may be more effective than the CFT approach. If terrorists for example, just carry USD 10,000 in cash and don't route it through the banking system, the CFT approach would not be effective.

Finally, I would like to encourage the banking community to cooperate with the Central bank of Afghanistan and jointly come over this fatal disease. This is our pleasure that we have recently established the FIU department with the Technical Assistance of the US Treasury Department.