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Central Bank of Afghanistan

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FOREWORD

It gives me great pleasure to present the second Quarterly Economic and Statistical Bulletin for 1385 (2005/06). The bulletin reviews economic developments over the period June to August 2006. Particular attention is paid to the formulation of monetary and fiscal policy, developments in the financial sector influencing the growth of the economy.

A major highlight in the second quarter was the approval by the International Monetary Fund of a Poverty Reduction and Growth Facility (PRGF) for Afghanistan on June 26, 2006. As a result of the approval, Afghanistan will receive a initial disbursement under the PRGF arrangement amounting to about US\$19.4 million.

The PRGF will provide a comprehensive framework for achieving fiscal sustainability and catalyzing improvements in budget planning and execution. Under the PRGF, in the fiscal area, the government is committed to enhancing revenue mobilization, including strengthening the large taxpayers' office, improving transparency and simplifying procedures, and upgrading administrative capacity. On the spending side, the government has committed to strengthening the enforcement of the manpower and appropriation ceilings, while moving gradually to a new pay and grading system. These efforts will be complemented by further improvements in implementation capacity to increase much-needed development spending.

Another major highlight of the second quarter was the granting by the Paris Club of creditor nations of 'Naples Terms,' to Afghanistan on July 19, 2006. This will eventually result in a 67% cancellation (US\$1.6 billion) of Afghanistan's arrears and late interest, as well as maturities up to 2009. The agreement reschedules US\$ 0.8 billion (33% of treated amounts) over 23 years, and provides for a deferral to 100 per cent of moratorium interest (the interest due during the grace period).

This treatment is a first step in the implementation of the commitments made by the Governments of Germany, the Russian Federation and the United State of America on the occasion of the London conference on Afghanistan of 31 January 2006, to cancel 100% of Afghanistan's debt within the context of a successful implementation by Afghanistan of the HIPC initiative process.

Monetary policy in the second quarter remained sound with quarterly inflation at 2.4 per cent compared -0.9 during the previous quarter. The exchange rate of Afghanis to the dollar moved in a relatively narrow band of Afs. 49.8 to 50.5 throughout the quarter reflecting increasing confidence in the local currency.

The banking system continued to grow at a healthy pace. Total assets of the banking system stood at Afs. 39.2 billion; a 12 per cent increase from the previous quarter. Total liabilities stood at Afs. 29.4 billion up by 15.3 per cent from the previous quarter. The overall quality of banks loan portfolio was highly satisfactory, with 88 per cent of the loans classified as standard.

On an overall assessment, economic performance in the second quarter was satisfactory. Da Afghanistan Bank maintained its emphasis on price stability and continued to provide appropriate liquidity to meet the genuine credit needs of the economy with due emphasis on quality. Monetary policy stance was geared to supporting the economic growth momentum by ensuring a conducive interest rate environment for macroeconomic, price and financial stability.

Noorullah Delawari

Acting Governor, Da Afghanistan Bank
(Central Bank)

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LIST OF ABBREVIATIONS

| | |
|-------|--|
| DAB | Da Afghanistan Bank |
| 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 Afghanis |
| GDP | Gross Domestic Product |
| ODCs | Other Depository Corporations |

I Macroeconomic Overview

1.1 Economic Growth and Per Capita Income:

The Afghan economy has continued to perform well during the fiscal year 1385 (2006-07). Real GDP growth is estimated to be 8 per cent compared to the previous year's (1384) growth of 14 per cent. Economic growth in the year 1385 was negatively effected by the drought in the agriculture sector which is estimated to have declined by 7 per cent in 1385 (2006-07) in comparison to the year 1384 (2005-06) when input increased by 11 per cent. On the positive side a greater momentum for real GDP growth seems to be emerging from sustained domestic growth from the industrial and services sectors such as construction, communication and transportation and other types of private sector activities.

The GDP data for the last five years are presented in Table 1.1, below:

Table 1.1: GDP and Per Capita Income 2002/03–2005/06

| | 2002/03 (1381) | 2003/04 (1382) | 2004/05 (1383) | Jun-05 Estimated (1384) | 2006/07 Projected (1385) | Average for the period 1381 (2002-03) to 1385 (2006-07) |
|------------------------------------|-------------------|-------------------|-------------------|-------------------------------|--------------------------------|---|
| GDP (in millions of U.S. dollars) | 4,084 | 4,585 | 5,971 | 7,309 | 8,399 | 5,444 |
| Real GDP growth rate (in per cent) | 28.6 | 15.7 | 8 | 14 | 8 | 14.9 |
| Nominal GDP growth (annual change) | 33.8 | 23.1 | 26.4 | 27.6 | 15.6 | 25.3 |
| Per Capita income (US dollars) | 182 | 200 | 253 | 300 | 354 | 257.8 |

Note: Central Statistics office (CSO) final figures for year 2005/06 are still not available; the estimates here are based on the IMF data and projections; these data exclude opium production.

Over the last five years from 1381-1385 (2002/03-2006/07), the Afghan economy has made significant progress with a strong real cumulative growth of over 80 per cent, with annual real GDP growth averaging about 14.9 per cent per annum as shown in Table 1. The surge in growth rate, albeit from a very depressed base, was due to continued donor support, construction boom in urban centres, and good harvests in 1381 (2002-03), 1382

(2003-04) and 1384 (2005-06). The economy is expected to continue to achieve comparably high growth rates during the next few years.

The Afghan Industrial sector has shown an impressive growth of 16 per cent in the year 1385 (2006/07) similar to the growth rate of the previous year. The services sector particularly construction, power, communication and transportation have turned in good performances as well at 17 per cent. As in previous years the industrial and services sectors have continued to lead the way.

Per capita income during the last five years has risen quite remarkably; it has increased from US\$ 182 to US\$ 354 or by 94.5 per cent during the five year period which works out to about 14 per cent per annum.

1.2 Structure of Production

The break-up of real GDP growth by industrial origin over the last four years is presented in Table 1.2.

Table 1.2: GDP Growth by Industrial Origin (annual percentage)

| Industrial Origin | 2002/03 (1381) | 2003/04 (1382) | 2004/05 (1383) | 2005/06 (1384) | 2006/07 Projected |
|-----------------------|-------------------|-------------------|-------------------|-------------------|----------------------|
| Agriculture | 27.7 | 17.0 | -17 | 11 | -7 |
| Industry | 21.2 | 12 | 32 | 16 | 16 |
| Services | 39.5 | 14 | 35 | 14 | 17 |
| Total Real GDP growth | 29 | 16 | 8 | 14 | 8 |

All figures based on IMF data and projections

With the rapid growth of services and industry in the last few years, the economy has become less dominated by agricultural as is evidenced from Table 1.3. In fact this year services clearly surpassed agriculture as a share of reported GDP.

Table1.3: GDP - Composition by Sector (per cent)

| Industrial Origin | 2002/03 (1381) | 2003/04 (1382) | 2004/05 (1383) | 2005/06 estimated (1384) | 2006/07 Projected (1385) |
|-------------------|-------------------|-------------------|-------------------|--------------------------------|--------------------------------|
| Agriculture | 49.8 | 48.5 | 37.2 | 35.9 | 30.9 |
| Industry | 20.1 | 21.3 | 24.4 | 24.4 | 26.2 |
| Services | 30.1 | 30.2 | 38.3 | 39.7 | 42.9 |

All figures based on IMF data and projections

Analysis of the consumption, savings, and investment in the Afghan economy for the last five years is presented in Table 1.4.

**Table 1.4: Consumption, Savings and Investment 1381-1383 (2002/03–004/05)
(Per cent of GDP)**

| | 1381 2002-03 | 1382 2003-04 | 1383 2004-05 | 1384 2005-06 | 1385 2006/07 |
|-----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Domestic expenditures | 133.5 | 151.0 | 144.9 | 141.9 | 141.8 |
| Consumption | 99.0 | 108.9 | 101.6 | 103.2 | 100.5 |
| Public | 7.8 | 9.4 | 9.1 | 8.6 | 11.0 |
| Private | 91.2 | 99.5 | 92.5 | 94.6 | 89.5 |
| Gross fixed capital | 34.5 | 42.0 | 43.3 | 38.7 | 41.3 |
| Public | 27.0 | 34.0 | 34.8 | 30.6 | 31.4 |
| Private | 7.5 | 8.1 | 8.5 | 8.1 | 9.9 |
| Domestic savings | 1.0 | (-8.9) | (-1.6) | (-3.2) | (-0.5) |
| Public savings | (-4.6) | (-4.4) | (-4.2) | (-2.3) | (-3.2) |
| Private savings | 5.6 | (-4.5) | 2.6 | -0.8 | 3.2 |

All figures based on IMF data and projections

Several observations are in order here:

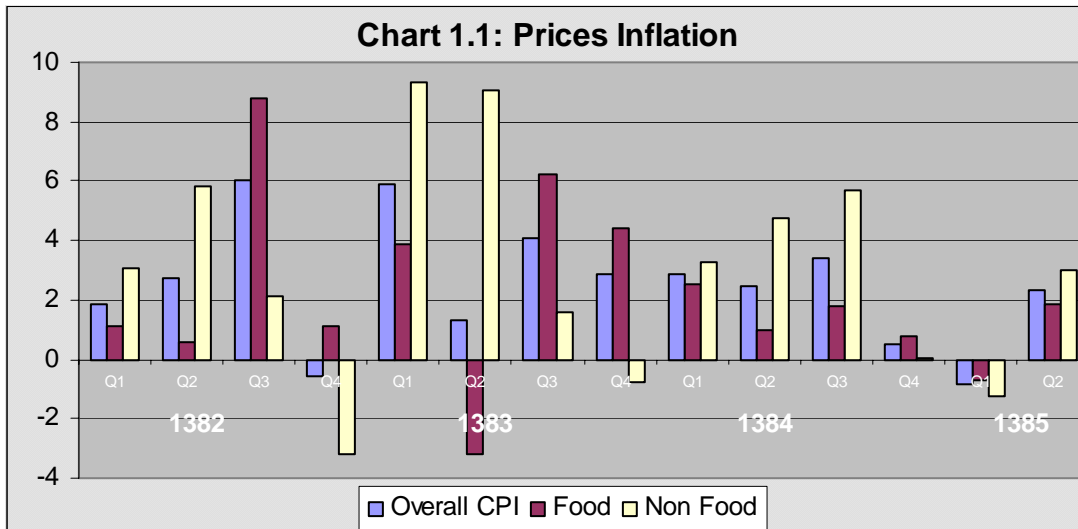
- Domestic expenditure in 1385 (2006-07) was some 141.8 per cent of GDP of which 100.5 per cent was consumption expenditure while 41.3 per cent was investment expenditure.
- As a percentage of GDP, consumption in year 1385 (2006-07) was less than those during the previous three years and has declined steadily since 1382 (2003-04).

- Domestic savings in the year 1385 (2006-07) were around -0.5 per cent of GDP comprising 3.2 per cent private savings which were offset by government dis-saving to the extent of 3.7 per cent of GDP.
- During the period 1381-1384 (2002-03 through 2005-06) public sector showed negative savings or dis saving. On the other hand, the private savings were negative during the years 1382 (2003-04) but remain positive during the years 1384 (2005-06), 1383(2004-05), and 1381(2002-03)
- Low domestic savings of -2.3 per cent during the year 1384(2005-06) is the result of the continuing dis savings in the public sector which offset private savings. Notably, the extent of dis saving in the latest year, 1384 (2005-06) has come down significantly compared to the year 1382(2003-04).
- During the year 1384(2005-06), investment growth was 40.3 per cent of the GDP, and of this, public investment accounted for the bulk, although there was some welcome pick-up in private investment especially in construction and other activities.

1.3 Inflation

Kabul Based CPI (March 2004 = 100)

The quarterly overall inflation rate based on Kabul-Based CPI, at the end of Sunbula 1385 (September 2006) was 2.4 per cent compared to the rate of -0.9 per cent registered during the previous quarter ending Jawza 1385 (June 2006). As can be seen from the Chart 1.1, both food and non-food prices show a distinct deceleration during first quarter of 1385 (March to June, 2006). Following this deceleration, the quarterly overall inflation rate rose to 2.4 per cent during Q2, 1385 ending Sunbula 1385 (Sep. 2006). During this period, food prices increased by 1.9 per cent while the non-food prices rose by 3.0 per cent. See Chart 1.1.



Cumulatively, since the completion of the currency conversion in about March 2003, the overall price index recorded an increase of 40.7 per cent up to September 2006 (42 months) which works out to a compound annual rate of about 11.6 per cent. Both food and non-food inflation were factors in the overall CPI inflation with food prices rising at an annual rate of 9.8 per cent while the non-food prices rose by 14.6 per cent during the 42-month period ending September 2006. Kabul based CPI data on monthly basis from March 2004 to Sep. 2006 are presented in Table 1.5 and illustrated in Chart 1.2.

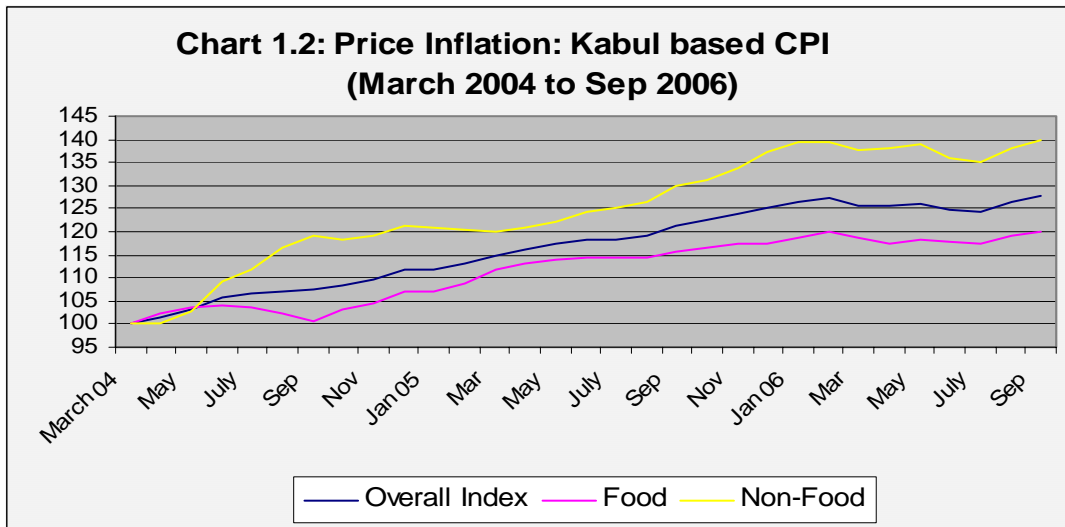


Table 1.5: Kabul based CPI

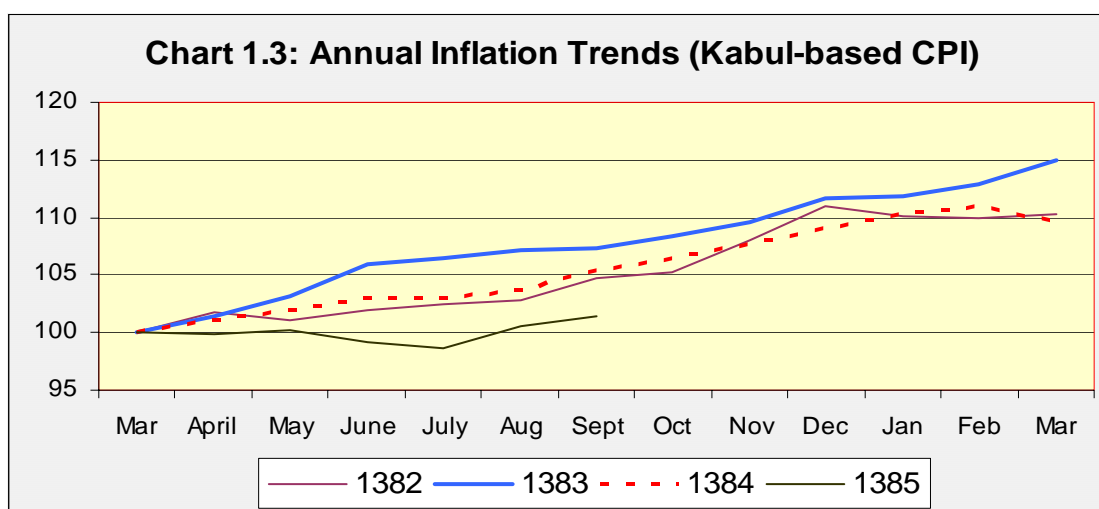
| Period | Overall Index | Food, Beverages & Tobacco | Non Food Items | Monthly Change (%) |
|----------|---------------|---------------------------|----------------|--------------------|
| March 04 | 100 | 100 | 100 | - |
| April | 101.5 | 102.2 | 100.3 | 1.50 |
| May | 103.2 | 103.5 | 102.6 | 1.67 |
| June | 105.9 | 103.9 | 109.3 | 2.62 |
| July | 106.5 | 103.8 | 111.7 | 0.57 |
| August | 107.2 | 102.4 | 116.6 | 0.66 |
| Sep | 107.3 | 100.6 | 119.2 | 0.09 |
| Oct | 108.3 | 103 | 118.3 | 0.93 |
| Nov | 109.5 | 104.6 | 119 | 1.11 |
| Dec 04 | 111.7 | 106.9 | 121.1 | 2.01 |
| Jan. 05 | 111.8 | 107 | 120.7 | 0.09 |
| Feb | 112.9 | 108.6 | 120.4 | 0.98 |
| Mar | 114.9 | 111.6 | 120.2 | 1.77 |
| Apr | 116 | 112.9 | 121 | 0.96 |
| May | 117.2 | 114 | 122.3 | 1.03 |
| June | 118.2 | 114.4 | 124.1 | 0.85 |
| July | 118.4 | 114.2 | 125.1 | 0.17 |
| August | 119 | 114.3 | 126.3 | 0.51 |
| Sep | 121.1 | 115.5 | 130 | 1.76 |
| Oct | 122.4 | 116.7 | 131.4 | 1.07 |
| Nov | 123.7 | 117.2 | 134 | 1.06 |
| Dec. 05 | 125.2 | 117.6 | 137.4 | 1.21 |
| Jan. 06 | 126.6 | 118.6 | 139.3 | 1.12 |
| Feb | 127.5 | 119.8 | 139.6 | 0.71 |
| Mar | 125.8 | 118.5 | 137.5 | -1.33 |
| Apr | 125.5 | 117.4 | 138.3 | -0.24 |
| May | 126.1 | 118.1 | 138.9 | 0.48 |
| June | 124.7 | 117.7 | 135.8 | -1.11 |
| July | 124.2 | 117.3 | 135.2 | -0.4 |
| Aug | 126.5 | 119.2 | 138.1 | 1.85 |
| Sep | 127.6 | 119.9 | 139.9 | 0.87 |

A comparative picture of inflation for the years 1383, 1384 and the first half of the year 1385 is presented in Table 1.6 and illustrated in chart 1.3.

Table 1.6: Overall Inflation (Kabul-based CPI) (Annual Rates)

| Year | Overall CPI | Food | N-Food | Overall CPI Excl. rents, housing and fuel |
|--|-------------|------|--------|---|
| 1382 (March 2003 – March 2004) | 10.3 | 11.9 | 7.3 | 8.1 |
| 1383 (March 2004 - March 2005) | 14.9 | 11.6 | 20.2 | 10 |
| 1384 (March 2005 -March 2006) | 9.5 | 6.2 | 14.4 | 7.7 |
| 1385 (first six months) (March 2006 to Sep. 2006) | 2.9 | 2.4 | 3.5 | 5.1 |

Note: Figures for first six months of 1385 are annualized figures.



As can be seen from Table 1.6, the annual inflation rate for the overall CPI was 14.9 per cent for the year 1383(2004-05). The overall price index recorded an increase of about 9.5 per cent during the year 1384 (March 05 to March 06) with food and non-food components of the CPI rising by 6.2 per cent and 14.4 per cent respectively. During 1384 and 1385 rents, transportation, fuel and housing prices, which are more structural than monetary in nature, were the fastest growing component of the non-food items of the CPI, increasing by 24.81 per cent, 7.83 per cent, 25.07 per cent and 22.57 per cent respectively during the 12-months period ending Hoot 1384 (March 2006). As can be seen from Table 1.6, the overall “core inflation” excluding rents, housing and fuel, turns out to be 10 per cent in 1383 and 7.7 per cent in 1384. There is thus a distinct deceleration of the “core inflation” after 1385.

National CPI

The national CPI (March 2004 = 100) includes surveys for six cities representing the regions of Kabul, Herat, Kandahar, Jalalabad, Mazar-e-Sharif and Khost. Quarterly inflation rate based on the overall national Consumer Price Index (CPI) was about -1.65 per cent in the March to June 2006 quarter (Jawza 1385) which shows a notable decline compared to the previous quarter, but it increased again by 2.27 per cent during the following quarter ending Sep. 2006 (Sunbula 1385). Cumulatively, since March 2004 the national CPI rose by 21.8 per cent which is a compound annual rate of 8.2 per cent. Food and non food components increased by 19.3 per cent and 25.7 per cent respectively which is shown in Chart 1.4 and presented in Table 1.7

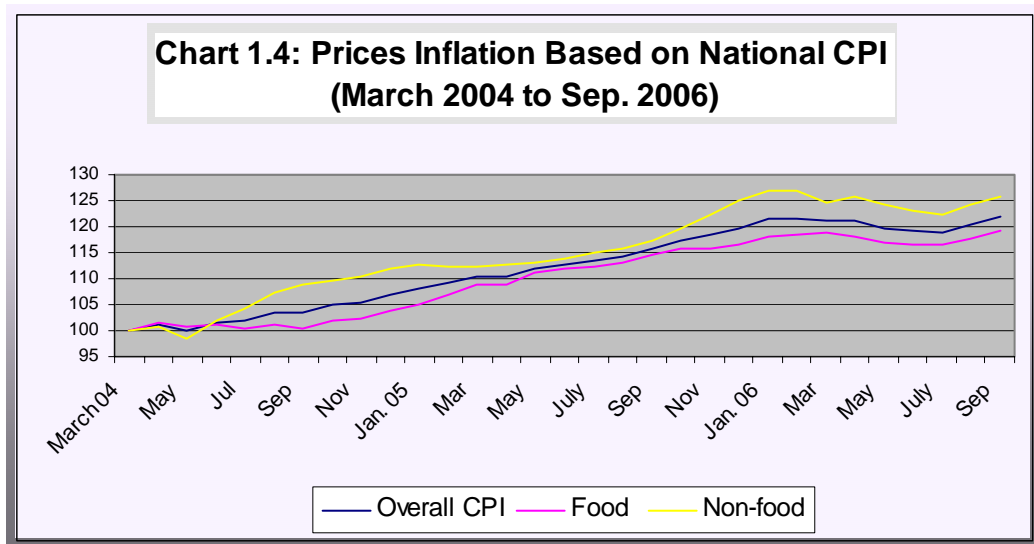


Table 1.7: National CPI

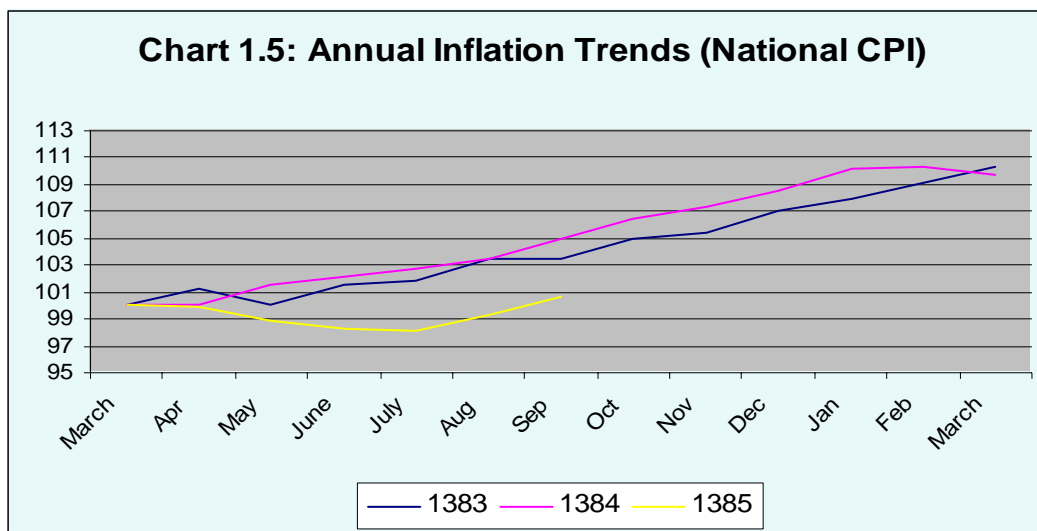
| Period | Overall CPI | Food | Non-food | % Change |
|---------|-------------|-------|----------|----------|
| March | 100 | 100 | 100 | - |
| Apr. | 101.2 | 101.4 | 100.8 | 1.2 |
| May | 100 | 100.9 | 98.6 | -1.19 |
| Jun | 101.5 | 101.3 | 101.9 | 1.5 |
| Jul | 101.9 | 100.4 | 104.3 | 0.39 |
| Aug | 103.5 | 101 | 107.4 | 1.57 |
| Sep | 103.5 | 100.2 | 108.8 | 0 |
| Oct | 104.9 | 101.8 | 109.6 | 1.35 |
| Nov | 105.4 | 102.4 | 110.2 | 0.48 |
| Dec | 107.1 | 104 | 112 | 1.61 |
| Jan | 107.9 | 104.9 | 112.6 | 0.75 |
| Feb | 109.1 | 107 | 112.4 | 1.11 |
| Mar | 110.3 | 108.9 | 112.5 | 1.1 |
| Apr | 110.4 | 109 | 112.7 | 0.09 |
| May | 111.9 | 111.2 | 113 | 1.36 |
| June | 112.7 | 112 | 113.9 | 0.71 |
| July | 113.3 | 112.2 | 115 | 0.53 |
| Aug | 114.1 | 112.9 | 115.9 | 0.71 |
| Sep | 115.7 | 114.6 | 117.5 | 1.4 |
| Oct | 117.3 | 115.9 | 119.6 | 1.38 |
| Nov | 118.4 | 115.9 | 122.3 | 0.94 |
| Dec. 05 | 119.8 | 116.5 | 125.1 | 1.18 |
| Jan | 121.4 | 117.9 | 126.9 | 1.34 |
| Feb | 121.7 | 118.4 | 126.9 | 0.25 |
| Mar | 121.1 | 118.8 | 124.8 | -0.49 |
| Apr | 121 | 118.1 | 125.6 | -0.08 |
| May | 119.7 | 116.8 | 124.4 | -1.07 |
| June | 119.1 | 116.6 | 123 | -0.5 |
| July | 118.8 | 116.5 | 122.4 | -0.25 |
| August | 120.3 | 117.7 | 124.3 | 1.26 |
| Sep | 121.8 | 119.3 | 125.7 | 1.25 |

The annual national inflation trends as presented in Table 1.8 and shown in Chart 1.5 indicate a notable success in containing national inflation in the year 1384 (i.e., 2005-2006) and for the first half of 1385 the results are even stronger with the overall national inflation rate during the first six months of 1385 running at an annual rate of about 1.2 per cent. This suggests that inflationary pressure is generally lower in the provinces than it is in Kabul.

Table 1.8: Overall Inflation (National CPI)

| Year | Overall CPI (%) | Food (%) | Non Food(%) | Overall CPI Excl. rents, housing and fuel |
|-------------------------|-----------------|----------|-------------|---|
| 1383 | 10.3 | 8.9 | 12.5 | 7.4 |
| 1384 | 9.8 | 9.0 | 10.9 | 8.2 |
| 1385 (first six months) | 1.2 | 0.8 | 1.4 | 3.1 |

Note: Figures for the first six months of 1385 are annualized figures.



“Core inflation” (i.e., excluding rents, housing and fuel) rates for the National CPI are presented in Table 1.8. These data also indicate the deceleration of inflation during the year 1384 and even more so in 1385. This further demonstrates the success that has been achieved by the monetary policy of the DAB in terms of price stability.

II. Monetary Policy and Market Operations

2.1 Monetary Aggregates Brief

The monetary aggregates in Afghanistan contain the following:

1. M1 or narrow money
2. M2 or broad money

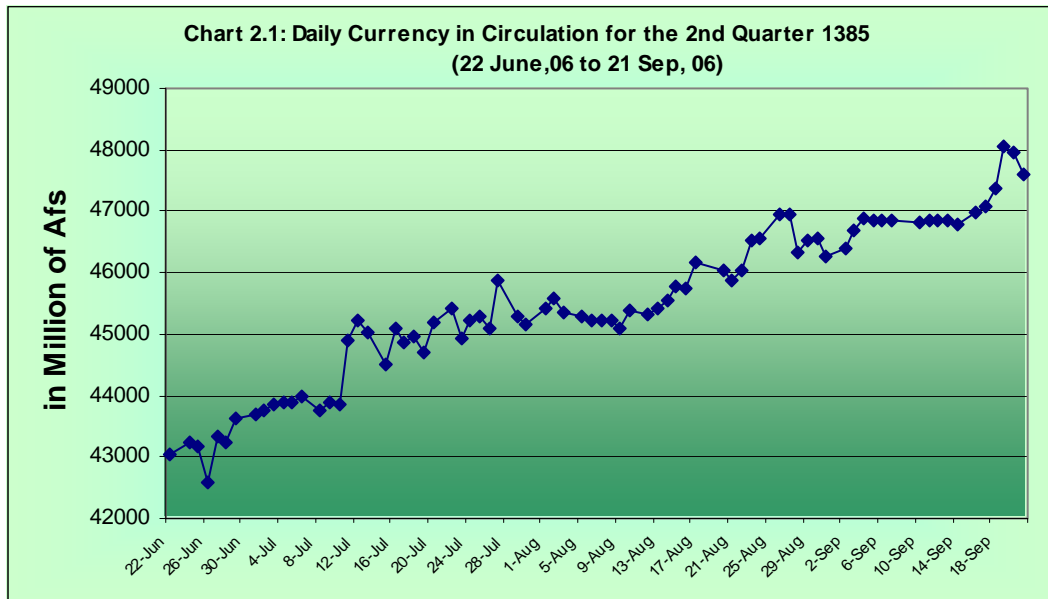
1) Narrow Money (M1)

M1 is composed of currency outside depository corporations and demand deposits. Currency outside depository corporations is equal to total issued money less cash in vaults of the DAB head office and its branches less Afghanis in vaults of commercial banks. Demand deposits or transferable deposits are those claims of customers on the banking sector which are less liquid than currency in circulation and can be withdrawn easily (with no penalties).

A. Currency in circulation

The current target of DAB for money supply is currency in circulation, which is defined as total currency issued less cash in vaults of DAB head office and its branches. Currency in circulation has been steadily growing according to the path projected by Da Afghanistan Bank (DAB) and agreed to by the International Monetary Fund (IMF). It grew by 37.5 per cent during the year 1383 (2004/05). During 1384 (2005/06) the growth of currency in circulation decelerated below the projected path of around 27 per cent growth and grew by 15.2 per cent. This was due to the large sterilization by DAB in order to bring down the inflation rate, principally through maintains of a stable nominal exchange rate at or near the level of 50 Afghanis per US Dollar.

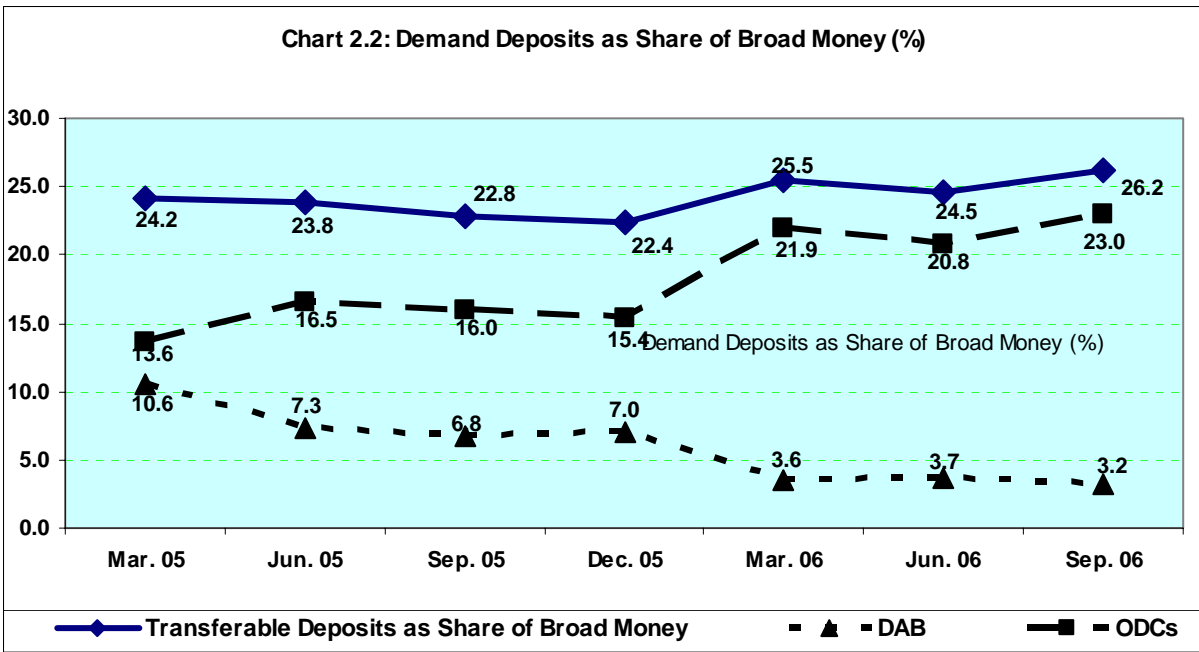
A daily time series data for the currency in circulation, which is the main operating target of monetary policy, is shown in the Chart 3. On end quarter basis the currency growth rate was about 10.59 per cent from Afs.43.02920 billion in the first quarter of 1385 to Afs.47.58697 billion in second quarter 1385. Compared with the last quarter, on quarter average basis the growth rate is 2 per cent higher.



This somewhat lower than expected growth in currency in circulation is due to smaller injection by Ministry of Finance since they had budget approval constraints imposed by the Parliament. Now that the budget is fully approved, the injections should increase in the quarter ahead. Yet another reason for the low growth of currency in circulation is the development of banking sector; the public is partially converting their cash to deposits and there is a hope that bank deposits will increase further with the advent of new interest rate structure that the DAB is encouraging. Finally, there is dollarization; most of the contracts of heavy procurements are done in US\$ or in other convertible currencies. The Afghani is used mainly for retail transactions.

B. Demand Deposits

Demand deposits or transferable deposits, which, as noted above, are less liquid than currency in circulation, are the other component of M1. In DAB these deposits mainly belong to the government and other public organizations. There are currently very few demand deposits which belong to individuals or the private sector in the commercial banks, but these should expand in the years ahead.



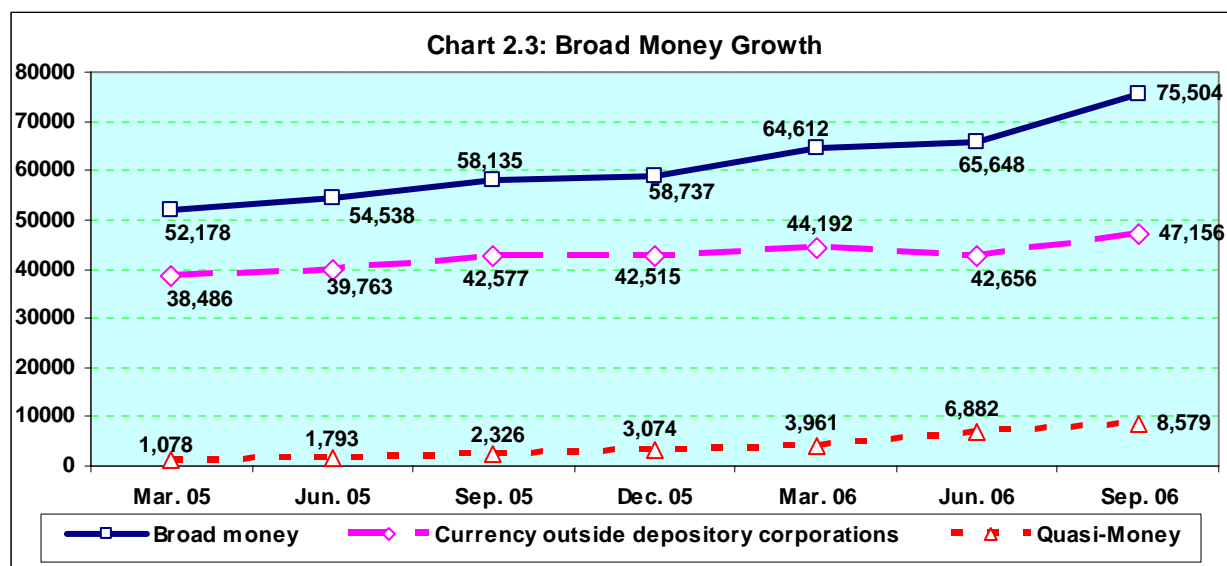
Source: Monetary Survey (estimated) 2005/06-2006/07, Monetary Policy Department, DAB

Chart 2.2 shows the movements in demand deposits from March 2005 through September 2006 as a share of broad money (M2). These deposits have been fairly stable over time as a share of broad money (M2) falling slightly in 2005 but then rising in 2006. The minimum share was 22.4 per cent (December 21, 2005) and since then they have increased reaching a share of 26.2 per cent of broad money (September 21, 2006). This suggests that there may be the beginning of improvement in the holding of overall demand deposits. Demand deposits are normally used for transaction based account settlements. However, in most cases the transaction settlements have been mainly taking place in cash. Shifting from cash settlements to account settlements is a crucial step for the development of financial sector in Afghanistan.

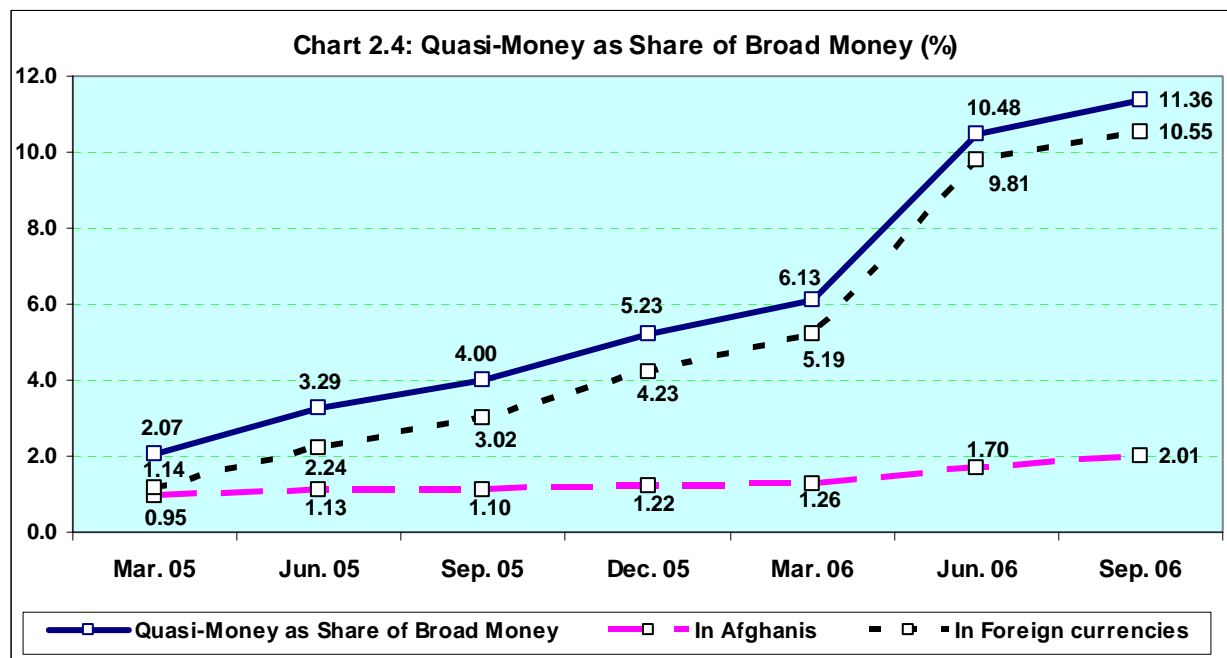
Interestingly, a comparison of the demand deposits with DAB and those with other depository corporations (ODCs) specifically the commercial banks shows a distinct improvement over time in demand deposits with ODCs. The commercial banks are thus doing well in terms of attracting the customers to deposit their money as demand deposits and the DAB is also encouraging the customers to deposit in commercial banks. The DAB has already put an end to its own commercial activities, which has helped in this regard.

2) Broad Money (M2)

M2 is equal to M1 plus quasi-money which normally would include time, savings and foreign currency deposits in commercial banks. Broad Money (M2) grew from Afs 52.2 billion in March 2005 to Afs 75.5 billion in September 2006, thus registering an expansion of nearly 45 per cent during the past year and a half. The movements in the various components of broad money are illustrated in Chart 2.3.



Source: Monetary Survey (estimated) 2005/06-2006/07, Monetary Policy Department, DAB



Source: Monetary Survey (estimated) 2005/06 – 2006/07, Monetary Policy Department, DAB

Quasi-money includes time and saving deposits plus foreign currency deposits. This has grown from 2.1 per cent of broad money in March 2005 to 11.4 per cent of broad money in March 2006. This indicates that people are beginning to put more of their money in the banks for longer maturities. Compared to demand deposits, time and saving deposits are increasing fairly rapidly, and foreign currency deposits are increasing at a faster rate than Afghani deposits. The interest rates on foreign currency and Afghani deposits are the same in all banks. Chart 2.4 shows a pattern of growing quasi-money from March 2005 to September 2006 as a share of broad money. This increase is about 80 per cent in foreign currency deposits; however, it is a good sign of improvement that the banking system is attracting more costumers.

Currency in circulation outside depository corporations continues to be the largest item within broad money in Afghanistan. In many developing countries this item is less than other monetary components like demand deposits, and the quasi-money. However, at this point in time quasi-money still contributes a small share of broad money in Afghanistan. The situation has begun to improve but there is still a long way to go.

2.2 Market Operations

A. Interest Rates

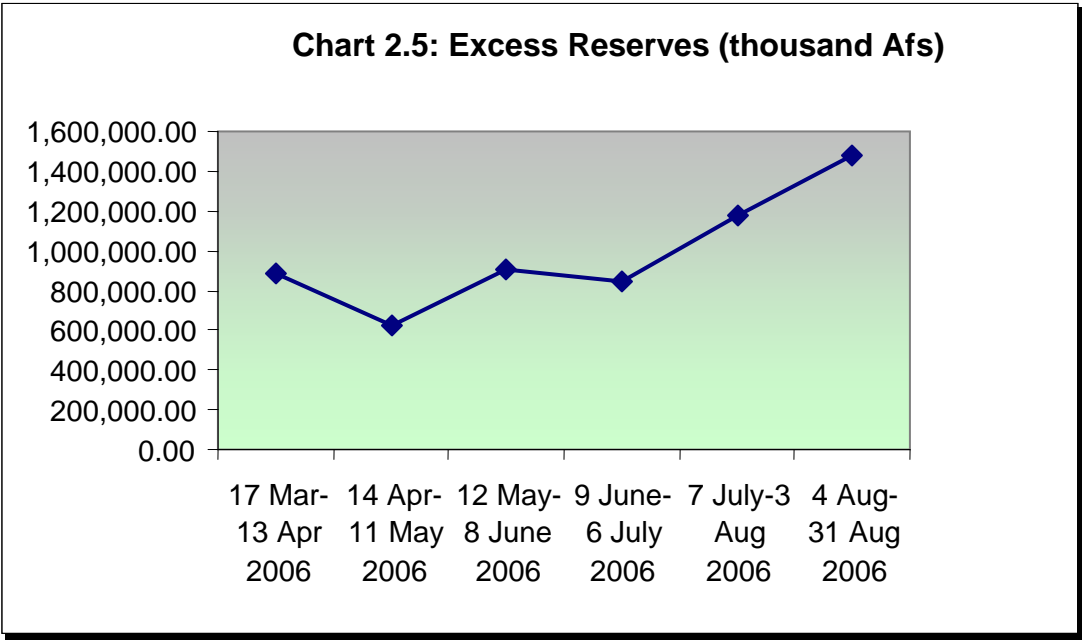
Afghani interest rates relative to inflation and foreign rates influence the willingness of banks and others to invest in Afghanistan and develop the country's financial markets. In general interest rates should be modestly positive in real terms (three to four per cent about the inflation rate plus applicable risk premiums). DAB influences market interest rates and the growth in bank deposits and credit by the level and rate of remuneration of required reserves, the rates on its overnight deposits, the rates on its overnight credit facility, and the rates on its Capital Notes. The Standing Facilities rates (overnight deposits and overnight credits) establish a minimum/maximum tunnel for short term interest rates. In general, rates on Capital Notes primary auctions should fall within the tunnel.

As points of reference, the CPI inflation rate over the second quarter was 9.6% at an annualized rate because of a relatively large increase in prices in August and the rate of price increase for the previous 12 months (September 2005 to September 2006) was 5.4 per

cent. For the first six months of 1385 (March 2006 to September 2006) the annual rate of price increase was 2.9 per cent.

B. Required reserves

During the first quarter required reserves averaged Afs 1.86 billion and excess reserves (including overnight deposits) averaged Afs 1.21 billion. These figures for the second quarter were Afs 1.49 billion and Afs 0.85 billion respectively. Required reserves were remunerated at a 1.5 per cent annual rate, well below the opportunity cost to banks and excess reserves were remunerated at 2.5 per cent annual rate if deposited in the overnight deposit facility. Chart 2.5



C. Capital Notes

DAB’s primary instrument for removing excess liquidity from the market is the sale of its own bills, so called Capital Notes. During the third quarter the outstanding stock of Capital Notes has remained at Afs. 600 million, with weekly auctions of Afs 100 million 28 day Notes and Afs 50 million 56 day notes. The average cover ratio (amounts bid as a per cent of amounts sold) was very high, peaking at around 400 per cent indicating very strong demand. In the middle of the quarter the number of bidders rose to six and then dropped back to two or three as interest rates on Notes fell over the quarter from almost 8 per cent

to below 6 per cent. The supply of Notes has not been sufficient to keep Note interest rates positive in real terms relative to quarterly inflation.

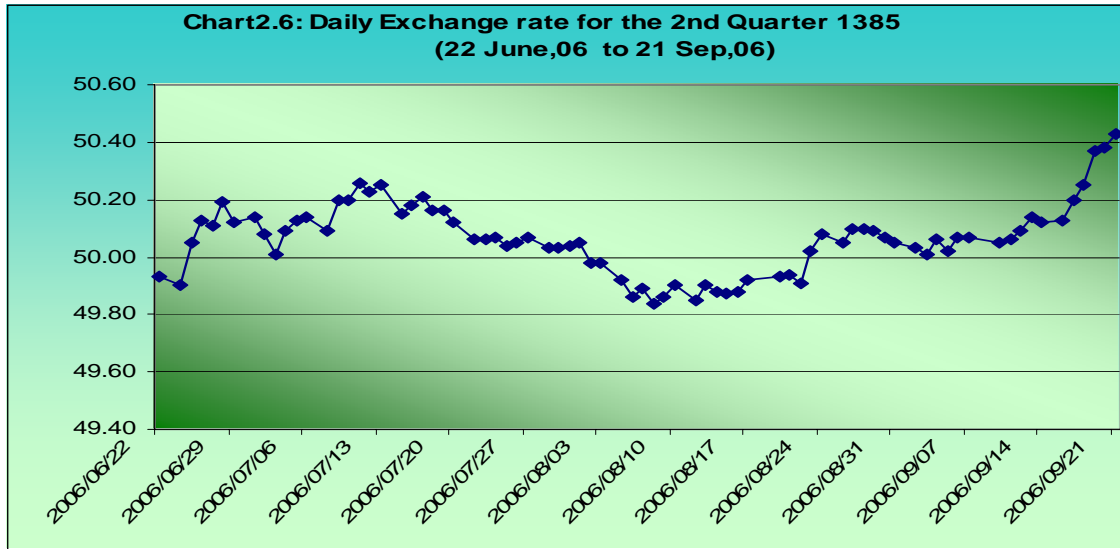
D. Standing Facilities

The spread between DAB's deposit and lending rates provides a safety net for market rates. With overnight deposits yielding 2.5 per cent and the overnight credit rate at 10 per cent, the "tunnel" provides the market with very little protection.

No over night credits were extended during the third quarter and none were extending in the preceding quarter. Overnight deposits, on the other hand, rose to over Afs 800 million during the quarter before dropping back to around Afs 500 million. This facility was first opened in April of this year. Deposits in the overnight facility should be temporary and balances should generally be at very low levels. The heavy use of this facility is a further indication of excess market liquidity and an inadequate supply of Capital Notes or other loanable securities or projects to absorb it.

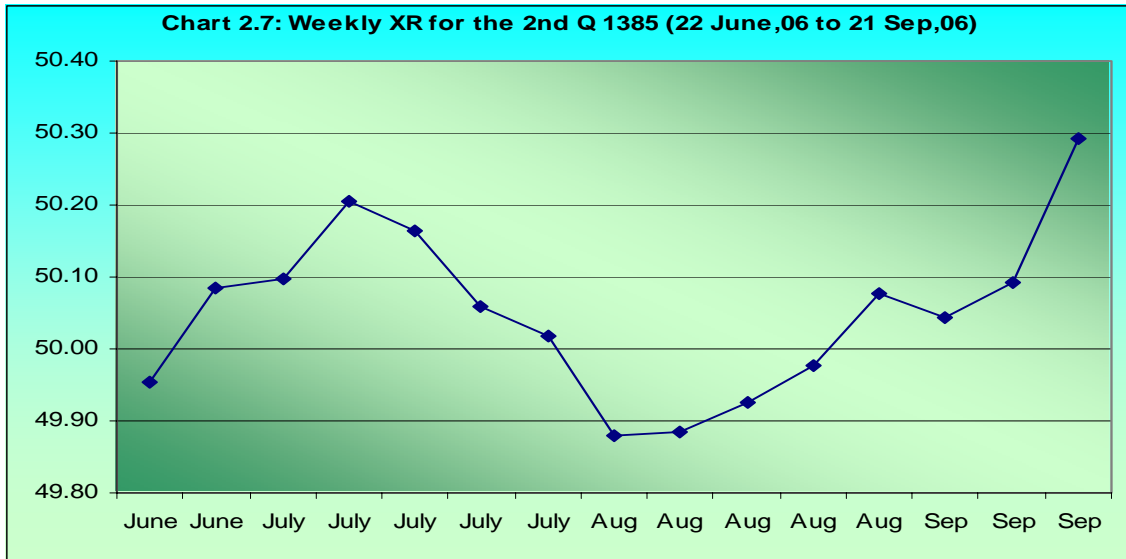
E. Foreign Exchange Market

The daily historic review of the exchange rate, Afs *vis a vis* US\$, for the second quarter of 1385 (22 June, 06 to 21 Sep, 06) is shown below in Chart 2.6. On the whole, the exchange rate of Afghani moved in a relatively narrow corridor of Afs.49.8 to 50.5 per US\$, throughout the quarter. By the end quarter basis the Afghani had depreciated by 1.0 per cent from Afs.49.93 per US\$ at the start of the quarter to Afs.50.43 per US\$ at the end of the quarter. On quarterly average basis, the Afghani depreciated by 0.64 per cent from the last quarter (Afs.49.74 per US\$) ended on 21 June, 2006, to the present level (Afs.50.1 per US\$).



The exchange rate movements on the weekly basis are depicted in Chart 2.7, given below, which shows two distinct phases. In phase one, the exchange rate started to depreciate in June 2006 and ended in mid-July 2006 moving from Afs.49.95 per US\$ to Afs.50.2 per US\$. Then the rate appreciated until mid August 2006, reaching to Afs.49.88 per US\$. In the phase two, starting from mid-August 2006 and going on to the mid-September 2006, the exchange depreciated from Afs.49.88 per US\$ to Afs.50.29 per US\$. A possible reason behind the phase one appreciation was that the DAB started decentralization of the foreign exchange auctions and extended the auction mechanism to the zonal hubs. Initially it was successfully implemented in Herat and it is expected to be extended to other areas, such as Jalalabad in the near future. Overtime this should help in stabilizing the Afghani exchange rate and making it uniform throughout the country. The other factor was that the Ministry of Finance had injections only from their operating budget, due to the issues raised by parliament.

The standard deviation and the coefficient of variation of the exchange rate movements for the current quarter (STD 0.12, CV 0.2) as compared with the last quarter (STD 0.14, CV 0.3) shows that exchange rate of Afghani was slightly stable in the current quarter compared with the last quarter ended on 21 June, 2006.



In sum, exchange rate analysis suggests that the exchange rate movements were under control throughout the second quarter with less volatility than in past years. This suggests that the expanded foreign exchange auction program is going smoothly

F. Foreign Exchange Auction:

For achieving the stability of the exchange rate, Da Afghanistan Bank has continued using its main policy instrument viz., the Foreign Exchange Auctions for the periodic intervention in the market to smoothen the fluctuations in the exchange rates and to control the growth of money supply. The Da Afghanistan Bank has maintained this bi-weekly sterilization policy, to mop up extra liquidity arising principally from government expenditures and the foreign peace-keeping forces. The foreign exchange auction size is determined by a liquidity forecasting framework, which takes in account the money demand on one hand and the currency growth ceiling agreed by the DAB with the IMF on the other.

Table 2.1 summarizes the results of DAB foreign exchange auctions during the period from 26 March, 2006 to 24 September, 2006, which covers the last two quarters.

In the most recent quarter the DAB intervention was US\$.128.11 million. The weighted average of all the 28 awarded auctions rate (sale price of the US\$) was 50.03, covering June, July, August and September, in which the total number of awarded bidders were 470. Compared with the last quarter, there were 22 auctions of US\$.91.27 million. The weighted average is 49.73, with the participation of 313 bidders.

Table 2.1: Foreign Exchange Auctions

| Auction Date | No of Bidders | High Price | Low Price | Cut off Price | Amount Awarded | No of Awarded Bidders |
|------------------------------|----------------------|-------------------|------------------|----------------------|-----------------------|------------------------------|
| 26-Mar-06 | | 49.96 | 49.8 | 49.92 | 7.15 | 20 |
| 28-Mar-06 | | 49.97 | 49.8 | 49.95 | 6.2 | 15 |
| 01-Apr-06 | | 49.86 | 49.6 | 49.86 | 0.02 | 1 |
| 04-Apr-06 | | 49.96 | 49.7 | 49.86 | 10.05 | 25 |
| 08-Apr-06 | | 49.86 | 49.7 | 49.8 | 6.3 | 25 |
| 11-Apr-06 | | 49.85 | 49.7 | 49.83 | 3.05 | 9 |
| 15-Apr-06 | | 49.75 | 49.6 | 49.71 | 6.05 | 19 |
| 18-Apr-06 | | 49.65 | 49.5 | 49.62 | 2.5 | 7 |
| 22-Apr-06 | | 49.78 | 49 | 49.74 | 7.75 | 26 |
| 25-Apr-06 | | 49.87 | 49.69 | 49.85 | 3.45 | 11 |
| 29-Apr-06 | | 49.85 | 49.6 | 49.68 | 4.3 | 18 |
| 02-May-06 | | 49.65 | 49.53 | 49.6 | 4.65 | 18 |
| 06-May-06 | | 49.52 | 49.4 | 49.48 | 4.75 | 17 |
| 09-May-06 | | 49.4 | 49.13 | 49.4 | 1.8 | 4 |
| 13-May-06 | | 49.52 | 49.25 | 49.5 | 3.45 | 16 |
| 16-May-06 | | 49.62 | 49.5 | 49.6 | 2.7 | 13 |
| 20-May-06 | | 49.72 | 49.6 | 49.68 | 5.1 | 18 |
| 23-May-06 | | 49.71 | 49.4 | 49.69 | 2.4 | 11 |
| 27-May-06 | | 49.72 | 49.62 | 49.67 | 3.05 | 12 |
| 30-May-06 | | 49.75 | 49.6 | 49.71 | 2 | 7 |
| 03-Jun-06 | | 49.6 | 49.4 | 49.56 | 2.3 | 11 |
| 06-Jun-06 | | 49.55 | 49.4 | 49.54 | 2.25 | 10 |
| 20-Jun-06 | 16 | 49.99 | 49.9 | 49.96 | 2.1 | 11 |
| 20-Jun-06 | 16 | 49.99 | 49.9 | 49.96 | 2.1 | 11 |
| 24-Jun-06 | 15 | 49.98 | 49.92 | 49.95 | 2.35 | 12 |
| 27-Jun-06 | 9 | 50.13 | 50.1 | 50.1 | 1.65 | 9 |
| 01-Jul-06 | 13 | 50.13 | 50.08 | 50.1 | 1.38 | 11 |
| 04-Jul-06 | 18 | 50.15 | 50.07 | 50.1 | 2.02 | 16 |
| 08-Jul-06 | 15 | 50.14 | 50.06 | 50.09 | 1.8 | 9 |
| 11-Jul-06 | 16 | 50.3 | 50.24 | 50.26 | 2 | 15 |
| 15-Jul-06 | 17 | 50.14 | 49.9 | 50.1 | 3.65 | 15 |
| 18-Jul-06 | 25 | 50.15 | 50 | 50.1 | 5.5 | 22 |
| 22-Jul-06 | 24 | 50.04 | 49.9 | 50 | 5.05 | 23 |
| 25-Jul-06 | 22 | 50.04 | 49.6 | 49.97 | 4.95 | 20 |
| 29-Jul-06 | 20 | 50.01 | 49.97 | 49.98 | 4.75 | 21 |
| 01-Aug-06 | 22 | 50.01 | 49.9 | 49.97 | 4.65 | 18 |
| 05-Aug-06 | 20 | 49.81 | 49.6 | 49.75 | 3.6 | 17 |
| 08-Aug-06 | 24 | 49.84 | 49.76 | 49.78 | 5.8 | 21 |
| 12-Aug-06 | 24 | 49.81 | 49.75 | 49.8 | 4.1 | 13 |
| 15-Aug-06 | 26 | 49.86 | 49.75 | 49.82 | 5.4 | 19 |
| 20-Aug-06 | 22 | 49.9 | 49.8 | 49.85 | 4.15 | 14 |
| 22-Aug-06 | 26 | 49.93 | 49.84 | 49.92 | 3.15 | 9 |
| 26-Aug-06 | 27 | 50.05 | 49.05 | 50.01 | 5.6 | 16 |
| 29-Aug-06 | 32 | 50.1 | 50 | 50.06 | 8.2 | 25 |
| 02-Sep-06 | 23 | 50.1 | 49.9 | 49.96 | 4.8 | 14 |
| 05-Sep-06 | 27 | 50.05 | 49.92 | 50.01 | 4.45 | 11 |
| 10-Sep-06 | 26 | 50.05 | 49.92 | 50.01 | 5.85 | 19 |
| 12-Sep-06 | 30 | 50.15 | 50 | 50.1 | 6.27 | 21 |
| 16-Sep-06 | 28 | 50.17 | 50.05 | 50.13 | 7.15 | 22 |
| 19-Sep-06 | 30 | 50.43 | 50.19 | 50.36 | 8 | 23 |
| 24-Sep-06 | 33 | 50.3 | 5.1 | 50.25 | 9.75 | 24 |
| Current Quarter Total | | | | | 128.11 | |
| C.Total | | | | | 221.48 | |

III. Financial Sector Developments

3.1 Banking Sector

The banking system review has been developing into a core output of Da Afghanistan Bank (DAB), which captures the condition as well as trends in the banking system of Afghanistan. Da Afghanistan Bank (DAB), the regulatory and supervisory body of the banking sector in Afghanistan, has been moving steadily and successfully towards modernization of the banking system. DAB is fully committed towards the implementation of the requirements of the Banking Law, DAB law, and relevant regulations and makes sure banking institutions are in full compliance of them. Of course, DAB will render any feasible cooperation to any banking institution as per request.

- The banking system in Afghanistan consists of 14 duly-licensed and permitted banking organizations: three re-licensed state-owned banks, six private full-fledged commercial banks, and five branches of foreign banks.
- Total assets of the banking system are Afs. 39.2 billion, up by 12 per cent from last quarter. The growth rate for private banks was the highest, 21 per cent.
- Of these assets, net loans portfolio currently is Afs. 12.1 billion, up by 25 per cent from the previous quarter, or 30.8 per cent of total assets. Non-performing loans decreased over the previous quarter, and asset quality is not considered a problem in the banking sector as a whole.
- Deposits are the major component of liabilities and amounts to Afs. 27.5 billion, up by 17 per cent from last quarter. Afs-denominated deposits' share in total deposits is still almost the same, only 18.7 per cent.
- Overall, the banking system is well capitalized. Total capital of the banking system is Afs. 9.8 billion.
- The banking sector overall is profitable. Total net profit for quarter is Afs. 43 million, up significantly from last quarter's Afs. -163.7 million. Total aggregate return on assets (ROA) is 0.46 per cent, annualized.

- The issuance of enforcement actions to those in violation of set limits reduced the open FX position of three banks to the level even below the threshold, whereas the other two are slightly above the limit.
- Overall, the banks are asset sensitive with regard to interest rate sensitivity, benefiting from an increase in market interest rates.

Assets

The banking system continues to grow. Total assets (size) of the banking system are Afs. 39.2 billion, up by 12 per cent or Afs. 4.2 billion from last quarter which is a respectable growth rate.

The size of private banks expanded Afs. 3.2 billion or 76 per cent of total increase in assets of the banking system, the highest among the three peer groups. The size of branches of foreign banks and state-owned banks improved in absolute terms but decreased in market share, indicating the rapid growth of private banks.

The shares of aggregate assets of the banking sector among different categories of banking organizations changed since last quarter and are summarized below:

Table 3.1: Share in Aggregate Assets (Per cent)

| | First Quarter Ended 1385 | Second Quarter Ended 1385 |
|---------------------------|--------------------------|---------------------------|
| State-owned Banks | 32.4% | 29.5 % |
| Private Banks | 44.0 % | 7.4 % |
| Branches of Foreign Banks | 23.7 % | 23.1 % |

The Consolidated Balance Sheet of Afghan Banking organisations (SOB+PB+Branches of foreign banks) is shown below in Table 3.2

Table 3.2: Consolidated Balance Sheet of all Banking Organizations (SOB, PB and Branches of Foreign Banks) (Afs-Million)

| A | Liabilities | End-1383 | End 1384 | End Q1, 1385 | End Q2, 1385 |
|----------|---|-----------------|-----------------|---------------------|---------------------|
| 1 | Capital | 8,883.4 | 9,499.0 | 9,543.0 | 9,797.0 |
| 2 | Deposits | | | | |
| | Afghani | 1,860.3 | 3,438.0 | 4,149.0 | 5,138.0 |
| | US Dollar | 6,641.4 | 15,476.0 | 18,440.0 | 21,390.0 |
| | Other Currencies | 593.4 | 786.0 | 961.0 | 994.0 |
| | Subtotal Deposits | 9,095.1 | 19,700.0 | 23,550.0 | 27,522.0 |
| 3 | Borrowings | 82.6 | 85.0 | 160.0 | 308.0 |
| 4 | Other Liabilities excluding interest payable | | | | |
| | Afghani | 228.3 | 214.0 | 538.0 | 337.0 |
| | US Dollar | 454.0 | 545.0 | 483.0 | 637.0 |
| | Other Currencies | 56.0 | 63.0 | 192.0 | 30.0 |
| | Subtotal | 738.3 | 822.0 | 1,213.0 | 1,004.0 |
| 5 | Other Liabilities | 503.0 | 619.0 | 582.0 | 585.0 |
| | Capital plus Liabilities | 19,302.0 | 30,725.0 | 35,048.0 | 39,216.0 |

| B | Assets | End-1383 | End-1384 | End Q1, 1385 | End Q2, 1385 |
|----------|---|-----------------|-----------------|---------------------|---------------------|
| 1 | Cash in Vault and claims on DAB | 3,031.0 | 4,812.0 | 6,124.0 | 7,265.0 |
| 2 | Claims on Financial Institutions | | | | |
| | Afghani | 9.0 | 16.0 | 73.0 | 18.0 |
| | US Dollar | 6,334.0 | 8,718.0 | 9,562.0 | 10,346.0 |
| | Other Currencies | 1,236.0 | 1,213.0 | 1,615.0 | 1,623.0 |
| | Subtotal | 7,579.0 | 9,947.0 | 11,250.0 | 11,987.0 |
| 3 | Investments | 785.0 | 772.0 | 800.0 | 814.0 |
| 4 | Loans | | | | |
| | Afghani | 673.0 | 1,060.0 | 1,254.0 | 2,705.0 |
| | US Dollar | 2,264.0 | 7,272.0 | 8,783.0 | 9,803.0 |
| | Other Currencies | 0.0 | 43.0 | 16.0 | 0.0 |
| | Subtotal | 2,937.0 | 8,375.0 | 10,053.0 | 12,508.0 |
| | Less Loan Loss Reserves | 72.0 | 280.0 | 367.0 | 418.0 |
| | Net Loans | 2,865.0 | 8,095.0 | 9,686.0 | 12,090.0 |
| 5 | Other Assets | 5,042.4 | 7,099.0 | 7,188.0 | 7,060.0 |

The major components of assets, in decreasing order as a percentage of total assets, are discussed as follows. Net Loans Portfolio replaced claims on financial institutions as the largest component of total assets, currently equal to Afs. 12.1 billion – a 25 per cent increase over the previous quarter – or 30.8 per cent of total assets. Increases in lending were observed at all but four of the banking organizations. Private banks outperformed the other groups by increasing their net loan portfolio up to Afs. 2.1 billion or 88 per cent of the total increase in net loans portfolio of the banking sector. Commercial loans are the

biggest subset of loans, making 86 per cent of the total. Other sub-categories changed insignificantly. Thus, lending is picking up, but still not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture.

5 private banks are the leading creditors, increasing their portfolio both in absolute terms as well as percentage of total loans, Afs. 9.5 billion or 79 per cent of total loans. State-owned banks and branches of foreign banks' share dropped, but slightly improved in absolute terms.

Claims on Financial Institutions' became the second largest among various asset categories, currently comprising Afs. 12 billion – a 10 per cent increase over June's total – or 30.6 per cent of total assets. All three peer groups increased their claims on financial institutions.

Asset Quality (adversely classified assets & past due status)

The overall quality of loans portfolio is highly satisfactory, with 88% of the loans classified as standard. However, on-site examinations would fully confirm the accuracy of the data. There are two indicators of loans quality: non-performing loans (NPL) & adversely classified loans (ACL). Because of the way these indicators are defined, NPL should be less than ACL.

Our focus is on the sum of loans, past due 91 days or more (Non-accrual) and other Non accrual loans. These loans are called non-performing loans. The total amount of non-performing loans is Afs. 379 million, while adversely classified loans (*loans classified Substandard, Doubtful, and Loss*) are Afs.573 million. The latter must be higher or at least equal to the former. NPLs are currently 3 per cent of gross loans, down by 1.8 percentage points over the previous quarter. State-owned banks' NPLs are 80 per cent of total NPLs of the banking sector.

Cash in Vault and Claims on DAB remains the third largest category, increasing both in absolute terms as well as percentage of total assets. Claims on DAB increased by 19 per cent from the previous quarter. Other claims on DAB (capital notes) amount to Afs. 803 million. When added up, these two categories make 12.6 per cent of total assets of the banking system.

Liabilities

Total liabilities of the banking sector as of first quarter ended are Afs. 29.4 billion up by 15.3 % from last quarter. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Increases in deposits of branches were reflected as comparable increases in total assets with unrelated parties for the period, indicating a shift from a source of funds for the home office towards active engagement in the country. Deposits are the major component of liabilities, currently equal to Afs. 27.5 billion, a 17% increase over the previous quarter. Private banks as a whole, and Kabul Bank and Azizi Bank in particular, attracted Afs.3.1 billion more deposits, 77 per cent of the total increase. Total deposits increased in absolute terms, as well as per cent of total liabilities. Total deposits of private banks also increased both ways, where more than half of it goes to Kabul Bank. Even though deposits of state-owned banks and branches are expanding in absolute terms, their share in total deposits lost some ground. Despite favourable movements in Afs. USD, and other currencies denominated deposits in absolute terms, their shares in total deposits stayed the same. Of the total Afs-denominated deposits, the state-owned banks are still the biggest holders, while private banks are catching up and showing considerable improvement. In fact, the banking organizations should do more to make Afs-denominated deposits more attractive for customers.

Other liabilities except Interest Payable remain the second major component of liabilities, down by 17 per cent, or 3.4 per cent of total liabilities.

Capital

The system, as a whole, is very well capitalized.

Total capital at full-fledged banks is Afs. 9.8 billion up by 3 per cent from the previous quarter. If the 20 per cent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the Afs. 9.5 billion can support assets of Afs. 49 billion, while total assets at the end of quarter were Afs. 39.2 billion.

Profitability

The banking sector overall is profitable. Total Net Profit of the banking sector for the quarter is Afs. 43 million, up significantly from last quarter's Afs -164 million, resulting in an overall return on assets (ROA) of 0.46 per cent. However, three banks ended up with higher profitability than last quarter.

Private Banks in particular are less profitable than before mainly due to the recent expansion of some banks into the provinces, whereas branches of foreign banks were more profitable. State-owned banks are making more accurate classification of their assets, which increased the credit provision expenses and, as a peer group, remained unprofitable.

The efficiency ratio (*net interest income + trading account gain/loss + other non-interest income* divided by *operating expenses*) of the system improved from a median of 1.54 in the last quarter to a median of 1.58 for the current period. Six banking institutions ended up with lower efficiency ratios.

Foreign Exchange Risk

The level of foreign exchange risk being taken by banks has been returning to levels below the maximum threshold set by DAB. In general, the long open FX positions of certain private banks are well below the thresholds set by DAB, while others are showing some improvement but still unable to fulfil the requirements of the enforcement actions. According to Open Positions in Foreign Currencies' Regulation, the overall open position in all foreign currencies shall not exceed 40 per cent of the institution's regulatory capital. (Branches of foreign banks are not subject to limitations on open F/X position, since that risk is managed on a whole-bank basis and not branch-by-branch). The enforcement actions require the elimination of these excess long positions in individual currencies by August 31, 2006 to no more than 20%, and by July 31, 2006 to no more than 40%. (The state-owned banks were not subject to enforcement actions; thus issue will be addressed as part of their overall restructuring.)

Interest Rate Risk

Interest rate sensitivity of the banks remained unchanged during the quarter, and all banks are in an asset sensitive position (benefiting from an increase in the interest rate). (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like F/X risk, interest-rate risk is managed on a whole-bank basis).

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

The current situation could be summarized as below:

- All banking organizations are asset-sensitive
- At the same time, core income [*(net interest income + trading account gain/loss + other non-interest income)* minus *operating expenses*] is declining slightly, making banks less able to withstand declines in NII caused by a shock.
- DAB may want to take into account this negative effect on banks if it were to consider lowering interest rates through monetary policy.

The traditional cause of interest-rate risk, the mismatch between the maturities of interest-earning assets and interest-costing liabilities, has not yet emerged in Afghanistan.

IV. Fiscal Sector

4.1 Fiscal Highlights

In the second quarter of the fiscal year Afghanistan entered into a program supported by a three year arrangement with the International Monetary Fund (IMF) under its Poverty Reduction and Growth Facility (PRGF). The arrangement, for the amount of US\$119.1 million was approved by the IMF Executive Board on June 26, 2006. As a result of the approval, Afghanistan will receive an initial disbursement under the PRGF arrangement amounting to about US\$19.4 million. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments

The PRGF will provide a comprehensive framework for realizing fiscal sustainability and catalyzing improvements in budget planning and execution. Under the PRGF, in the fiscal area, the government is committed to enhancing revenue mobilization, including strengthening the large taxpayers' office, improving transparency and simplifying procedures, and upgrading administrative capacity. On the spending side, the government has committed to strengthening the enforcement of the manpower and appropriation ceilings, while moving gradually to a new pay and grading system. These efforts will be complemented by further improvements in implementation capacity to increase much-needed development spending.

Another major development with fiscal implications in the second quarter was the granting by the Paris Club of creditor nations of 'Naples Terms,' to Afghanistan on July 19, 2006. This will eventually result in a 67% cancellation (US\$1.6 billion) of Afghanistan's arrears and late interest, as well as maturities up to 2009. The agreement reschedules US\$0.8 billion (33% of treated amounts) over 23 years, and provides for a deferral of 100 percent of moratorium interest (the interest due during the grace period).

This treatment is a first step in the implementation of the commitments made by the Governments of Germany, the Russian Federation and the United States of America on the occasion of the London conference on Afghanistan of 31 January 2006, to cancel 100% of Afghanistan's debt within the context of a successful implementation by Afghanistan of the HIPC initiative process.

4.2 Budgetary Performance

Overall, fiscal performance during the second quarter of 2006 was satisfactory even though domestic revenue was down slightly from Afs 7.4 billion in the first quarter to Afs 6.6 billion in the second quarter (see Table 4.1). This slight dip in revenues can be explained by seasonal factors as reflected in the large difference between other taxes in the first and second quarters. Other taxes dropped from Afs 2.2 billion to 245 million in the second quarter.

The operating budget deficit stood at Afs 10.6 billion largely due to a drop in external grants. However, the drop in external grants was matched by the unanticipated sale of a telecommunications spectrum bandwidth (about 0.5 percent of GDP) which led to a slightly higher increase in government deposits.

In addition, lower than expected custom receipts, resulting from delays in introducing a new tariff schedule and concessions made to traders were offset by higher collection of taxes on income and profits and the business receipts tax (BRT).

A draft law to eliminate nuisance taxes and introduce collection of BRT on imports was submitted to Parliament, but was returned to the government, partly because of procedural issues.

Core operating expenditures in the second quarter were low due to delays in parliament's approval of the annual budget. However, it gradually recovered and reached 43 percent of the approved operating budget by September, 2006.

The 2005/06 core budgeted audited financial statements were submitted to parliament in September. In addition, a working group has been established between the Ministry of Finance and the control and audit office (CAO) to follow up on the auditor's recommendations. The appeals process for customs and revenue has been established and the training of officials is underway.

Table 4.1: Afghanistan Operating Budget: Executions for the first Two Quarters of 1385

| | 1385 (In Thousand Afghanis) | |
|---|-----------------------------|---------------------|
| | Q1 | Q2 |
| Donor Revenue | 4,331,024 | 3,257,818 |
| Operating Budget | 2,615,688 | 580,097 |
| Development Budget | 1,715,335 | 2,677,720 |
| Domestic revenue | 7,368,496 | 6,614,789 |
| Taxation | 5,899,188 | 5,956,651 |
| Fixed Taxes | 62,231 | 100,548 |
| Income Taxes | 728,288 | 1,019,766 |
| Property Taxes | 15,392 | 24,450 |
| Sales Taxes | 878,287 | 1,374,626 |
| Excise Taxes | 31 | (20) |
| Other Taxes | 2,199,161 | 244,151 |
| Tax Penalties and Fines | 24,916 | 57,423 |
| Customs duties and taxes imports | 1,990,883 | 3,135,707 |
| Other Revenues | 1,469,308 | 658,138 |
| Note 2B1 - Social contributions | | |
| Retirement contributions | 48,277 | 62,355 |
| Total social contributions | 48,277 | 62,355 |
| Note 2B2 - Other revenue | | |
| Income from Capital Property | 17,647 | 23,793 |
| Sales of Goods and Services | 392,161 | 422,166 |
| Administrative Fees | 435,905 | 564,162 |
| Royalties | 6,262 | 9,790 |
| Non Tax Fines and Penalties | 13,758 | 16,231 |
| Miscellaneous Revenue | 548,830 | (480,590) |
| Sale of Land and Buildings | 6,468 | 40,231 |
| Total other revenue | 1,421,031 | 595,783 |
| Note 2C - Donor contributions | | |
| Afghanistan reconstruction trust fund | | |
| Law and order trust fund - Afghanistan | | |
| Foreign loans | | |
| Donor revenue | | |
| Total donor contributions | | |
| Revenue from previous years | | |
| Other misc revenue | | |
| Returns - advance payments | | |
| Sale of land and building | | |
| Revenue - natural resources | | |
| Total Government Expenditure | 170,692 | 22,519,744 |
| Economic classification (Development Budget) | 166,635 | 5,299,976 |
| Salaries and allowance | 32,656 | 53,943 |
| Goods and services | 116,960 | 3,163,448 |
| Pension payments | - | - |
| Grants | - | - |
| Capital expenditure | 17,018 | 2,082,584 |
| Interest payments | - | - |
| Economic classification (Operating Budget) | 4,057 | 17,219,769 |
| Salaries and allowance | 2,559 | 11,680,905 |
| Goods and services | 1,497 | 4,021,394 |
| Grants | - | 1,107,512 |
| Capital expenditure | - | 327,091 |
| Interest payments | - | 82,867 |
| Operating Budget Balance | 7,364,439 | (10,604,980) |
| Overall Balance | 11,528,828 | (12,647,138) |
| Float and adjustment 1/ | (11,528,828) | 12,647,138 |
| Balance Da Afghanistan Bank | - | - |
| Donor assistance grants and loans | - | - |
| ARTF | - | - |
| LOTFA | - | - |
| Other Grants | - | - |
| Program Loans | - | - |
| Budget Support Loans (Programme Loans) | - | - |
| Project Loans | - | - |
| Bilateral Contributions Through Treasury | - | - |
| Change in GoA's Account at DAB | - | - |
| Banking financing 2/ | - | - |
| External Loans | - | - |
| Domestic Loans (net) | - | - |

V. External Sector Developments

Merchandise Trade

The main source of the merchandise trade data discussed in this section is the Central Statistics Office (CSO) which is responsible for the collection of data from all custom offices in the country. The Balance of Payments Section of the Monetary Policy Department of DAB compiles the merchandise trade and external sector developments on quarterly and annual basis. For comparison of trade data the central bank also receives data from the IMF based on Data from Afghanistan's trading partners. A considerable share of the country's imports and exports is not in the record of the customs offices. Accordingly the amounts reported by CSO are undervalued and understate the volume of Afghan trade.

The IMF team in Afghanistan also collects data from the partner countries to arrive at some adjustments to estimate merchandise trade of Afghanistan. The partner countries' data uses export data from other countries (such as Pakistan, Iran and Japan) to Afghanistan as a means of estimating Afghanistan's imports. Conversely, the other countries' imports from Afghanistan are used to estimate Afghanistan's exports. The main problem with the partner countries data is that the import figures generated are actually at lower levels than the CSO figures. This is due to the fact that most of our trading partners are also facing the same underestimation problems as Afghanistan does, so that the partners' data may not be completely enumerating their actual levels of trade either comparing both of the above plus some of its own survey work, the DAB team makes further adjustments in estimating the trade statistics.

There are no solid figures on the magnitude of smuggling from the neighbouring countries i.e. Iran and Pakistan. According to an un-official survey of DAB Statistics Unit conducted at the beginning of 2005 and using data from recent surveys and working closely with the CSO, it is estimated that approximately 20 per cent of recorded imported items are re-exported. Smuggled exports are estimated to be equal to 30 per cent of recorded exports, and smuggled imports are estimated to be roughly 30 per cent of recorded imports. However there are large uncertainties inherent in these estimates.

The official CSO trade statistics do not include the ongoing smuggling activities along the Iranian and Pakistani borders. The real dimensions remain unknown, but based on the

trade survey conducted by the DAB Statistical Unit in July 2005 and the discussions held with recent IMF mission to Afghanistan regarding closing the gap in the estimation of trade, suitable adjustments are being made to try to include the unrecorded trade. These adjustments begin with 1384 (March 21st 2005 to March 20th 2006). The trade data shown in Tables 5.1 and 5.2 includes estimates of unrecorded trade. The IMF recorded and unrecorded trade figures shown in Tables 5.1 and 5.2, (which are much higher than the CSO estimates) are based on the consumption pattern of the country and the GDP growth. On the other hand, the CSO and DAB work from the trade data surveys which do not take consumption activities directly into consideration in their estimation. A comparison of the two sets of data for 1382, 1383, 1384 and first half of 1385 (March 21st to September 22nd 2006) is presented below:

Table 5.1: Comparison of Trade Statistics (in million of US\$)

| Items | 1382 | 1383 | | 1384 | | First half of 1385 | |
|------------------|---------|---------|---------|----------|----------|--------------------|---------|
| | CSO | IMF | CSO | IMF | CSO | IMF | CSO |
| Trade balance | -2031.8 | -2113.8 | -1969.8 | -2324.71 | -2218.98 | -1911.91 | -902.41 |
| Exports of goods | 815 | 1750 | 826.4 | 780.34 | 992.98 | 583.62 | 431.22 |
| Recorded | 144 | 457.2 | 304.8 | 232.8 | 383.72 | 153.61 | 173.88 |
| Unrecorded | 617 | 1292.8 | 521.6 | 547.54 | 609.26 | 430.01 | 257.34 |
| Imports of goods | 2846.8 | 3863.9 | 2796.2 | 3105.05 | 3211.96 | 2495.53 | 1333.63 |
| Recorded | 2,101.0 | 3196.4 | 2150.9 | 2388.5 | 2470.74 | 1919.64 | 1025.87 |
| Unrecorded | 745.8 | 667.5 | 645.3 | 716.55 | 741.22 | 575.89 | 307.76 |

The above two sets of figures reflect the current status of the two approaches being used to estimate Afghanistan's trade flows. 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 relevant institutions. It is clear that CSO is the best long term source for getting the correct numbers regarding the trade and other economic and social data. As the CSO's coverage capacity improves, the statistical base of the external sector of the country will improve and progress along these targeted lines will be reported in future issues of this Bulletin.

In evaluating the trade account of Afghanistan on the basis of currently available statistics a certain degree of caution is necessary since the trade data clearly have

shortcomings. The data reported by CSO for first half of 1385 (March 21st to September 22nd 2006), shows that recorded imports rose to a level of \$1025.87 million and the total recorded exports were estimated to be approximately US \$ 173.88 million. Estimates for unrecorded import data are subject to a considerable degree of uncertainty, but were thought to be on the order of magnitude of US\$ 678.3 million in 1380 (2001/02), US\$ 928.8 million in 1381 (2002/03), US\$ 745.8 million in 1382 (March 2003 to March 2004), and US\$ 645.3 million in the year 1383. Total recorded imports were estimated to be US\$ 2470.74 million during 1384. Assuming the levels of unrecorded imports to be 30 per cent of recorded imports it follows that unrecorded imports were in the range of US\$ 307.76 million for the first half of 1385 (March 21st to September 22nd 2006). The total amount of recorded exports was estimated to be \$173.88 million and the unrecorded exports together with re-exports, excluding exports of opium, was estimated to be at the level of US \$ 257.34 million for the first half of 1385 (March 21st to September 22nd 2006).

The trade deficit for the first half of 1385 (March 21st to September 22nd 2006), estimated by both DAB and CSO, excluding opium exports, works out to be roughly US \$902.41 million or about 24.66 per cent of GDP (see Table 5.2). As long as the donor support continues and the deficit is declining as a percentage of GDP, this should be a manageable and appropriate level of deficit given the magnitude of the country's reconstruction requirements, particularly in the area of infrastructure. Importantly, the trade deficit appears to be declining as a percentage of GDP. However, continued steady progress is needed in the coming years. (See Chart 5.1)

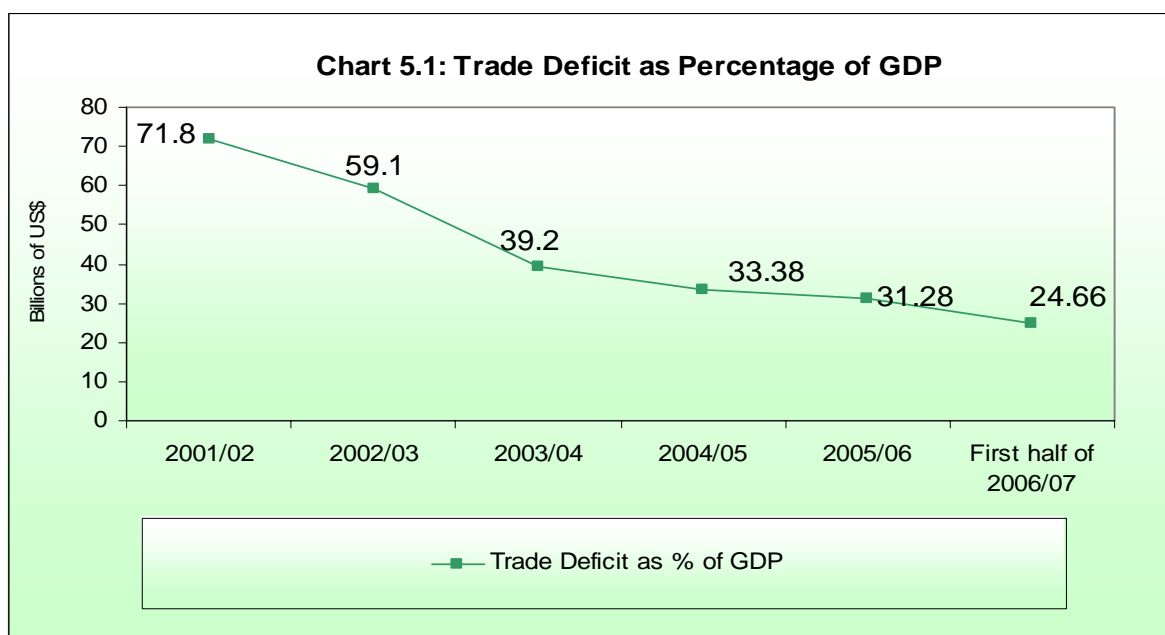


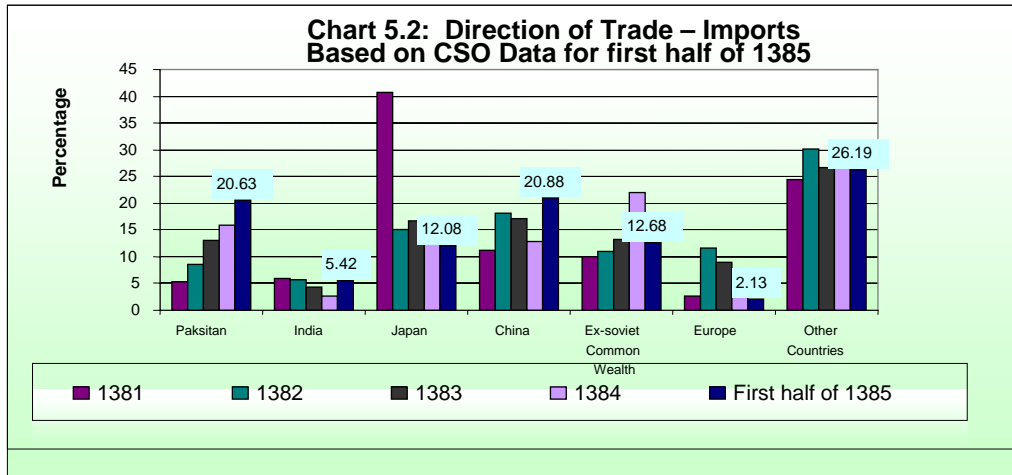
Table 5.2: Merchandise Trade (in US\$ million)

| | | 1380 | 1381 | 1382 | 1383 | 1384 | First half of 1385 |
|----------------------------------|---------------------------------------|----------------|-----------------|-----------------|----------------|----------------|--------------------|
| Imports: | (from previous period) | 2,374 | 3,250.90 | 2,846.80 | 2796.2 | 3211.96 | 1333.63 |
| | Recorded Imports | 1695.7 | 2322.1 | 2101 | 2150.9 | 2470.74 | 1025.87 |
| | Consumer goods | 872.4 | 767.5 | 903.4 | 383.3 | 478.63 | 183.73 |
| | Industrial supplies & materials | 245 | 807.8 | 399.2 | 667.4 | 541 | 251.92 |
| | Capital goods & others | 562.3 | 724.4 | 777.4 | 1034 | 1206.5 | 536.15 |
| | Fuel and lubricants | 16 | 22.4 | 21 | 66.2 | 244.61 | 54.07 |
| | Unrecorded | 678 | 928.8 | 745.8 | 645.3 | 741.22 | 307.76 |
| Exports: | | 604.2 | 836.7 | 815 | 826.4 | 992.98 | 431.22 |
| | Domestic | 68.2 | 100.1 | 144 | 304.8 | 383.72 | 173.88 |
| | Re-exports & shuttle trade | 536 | 736.6 | 617 | 521.6 | 609.26 | 257.34 |
| Trade balance: | | -1769.8 | -2414 | -2031.8 | -1969.8 | - | 2218.98 |
| Trade Balance as % of GDP | | 71.8 | 59.1 | 44.3 | 33.4 | 31.28 | 10.48 |

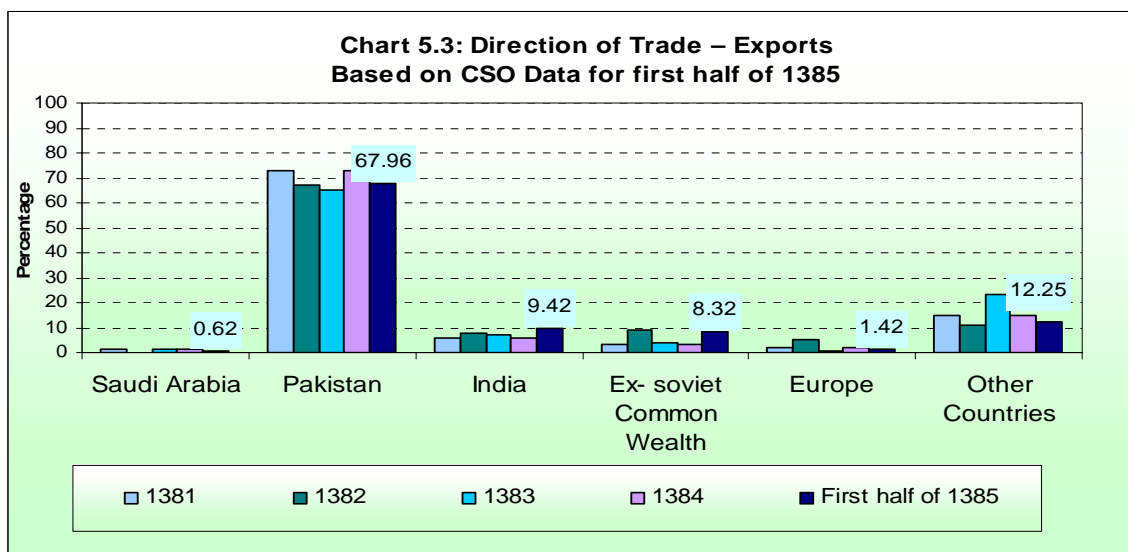
Direction of Trade

The direction of trade for Afghanistan has been analyzed using unadjusted CSO trade data. The Charts 5.2 and 5.3 results include only recorded trade reported by CSO. They show the direction of trade, for both imports and exports, for Afghanistan during the period 1381 to the first half of 1385 (March 21st to September 22nd 2006). The statistics reported by CSO in the first half of 1385 (March 21st to September 22nd 2006) show that “Other countries” remained the largest source of imports to Afghanistan placed at about 26.19 per

cent. They were followed by China with share of 20.88 per cent, Pakistan with 20.63 per cent, and the ex-soviet Common Wealth with 12.68 per cent of total imports. Japan stood at about 12.08 per cent, India with 5.42 per cent, and Europe with 2.13 per cent share of imports to Afghanistan.



In the field of exports, Pakistan remained Afghanistan’s largest customer by a large margin. Pakistan’s share of total exports from Afghanistan increased in the first half of 1385 (March 21st to September 22nd 2006) to 67.96 per cent from 65.03 per cent in 1383, ‘Other Countries’ share was 12.25 per cent, and India was third at 9.42 per cent. Common Wealth share of total exports was placed at 8.32 per cent, Europe 1.42 per cent and Saudi Arabia 0.62 per cent.



Composition of Trade

The composition of imports during the first half of 1385 (March 21st to September 22nd 2006) indicates that imports of ‘Other Equipment’ had the largest share of 34.90 per cent with Machinery & Equipments at 17.37 per cent, Construction Material at 14.59 per cent, followed by “Textile Clothing & Footwear” totalling 13.40 per cent, Food Items at 10.62 per cent, Fuel at 5.27 per cent, and Transportation Equipments & Spare parts at 3.85 per cent. (Chart 5.4)

A comparison of imports for the first half of 1385 (March 21st to September 22nd 2006) with the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005) shows that the composition has changed considerably. The share of item “Other” has increased in the first half of 1385 (March 21st to September 22nd 2006) to 34.90 per cent from only 23.71 per cent in the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005) while on the other hand, the share of item “Fuel” has declined to 5.27 per cent during in the first half of 1385 (March 21st to September 22nd 2006) from 11.63 per cent in the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005).

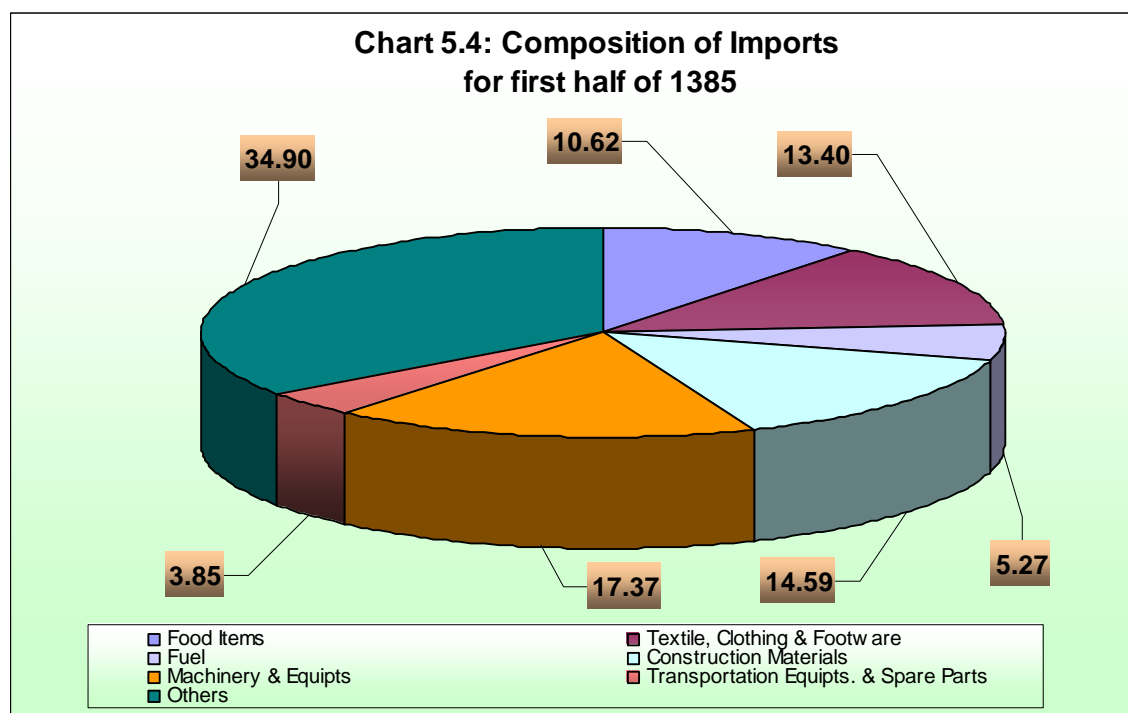


Chart 5.5 shows composition of the total exports for the first half of 1385 (March 21st to September 22nd 2006) by the main commodities and products, “Carpet & Rugs” with 45.74 per cent is the largest export component followed by “Food Items” which constituted some 32.71 per cent of total exports, Wool at 8.60 per cent, Medical Seeds at 5.96 per cent “Others” 4.32 per cent, and Leather 2.66 per cent.

Comparing the composition of exports for the first half of 1385 (March 21st to September 22nd 2006) with the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005) it is clear that the composition is almost the same. There is only slight shift in the pattern; notably the share “Carpet & Rugs” items has increased from 32.07 per cent in the first half of 1385 (March 21st to September 22nd 2006) to 45.74 per cent the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005). Also a change in the Item “Others” has been decreased from 22.90 per cent in the first two Quarters of 1384 (March 21st 2005 to September 22nd 2005) to 4.32 per cent in the first half of 1385 (March 21st to September 22nd 2006).

