Da Afghanistan Bak

Central Bank of Afghanistan

Quarterly Economic and Statistical Bulletin

First Quarter of 1388

March 22 - June 21 2009

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Data Notes

Afghanistan uses the Persian calendar also known as the Jalali calendar, which was introduced on March 15, 1079 by the Seljuk Sultan Jalal-u-ddin Malik Shah I, based on the recommendations of a committee of astronomers, including Omar Khayyam, at the imperial observatory in his capital city of Isfahan. It is a solar calendar in which each year begins on March 21. This Quarterly Bulletin covers developments in the first quarter of 1388 which is equivalent March 22, 2009 – June 21, 2009 in the Gregorian calendar.

Afghanistan figures are in current afghani unless otherwise specified.

Billion means 1,000 million

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LIST OF ABBREVIATIONS

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

GOVERNOR'S STATEMENT

On behalf of the Supreme Council, I am pleased to present the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for first quarter of 1388 (March 22 – June 21, 09). This quarterly bulletin reflects the main results of the Bank's activities aimed at keeping inflation low, maintaining stability of the national currency and developing a robust banking sector in support of sustainable economic growth.

The first quarter of 1388 was a favourable quarter for Afghanistan with a significant increase in the wheat harvest due reasonable rainfall at the beginning of the year. The global recession paced to emerging market countries, specially trading partner countries of Afghanistan which caused low demand and low inflation. The global recession will have a silver lining for net-food importing countries like Afghanistan as the decline in commodities prices is likely to lead to a decline in imported inflation going forward. In Afghanistan headline inflation, as measured by year-on-year percentage changes in Kabul CPI entered negative territory at the beginning of the quarter.

The global economy has shown positive signs indicating the recession is coming to an end, while the recovery is expected to be slow and sluggish. Japan, Germany and France experienced positive quarterly growth in the second quarter of 2009 after four consecutive quarters of economic contraction. The pace of decline in other economies was moderate as the U.S and the U.K contracted by less than one percent in the quarter under review.

Financial conditions improved in the advanced economies owing to effective and timely public interventions. However, stability in the financial sector has not been fully restored as corporate bankruptcies were widespread and numerous financial institutions in the U.K and the U.S registered significant losses.

Inflation remained near zero in the advanced economies both due to falling oil and food prices and due to declining demand. In the U.S and Japan, inflation entered negative territory which was -1.1 and -0.98 percent, respectively. However, risks for sustained deflation are small, as core inflation and inflation expectations in most major economies are still holding in the 1- 2 percent range.

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

Narrow Money (M1) grew by 4 percent in the quarter under review down from 7.7 percent in the previous quarter. Currency outside depository corporations (CODC) which is the component of narrow money grew by 1.1 percent in the first quarter of 1388 down from 5.3

percent in the fourth quarter of 1387. Furthermore, the demand deposits the other component of M1 increased by 6.5 percent in the first quarter of 1388 in contrast to 9.8 percent in the fourth quarter 1387. Quasi money, a component of broad money, increased by 27.2 percent in the quarter under review, up from -8.8 percent in the fourth quarter of 1387. Net domestic assets (NDA) which is a determinant of monetary growth, increased by 11.8 percent in the quarter under review. Another determinant of monetary growth is net foreign assets (NFA) which increased by 5.33 percent in the first quarter of 1388. Reserve money (RM) declined by -13 percent in the quarter under review.

Headline inflation is currently experiencing deflationary pressures as a result of worldwide recession which caused low demand. The upcoming Presidential and Provincial Council elections could be another reason behind the slowdown in economic activities in the local economic territory.

Headline Consumer Price Index (CPI), for Kabul stood at 161.84 at the end of the quarter under review, representing an inflation rate of -10.04 percent down from 33.3 percent in the same period a year ago.

The sharp decline in the CPI was mainly attributed to decreases in the prices of food, construction materials, fuel and electricity, and transportation. Inflation is projected to be negative in the second half of 1388. Downside risks to the macroeconomic outlook include heightened political uncertainty due to upcoming presidential elections that could reduce inflows of Foreign Direct Investment (FDI), security concerns that could hamper economic activity. The central bank remains committed to ensuring sound monetary and financial policies in support of sustainable economic growth.

On the fiscal side, government finances remained on track to meet revenues and spending targets. Total expenditures in the quarter under review declined to AF 19,541 million down from AF 38,984 million in the fourth quarter of FY1387, this represents a 50 percent decline. Total expenditures accounted for 3.07 percent of GDP.

Total expenditures are classified into development and operating expenditures. Development expenditures declined to AF 3,116 million in the quarter under review from AF 18,696 million in the previous quarter, this represents 83 percent decline.

On the other hand operating expenditures increased to AF 16,425 million from AF 20,288 million in the fourth quarter of FY1387, this represents 19 percent increment.

The banking system continued to perform satisfactorily. Total assets of the banking system stood at AF 134 billion (USD 2.7 billion) as of June 21, 2009, up by 51 percent or AF 45 billion in the same period a year ago. Loans amounted to AF 51 billion (USD 1.0 billion) an increase of AF 8.9 billion (USD 195 million) or 21 percent since June 2008. Deposits stood at AF 108 billion (USD 2.2 billion) over the period under review; a 59 percent increase since June 2008. Deposits were largely denominated in USD (66 percent) with Afghani denominated deposits were lagging at 30 percent. However, the AF-denominated deposits increased to AF 32 billion (USD 537 million), as compare to the last period (June 2008), where it was 15 billion (USD 291 million). Total capital of the banking system stood at AF

19.4 billion (USD391 million), up by 17 percent since June 2008. Banking sector overall was profitable earning profit of AF 446 million (USD 8.95 million) since the beginning of 1388.

On the external sector, balance of payments statistics reflect essential activities in the economy and flows of fund specifically foreign exchange. These flows are reflected in the economy's account for goods and services and consequently affect the measurement of gross domestic product (GDP) and its composition in terms of final demand components.

The merchandise trade, which solely records goods account, experienced huge diminution in the first quarter of SY 1388. The merchandize trade reveales a deficit of USD 418 million or 3 percent of GDP in the quarter under review compared to the deficit of USD 499 million or 4 percent of GDP in the first quarter of 1387. Auspiciously, merchandize trade deficit reduced from USD 499 to USD 418 million.

This report could not have been written without the tireless efforts and generous support of numerous individuals from several departments of the Bank. The work was coordinated by the Monetary Policy Department (MPD). A team under the overall guidance of Patrick Asea, Senior Macroeconomic Advisor prepared this report. The team comprised the following members of the monetary policy department: Matiullah Faeeq (Director General), Raiyt Alamyaar (Deputy Director General), Omar Joya (Sr. Analyst, Real Sector), Ahmad Javed Wafa (Sr. Analyst External Sector), Samiullah Baharustani (Sr. Analyst Monetary Sector), Sher Agha Ghiacy (Monetary Analyst), Naib Khan Jamal (Sr. Analyst Fiscal Sector), and Rahmatullah Haidari (Sr. Inflation Analyst). Other members of the team included Allah Jan Shirzad (Capital Notes Manager) from the Market Operations Department and Mohammad Qaseem Rahimi (Deputy Director) from the Banking Supervision Department. Special thanks to Rahmatullah Haidari for superb desktop publishing work.

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank

(Central Bank)

1

International Economic Environment

1

INTERNATIONAL ECONOMIC ENVIRONMENT

SUMMARY

The global economy has shown positive signs indicating the recession is coming to an end, while the recovery is expected to be slow and sluggish. Japan, Germany and France experienced positive quarterly growth in the second quarter of 2009 after four consecutive quarters of economic contraction. The pace of decline in other economies was moderate as the U.S and the U.K contracted by less than one percent in the quarter under review.

Financial conditions improved in the advanced economies owing to effective and timely public interventions. However, stability in the financial sector has not been fully restored as corporate bankruptcies were widespread and numerous financial institutions in the U.K and the U.S registered significant losses.

Inflation remained near zero in the advanced economies both due to falling oil and food prices and due to declining demand. In the U.S and Japan, inflation entered negative territory which was -1.1 and -0.98 percent, respectively. However, risks for sustained deflation are small, as core inflation and inflation expectations in most major economies are still holding in the 1-2 percent rage.

Unemployment was, however, a serious concern in the quarter under review, especially for the advanced economies where job losses increased dramatically. Unemployment rose to 9.3 percent in the Euro area, 9.2 percent in the U.S and 5.2 percent in Japan in the second quarter of 2009, compared to 7.4 percent, 5.4 percent and 4 percent, respectively, in the same quarter previous year. On the other hand, international trade declined by more than 30 percent at an annual rate in May 2009 for the OECD countries.

Emerging and developing economies experienced a relatively low level of growth in the second quarter of 2009 compared with their long-run average of their real GDP growth. The IMF expects that these economies will regain growth momentum in the second half of 2009.

However, low-income countries are facing important challenges because official aid has fallen and these economies are particularly vulnerable to fluctuations in commodity prices.

The global economy is projected by the IMF to contract by -1.4 percent in 2009 and to grow by 2.5 percent in 2010. Advanced economies are forecast to contract by 3.8 percent in 2009, while emerging and developing economies will have a positive growth of 1.5 percent. The recovery is expected to be much slower and the IMF projects advanced economies as a whole not to show a sustained pickup in activity until the second half of 2010. However, the leading economic indicators for the U.S and the OECD member countries have shown an improvement which may signal a pickup in economic activities in a near future.

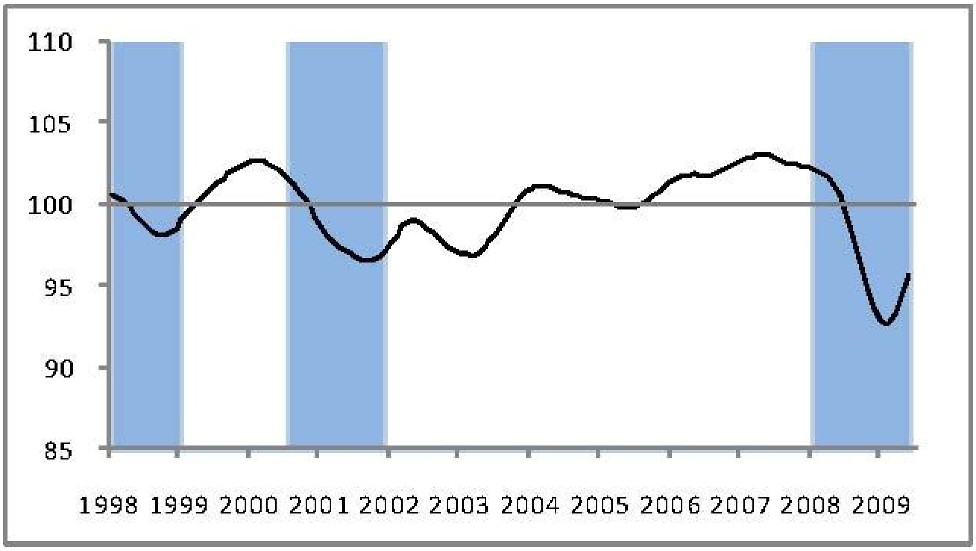
ADVANCED ECONOMIES

Advanced economies are facing several important challenges at once: widespread bankruptcies, falling investment, loss of confidence in the stability of the financial sector, declining domestic & external demand, decreasing output and rising unemployment. Although difficult days of financial turmoil have passed away, advanced economies are now coping with macroeconomic challenges: low demand, high unemployment, and large fiscal deficits.

Fiscal deficit is one of the major concerns in advanced economies as a result of rising counter-cycle policies and stimulus packages. Fiscal sustainability will be one of the core issues that governments would focus on, after the recession is ended. Large fiscal adjustments are expected in 2010 and afterwards so that governments will be able to meet their targets for sustainable fiscal indicators. The fiscal deficit in the United States is projected to reach 10.2 percent of GDP, in Japan 7.8 percent and in the Euro area to reach 5.6 percent of GDP in 2009.

Although the recovery is projected to take place in 2010, the OECD's Composite Leading Indicators (CLIs) show earlier strong signals of improvement in the economic outlook of OECD countries for June 2009. The CLI for the whole OECD area increased by 1.2 point in June 2009 compared to 0.6 point in April 2009. (see Figure 1.1) The CLI indicates turning points in economic activity (peaks and troughs of a business cycle) approximately six months in advance.

Figure 1.1: OECD Composite Leading Indicators (June 2009)



1.1 United States Economy

The U.S economy experienced a quarterly contraction of 0.25 percent in the second quarter of 2009 compared to 1.6 percent in the first quarter. This was its fourth consecutive quarterly contraction since the beginning of the recession in 2008.

The major drag on GDP was a significant decline in private investment, more specifically in residential investment. In quarterly comparisons, residential investment declined by 29.3 percent in the second quarter compared to a 38.2 percent decline in the previous quarter. This was due to falling house prices which are yet to reach the bottom. Gross private domestic investment dropped by 20 percent in the quarter under review while it declined by 50.5 percent in the first quarter of 2009.

Private consumption declined by 1.2 percent, while government consumption (expenditures & gross investment) increased by 5.6 percent as a result of counter-cycle fiscal policy which partly offset the negative impact of other expenditure categories on GDP. Exports dropped for the fourth consecutive quarter by 7 percent due to a decline in world demand, and imports which are a subtraction in the calculation of GDP decreased faster than the exports.

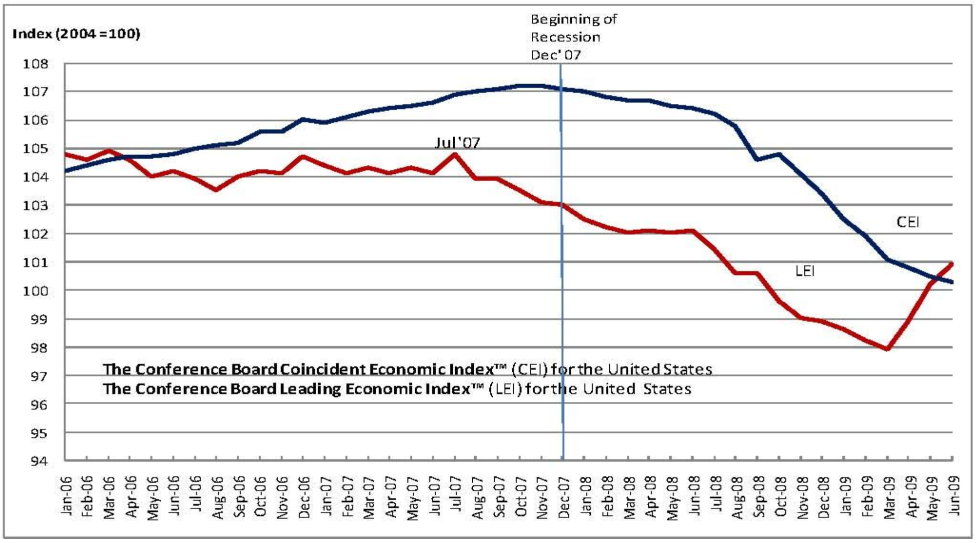
Consumer and business confidence has been severely affected since 2008 by falling asset prices and aggravating financial conditions. Recent surveys showed that consumer and business confidence started to improve towards the end of the quarter and is likely to generate positive effects on the economy in the second half of 2009.

Inflation which was near zero in the first quarter of 2009 entered negative territory in the second quarter. The year-on-year inflation dropped to -1.4 percent in June 2009 down from 0.23 percent in February. The deflationary pressure has been generated by a decline in world commodity prices. However, the risk of persistent deflation is low. First, recent surveys show that long-term inflation expectations have remained relatively stable in the United States and are also relatively high (at least 2 percent). This can be a useful indicator for future inflationary trends because, according to the Philips curve, inflation is driven by expected inflation adjusted for the amount of slack in the economy. Second, studies suggest that this time inflation is less responsive to the economic slowdown than previous experiences, because globalisation has weakened the forces which drive deflationary pressures and because central banks have achieved more credibility to maintain stable inflation.

Unemployment rose remarkably in the quarter under review as financial and non-financial institutions announced major layoffs in order to cope with losses. Unemployment reached 9.2 percent in the second quarter of 2009 while it was 5.4 percent in the same quarter previous year. This was the highest unemployment rate in the United States since 1983.

Although a full recovery is expected to take hold in the second quarter of 2010, various leading indicators for the U.S economy show signs that the recession may come to an end even earlier. The Conference Board's Leading Economic Index (LEI) for the U.S improved for the third consecutive month in June 2009 by 0.7 percent. (Figure 1.2) The average increase over the second quarter of 2009 is 1 percent. The Conference Board has stated that if the improvement continues, a slow recovery is expected in autumn 2009.

Figure 1.2: The Conference-Board Leading Economic Index for the U.S

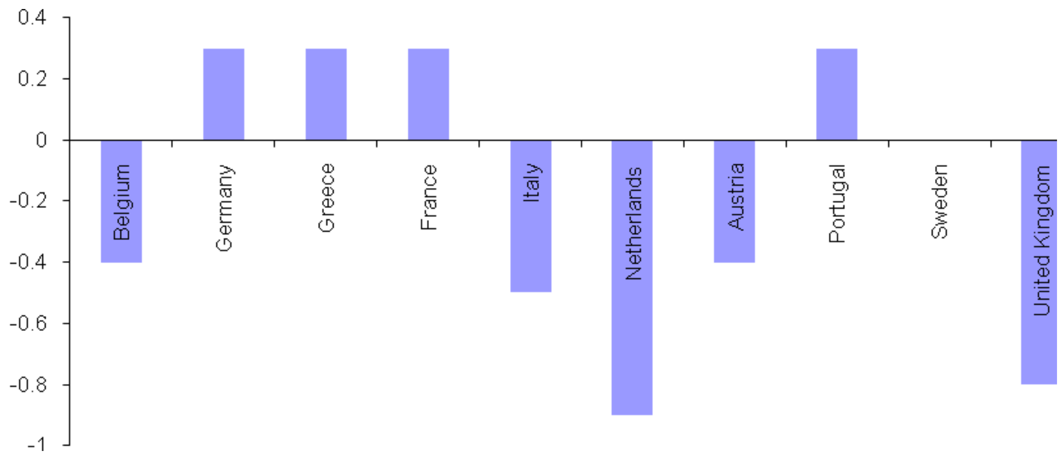


1.2 Western Europe

The quarterly economic contraction moderated in the second quarter of 2009 in both the United Kingdom and the Euro area. In quarterly comparisons, real GDP in the Euro area contracted by 0.1 percent in the second quarter compared to a contraction of 2.5 percent in the first quarter. In the United Kingdom, the economy contracted by 0.8 percent compared to 2.4 percent in the first quarter.

The two major economies in the Euro area – Germany and France – achieved positive growth after four consecutive quarters of economic slowdown. The German economy grew by 0.3 percent compared to -3.5 percent in the previous quarter, and the French economy grew by 0.3 percent compared to -1.3 percent in the first quarter (see Figure 1.3 below). The main drivers of a positive growth in the two countries were an increase in private and public consumption and an improvement in the trade balance. Gross fixed capital formation increased by 0.8 percent in Germany – which contributed in the growth – but declined in France by 1 percent. The unexpected positive growth in the two largest economies of the Euro area is likely to improve economic agents' expectations which can later positively influence consumer and business confidence in the whole Eurozone. This gives a strong indication that the recovery is not too far for the Euro area economies.

Figure 1.3: Euro Economies Real GDP Growth in the Second Quarter of 2009



Source: Eurostat

Industrial production in June 2009 compared with the previous month declined by 0.6 percent in the Euro area but increased by 0.3 percent in the United Kingdom. For the Euro area, production in the durable consumer goods industry declined the most. This shows the effect of recession on consumers' behaviours which tend to decrease their consumption of durable goods.

Trade surplus in the Euro area increased to 4.6 billion euro in June 2009 up from 2.1 billion in May 2009 and compared to 0.0 billion in June 2008. In Germany, the largest exporter in the Euro area, trade surplus increased from 4.2 billion euro in May 2009 to 4.5 billion in June 2009. However, the trade deficit remained unchanged in the UK over May-June 2009 at 3.6 billion euro.

Inflation in the Euro area entered for the first time since its creation in 1998 into a negative territory. Annual inflation as measured by the Harmonized Index of Consumer Prices (HICP) was recorded at -1 percent in June 2009 in the Euro area compared to 0.0 percent in May 2009. Inflation in Germany remained at zero for the second month in June 2009, while inflation in France was below zero percent at -0.6 percent in June down from -0.3 percent in May. However, inflation has been well above zero percent in the UK. Inflation in the UK declined to 1.8 percent in June down from 2.2 percent in May 2009.

Unemployment in the Euro area increased to 9.3 percent in the second quarter of 2009 compared to 7.4 percent in the same period of the previous year. In Germany, unemployment increased moderately to

7.6 percent up from 7.4 percent in the second quarter of 2008. In contrast, unemployment rose dramatically in Spain to 17.9 percent in the second quarter of 2009 up from 10.5 percent in the same quarter a year earlier. In the United Kingdom, unemployment rate was 7.8 percent in the second quarter of 2009 which was up 2.4 over the year.

The economic activity is expected to start rising in the next quarter but the recovery will be much slower. A full recovery is forecast to hold in the second half of 2010 both in the Euro area and in the United Kingdom.

1.3 Japan

The Japanese economy grew by 0.9 percent in the second quarter of 2009 after four consecutive quarters of economic contraction. The positive growth comes as exports and industrial output enhanced and consumption in the economy increased.

Japanese exports increased by 8.7 percent in the second quarter while imports declined by 6.2 percent, in quarterly comparisons. In the first six months of 2009, Japanese exports to ASEAN countries, Australia and the Middle East increased significantly while dropped in the other regions. This shows that the demand for Japanese goods varies across the world and is substantial in the regions which have not been deeply affected by the global recession (for example the Middle East). Japan's trade balance which had a deficit of $9.7 billion in the first quarter turned to a surplus of $8.9 billion in the second quarter.

Industrial output increased by 8.3 percent in the quarter under review as the auto industry ceased to tighten. However, gross fixed capital formation declined by 2.6 percent which was offset by an increase in private consumption and an improvement in the trade balance. Private consumption increased by 0.8 percent thanks to the stimulus package of $260 billion.

Deflationary pressure has been building up in the Japanese economy as inflation remained in the negative territory for the fifth consecutive month. Inflation dropped to -1.8 percent in June down from zero percent in January. Deflation, this time, is due to a loss of consumer confidence and a negative outlook for the economy. If growth persists in the Japanese economy for the next couple of quarters and/or if outlook for the economy improves, it is expected that the deflationary pressure will ease and that inflation will move towards positive territory.

Unlike other advanced economies, such as the U.S, the U.K and the Euro area, the increase in unemployment rate is steady in Japan. Unemployment increased to 5.2 percent in the second quarter of 2009 compared to 4 percent in the same quarter of the previous year.

Outlook for the Japanese economy depends highly on the global demand because exports make a large portion of the GDP. The auto industry, machinery and electric equipments industries which are the largest in the country depend significantly on exports. The IMF projects that a recovery will take hold in 2010 and the real GDP is forecast to increase by 1.7 percent next year.

REGIONAL ECONOMIES

The global recession which initially centred in the advanced economies started to influence the developing Asian economies at the end of 2008 through the trade channel. Demand for Asian products declined in the western advanced economies which affected several export dependent economies in the east.

The Chinese economy grew by an annual rate of 7.1 percent in the first half of 2009 compared to 10.4 percent in the same period of the previous year. Chinese exports fell by 1.3 percent in the second quarter decreasing the trade balance by more than a half. Prices have also dropped in China due to falling commodity prices. Inflation declined to 1.9 percent in June 2009 down from 5 percent in March.

The Indian economy is projected to have grown by 6 percent (in the second quarter of 2009 compared with the same period previous year) most of which generated by the services sector. This was 2.2 percentage points lower than the rate of growth in the second quarter of 2008. However, unlike other Asian economies, prices in India did not decline as a result of falling commodity prices. Inflation slightly increased in June 2009 to 9.3 percent up from 8 percent in March.

IMF expects that emerging and developing economies will regain growth momentum during the second half of 2009. It has projected the developing Asian economies to grow by 5.5 percent in 2009; India to grow by 5.4 percent down from 7.6 percent in 2008, and China to grow by 7.5 percent in 2009 compared to 9 percent a year earlier.

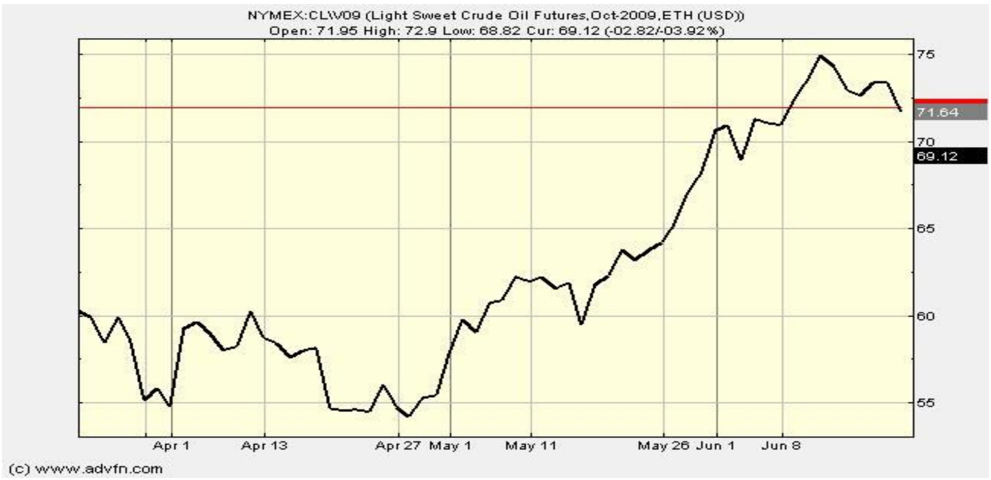
2.1 Commodity and asset prices

2.1.1 Oil & Food prices

Commodity prices slightly increased (in quarterly comparisons) in the second quarter of 2009 after it had dropped by 15 percent in the previous quarter. Commodity Prices Index, calculated by the IMF, increased by 15.7 percent in the second quarter of 2009 compared with the previous quarter. However, this was 43.1 percent lower than the same period of the previous year.

Fuel and energy prices slightly picked up in the second quarter of 2009 as prospect for the global economy improved. IMF's Commodity Fuel Index increased by 20.1 percent in quarterly basis, while it declined by 50.3 percent in annual terms. As shown in the figure below, Light Sweet Crude Oil Futures Index increased from $60.3 on Mar 21, 2009 to $71.9 on June 20, 2009, which is almost a 20 percent rise.

Figure 1.4: Light Sweet Crude Oil Futures Index in the first quarter of 1388



Oil prices are expected to show a minor increase till the end of the year 2009 and, according to the IMF's World Economic Outlook report, forward markets project oil prices at $74.50 for 2010.

Moreover, IMF's Commodity Food Index increased by 10.2 percent in the second quarter of 2009 compared with the previous quarter but it was down by 20.5 percent in annual comparisons.

2.1.2 Stock markets

Stock markets' values improved in the quarter under review after almost four quarters of decline. Stock markets which collapsed along with the outbreak of the financial turmoil in 2008 now seem to have started rebounding. An enhancement in stock markets gives a strong positive outlook for the global economy and is a signal that the recovery will not be too far ahead.

As presented in the Figure 1.5 below, Dow Jones Industrial Average was up by 13.7 percent, NASDAQ Composite Index gained 21.5 percent of its value, FTSE 100 rose by 11.9 percent, DAX was up by 15.4 percent, CAC 40 of France was up by 8.8 percent and Nikkei of Japan gained 23.3 percent of its value during the first quarter of 1388 (Mar 21, 2009 – Jun 20, 2009).

Figure 1.5: Stock Markets' Performance in the First Quarter of 1388 (Mar 21–Jun 20, 2009)

Dow Jones Industrial Average

NASDAQ Composite Index

FTSE 100

DAX

CAC 40

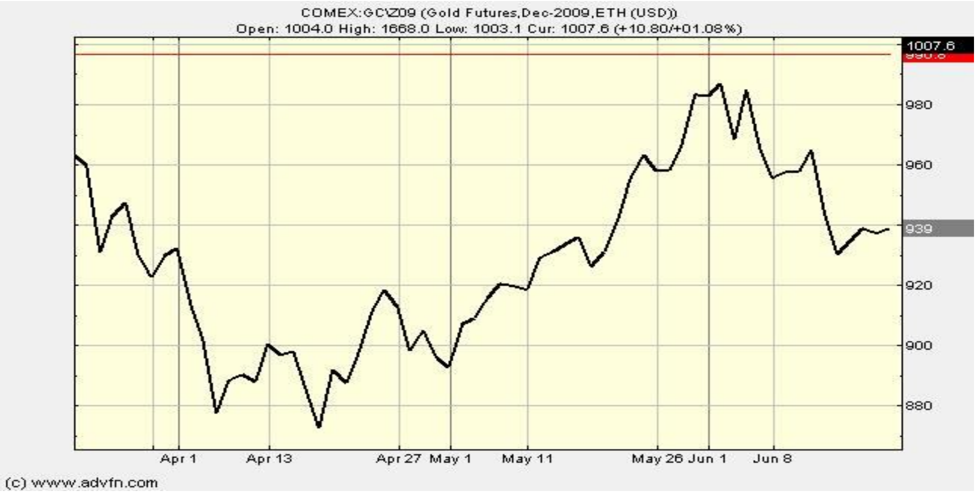
Nikkei

Source: Reuters and advfn.com

2.1.3 Gold prices

Gold prices which opened the quarter at USD 964.6 per oz. declined in the middle of April 2009 to under $880, and then climbed to over $980 in the beginning of June 2009 before closing the quarter at $939.44 per oz. (see Figure 1.6 below) Gold prices had a strong fluctuation during the quarter as their volatility, calculated by the standard deviation, was 30.14.

Figure 1.6: Gold Futures Index in the first quarter of 1388



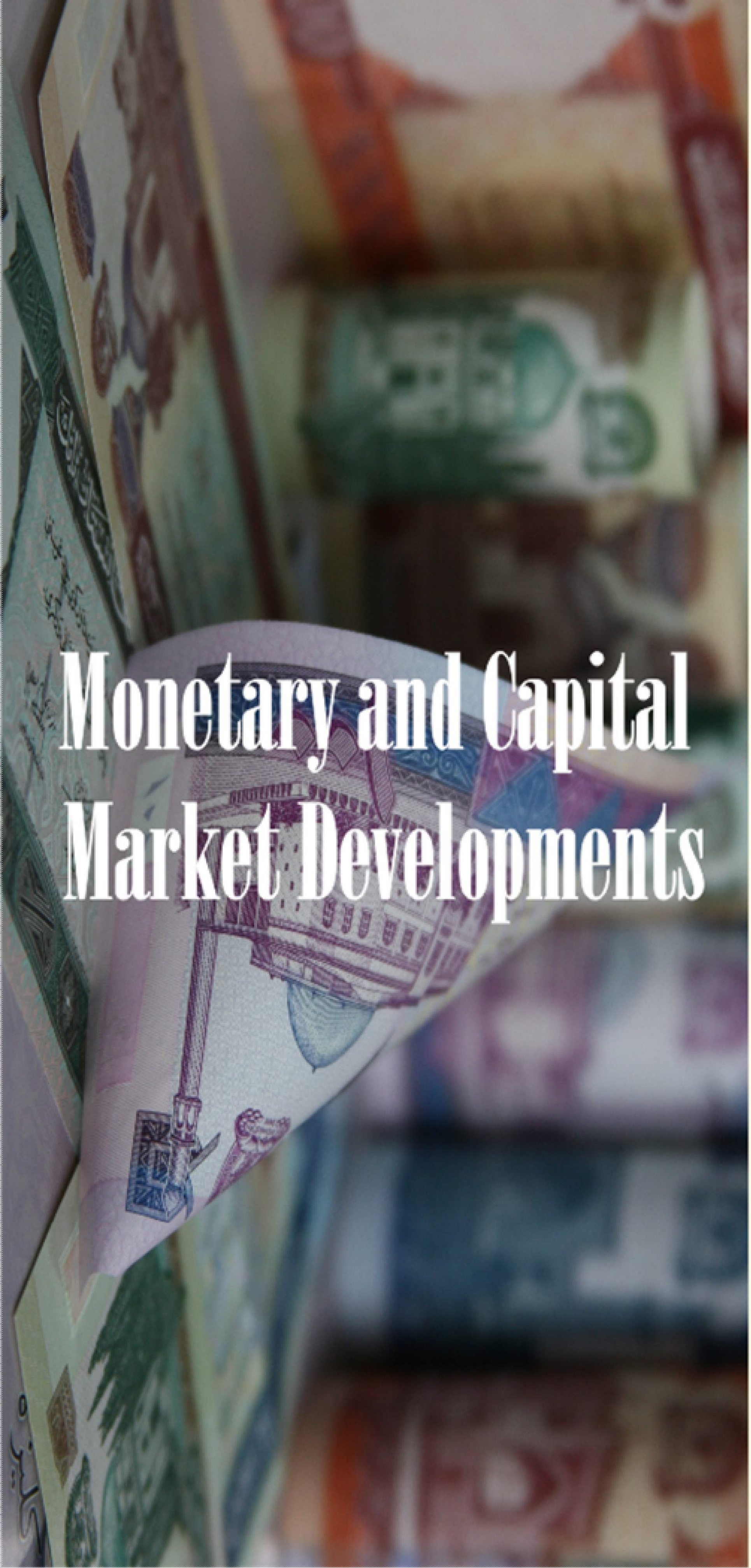
2.2 Global exchange rates

The US Dollar lost its value against the Euro and the Pound sterling in the quarter under review. The US dollar was traded at 0.73 euro on March 21st while dropped to 0.72 euro on June 20th. The US dollar exchange rate vis-à-vis the Pound sterling was £0.69 on March 21, 2009 but dropped to £ 0.61 on June 20, 2009.

However, the US dollar appreciated against the Japanese Yen. The exchange rate increased from 95.05 yens in the beginning of the quarter to 96.61 yens at the end of the quarter. (see Table 1.1 below).

Table 1.1: Major currencies' Exchange Rate against the U.S Dollar

	Euro	Pound sterling	Japanese Yen
Mar 21, 2009	0.73	0.69	95.05
Jun 20, 2009	0.72	0.61	96.61
Maximum	0.77	0.70	100.82
Minimum	0.70	0.61	94.30
Average	0.74	0.66	97.64



2

Monetary and Capital Market Developments

2

MONETARY AND CAPITAL MARKET DEVELOPNENTS

SUMMARY

In the quarter under review monetary aggregates had mixed performance: Currency in circulation followed an upward trend; well below the PRGF ceiling up to the end of the quarter under review. Currency in circulation grew sharply at the end of the quarter reaching at almost 12 percent. The positive growth of the CiC in the quarter under review is attributed to the budgets disbursement which was delayed in the first quarter resulting a negative growth.

Reserve money (RM), which had grown by 65 percent in the previous year mainly because of huge foreign deposits with the commercial banks, recorded an increase of 15 percent growth in the quarter under review. The increase in RM is attributed mainly spending by ISAF forces as well as execution of the budget that resulted an increase in the CiC and demand deposits of the commercial banks with the central bank.

On the other hand, narrow money (M1) grew by 11.54 percent during this period up from 4 percent in the previous quarter. The main drivers of the increase in M1 are currency outside depository corporations (CODC) which grew by 10.52 percent up from 1.1 percent in the previous quarter and demand deposit which grew by 12.37 percent up from 6.9 percent in the previous quarter.

Broad money (M2) increased by 12.18 percent in the quarter under review compared to 4.8 percent in the previous quarter.

Following the reserve money's trend, outstanding stock of capital notes (CNs) declined by 29 percent in the quarter under review. While 182-day stock of capital notes declined slightly by 18 percent; however, stock of 28-day CNs declined by 76 percent mainly because commercial banks had used them to invest their short-term liquidity corresponding to foreign demand deposits. By the end of the quarter total stock of capital notes was AF 10.27 billion with around AF 2.1 billion in 28-day CNs and the remaining in 182-day capital notes.

The excess liquidity in the banking system pushed down the interest rates on capital notes with the weighted average interest rates falling from 9.39 percent to 5.3 percent for 28-day CNs; and from 10.57 percent to 7.6 percent for 182-day CNs.

In the meantime, afghani exchange rate appreciated by 2.6 percent in the first quarter of 1388 – the exchange rate which was AF 51.76 per US dollar, appreciated to AF 50.14 per US dollar. This appreciation is attributed to wealth effect because of the good harvest season in Afghanistan and unprecedented influx of foreign inflows.

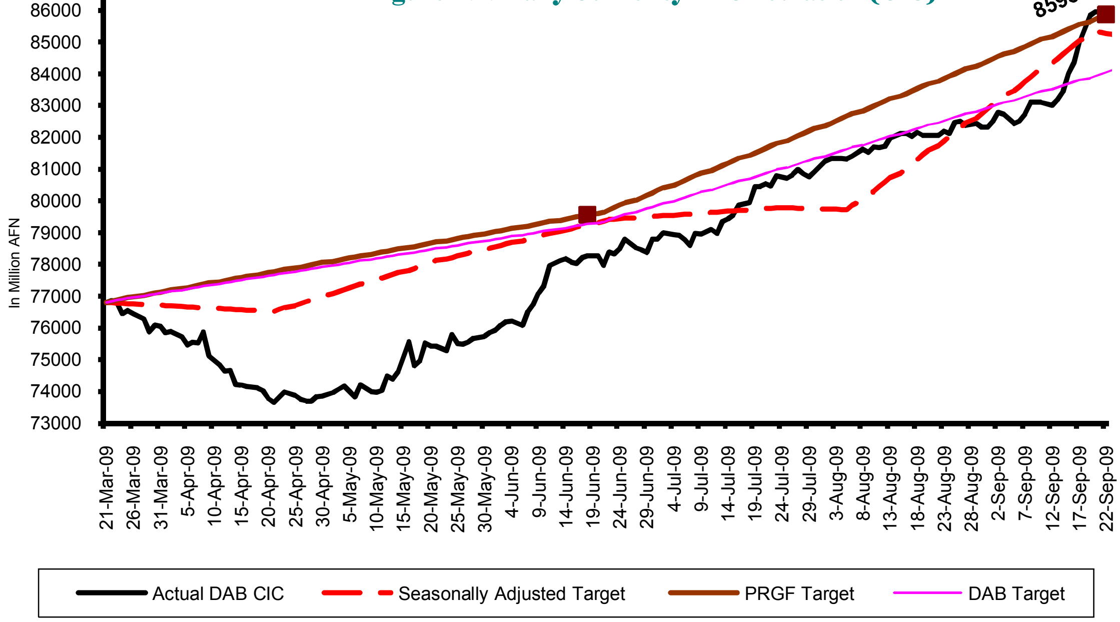
PRGF Monetary Program

Currency in circulation (CiC) is a performance criterion for the DAB under the Poverty Reduction and Growth Facility (PRGF) arrangement with the IMF. The CiC ceiling set for the first quarter of 1388 was 11.91 percent while the annual growth for this variable was 22 percent. The DAB achieved this target when the actual CiC grew 11.91 percent in the quarter under review.

Considering the tight ceiling on currency in circulation, DAB continued to conduct aggressive FX auction to avoid any surprise injection of liquidity by the government. The amount of FX auction in the quarter under review stood at USD 873.20 million compared to USD 553.00 million in the same period a year ago. Furthermore, the increase in size of FX auction was due to increase in the number of NATO troops in Afghanistan which caused additional spending of the NATO as well as increase in the salaries of national police and national army by the government. The high demand for afghani due to Eid festival in the quarter under review caused CiC to grow sharply by 12 percent.

Figure 2.1 shows the trend of currency in circulation in the period under review:

Figure 2.1: Daily Currency in Circulation (CiC)



According to the monetary and financial statistics manual [MFS Compilation Guide 2008, Para 3.61], monetary bases (reserve money) is defined as "central bank liabilities in the form of currency issuance, liabilities to ODCs, and deposits accepted from other sectors (excluding the central government)". However, in the context of PRGF program reserve money has been defined as central bank liabilities in the form of currency issuance and afghani-denominated liabilities to commercial banks (ODCs) excluding capital notes.

The PRGF program has also an indicative target on reserve money based on the definition provided above – the annual ceiling on reserve money for the fiscal year 1388 is 17 percent growth while the target for the first quarter was 3 percent. The reserve money had grown by 15.1 percent in the quarter under review as a result of 41 percent increase in commercial banks deposits with DAB.

2. Monetary Aggregates

The monetary aggregates -- narrow money and broad money -- are compiled following the MFS methodology and definition.

In the quarter under review, narrow money (M1) grew to AF 184,089 million indicating a quarterly growth of almost 12 percent which is higher than 4.2 percent growth recorded in the previous quarter. Narrow money includes currency outside depository corporations and demand deposits almost in equal proportion. Commercial banks' demand deposits grew by 12.4 percent leading the growth in M1.

On the other hand, broad money which adds to narrow money the time deposits of commercial banks (Quasi Money) grew by 12.2 percent. Though Quasi Money grew by 32.5 percent in the second quarter, however, because Quasi Money roughly constitutes 3 percent of broad money, this significant growth was not reflected in M2. Both afghani and foreign currency denominated time deposits recorded a double digit growth in the second quarter of 1388: Afghani denominated deposits grew by 26.5 lower growth than the first quarter which ended at 42.4 percent while foreign currency denominated deposits grew by 40.9 percent higher than 10.6 percent as compared to first quarter of 1388. By the end of second quarter of 1388 (23 Sep, 2009), the stock of broad money was AF 191,083 million.

According to the monetary program, reserve money increased by 15 percent attributed to an increase of 41 percent in banks deposits with DAB which is one of the components of reserve money along with CiC for DAB increased by 10 percent in the second quarter of 1388. Reserve money stood at 106,039 at the end of second quarter for the 1388 fiscal year.

Net Foreign Assets increased by 10 percent in the quarter under review up from -7 percent in the previous quarter which shows a deviation of 7 percent. Net Claims on General Government which is a key component of Domestic Assets, increased by 20 percent in the second quarter 1388 form 4 percent in the previous quarter in which the deviation from the monetary program is 86 percent. This is mostly driven by Gross Claims on Government which decreased by 185 percent in the quarter under review form 19 percent in the previous quarter.

Table 2.1 summarizes monetary aggregates of depository corporations.

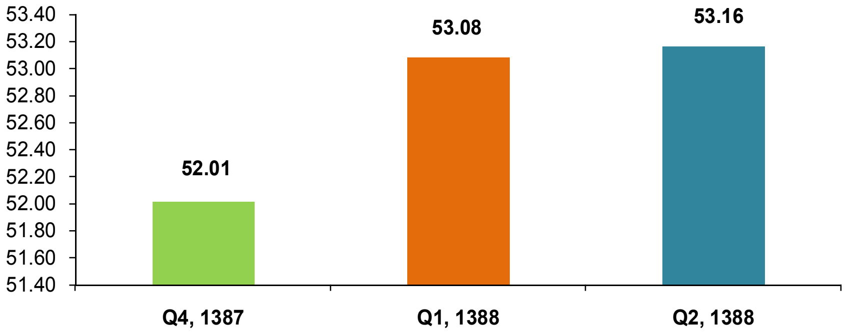
Table 2.1: Monetary Aggregate, Second Quarter 1388 (in million AF)

	1387		Quarter Change (Q4-Q1)	Difference (Q4-Q1)	1388	Quarter Change (Q1 – Q2)	Difference (Q1-Q2)
	Q4	Q1			Q2		
	Amount	Amount			Amount		
1. Net Foreign Assets	**183,997**	**193,851**	**5.4%**	**9,854**	**224,479**	**15.80%**	**30,628**
(a) Foreign Assets	219,112	213,187	-2.7%	-5,926	240,447	12.79%	27,261
DAB Foreign exchange reserves	185,037	175,358	-5.2%	-9,679	200,441	14.30%	25,084
Gold	34,641	34,641	0.0%	0.000	34,641	0.00%	0.000
Other	150,396	140,717	-6.4%	-9,679	165,800	17.83%	25,084
Other foreign assets	34,075	37,829	11.0%	3,754	40,006	5.75%	2,177
(b) Foreign Liabilities	35,115	19,335	-44.9%	-15,779	15,968	-17.41%	-3,367
2. Net Domestic Assets	**-21,447**	**-23,507**	**9.6%**	**-2,060**	**-33,373**	**41.97%**	**-9,866**
(a) Net Domestic Credit	6,717	10,928	62.7%	4,211	7,399	-32.29%	-3,528
Net Credit to Non-financial Public Sector	-43,591	-39,606	-9.1%	3,985	-47,371	19.60%	-7,765
Net Credit to Central Government	-44,609	-44,724	0.3%	-115	-53,150	18.84%	-8,426
Credit to Central government	6,659	7,452	11.9%	793	17,632	136.62%	10,181
Liabilities to Central government	51,268	52,176	1.8%	908	70,782	35.66%	18,606
Net Credit to State and Local Government	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Non-financial Corporation	1,017	5,118	403.0%	4,101	5,779	12.92%	661
Credit to Private Sector	49,842	49,741	-0.2%	-101	53,543	7.64%	3,803
Net Credit to Other Financial Corporations	466	793	70.2%	327	1,227	54.66%	434
(b) Capital Accounts	49,846	52,765	5.9%	2,920	63,246	19.86%	10,481
(C) Other Items Net	21,682	18,331	-15.5%	-3,351	22,474	22.60%	4,143
3. Broad Money (M2)	**162,527**	**170,329**	**4.8%**	**7,802**	**191,083**	**12.18%**	**20,754**
Narrow Money (M1)	158,376	165,050	4.2%	6,674	184,089	11.54%	19,039
CiC (Currency outside depository corporations)	*73,842*	*74,645*	1.1%	803	*82,500*	10.52%	7,856
Demand Deposits	*84,534*	90,405	6.9%	5,871	101,589	12.37%	11,184
Other Deposits (Quasi Money)	4,151	5,279	27.2%	1,128	6,994	32.47%	1,714
In afghni	2,164	3,082	42.4%	918	3,898	26.49%	816
In foreign currency	1,988	2,198	10.6%	210	3,096	40.85%	898
Securities Other than Shares	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Source: Monetary Survey Section, Monetary Policy Department DAB

Meanwhile bank deposits as share of broad money grew by 53.16 percent in the second quarter of 1388 up from 53.08 percent in the first quarter of 1388. (Figure 2.2)

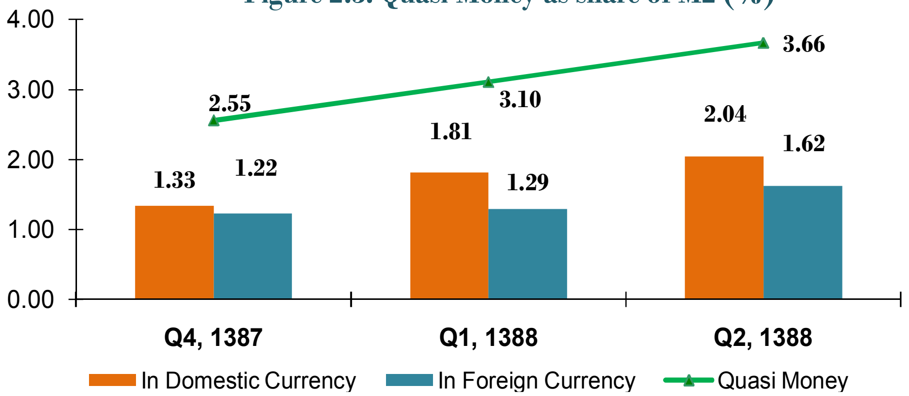
Figure 2.2: Bank Deposits as share of M2(%)



Source: Monetary Survey Section, Monetary Policy Department DAB

Similarly Quasi Money as Share of Broad Money grew to 3.66 percent in the quarter under review up from 3.10 percent in the first quarter of 1388. The growth was led by afghani-denominated time deposits included in quasi money which grew by 26.5 percent. Afghani-denominated time deposits constitute 2.04 percent of broad money while foreign currency denominated deposits made 1.62 percent of M2.

Figure 2.3: Quasi Money as share of M2 (%)



Source: Monetary Survey Section, Monetary Policy Department DAB

2. Capital Markets and Liquidity Conditions

2.1 Capital Note Auctions

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

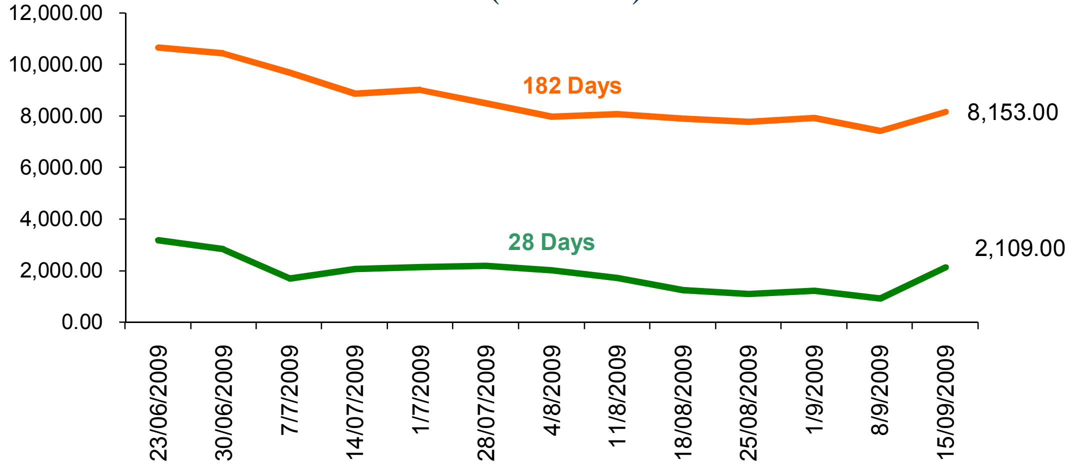
The amount to be auctioned is announced every Monday to the banks electronically. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase desired values of capital notes at different discount prices. Bids have to be submitted before 10:00 am on the auction day.

The amounts awarded in the quarter under review fluctuated between AF 229 million and AF 1.2 billion for 28 day notes and between 65 million and AF 1,400 million for the 182 day notes. The amounts announced for both 28 day and 182 day notes were AF 200 million and AF 100 million respectively.

In the quarter under review, the outstanding stock of 28 day notes fluctuated between 0.909 billion and 3.165 billion Afs. It dropped by 900 million at end of the second quarter to the outstanding amount of 2.1 billion Afs. Similarly, the stock outstanding of 182 day notes noticed a decrease of 2.6 billion Afs. It made the outstanding amount decrease to 8.1 billion Afs, at end the quarter under review.

The total outstanding stock of both maturities stood at AF 10.27 billion at the end of the reporting period. (Figure 2.4)

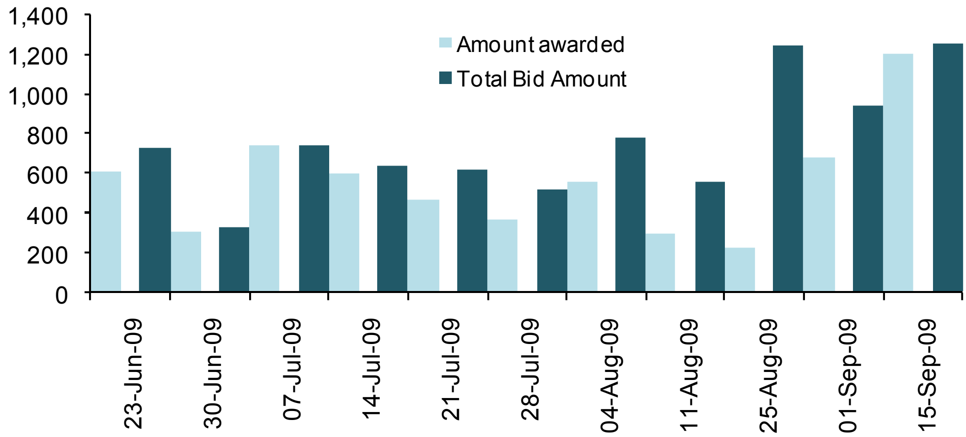
Figur 2.4: Capital Notes Stock outstanding (million AF)



Source: Market Operations Department, DAB.

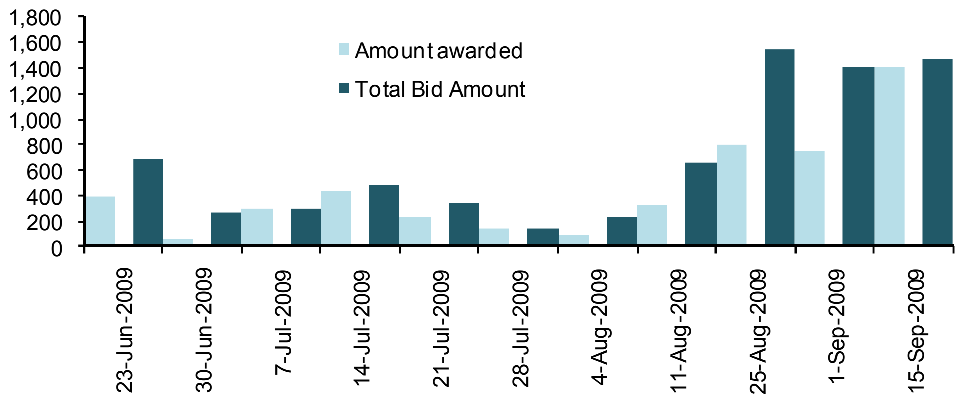
The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the bid amount for 28 days notes was AF 8,347 million and amount awarded was AF 6,052 million for a cover ratio of 1.38. The bid amount for 182 day note was AF 7,519 million and amount awarded was AF 4,949 million for a cover ratio of 1.52. Comparing the cover ratio in the second quarter to that in the previous quarter, the cover ratio for the 28 day note was 3.08 and for 182 day note it was 4.03. The ratio of amount awarded to auction announced amount (fixed 200 million AF 28 days and 100 million AF 182 days) was 2.72. This reflects that there is still high demand for CNs from commercial bank, despite large amount of supply by DAB. (Figure 2.5 for 28 day CNs and Figure 2.6 for 182 day CNs).

Figure 2.5: Demand and Awarded Amount for 28 Day Capital notes (million AF)



Source: Market Operations Department, DAB

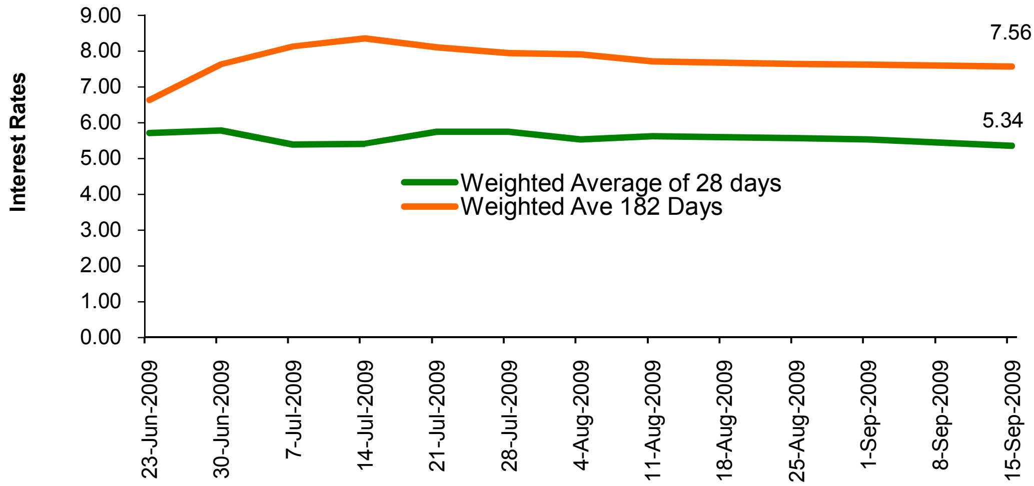
Figure 2.6: Demand and Awarded Amount for182 Day Capital Notes (million AF)



Source: Market Operations Department, DAB

The weighted average interest rates for 28 day notes noticed a gradual decrease of 40 basis points during the quarter under review that declined the interest rate for 28 day notes to 5.30 percent. On the other hand, the weighted average interest rate for 182 day notes increased by 170 basis points at the beginning of the quarter before it dropped down to 7.60 percent at the end of the quarter. The previous quarter ended with weighted average interest rate 5.70 percent 28 day notes and 6.70 percent for 182 day notes (Figure2.7).

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



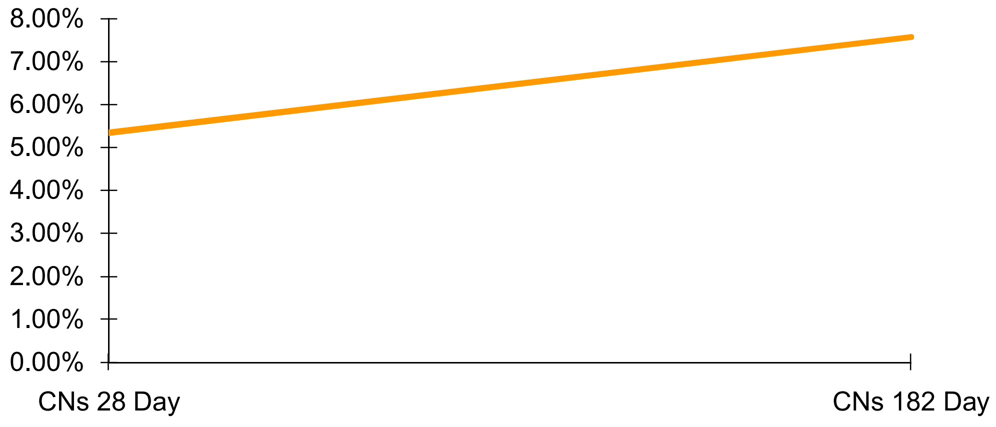
Source: Market Operations Department, DAB

2.1 Term Structure of Interest Rates

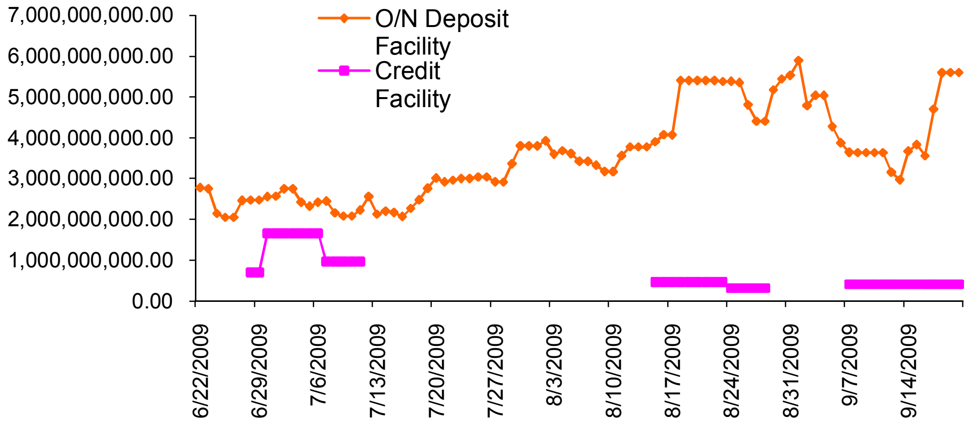
The term structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity on a security. The yield of the capital notes is the annualized percentage increase in the value of the CN.

The yield curve for September 20, 2009 is positive.

Figure 2.8: Term Structure of Interest Rates Yield Curve Sep 20, 2009



Figur 2.9: O/N Deposit Balances (million AF)



Source: Market Operations Department, DAB

2.2 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted towards required reserves. The interest rate on the overnight deposit facility is now 350 basis points below 28 auction cut-off rate (based on a circular to all banks approved by DAB Supreme Council on Feb 27, 2007). The outstanding amount of deposit facility balances fluctuated between AF 2 billion and AF 6 billion. The quarter under review ended with stock outstanding amounting to AF 5.6 billion.

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

It is worth mentioning during the quarter under review four Banks used the credit facility amounting 2.5 billion AF. During the quarter, required reserves averaged AF 464 million per bank. This figure was AF 388 million.

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

Figure 2. 10 Excess Reserve (Deposit Facility not included) (million AF)

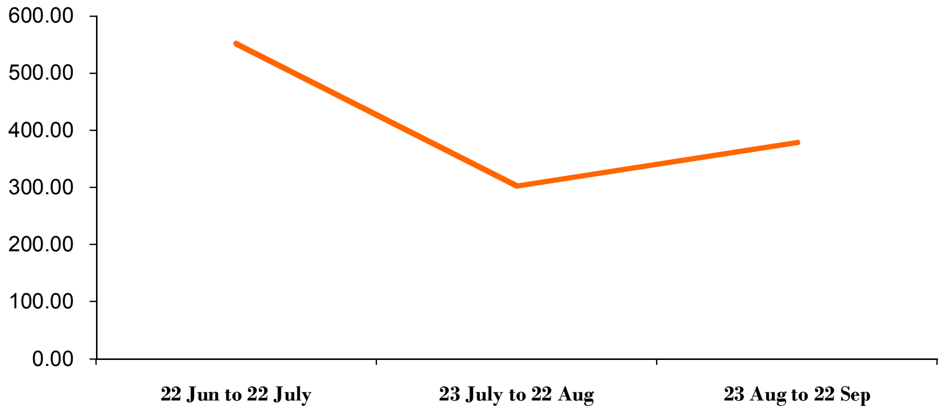


Table 2.3: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut of Rate	Low Bid	Weighted Average
23-Jun-09	200	605	730	5	6	5.99%	5.03	5.71
30-Jun-09	200	304	329	4	5	5.98%	5.00	5.77
07-Jul-09	200	740	740	4	4	5.90%	5.00	5.38
14-Jul-09	200	600	640	2	3	5.85%	5.30	5.41
21-Jul-09	200	470	620	3	4	5.80%	5.20	5.74
28-Jul-09	200	364	514	4	4	5.80%	5.50	5.75
04-Aug-09	200	560	780	5	7	5.70%	5.40	5.52
11-Aug-09	200	300	560	1	4	5.62%	5.60	5.61
25-Aug-09	200	229	1,244	3	5	5.59%	5.40	5.56
01-Sep-09	200	680	940	6	7	5.55%	5.40	5.52
15-Sep-09	200	1,200	1,250	2	3	5.50%	5.30	5.34
Total	**2,200**	**6,052**	**8,347**					

Table 2.4: Auction of 182 Day Capital Notes

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut of Rate	Low Bid	Weighted Average
23-Jun-09	100	398	688	2	5	6.70%	6.45	6.62
30-Jun-09	100	65	265	2	3	8.25%	6.99	7.62
07-Jul-09	100	300	300	2	2	8.49%	7.98	8.12
14-Jul-09	100	430	485	2	4	8.40%	8.30	8.35
21-Jul-09	100	236	336	1	2	8.10%	8.10	8.10
28-Jul-09	100	140	140	2	2	8.00%	7.70	7.94
04-Aug-09	100	100	230	1	3	7.90%	7.90	7.90
11-Aug-09	100	330	660	3	4	7.80%	7.58	7.71
25-Aug-09	100	800	1,550	3	3	7.75%	7.48	7.64
01-Sep-09	100	750	1,400	3	5	7.65%	7.58	7.61
15-Sep-09	100	1,400	1,465	3	4	7.60%	7.49	7.56
Total	**1,100**	**4,949**	**7,519**					

3. Foreign Exchange Market

3.1 Foreign Exchange Rates

Though Da Afghanistan Bank (Central Bank) does not target the nominal exchange rate of afghani against other foreign currencies, however, maintaining stability in domestic price levels is one of the main mandates for DAB. Price stability is implemented by controlling of currency in circulation. Nevertheless, the central bank monitors nominal exchange rates for huge fluctuations as the over fluctuations in the level of exchange rate of afghani will have a negative impact on economic indicators, especially inflation rate. Therefore, stability in the value of afghani and reducing the over-fluctuations against other foreign currencies is one of the main targets for DAB.

DAB follows the managed floating exchange rate where the exchange rate of afghani is determined by the market. DAB interferes in the market by selling and buying of US dollar through auctions on a bi-weekly base primarily for controlling currency in circulation which is a monetary target.

The daily historic review of the exchange rate, AF vis–a-vis USD, for the second quarter of 1388 (September 21, 09) is shown in Figure 2.11. The nominal exchange rate of afghani against US dollar appreciated sharply at the beginning of the quarter under review and became almost stable through end of the quarter. The nominal Exchange rate of afghani against US dollar reached AF 50.14 per USD at the end of the quarter. The main reasons behind this appreciation is: 1- huge influx of foreign inflows, 2- increased demand for afghani as confidence grows on national currency's credibility as a store of value, and 3- de-dollarization momentum.

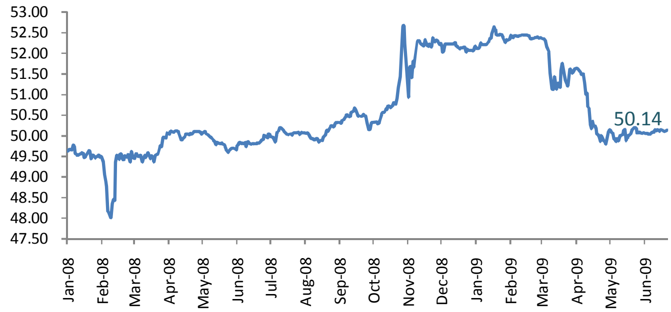
Likewise, afghani appreciated against Pakistani rupee (PKRs) and euro by 21.33 percent and 5.47 percent respectively in the quarter under review.

Table 2.5: Exchange Rate against selected currencies Q2 1387

Period	USD	PKR	EURO
Average for Q1 1388	50.40	0.6251	68.21
Average for Q1 1387	49.90	0.7533	77.72
% Appreciation (-) or depreciation(+) of AF against respective currency	**1.00**	**-17.02**	**-12.24**
Closing rate on June 21, 09	50.14	0.6228	70.29
Closing rate on Mar 21, 09	51.76	0.6413	67.55
% Appreciation (-) or depreciation(+) of AF against respective currency	**-3.13**	**-2.88**	**4.06**

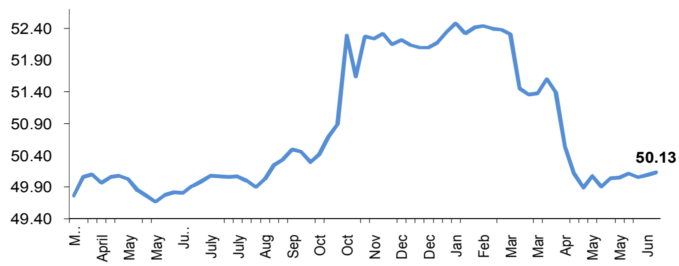
Source: Monetary Policy Department/ Market operations Department/ DAB

Figure 2.10: Daily Average Exchange Rate AF/USD (June 21, 09)



Source: Monetary Policy Department/ Market operations Department/ DAB

Figure 2.11: Weekly Average Exchange Rate (AF/USD):
(March 09 to June 09)



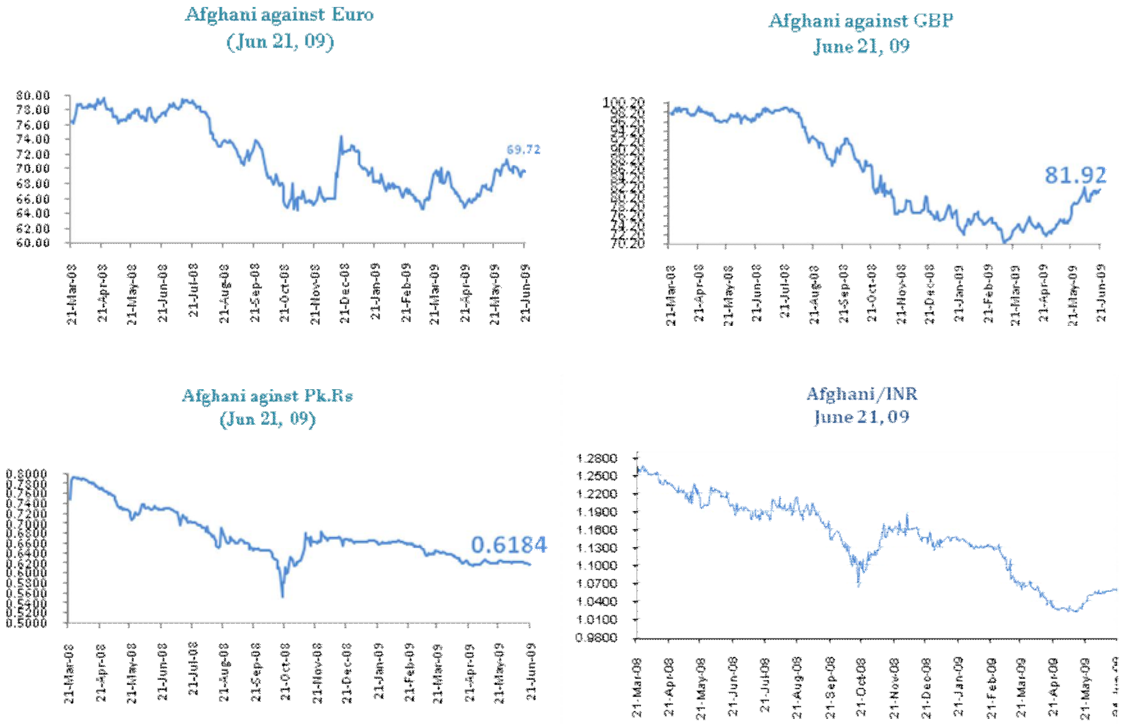
Source: Monetary Policy Department

The exchange rate movement of afghani vis-à-vis USD on the weekly basis appreciated sharply at the beginning of the quarter under review and became almost flat throughout the quarter. The weekly movement is depicted in Figure 2.11. As can be seen from the Figure, the afghani started appreciating vis-à-vis USD from beginning of March 2009, and continued up to end of April 2009, from AF 52.31 to AF 49.89 per USD. The Afghani started depreciating slightly up to end of the quarter under review reaching at AF 50.13 per USD.

The standard deviation of the exchange rate movement for Q1 1388 stood at 0.55 percent compared to 0.15 percent in the same quarter a year ago. The difference in standard deviation between two quarters shows that the exchange rate of afghani against US dollar was less stable in the quarter under review

The comparison of historic review of the daily average exchange rate of afghani against some major foreign currencies for Q1 of 1388 (March 22, 09 to June 21, 09) is shown in Figure 2.12

Figure 2.12: Daily Exchange Rates of AF against Some Major Currencies



3.2 Foreign Exchange Auction:

In the absence of other monetary policy tools, foreign exchange auction is primarily used to control growth of money supply which is defined as currency in circulation in the context of the PRGF program. However, given the above, foreign exchange aucton could possibly be used to smooth fluctuations in the exchange.

DAB has maintained the bi-weekly sterilization policy, to mop up extra liquidity arising principally from government expenditures and the foreign inflows. The foreign exchange auction size is determined by a liquidity forecasting framework, which takes into account the money demand on one hand and the currency growth ceiling agreed by the DAB with the IMF under the PRGF on the other.

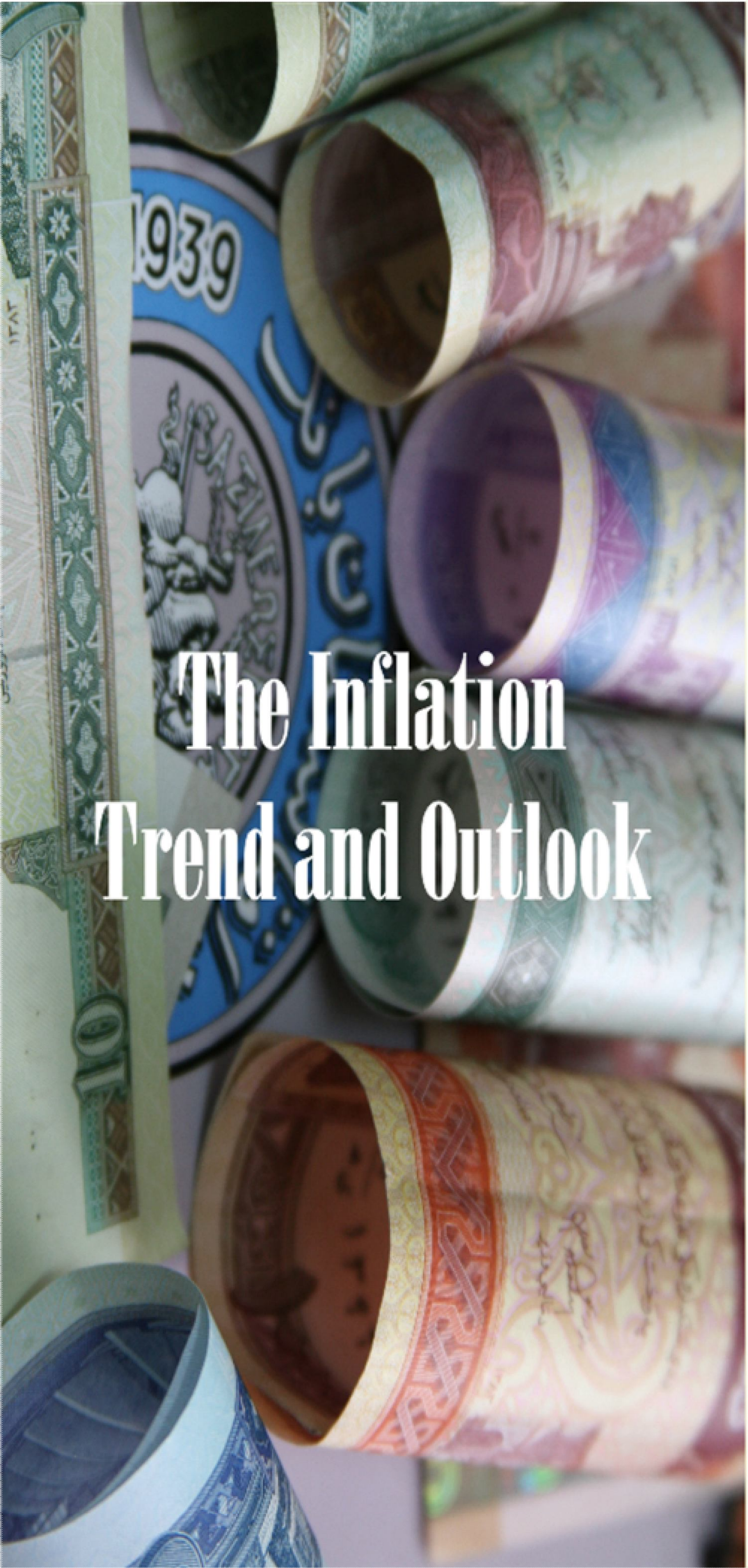
In the quarter under review the DAB intervention reached a total of USD 491.35 million. The weighted average rate of the entire 27 FX auction sessions (sale price of the USD) was 50.4, covering March 22, 09 to June 21, 2009; while in the previous quarter there were 23 FX auction sessions of USD 374 million. The weighted average selling rate was 51.48.

Table 2.6 summarizes the result of DAB foreign exchange auctions during the period of March 22, 09 to June 21, 2009.

Table 2.6: DAB Foreign Exchange Auction Summary, Q1- 1388 (million USD)

Auction Date	No of Bidders	High Price	Low Price	Cut Off Price	Market Rate	Amount Announced	Amount Awarded	No of Awarded Bidders
22-Mar-09	47	51.352	50.300	51.15	51.34	20.00	15.80	31
24-Mar-09	50	51.180	50.970	51.13	51.21	20.00	21.05	25
28-Mar-09	55	51.570	51.350	51.51	51.57	20.00	25.15	24
31-Mar-09	56	51.673	51.470	51.622	51.63	20.00	24.45	31
04-Apr-09	52	51.525	51.220	51.415	51.55	22.50	23.60	43
07-Apr-09	58	51.432	51.100	51.362	51.49	22.50	23.75	38
11-Apr-09	60	50.850	51.100	50.655	51.04	22.50	20.65	39
14-Apr-09	60	50.260	49.850	50.13	50.28	22.50	20.50	37
18-Apr-09	57	50.260	49.810	50.2	50.24	20.00	21.20	28
21-Apr-09	59	50.000	49.050	49.901	50.04	20.00	19.10	37
25-Apr-09	47	49.870	49.450	49.77	49.89	20.00	20.65	33
29-Apr-09	44	49.831	49.500	49.782	49.87	20.00	12.00	24
02-May-09	52	49.782	49.500	49.75	49.8	20.00	16.55	27
05-May-09	58	50.180	50.000	50.155	50.14	20.00	25.85	22
09-May-09	59	50.052	49.880	50.02	50.08	20.00	21.50	30
12-May-09	55	49.821	49.000	49.8	49.86	20.00	15.85	24
16-May-09	50	50.000	49.830	49.99	49.94	17.50	15.45	13
19-May-09	46	50.130	49.990	50.102	50.04	17.50	17.35	15
23-May-09	49	50.270	50.060	50.212	50.21	17.50	15.55	24
26-May-09	48	50.070	49.900	50.052	50.08	17.50	16.05	17
30-May-09	43	50.040	49.900	50.015	50.06	17.50	12.30	18
02-Jun-09	39	50.070	50.000	50.06	50.05	17.50	15.50	18
06-Jun-09	44	50.075	49.970	50.063	50.05	17.50	15.85	20
09-Jun-09	42	50.110	0.013	50.09	50.08	17.50	12.45	18
13-Jun-09	45	50.205	50.100	50.175	50.15	17.50	16.15	29
16-Jun-09	39	50.150	50.000	50.13	50.14	17.50	13.50	19
20-Jun-09	36	50.142	50.050	50.126	50.12	17.50	13.55	17
Total FX announced & awarded						**522.5**	**491.35**	**701**

Source: Market Operation Department & MPD staff calculation



3

The Inflation Trend and Outlook

3

THE INFLATION TRENDS AND OUTLOOK

SUMMARY

Headline inflation is currently experiencing a negative trend as a result of international economic slowdown which caused low demand. The Presidential and Provincial Council elections could be another reason behind this slowdown in economic activities inside the local economic territory.

Headline consumer price index (CPI), the broadest measure of the rise in the general level of prices for Kabul stood at 165.19 at the end of the second quarter of 1388, representing an inflation rate of -14.94 percent down from 35.71percent in the same period a year ago.

The decrease in the headline CPI was mainly attributed to decreases in the prices of bread & cereals, meat, oil and fats, construction materials, fuel and electricity, and transportation. The food price index fell dramatically by 21.94 percent because of a decrease in demand in the international markets as well as significant wheat harvest inside the country.

Core inflation calculated as headline inflation excluding bread and cereals, oil and fats, and transportation also decreased by 1.41 percent in the quarter under review down from 11.97 percent in the same quarter a year ago. Core inflation calculated by Trimmed Mean also depicts a downward trend reaching at 0.5 percent in the quarter under review compared to 14.5 percent in the same quarter a year ago.

1. INFLATION CONTINUES TO INCREASE IN THE SECOND QUARTER OF 1387

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation, as measured by year-on-year percentage changes in Kabul CPI continued to be negative in the second quarter of the year. Headline inflation declined dramatically to -14.9 percent at the end of the quarter under review compared to 35.7 percent in the same quarter a year ago.

The CPI measures the average price of a fixed set (or basket) of goods and services. The basket of goods and services is intended to reflect all of the items a typical family buys to achieve some minimum standard of living in some base period (currently 2004). The CPI does not count the price of each item equally but weights each according to its share of total household expenditures in the base period, so that changes in the index from one period to the next are broadly reflective of changes in a representative household's current cost of living.

The breakdown of Kabul headline CPI inflation is presented in Table 3.1 and illustrated in Figure 3.1. The decrease in Kabul headline CPI to -14.9 percent in the second quarter of 1388 compared to 35.7 percent in the same quarter a year ago was largely due to the following factors:

First, the food sub-index accounts for 61.3 percent of the CPI basket: this price index declined sharply by 21.9 percent as a result of low demand driven by global recession. The global recession will have a silver lining for net-food importing countries like Afghanistan as the decline in commodity prices is likely to lead to a decline in imported inflation going forward.

The favorable climate conditions and the significant rainfalls at the beginning of the year contributed to an increase in domestic cereal production. The domestic wheat production increased significantly which could meet a significant proportion of total of wheat requirements for the country.

Another reason behind this decline could be the measures taken by the government in response to the shortage in food supply occurred in the last year.

Second, bread and cereals sub-index accounts for 28 percent of the CPI basket: this price index fell dramatically to -35.9 percent in the quarter under review down from 91.9 percent in the same quarter a year ago. The main causes of this decrease are attributed to both domestic and international factors. In the international side, the world economic slowdown pulled down the aggregate demand in the international markets. In the domestic side, the agricultural productions increased notably in the current year.

Third, the Non-food sub-index accounts for 38.7 percent for the CPI basket. This sub-index fell to -0.8 percent in the quarter under review compared to 10.8 percent in the same quarter a year ago. The main drivers of the decrease are construction material, transportation, and fuel and electricity.

Table 3.1: Breakdown of Kabul Headline CPI

(Percent changes year on year)
Consumer Price Index (March 04=100)

	Weights	1386				1387				1388	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2*
Headline	**100.0**	**8.1**	**12.1**	**17**	**20.7**	**33.3**	**35.7**	**22.7**	**3.2**	**-10.04**	**-14.9**
Food and Beverages	**61.3**	**11.8**	**15.8**	**25.6**	**30.6**	**48.6**	**52.7**	**30.3**	**0.9**	**-17.50**	**-21.9**
Bread and Cereal	28.0	13	21.5	42.6	51.8	91.4	91.9	49.4	-3.6	-30.18	-35.9
Meat	6.0	1.1	-5.9	-0.8	4.1	5.9	11.0	7.0	-0.6	-0.3	-1.4
Milk and cheese	5.6	18.9	22	24.1	21.7	8.8	9.6	7.3	9.7	4.65	0.6
Oil and Fat	5.3	43	36.7	42.5	45.2	20.2	27	-1.7	-14.1	-17.50	-21.2
Fresh & dried fruits	4.9	5.0	8.9	5.1	5.2	3.9	15.3	12.8	15.0	15.4	9.8
Vegetables	4.9	4.0	13.2	8.8	6.0	27.6	28.4	23.3	16.6	-0.05	-1.1
Sugar & Sweets	1.8	-2.3	-6.2	-6.6	-5.5	-3.2	8.8	7.8	10.4	16.3	18.2
Spices	1.1	7.6	7.1	7.8	2.7	11.6	20.7	22.5	18.7	8.4	5.6
Tea & Beverages	2.0	3.4	3.5	1.5	3.9	13.3	15.7	17.2	12.6	2.1	0.3
Tobacco & Cigarettes	1.7	4.0	2.7	5.8	5.7	7.0	8.4	6.6	7.3	3.2	2.1
Non – Food	**38.7**	**3**	**7.1**	**5.4**	**6.9**	**10.3**	**10.8**	**10.5**	**7.4**	**5.01**	**-0.8**
Clothing	7.2	3.0	4.5	5.8	6.7	5.6	11.0	9.0	8.8	6.8	3.0
Housing	17.2	1.3	10	5.4	6.5	10.3	9.9	10.3	7.2	7.06	-2.3
Rents	7.1	-25.3	-19.9	-2.8	1.8	6.8	7.6	8.8	9.1	8.55	3.8
Construction materials	3.2	-5.3	8.7	17.1	17.9	15.6	17.3	11.2	4.2	0.95	-14.1
Fuel and Electricity	6.8	52.8	58.4	9.5	7.5	11.9	9.5	11.2	6.6	7.67	-3.4
Household goods	7.0	2.2	2.0	2.0	1.9	2.7	3.5	2.9	3.7	3.0	2.5
Health	2.0	4.4	4.3	3.8	3.3	7.8	19.2	21.3	23.9	19.3	7.2
Transportation	2.3	16	8.5	14.6	23.9	40.5	25.9	21.3	1.0	-14.03	-11.9
Communications	0.9	-2.9	-2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.2	0.3	-0.7	-1.1	-0.8	0.5	1.6	2.1	1.4	0.6	0.1
Miscellaneous	0.9	10.2	9.5	6.5	13.7	15.8	22.6	27.0	17.9	12.6	8.4
Core inflation (28% TM)		**4.9**	**6.7**	**6.2**	**7.2**	**9.8**	**14.2**	**11.8**	**7.6**	**4.2**	**0.5**
Core infl. (headline excluding bread and cereals, oil and fats, and transportation)			**7.1**	**5.7**	**6.2**	**8.9**	**12.0**	**10.8**	**9.0**	**6.2**	**1.4**

Source: Central Statistics Office and DAB staff calculations

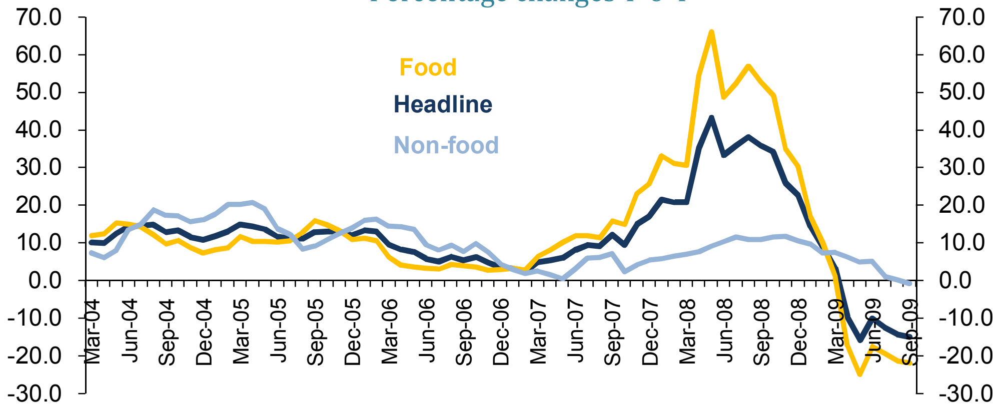
Fourth, construction materials sub-index accounts for 3.2 percent for the CPI basket. This sub-index declined by 17.3 percent in the quarter under review, compared to 17.3 percent in the same quarter a year ago. The main reason behind this decline is thought to be the uncertainty in political situation driven by the Presidential and Provincial Council elections.

Fifth, the transportation sub-index accounts for 2.3 percent of the CPI basket. This sub-index declined by 11.9 percent in the quarter under review compared with 25.9 percent in the same quarter a year ago. The main reason behind this decline could be the global recession which caused low demand in the international markets. The second reason is thought to be the completion of reconstruction work of some highways such as Kabul – Turkham highway which reduced the transportation cost of imported goods.

On the other hand the following categories posted increase:

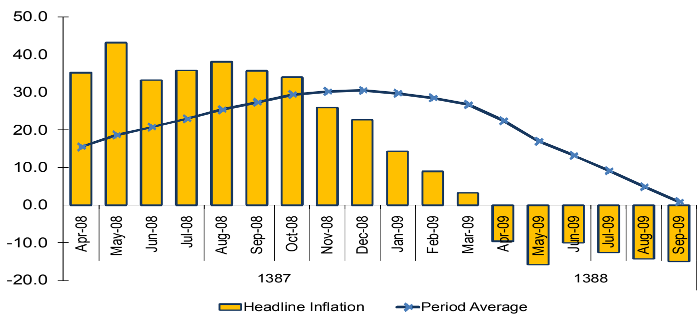
First, the sugar and sweets sub-index accounts for 1.8 percent of the CPI basket. This sub-index increased by 18.2 percent in the quarter under review, compared to 8.8 percent in the same quarter a year ago.

Figure 3.1: Breackdown of Kabul Headline CPI
Percentage changes Y-o-Y



Source: Central Statistics Office and DAB staff calculations.

Figure 3.3: Kabul Headline Inflation,
End Period compared to Period Average



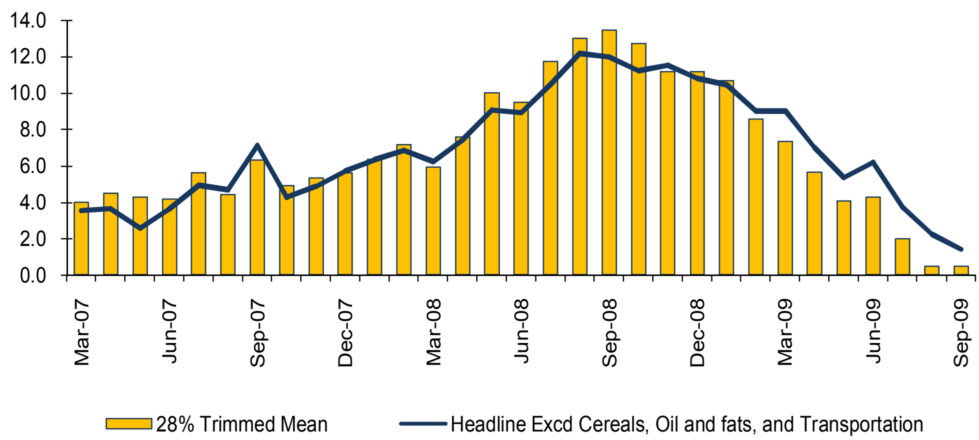
Source: Central Statistics Office and DAB staff calculations.

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

The breakdown includes a measure of core inflation because comparing one period's price statistics with some other period gives a crude measure of inflation (if the general level of prices has risen). But such a measure does not discriminate between relative price changes and inflation, so an increase in the price of a single item, such as food, may cause a price index to rise. For this reason, a measure of core inflation, which is obtained by excluding most extreme items in the CPI basket (Trimmed Mean is one of the preferred methods to calculate the core inflation, the most fluctuated items from both, top and bottom of the CPI basket is being trimmed and the average of the remainder items represents the core inflations, which is also often interpreted as measuring the long run or persistent component of the index at 13.5 percent over the second quarter of 1387.

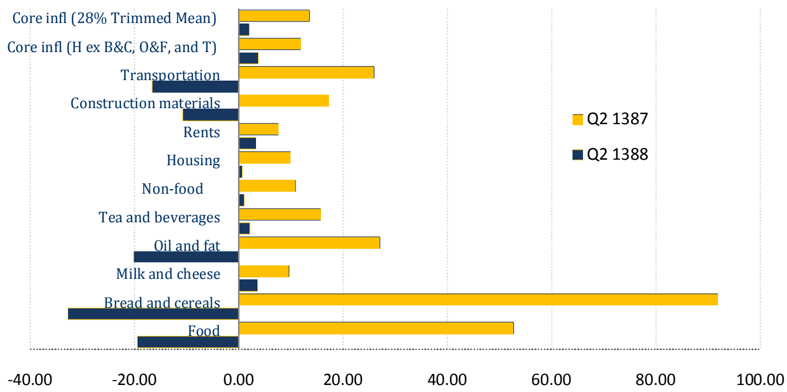
Trimmed mean inflation for Kabul CPI is illustrated in Figure 3.4.

Figure 3.4: Core Inflation



Source: Central Statistics Office and DAB staff calculations.

Figure 3.5: Contribution to Kabul Headline CPI



Source: Central Statistics Office and DAB staff calculations

1.2 Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis.

Headline inflation, as measured by year-on-year percentage changes in national CPI continued to be in the negative territory in the second quarter of 1388. Headline inflation decreased dramatically to -17.7 percent in the quarter under review compared to 38.8 percent in the same quarter a year ago. The main drivers behind this decrease are food and non-food sub-indexes. The political uncertainty due to Presidential and Provincial Council elections also caused slowdown the economic activities inside the country. The breakdown of national CPI into its respective components is presented in Table 3.2 and illustrated in Figure 3.6.

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

	Weight	1386				1387				1388	
		Q1	Q2	Q3*	Q4	Q1	Q2	Q3	Q4	Q1	Q2*
Headline	**100.0**	**9.6**	**14.9**	**20.5**	**24.3**	**41.5**	**38.8**	**23.82**	**4.8**	**-14.6**	**-17.7**
Food and Beverages	**61.3**	**13.0**	**16.8**	**27.1**	**31.9**	**57.9**	**56.8**	**32.63**	**4.3**	**-22.4**	**-25.2**
Bread and Cereal	28.0	16.2	20.8	41.8	50.0	100.4	97.4	51.49	3.0	-34.9	-38.7
Milk and cheese	5.6	10.9	15.1	14.7	15.6	14.8	13.7	10.64	8.8	2.4	-0.9
Oil and Fat	5.3	24.5	40.3	42.2	52.3	40.6	27.3	0.25	-18.8	-24.0	-27.1
Non – Food	**38.7**	**4.4**	**11.9**	**11.0**	**12.2**	**14.6**	**10.5**	**8.85**	**5.9**	**3.0**	**-0.8**
Housing	17.2	3.7	15.0	12.1	13.3	13.9	9.5	6.32	3.8	3.3	-1.9
Rents	7.1	-12.8	-3.7	4.7	11.7	9.1	3.5	4.28	3.3	3.6	6.0
Construction mat	3.2	-1.0	10.0	13.4	13.4	13.6	10.2	7.76	6.3	0.5	-6.1
Fuel and Electricity	6.8	28.6	40.4	18.6	14.8	18.7	14.3	7.55	3.4	3.9	-6.9
Transportation	2.3	11.7	11.1	20.5	27.9	36.4	27.9	17.13	-1.3	-12.3	-16.7
Core inflation (28% TM)		**6.7**	**10.4**	**10.5**	**11.3**	**14.1**	**12.6**	**10.6**	**7.8**	**4.3**	**2.0**
Core inflation (Headline exc B&C, O&F, and T)		**5.5**	**10.7**	**9.7**	**10.3**	**12.5**	**11.9**	**10.5**	**8.5**	**4.2**	**1.7**

Source: Central Statistics Office and DAB staff calculations

The decrease in the national CPI inflation to -17.7 percent in the second quarter of 1388 from 38.8 percent in the same quarter a year ago was mainly attributed to the following factors:

First, the bread and Cereals sub-index accounts for 28 percent of the CPI basket: this price index declined sharply by 38.7 percent at the end of quarter under review from 97.4 percent at the end of the same quarter a year ago. The main reasons behind this decrease are thought to be the decline in the aggregate demand in the international markets as a consequence of global recession. The second reason could be an attractive wheat harvest and good performance of the agriculture sector due to favorable seasonal rainfalls.

Second, Oils and fats sub-index accounts for 5.3 percent of the CPI basket: this sub-index declined dramatically by 27.1 percent at the end of second quarter of 1388 down from 27.3 percent in the same quarter a year ago.

Third, construction materials sub-index accounts for 3.2 percent of the CPI basket: this sub-index fell to -6.1 percent at the end of second quarter of 1388 down from 10.2 percent in the same quarter a year ago.

Fourth, the transportation sub-index accounts for 2.3 percent of the CPI

basket: this sub-index declined sharply to -16.7 percent at the end of the second quarter of 1388 compared to 27.9 percent at the end of the same quarter a year ago. The main reasons behind this decrease are thought to be the decrease in oil prices in the international markets. The second reason is thought to be the completion of construction works on the some highways which caused decrease in transportation costs.

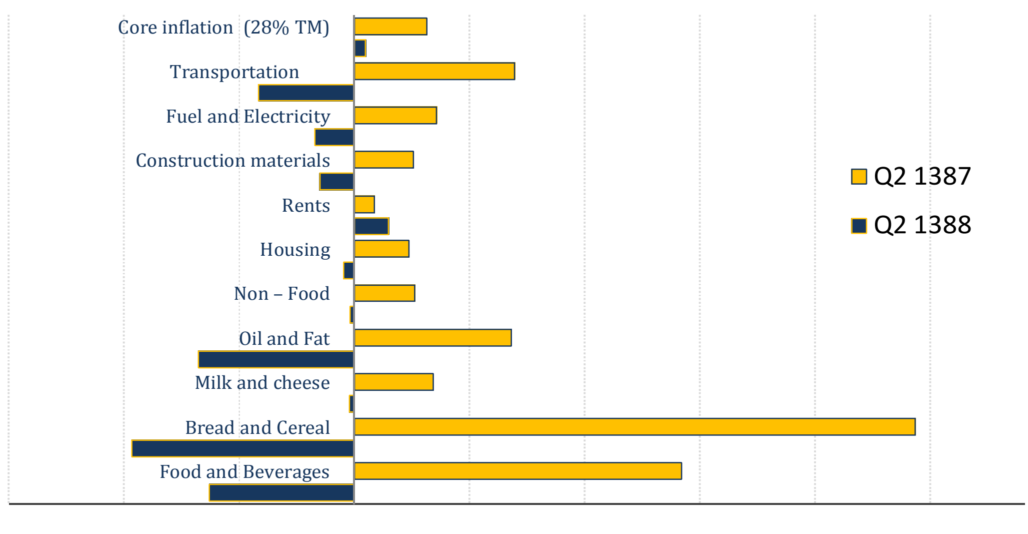
On the other hand some categories of the national CPI show increase:

First, rents sub-index accounts for 7.1 percent of the CPI basket: this sub-index increased by 6 percent at the end of the quarter under review from 3.5 percent at the end of the same quarter a year ago. The breakdown of national CPI is presented in figure 3.5.

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

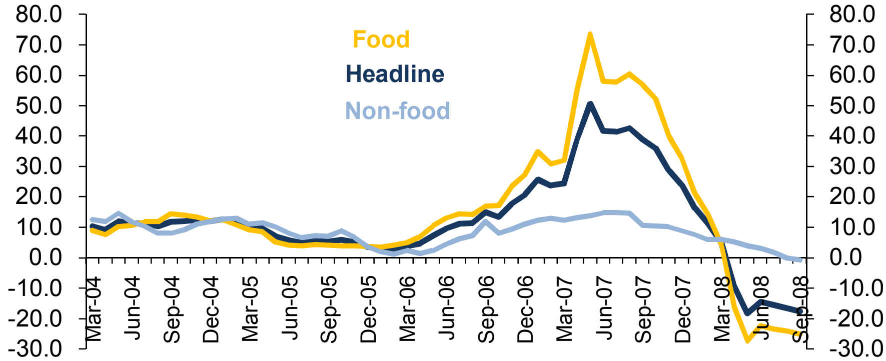
Figure 3.6 presents inflation trend for national CPI.

Figure 3.6: Contribution to nationa headline CPI



Source: Central Statistics Office and DAB Staff calculations

Figure 3.1: Breackdown of National Headline CPI
Percentage changes Y-o-Y



Source: Central Statistics Office and DAB Staff calculations

1.3. Quarterly changes in Kabul headline CPI

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

The Kabul headline CPI in the second quarter of 1388 increased by 2.1 percent compared to -1.5 percent in the first quarter of 1388. The increase in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: this sub-index rose by 2.3 percent in the quarter under review from -2.5 percent in the first quarter 1388 with a contribution of 3.8 percent by milk and cheese. However, the bread and cereals sub-index is still in the negative territory, but it has recovered in the quarter under review compared to that in the first quarter of 1388.

Non-food: This price index rose by 1.7 percent in the quarter under review form 0.2 percent in the first quarter of 1388, with a contribution of 2.2 percent by rents, 2.2 percent by fuel and electricity and 2.7 percent by transportation sub-indexes.

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

Table 3.3: Quarterly Changes in Kabul Headline CPI
(Percent changes quarter on quarter)
Consumer Price Index (March 2004=100)

				1386	1387				1388	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**2.4**	**6**	**5.9**	**5**	0.7	5.2	-2.5	-9.4	-1.5	2.1
Food and Beverages	**4.7**	**5.3**	**9.4**	**8.3**	0.1	5.8	-4.4	-13.0	-2.5	2.3
Bread and Cereal	5.7	8.2	17	13.4	-0.8	5.6	-6.3	-21.8	-3.5	-0.3
Milk and Cheese	9.8	7.2	2.9	0.5	-2.4	7.0	1.2	2.2	-6.3	3.8
Oil and Fat	23.0	-1.1	8.3	10.2	0.5	1.7	-9.4	-4.8	-2.2	-0.1
Non – Food	**-0.7**	**7.1**	**0.8**	**-0.3**	**2.1**	**4.0**	**1.4**	**-2.8**	**0.2**	1.7
Housing	-2.9	11.5	0.6	-2.3	0.6	5.1	3.1	-4.6	0.5	1.4
Rents	-3.6	6.1	-0.9	0.4	1.1	1.3	0.5	0.1	0.6	2.2
Fuel and Electricity	-4	16.4	1.7	-5.4	0.5	8.7	8.2	-8.3	0.9	2.2
Transportation	4.3	12.0	1.3	4.3	15.8	-1.8	-4.4	-8.5	0.7	2.7

Source: Central Statistics Office and DAB Staff calculations

1.4. Quarterly changes in national headline CPI

This section analyzes quarter-on-quarter changes in national headline CPI.

The national headline CPI rose by 1.4 percent in the quarter under review from -3.7 percent in the first quarter 1387. The increase in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: this price index increased by 1.3 percent in the second quarter of 1388, compared to -5.7 percent in the first quarter of 1388. Bread and cereals sub-index fell by 0.8 percent and oil and fat by 2.7 percent respectively, while Milk and cheese sub-index rose by 1.0 percent from -2.9 percent in the first quarter of the year.

Non Food: rose by 1.7 percent with the housing sub-index increasing by 3.1 percent, rents 5.6 percent, fuel and electricity 2.4 percent respectively, while transportation fell by 0.7 percent to compare with 0.1 percent in the first quarter of 1388.

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

Table 3.4: Quarterly Changes in National Headline CPI

(Percent changes quarter on quarter)

Consumer Price Index (March 2004=100)

	1386				1387				1388	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**3.8**	**7.2**	**7**	**4.4**	**5.2**	**4.1**	**-3.1**	**-10.1**	**-3.7**	**1.4**
Food and Beverages	**5.8**	**5.8**	**10**	**7.2**	**6.5**	**4.1**	**-5.0**	**-13.8**	**-5.7**	**1.3**
Bread and Cereal	8.3	6.9	16.7	11	9.7	4.2	-7.7	-21.7	-8.6	-0.8
Milk and Cheese	3.9	5.4	3.6	1.9	1.9	3.5	0.6	-0.6	-2.9	1.0
Oil and Fat	15.2	12.0	8.5	8.7	-0.7	-0.5	-11.3	-8.1	-0.5	-2.7
Non – Food	0.6	**9.5**	**2.3**	**-0.4**	**2.3**	**4.2**	**1.0**	**-2.7**	**-0.1**	**1.7**
Housing	0.2	13	2.5	-2.3	0.6	6.8	0.03	-4.4	0.2	3.1
Rents	2.1	8.7	0.6	0	-0.6	2.1	-0.01	-1.4	0.1	5.6
Fuel and Electricity	-3.1	18.6	5	-4.8	1.7	12.3	0.6	-7.9	0.6	2.4
Transportation	5.6	11.5	7.0	1.5	11.7	3.1	-0.9	-9.7	0.1	-0.7

Source: Central Statistics Office and DAB Staff calculations

Box 1: Deflation-the real risks to global economy

Deflation means a complete mental rethink and is beyond the understanding of most people today who were raised in inflationary times. The real question is an emotional one: how will ordinary people behave if they think prices are going to fall year on year for more than a very short period?

And how will investors in the market behave? As we saw in Japan (1990s), if they start pricing in an expectation of deflation across most sectors, rather than just 40% in some sectors, it will have a significant effect on valuations and reduce appetite even more for buying stocks.

Consumers often rely on inflation to help them repay debts - particularly house loans. Inflation of 5% means a mortgage is only half what it was in real terms in 15 years.

What happens in deflation?

When prices fall, the value of cash rises. Anyone with money has an advantage and those with debts lose. If I have a mortgage of $250,000 this year, and deflation runs at 5% a year, it means in real terms my loan will double in size over 15 years. Most worryingly, in deflation, my loan (which was only 70% of the value of my home) will become so huge that even if I sell my home, I will be left with large debts.

We have all seen deflation before in one key area: computers and digital technology where deflation has been eating away at price levels for three decades or more. But this is different. It is one thing to write off an investment in a computer system over three years, but another to find that one of your greatest assets, your own home, is worth only a small fraction of what it was twenty years ago, and that prices of every other asset you own are also expected to go on falling.

Of course if you have cash in hand, the temptation is to spend nothing, and invest in nothing. What is the point of buying when you know that in six months time the chances are you could buy more? So money gets left as cash under the bed, or in a bank account (if you are prepared to risk the bank going bust because so many loans were secured against assets, now worth almost nothing). Spending falls, feeding a further frenzy of price cutting, downward pressure on salaries, bonus cutting, and so on. But it is easier to pay people less and get away with it when they know they need less to live on this year than last year.

Interest rates fall to zero, because no one in their right minds wants to borrow large amounts of an asset (cash) which is going to inflate with time. Indeed the only asset for ordinary men and women that grows in value in a deflationary economy is cash, and cash is what you find they hang on to. Just look at Japan which has experienced deflation for years with terrible consequences.

How serious is the risk of deflation hitting other economies?

What happens when interest rates fall to zero?

The main tool that governments use to control inflation is interest rates, but this tool can lose its power if rates are already so low that there is hardly any room left to cut further before the cost of borrowing falls to zero.

Think about it from the ordinary man or woman in the street's point of view. If interest rates are zero, I can go out and get a huge loan and it costs me nothing at all. Of course the loan must one day be repaid, but when? The bank soon realises I am over extended and cannot repay, but is in no hurry because the loan repayments will be worth more to them in the future, if they give me longer to find the money. They are not losing a penny in interest because the interest rate is zero. In fact every day the bank waits, the more they make, because the price of money is rising as the price of everything else falls - that is the reality of deflation.

Old economics relied on inflation running at a safe modest level - not too high and not too low. It taught us that raising the cost of borrowing also raises the returns to savers, and sucks money out of the economy so less is around to be spent by consumers, goods hang around before being sold and market prices are constrained. Lowering interest rates encourages people to spend without worrying; more cash chases goods for sale, prices rise.

Unfortunately there are a number of drivers of deflation, so it will be easy for governments to find rates lower turn out lower than they expected. That's why banks try to keep a margin for error and will take radical steps to prevent inflation falling from - say - an absolute minimum of 2.5% or even 3% a year.

Deflation Drivers

1. Globalization: every time a job moves from a high income country to a low income country, the price of production falls, and the potential for price cutting increases, while maintaining profits and market share. We are currently witnessing rapid and accelerating changes in industry and services. Even less developed countries like Mexico are finding large chunks of their manufacturing capacity moving to places such as China. India is taking a significant share of software development, with entire teams being made redundant in the UK and the US, replaced by teams twice the size at a fraction of the cost in places like Hyderabad and Bangalore. And as prices rise in places like coastal China, jobs will shift to other less developed regions.

2. Technology innovation: every time a new production process is developed, using less people and fewer resources, prices fall. In the past, technology purchases formed only a small part of our lives, but the techno-economy continues to grow dramatically, despite the hype and gloom of investors. And the indirect spin-offs are becoming greater every day. Take for example food technology and processing, where new automated packaging and distribution systems have contributed to falling food prices for over a decade, or new farming methods with increased yields, or the impact of online business to business relationships and just-in-time delivery systems.

3. Economic cycles and global shocks: every economy goes through ups and downs and events outside any government's control also have impact. Take for example major terror attacks or turmoil in the Middle East affecting oil prices, which have recently fluctuated widely and may continue to do so. When oil prices rise, there is inflationary pressure. Governments respond by factoring this into decisions to raise interest rates and inflation falls towards a base level. But if that minimum is too low, what happens if there is another major downwards correction and for a while oil prices fall very significantly? The answer is an added risk of undershooting and causing deflation.

Acting to prevent further deflation

So then, as we have seen, sectors in many economies are already deflating. What can governments do if they are worried about deflation, or to correct national deflation once it starts?

Firstly they can cut interest rates more aggressively while they are still able. Secondly they can suspend or revoke tax rises for a limited period. Thirdly they can increase expenditure. Both these options of course affect government debt and are sustainable only in the short term without profound consequences.

In summary then, both inflation and deflation pressures can worry governments, with potential risks to stability in countries where inflation has been allowed to fall too low. Governments should be expected to act from time to time, aiming to maintain around 2.5% to 3.0% inflation throughout economic cycles, giving room for adjustments and economic shocks in both directions.

Source: *www.citehr.com/172044-deflation-real-risks-global-economy*

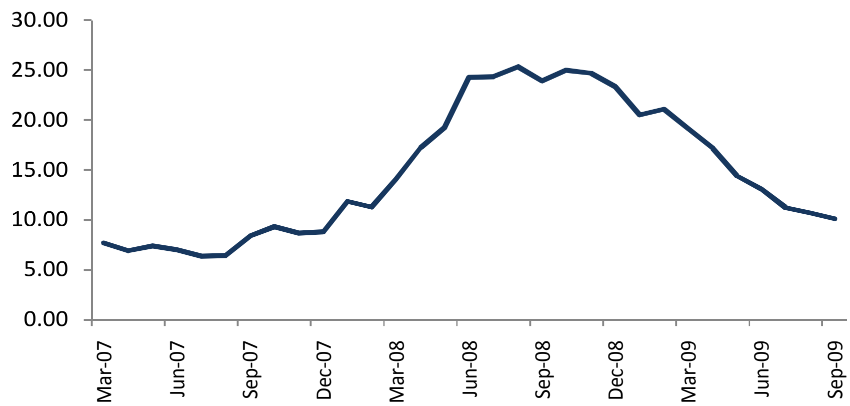
2. THE REGIONAL INFLATION

This section analysis inflation trends in some regional countries. The significant moderation in Global inflation that had started with the onset of the global crisis in 2008-09, continued in 2009-10, with several advanced countries experiencing negative inflation due to sharp fall in commodity prices in the second half of 2008-09 and the sustained recession in aggregate demand. Prices of food, fuel and metal had bottomed in December 2008 and have been firming up moderately since then. Sluggish global demand and presence of unutilized capacity have, however, contained the risk of inflation, thereby allowing the central banks around the world to sustain the accommodative monetary policy stance to spur economic growth. Likewise the advanced economies, regional countries also experienced negative inflation in the second half of 2009-2010. The inflationary trend of some regional countries has been tracked.

2.1 Inflation Trend in Pakistan

Headline continued to decline on Y-o-Y basis, reaching at 10.1 percent during September 2009 compared to 10.7 percent in the preceding month and 23.9 percent during the corresponding month last year. The declines were visible in both, food and non-food groups of COI. CPI inflation (M-o-M) also declined during September 2009 to 0.5 percent compared to 1.7 percent in August 2009.

Figure 3.8: Pakistan Headline CPI (Y-o-Y)



Source: State Bank of Pakistan

Table 3.5: Breakdown of Pakistan Headline Inflation

	CPI			Core Inflation		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Sep 08	23.91	29.9	19.2	17.3	21.2	33.2
Oct 08	25.00	31.7	19.7	18.3	21.7	28.4
Nov 08	24.68	30.4	20.2	18.9	21.3	19.9
Dec 08	23.34	27.9	19.8	18.8	21.7	17.6
Jan 09	20.52	21.6	19.7	18.9	19.6	15.7
Feb 09	21.07	22.9	19.6	18.9	20.8	15.0
Mar 09	19.1	19.7	18.5	18.5	19.3	11.1
Apr 09	17.2	17.0	17.3	17.7	17.6	8.3
May 09	14.4	12.1	16.3	16.6	16.7	4.7
Jun 09	13.1	10.5	15.4	15.9	15.5	4.1
July 09	11.2	10.7	11.6	14.0	13.9	0.5
Aug 09	10.7	10.6	10.8	12.6	13.1	0.3
Sep 09	10.1	10.0	10/2	11.9	12.4	0.7

* NFNE is Non-food non-energy inflation,
Source: State-Bank of Pakistan

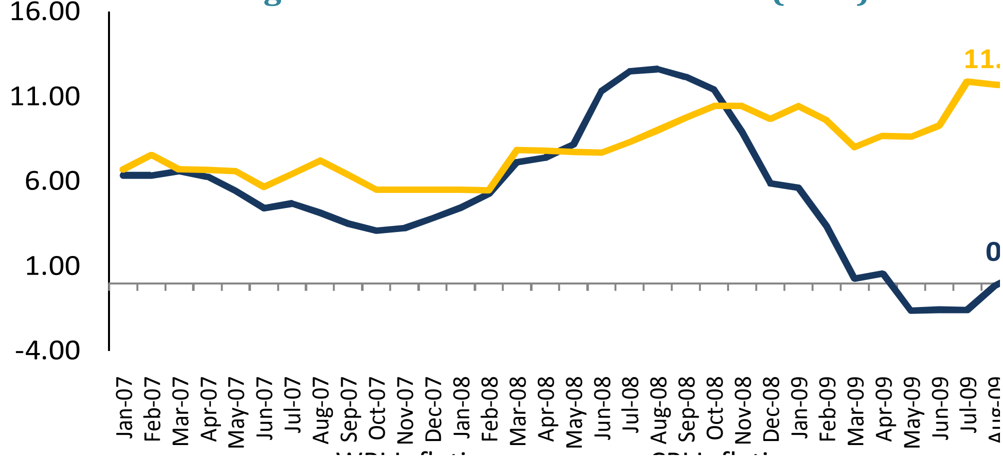
Core inflation measured by both non-food non-energy (NFNE) and 20% trimmed mean declined during the month under review compared to both, September 2008 as well as August 2009. NFNE inflation reached 11.9 percent on a y-o-y basis during September 2009 compared to 17.3 percent in the same period a year ago. likewise 20% trimmed mean inflation y-o-y dropped, reaching 12.4 percent compared to 21.2 percent in the same period a year ago.

2.2 Inflation in India

The year-on-year WPI inflation during 2009-10 has been significantly volatile, and in recent months inflation has firmed up, reflecting the increase in food and fuel prices as well as the impact of the waning of base effect. The WPI inflation was negative during June-August 2009, before turning positive in September.

Overall, the WPI inflation in India has shown significant firming up in recent months, with the pressure though coming from primary articles and manufactured food products. The dominance of food prices as the key driver of inflation in recent months indicates a limited role for demand management in effectively curbing the price pressures. Consumer price inflation continues to remain firm and the divergence between CPI and WPI inflation still persists. Unlike the inflation episode of the first half of 2008, when the external supply shocks conditioned the inflation path, the current episode is characterized by dominance of domestic supply side pressures largely emanating from deficient South-West monsoon and its impact on food-grain production. Persistence of food price inflation over a long period could erode the purchasing power of the public at large who may be compelled to devote larger share of their disposable income to food consumption. Moreover, high food inflation and elevated CPI inflation could potentially generate wage-price spiral and raise inflationary expectations.

Figre 3.9: India Headline Inflation (Y-oY)



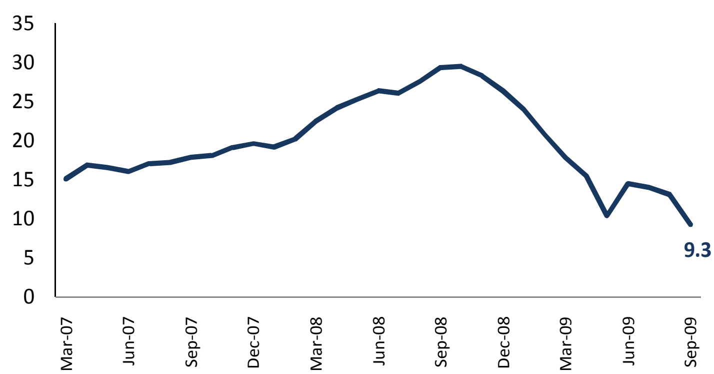
Source: Reserve Bank of India

2.3 Inflation Trend in Iran

The Consumer Price Index (CPI) went up 13.5 percent in the first six months of 1388 compared to the same period a year ago. The CPI increased 0.4 percent in September 2009. The overall CPI stood at 202.9 in September 2009 representing a y-o-y inflation rate of 9.3 percent.

The breakdown of headline CPI is presented in Table 3.6.

Figre 3.10: Iran CPI Inflation (Y-oY)



Source: Central Bank of Islamic Republic of Iran

Table 3.6: Breakdown of Iran Headline Inflation

Description	Base Year Weight	Index Number in Sept 2009	Percentage Changes	
			Prev. month	Sep 2009 compared to Sep 2008
General Index	**100.00**	**202.9**	**0.4**	**9.3**
1. Food and Beverages	**28.49**	**219.3**	**-0.7**	**6.6**
2-Tobacco	**0.52**	**223.3**	**0.9**	**43.0**
3-Clothing and Footwear	**6.22**	**178.0**	**0.5**	**10.1**
4-Housing, Water, Electricity, Gas and other Fuels	**28.60**	**220.5**	**1.0**	**12.0**
5-Furnishings, Household Equipment and Routine- Household Maintenance	**6.26**	**185.4**	**-0.9**	**1.2**
6-Medical Care	**5.54**	**228.9**	**3.0**	**19.7**
7-Transportation	**11.97**	**156.8**	**0.4**	**3.4**
8-Communication	**1.63**	**97.4**	**0.0**	**0.9**
9-Recreation and Culture	**3.80**	**146.7**	**1.8**	**9.2**
10-Education	**2.07**	**206.5**	**0.4**	**15.0**
11-Restaurants and Hotels	**1.72**	**214.3**	**0.3**	**14.2**
12-Miscellaneous Goods and Services	**3.18**	**205.7**	**0.9**	**12.2**
Special Groups:				
1-Goods	**57.13**	**188.4**	**-0.3**	**5.1**
2-Services	**42.87**	**222.1**	**1.2**	**14.2**
3-Housing, Water, Electricity, Gas and other Fuels	**28.60**	**220.5**	**1.0**	**12.0**

Source: Central Bank of Islamic Republic of Iran

3. INFLATIONARY OUTLOOK

Afghanistan is experiencing deflationary pressures since the beginning of the year. The headline inflation as measured by percentage changes y-o-y is expected to turn positive at the end of the year as a result of some easing of monetary policy as well as recovery from the global downturn which may improve the aggregate demand.

However, upside risks to inflation include international price shock for oil and food.

3.1 Risks to inflation remain

Foreseeable risks to future inflation remain. These risks include further increase in grain prices and prolonged liquidity surge given expectations of steady foreign exchange inflows from remittances, the illegal opium trade and donor funds. Additional risks include the secondary effects of inflation on asset prices. Inflation will depress real returns to saving, bringing real (inflation-adjusted) deposit rates to negative levels. Negative real interest rates would lead to record high loan growth. A negative interest rates scenario favors barrowers, and risks fuelling asset inflation and sparking a housing property boom.

4

Fiscal Developments

4

FISCAL DEVELOPMENTS

SUMMARY

The overall fiscal performance in the first quarter of FY1388 was almost balanced with small fluctuations in some variables. Some fiscal indicators show good performance while the others did not.

On the positive side the property taxes increased to AF 46,968 million in the quarter under review up from AF 21,454 million in the fourth quarter of 1387. This represents 119 percent increase. Royalties taxes increased to AF 70,255 million in the quarter under review compared to AF 32,593 million in the previous quarter, representing 116 percent increment. Sales tax and fixed taxes showed good performances in the quarter under review representing increase of 79 percent and 48 percent respectively.

On the negative side income from capital properties decreased declined to AF 50,005 million in the quarter under review down from AF 122,304 million in the fourth quarter of 1387, representing 59 percent decline. The total social contribution declined to AF 175,044 million in the quarter under review compared to AF 274,666 million in the previous quarter. This represents 365 percent decline.

Budget deficit in the quarter under review stood at AF 16,624 million compared to the budget deficit of AF 25,105 million in the fourth quarter of 1387.

Total domestic revenues increased to AF 14,272 million in the quarter under review from AF 13,879 million in the previous quarter, this represents a 3 percent increment and is a good sign of the fiscal performance of the government. Total domestic revenues accounted for 2.24 percent of GDP, which is well below the global and regional average.

Total domestic revenues are composed of tax and non-tax revenues. Tax revenues increased to AF 12,363 million in the quarter under review compared to AF 8,587 million in the fourth quarter of FY1387. This represents 44 percent increase.

On the other hand non-tax revenue declined to AF 1,909 million in the quarter under review compared to AF 5,292 million in the fourth quarter of FY1387. This represents 64 percent decline.

On the spending side total expenditures in the quarter under review declined to AF 19,541 million down from AF 38,984 million in the fourth quarter of FY1387, which reveals a 50 percent decline. Total expenditures accounted for 3.07 percent for the GDP.

Total expenditures are classified into development and operating expenditures. Development expenditures declined to AF 3,116 million in the quarter under review from AF 18,696 million in the previous quarter, this represents 83 percent decline.

On the other hand operating expenditures increased to AF 16,425 million from AF 20,288 million in the fourth quarter of FY1387, this represents 19 percent increment.

The total grants allotted to the operating expenditures declined to AF 5,024 million in the quarter under review down from AF 9,314 million in the previous quarter, this represent 23 percent decline.

On the other hand total grants allotted to the development expenditures declined to AF 5,767 million down from AF 7,566 million which represents 24 percent decline. The main contributors to the development expenditures are ARTF, LOTFA, ADB, EC, World Bank, CNTF and others.

1. REVENUES

The budgeted revenue target for the fiscal year 1388 was set at AF 50.6 billion (IMF/PRGF target is AF 51 billion), compared to 1387 target of AF 41.5 billion. As a result the domestic revenue to GDP ratio's target increased from 7 percent to 7.6 percent.

Total domestic revenue in the quarter under review stood at AF 14.272 million which exceeds the target of AF 12.3 million by 13 percent. The improvements in the domestic revenues collection attributed to good performance of both tax revenue (partly through new tax measures) and custom duties (partly through improved customs administration.

The total domestic revenues are classified as follow: taxes (fixed taxes, income taxes, property taxes, sales taxes, excise taxes and others), customs duties, non-tax revenues and others (social contributions, income from capital property, sale of goods and services, royalties, non tax fines and penalties, and sale of land and buildings).

Total domestic revenues increased to AF 14,272 million in the quarter under review up from AF 13,879 million in the fourth quarter of FY1387 representing a 3 percent increment, which is a good sign improvement in the economic activities. On the other hand, tax revenues increased to AF 12,363 millions in the quarter under review from AF 8,587 millions in the fourth quarter of 1387 recording a growth of 44 percent.

In the meantime, non-tax revenues (income from capital property, sales of goods and services, administrative fees, royalties and non tax fines and penalties) declined to AF 1,909 million from AF 5,292 million in the fourth quarter of 1387. (see table 1.1).

The total grants allotted to the operating expenditures declined to AF 5,024 million in the quarter under review from AF 7,414 million in the fourth quarter of 1387.

On the other hand total grants allotted to the development expenditures declined to AF 4,973 million in the quarter under review down from AF 7,121 million in fourth quarter of 1387 which represents 30 percent decline.

Main contributors to the increase in total tax revenues are fixed taxes, income taxes (in particular corporate income tax), and sales taxes in particular business receipt tax (BRT), Large Taxpayer Office's (LTO) and Medium Taxpayer Office (MTO) in Kabul which contributed around AF 3 billion or 42 percent to the total amount of tax revenues, highlighting Kabul province's role as the economic heart of the country. In terms of geographical distribution of customs revenues, Herat, Kandahar, Balkh, Ningarhar and Nimroz remained the major contributors to the total customs revenues in the quarter under review. Among five major contributing provinces, Herat remains the first contributing province with 33 percent followed by Nangrahar by 27 percent share in total custom duties in the last five quarters.

Revenues from customs duties increased to AF 5,162 million in the quarter under review up from AF 3,707 million in the fourth quarter of 1387 representing 35 percent increase.

Sale taxes revenue increased to AF 3,168 million in the quarter under review up form AF 1,771 million in the fourth quarter of 1387 representing a 79 percent increase.

Total social contribution declined to AF 97 million in the quarter under review down from AF 208 million in the previous quarter, which represents 53 percent decline. (See table 1.3).

Table 4.1: Revenue Collection as of First Quarter 1388 (in million AF)

	Q4 1387 Revenue Actual	Q1 1388 Revenue Actual	% Δ from Q4 1387 to Q1 1388
Total Domestic Revenues (Tax and Non Tax)	13,879	14,272	3%
Tax Revenues	8,587	12,363	44%
Non Tax Revenues	5,292	1,909	-64%

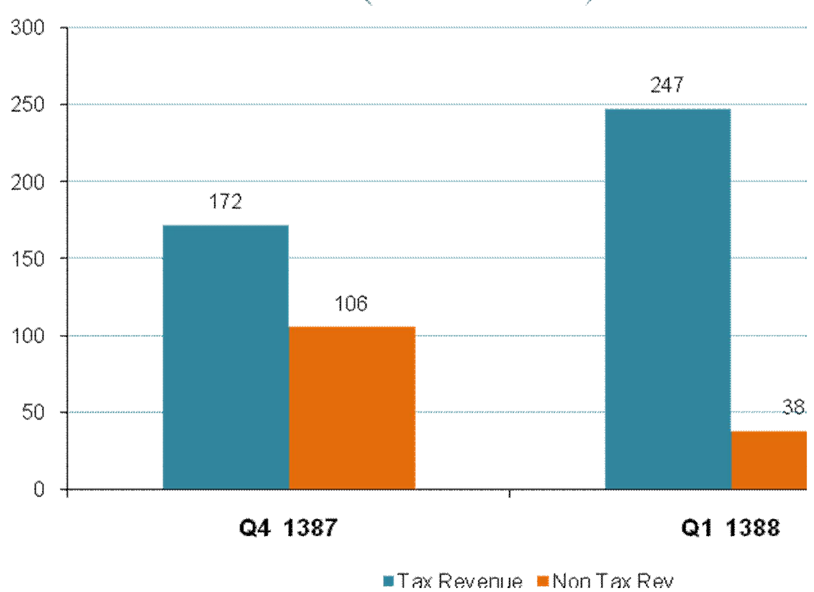
Source: MoF website and DAB staff estimation

Table 4.2: Total Revenue in million USD

	Q4-1387	Q1-1388
Total Revenue (Tax & non- Tax revenue)	278	285
Tax Revenue	172	247
Non Tax Rev	106	38

Source: MoF website and DAB staff estimation

Figure 4.1: Revenue Collection as of Q1-1388 (in million of USD)



Source: MoF website and DAB staff calculations

Table 4.3: Breakdown of Total Domestic Tax and Non-tax Revenues (in million AF)

Tax and non-Tax Revenues	Q1-1388	Q4-1387	% Changes
Taxation & Customs Revenues			
Fixed Taxes	1,842,915,588	1,246,257,458	48%
Income Taxes	1,828,737,861	1,462,778,071	25%
Property Taxes	46,968,318	21,454,136	119%
Sales Taxes	3,168,454,605	1,771,620,465	79%
Excise Taxes	0	0	
Other Taxes	251,759,596	281,424,692	-11%
Tax Penalties and Fines	62,136,690	96,568,651	-36%
Customs duties	5,162,788,500	3,707,128,404	39%
Total taxation revenues	**12,363,761,158**	**8,587,231,877**	44%
Social contributions			
Retirement contributions	175,044,086	274,666,186	-36%
Total social contributions	**175,044,086**	**274,666,186**	**-36%**
Other revenue			
Income from Capital Property	50,005,960	122,304,887	-59%
Sales of Goods and Services	764,012,538	608,284,529	26%
Administrative Fees	1,361,155,717	1,653,188,423	-18%
Royalties	**70,255,256**	32,593,368	116%
Non Tax Fines and Penalties	38,441,759	54,285,902	-29%
Miscellaneous Revenue	-381,544,707	2,807,784,227	-114%
Sale of Land and Buildings	7,615,353	14,343,650	-47%
Total other revenue	**1,909,941,876**	**5,292,784,986**	**-64%**

Source: MoF website and DAB staff estimation

2. EXPENDITURES:

The Government's expenditure programs are planned within a pragmatic and sustainable medium term macroeconomic and fiscal framework (MTFF). Enhancing revenue mobilization, as part of this framework is a necessary condition to provide the required resources to support the implementation of the Afghanistan national development strategy (ANDS).

The total core budget for 1388 adds up to AF 216 billion. Operating budget sum to AF94 billion while the remaining 122 billion (including carry forward from 1387) are allocated to the development budget of the government. The 1388 budget is 16 percent higher than that of 1387 (which was AF186 billion) and in turn reflecting the increased expenditure on Army and Police expansion together with the rise up in the teachers' salaries. Total operating budget grew by around 27 percent in 1388 as against AF 73 billion allocated to operating budget in 1387. The development budget increased by around AF 10 billion from AF 112 billion budgeted in 1387 to AF 122 billion in 1388. Total expenditures decreased to AF 19,541 million in the quarter under review down from AF 38,948 million in the fourth quarter of 1387, which represents 50 percent decline. Total expenditures accounted for 3.07 percent of the GDP. (See table 2.1).

Total expenditures are classified into development and operating expenditures.

Development expenditures declined to AF 3,116 million in the quarter under review from AF 18,696 million in the fourth quarter of 1387, this represents 83 percent decline.

On the other hand operating expenditures declined to AF 16,425 million from AF 20,288 million in the fourth quarter of 1387, this represents 19 percent increment (see table 4.1).

Recurrent expenditures are classified into the following five categories:

(a) Compensation of employees,

(b) Goods and services,

(c) Subsidies and grants,

(d) Interest payment,

(e) Acquisition of non-financial assets.

Expenditure on compensation of employees declined to AF 12,319 million in the quarter under review compared to AF 14,996 million in the fourth quarter of 1387, this represents 18 percent decline. Around 98 percent of employee compensation was paid out in the form of wages and salaries (including transport and food for employees) while the remaining 2 percent was spent in the form of social benefits.

Expenditure on supplier decreased to AF 3,128 million in the quarter under review from AF 11,004 million in the fourth quarter of 1387, this represents 72 percent decline.

Expenditures on interest payments increased to AF 32,176 million in the quarter under review compared to AF 19,141 million in the fourth quarter of 1387, this represents 68 percent increment. Interest payments accounts for around 0.2 percent of the operating budget for 1388 since the Government of Afghanistan only borrows externally at highly concessional rates. It is to be noted that most of the external support is in the form of grants rather than loans. It is expected that AF 201 million will be paid as interest payment till the end of 1388. Around 50 percent of the annual interest payment (AF 100 million) is to be paid to the World Bank while the remaining AF 100 million will be paid to the IMF, Asian Development Bank and Islamic Development Bank.

Subsidies, grants and social transfers are the third largest component of the recurrent expenditures, this includes subsides to state-owned enterprises, capital transfers to municipalities and pensions to retired public servants.

Around 80 percent of the expenditure on this group is spent on social transfers, principally pensions.

Expenditures on subsidies, grants and contributions increased to AF 1,306 million in the first quarter of the 1388 up from the AF 955 million in the fourth quarter of 1387 which represents 37 percent increment (see table 2.3).

Table 4.4: Core Expenditures as of First Quarter 1388 (in million AF)

Particulars	Q4-1387 Expenditure Actual	Q1-1388 Expenditure Actual	% Changes
Total Expenditures(Development and Operating)	38,984	19,541	-50%
Development Expenditures	18,696	3,116	-83%
Operating Expenditures	20,288	16,425	-19%

Source: Ministry of Finance website and DAB staff estimation

Table 4.5: Core Expenditures (in million USD)

	Q4-1387	Q1-1388
Total Expenditures	780	391
Development Expenditures	406	329
Operating Expenditures	374	62

Figure 4.2: Afghanistan Budget Q1-1388

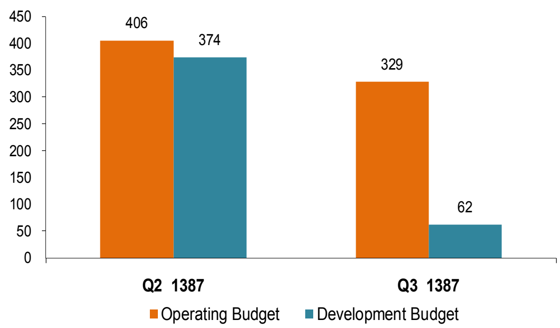


Table 4.6: Total Core Expenditures (Development & Operating) (in million AF)

Expenditure Splits	Q1-1388	Q4-1387	% Changes
Employees			
Salaries in cash	9,680,214	12,217,123	-21%
Salaries in kind	2,330,184	2,705,456	-14%
Salaries and wages advance	122,396	(67,273)	-282%
Social benefits in cash	186,903	141,334	32%
Social benefits - in kind	-	16	-100%
Total employee expenditure	**12,319,697**	**14,996,657**	**-18%**
Supplier Expenditure			
Travel	237,935	444,172	-46%
Communications	105,569	206,603	-49%
Contracted services	1,000,029	6,285,516	-84%
Repairs and maintenance	268,308	1,270,344	-79%
Utilities	119,869	176,503	-32%
Fuel	303,185	1,291,949	-77%
Tools and materials	609,326	1,891,183	-68%
Other	169,795	788,771	-78%
Advances and return of expenditure	314,248	1,351,011)	-123%
Total supplier expenses	**3,128,264**	**11,004,031**	**-72%**
Subsidies, grants, contributions and pensions			
Grants	-	7,188	-100%
Grants to foreign government a	-	218,245	-100%
Social security benefits cash	910,801	653,565	39%
Social assist benefit in cash	135,779	120,249	13%
Advance Subsides Grants	260,000	43,947)	-692%
Total subsidies, grants, contributions and pensions expenditure	**1,306,580**	**955,300**	**37%**
Capital expenditure	**-**	**-**	
Buildings and structures	892,059	9,931,766	-91%
Machinery and equip (>50,000)	85,190	5,803,393	-99%
Valuables	-	10,450	-100%
Land	17,566	134,790	-87%
Capital advance payments	1,760,759	(3,870,500)	-145%
Total capital expenditure	**2,755,574**	**12,009,900**	**-77%**
Interest	**-**	**-**	
Interest	32,176	19,141	68%
Total interest expenditure	32,176	19,141	68%

Source: Ministry of Finance website and DAB staff estimation

3. FINANCING THE CORE BUFGET

The total grants in the quarter under review stood at AF 9,998 million, (See table 3.1).

A significant portion of the core budget is financed through grants while the remainder small portion is financed through concessional loans. The operating budget is financed through domestic revenues, while grants make up a significant proportion in particular in the security sector.

Japan Non Project Grant Aid, which received AF 599 million and the Emergency National Solidarity Project II received AF 454 million. Expanding Microfinance Outreach and Improving Sustainability program funded by the World Bank, received AF 382 million in the first quarter of 1388.

Disbursement of ARTF grants to the operating budget in the first quarter of 1388 stood at AF 306 million, which is significantly lower than that in the last three quarters of 1387. Disbursement of CSTC-A grants have increased over the last two quarters, from AF 1.6 billion in Q4-1387 to AF 1.7 billion in Q1-1388.

LOTFA (Law and Order Trust Fund for Afghanistan) disbursement shows a decline in the quarter under review reaching at AF 3 billion compared to AF 4.3 billion in the fourth quarter of 1387. Over the last year, ARTF grants made up 48 percent of overall disbursement, LOTFA grants 38 percent, CSTC-A grants 13 percent, and Other donors 0.1 percent. Afghanistan is mineral recourses rich country and through privatization of state owned enterprises (SEO) we can finance the deficit.

Afghanistan has significant mineral resources, including copper, iron, gold, coal, and semi-precious stones.

Despite considerable exploration and deposit identification, large-scale mining has had limited development, and represents less than one percent of GDP.

In November 2007, Afghanistan tendered the right for exploration of its first large-scale copper mine. The mine is considered to be the world's second largest untapped copper deposit, with estimated reserves of up to 13 million tons. When Aynak reaches its expected peak, Fiscal revenues in terms of royalties and taxes are projected at USD 200 million a year.

Total FDI inflows associated with the project at USD2.8 billion over the next six years, enabling annual production of up to 200,000 tons accounts to (1.3 percent of current world production), which will amount to 2 percent of GDP in ten years,

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

Table: 4.7: Donor Contribution, Grants and Loans Q1-1388

Donor contributions	Operating	Development	Total Grants
Afghanistan reconstruction trust fund	305,961	616,291	922,252
Law and order trust fund - Afghanistan	2,999,400		2,999,400
CSTC - MoD	1,707,174		1,707,174
Foreign loans			-
World Bank		24,095	24,095
Asian Development Bank		97,284	97,284
Other		107,655	107,655
Donor revenue			-
World Bank		1,778,307	1,778,307
European Commission			-
ADB		1,585,564	1,585,564
CNTF			-
Others	12,426	764,395	776,821
Total donor contributions	**5,024,961**	**4,973,592**	**9,998,552**

Source: Ministry of Finance website and DAB staff estimation

Box 2: Some Issues in Fiscal Policy and Central Banking:

The interaction between monetary and fiscal policies:

Fiscal policy affects the success of monetary policy in various ways: through its impact on general confidence in monetary policy, through short-run effects on demand and also through modifying the long-term conditions for economic growth and low inflation. An unsustainable fiscal policy raises doubts about monetary policy's overall focus on low inflation and stable growth. Dahan (1998) argues that a high level of public debt, a large budget deficit and a large share of short-term bonds are conditions under which it is more difficult to gain enough credibility to lower inflation by monetary measures alone. This unsustainable situation in the 1990s necessitated a program with strong fiscal fundamentals as well as monetary measures. Changes in fiscal policy also affect monetary policy through their direct impact on demand. An adjustment of tax level affects company profits or disposable income and thereby economic decisions such as investment and consumption. This makes fiscal policy important when assessing economic activity and future inflationary pressure. Another aspect of fiscal policy's interaction with inflation is related to fiscal effects on potential output. Lower corporate taxes may lead to more companies being established and in turn raise potential output. Similarly, lower tax on labor may generate an increased supply of labor and also influence wage formation. In countries with high inflation such as Turkey, the operational deficit is a better indicator of fiscal stance. However, traditionally, the primary surplus and budget deficit are more closely monitored by the authorities and markets. In this sense, "financing strategy of the budget", "structure of debt stock" and "distribution of debt stock according to buyers" determine the monetary conditions. On the other hand, the degree of monetary policy credibility is also an important factor that determines the fiscal position. As credible monetary policy implies an independent central bank, it prevents the monetization of government debt to a certain degree, which means that fiscal deficit is more endogenous. Considering the Turkish case, the Treasury relied heavily on cash advances from the CBRT in 1990-94. Afterwards, with some practical arrangements, the Treasury's access to central bank sources was gradually lowered. In 1997, the CBRT and the Treasury engaged in a protocol that limited the CBRT's deficit financing further, and transferred to the CBRT the power and responsibility for setting short-term interest rates. An amended Central Bank Law in May 2001 made the CBRT autonomous in pursuing its primary objective of maintaining price stability as well as determining the monetary policy tools to achieve this goal. Another important aspect of interaction between fiscal and monetary policy is the need for a high degree of coordination in response to financial crises. The recent literature illustrates that the crises in the last decade were more global and potentially more damaging. Accordingly, well designed crisis management strategy is now one of the most challenging policy issues. Crisis management requires extremely strong coordination and quick responses in both fiscal and monetary policy and adjustment in external financing. In line with this argument, timely adjustments in the monetary policymaking process after the float in 2001 and restructuring operations in the banking sector, together with the over performance in the government's primary balance, contributed significantly to Turkey's recent efforts to manage the crisis. Although the banking restructuring and the subsequent liquidity operation were at the expense of the CBRT's balance sheet and increased domestic debt stock, the Treasury would not have been able to roll over domestic debt without this well coordinated operation.

References: Boratav, K and E Yeldan (2001): "Turkey, 1980-2000: financial liberalization, macroeconomic (in)-stability, and patterns of distribution", May, (www.bilkent.edu.tr/~yeldane/CEPA2001_B&Y.pdf),
(2002): *The impact of globalization on the Turkish economy*, June, and more others.

5

Banking System Performance

5

BANKING SYSTEM'S PERFORMANCE

SUMMARY

Total assets of the banking system is AF 144 billion (USD 2.93 billion) as of September 2009, up by 42 percent or AF 42.27 billion since September 2008. Loans amounted to AFN 58 billion (USD 1.17 billion) an increase of AF 9.14 billion (USD 186 million) or 19 percent since September 2008. Deposits stood at AFN 118 billion (USD 2.40 billion) over the period under review; a 48 percent increase since September 2008. Deposits were largely denominated in USD (66 percent) with Afghani denominated deposits were lagging at 30 percent. However, the AF-denominated deposits increased to AF 36 billion (USD 723 million), as compare to the last period (September 2008), where it was 22 billion (USD 447 million) in the previous period (September 2008). Total capital of the banking system stood at AF 20.08 billion (USD 408 million), up by 16 percent since September 2008. Banking sector overall was profitable earning profit of AFN 1,125 million (USD 22.88 million) since the beginning of 1388. An overall return on assets (ROA) decreased by 1.61 percentage points as compare to previous year's 3.24. The main causes for the decrease in ROA, is, the increase in average total assets is more than increase in profitability. Private Banks are the most profitable institutions in overall banking system.

1. Assets of the Banking System

The banking system continues to grow at a brisk rate. Total assets (size) of the banking system at the end of the quarter under review stood at AF 144 billion (USD 2.93 billion) up by 42 percent or AF 42.27 billion (USD 860 million) from the same quarter a year ago (Figures 5.1 and 5.2).

The major components of this increase were, increases in cash in vault/claims on DAB (up by AF 25 billion) and loans (up by AF 19 billion) and claims on financial institutions (up by AF 10.4 billion). Moreover, the remaining part is made up of other asset categories such as loans other assets except interest receivable and Net Due from (NDF). Comparing to the last quarter June, there is a increase of AFN 10 billion in total assets, AFN 4 billion in loans and AFN 4 billion in claims on financial institutions, but there is decrease of AFN 17 billion in cash in vault/claims on DAB.

The most important components of the system's total asset portfolio are loans (38 percent), cash in vault/claims on DAB 31percent, claims on financial institutions 15 percent, net due from 8 percent, and other assets except interest receivable 4 percent. Other components of total assets are negligible.

Figure 5.1: Banking System's Growth Rate
Growth Rate = 42 percent or AF 42 billion

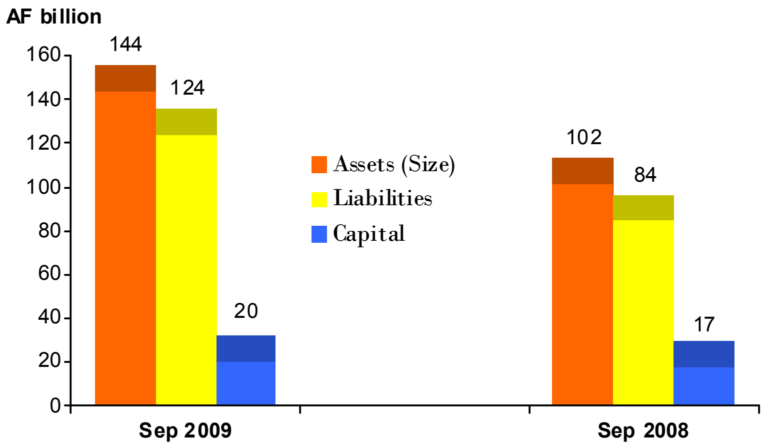
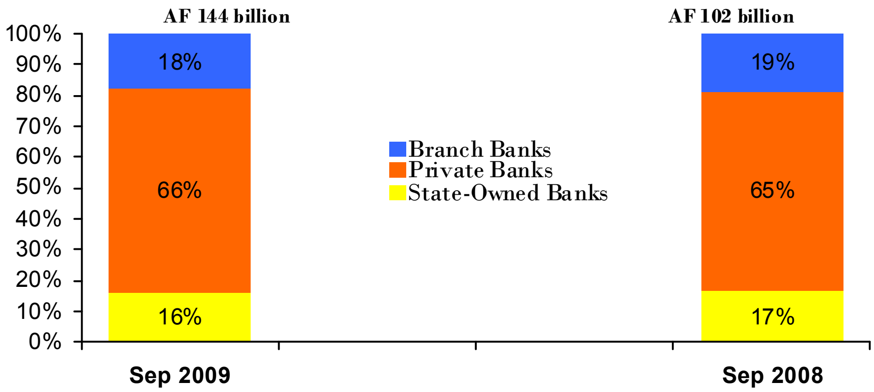


Figure 5.2: Size of Banking Sector (total assets)
Increased by 42 percent or AF 42 billion



1.1 Claims on Financial Institutions

Claims on financial institutions are the third largest among various asset categories, currently comprising AF 20 billion – a 15 percent of total assets, 47 percent increase since June 2008. This indicates that the banking sector channels a portion of its attracted funds as deposits in other financial institutions, if credible borrowers are not found. These institutions are both inside and outside the country. Later on for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets.

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

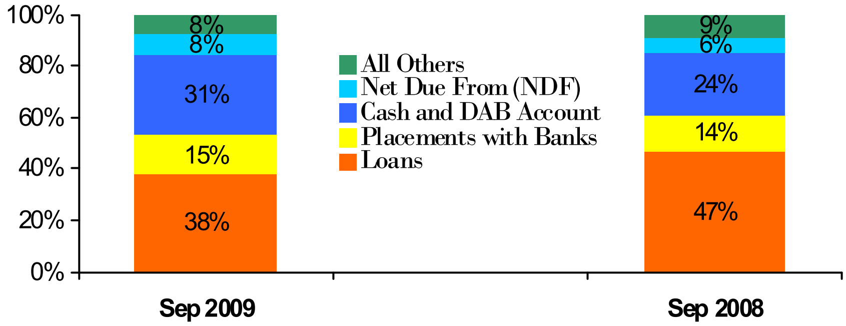
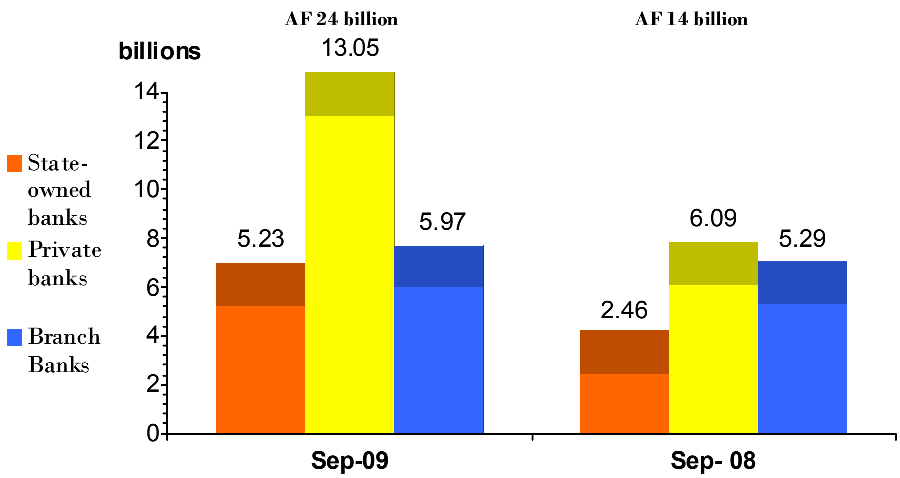


Figure 5.4: Claims on Financial Institutions



Private banking sector is the leading creditors increasing their portfolio both in absolute terms as well as percentage of total loans which are AF 42 billion and 82 percent of total loans respectively. The portfolio of state-owned banks and branches of foreign banks' share and amount stood at AF 6.5 billion and AF 2.7 billion respectively.

1.2 Net Loans

The loan portfolio continues to grow totaling AF 51 billion (USD 1.0 billion) as of June 2009 – up by AF 8.9 billion or 21 percent since June 2008 – 38 percent of total assets; the highest amount as well as share percentage in total assets among different asset categories. The increase was in gross loan portfolio, loss reserves as percentage of gross loans remained unchanged at around 1 percent. Increases in lending were observed as whole, however two-third of the growth is still attributable to private banks' group.

By far, the major component of loan portfolio is "other commercial loans" (71 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend. Thus, lending is picking up, but still not sufficient enough in some loan categories related to important sectors of the economy e.g. agriculture, has not benefited much from this increase.

Figure 4.5: Loans Portfolio Increased 39 percent (as of TA) or AFN8.6 billion

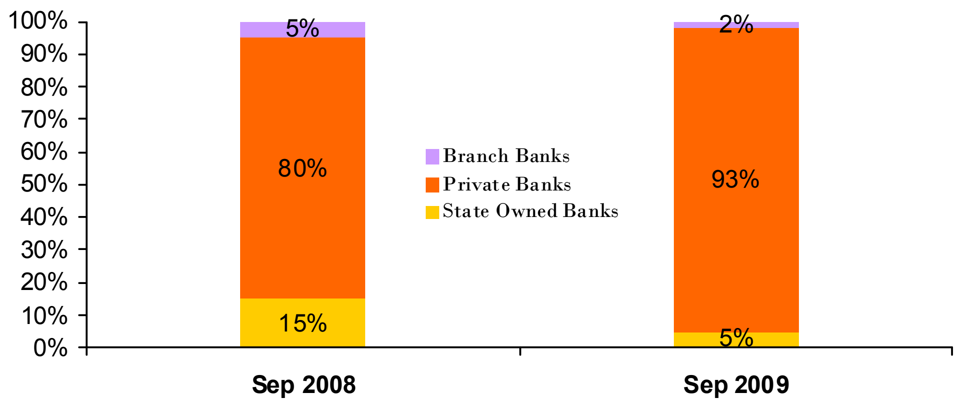
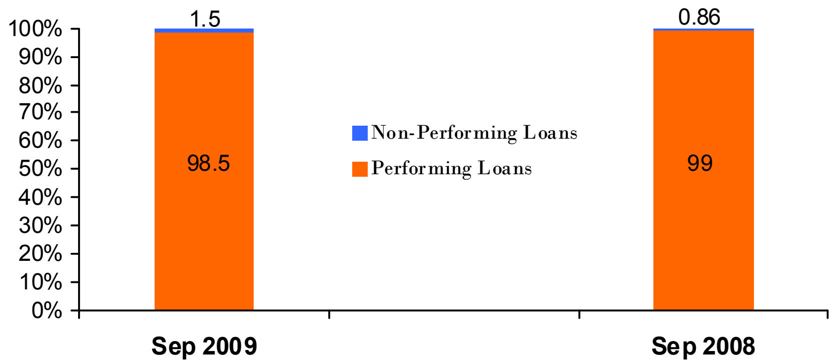


Figure 5.7: Quality of Loan Portfolio



1.3 Non-performing loans

The banking system's non-performing loans consists 1.51 percent of gross loans and has increased to AF 804 million up by AF 510 million or by 173 percent since June 2008. The ratio of non-performing loans to total loans has increased to 1.51 percent which was 0.69 percent in the previous period (March 2008). Although the ratio is not alarming but the trend is of concern.

1.4 Adversely-classified loans

Adversely-classified loans increased to AFN 2.2 billion in the current quarter ending June 2009.The percentage share of adversely-classified loans in total loans increased to 4.1 percent, which was 1.2 percent in previous period (June 2008). Loans under "Watch"

Category increased to AFN 4.2 billion in the current quarter from AFN 2.5 billion in the previous period. As compare to last quarter Adversely-classified loans decrease by 14 percent in the current quarter ending June. But still this trend should be monitored closely, to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative. Adversely-

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

1.5 Cash in Vault and Claims on DAB

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

2. LIABILITIES

Total liabilities of the banking sector were AF 114 billion, up by 59 percent from June 2008. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector. As compare to last quarter March 2009 total liabilities are down by AFN 12 billion or 10 percent.

Figure 5.8: Liabilities Increased by AF 39 billion or 47 percent

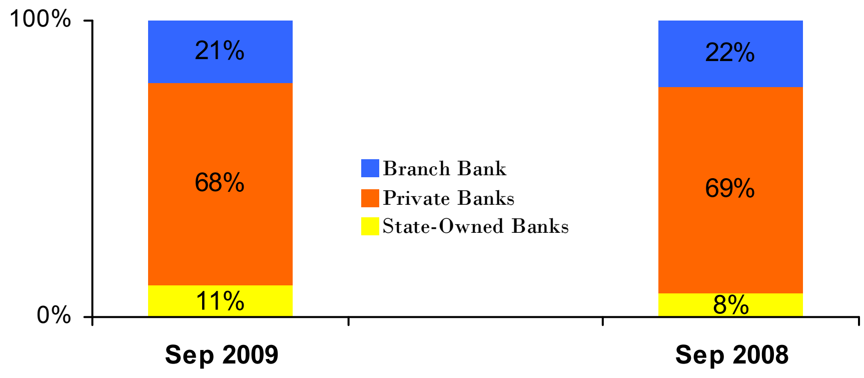
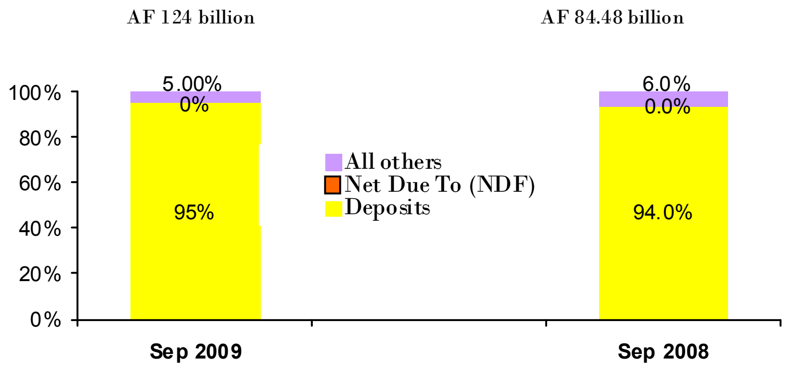


Figure 5.9: Major Liability Categories



2.1 Deposits

Deposits are the major components liabilities, currently equal to AFN 108 billion, 58 percent or AFN 40 billion increases since June 2008, where it was AFN 67.8 billion(USD 1.4 billion). The share of state-owned banks increased to AFN 9 billion (up by 58 percent), which was AFN 5.7 billion in June 2008. Private Banks attracted AFN 74 billion or 68 percent increase since previous period (June 2008), where it was AFN 44.1 billion.

The share of branches of foreign banks increased to AFN 25 billion (up by 37 percent), which was 18 billion in previous period (June 2008). Increases in deposits of branches were reflected as highly 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. As compare to last quarter deposits decreased by 8 percent in the current quarter (June 2009).

Figure 5.9: Afghani Denominated Deposits

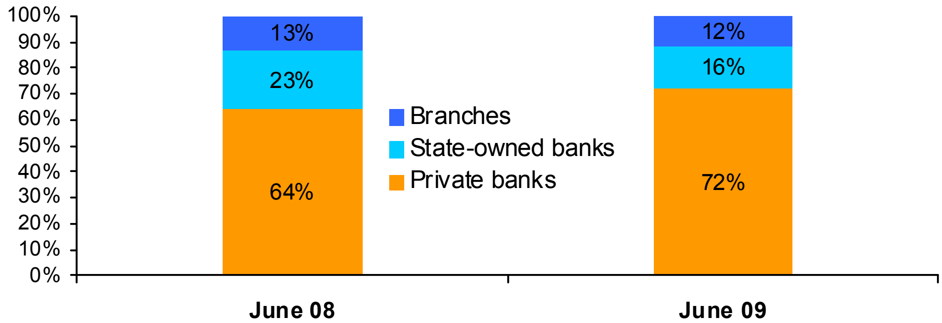


Figure 5.10: Currency Composition of Deposits

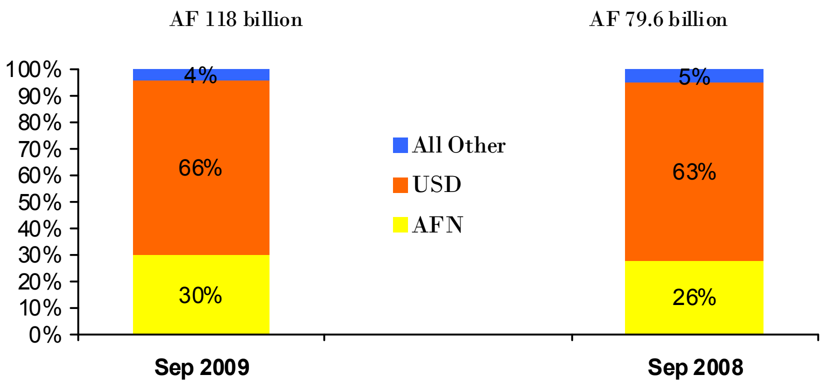
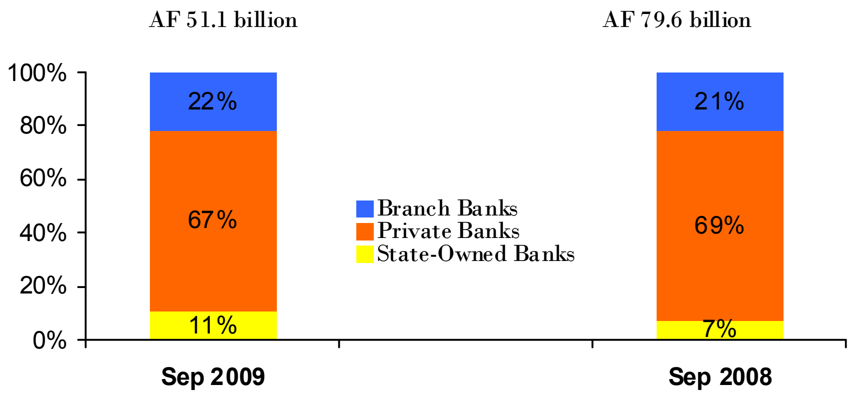


Figure 5.11: Deposits Increased by AF 38 billion or 48 percent



2.2 Capital

The system, as a whole, is well capitalized. Total financial capital at full-fledged banks is AFN 19.49 billion (USD 391 million), up by 17.1 percent since June 2008. If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AFN 19.1 billion consists 14.5 percent of AFN134 billion, which is far below the benchmark, while total assets of the full-fledged commercial banks are AFN 89.8 billion.

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

The NDT and NDF positions have increased by AFN 116 million and 4.3 billion respectively in the current month as compare to June 2008. In comparison with the last quarter the NDF position has increased by 2.7 billion, where as NDT position has decreased by 0.61 million. One bank is in a favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining four. In the current quarter one bank switched to NDF position, which was in NDT position in the last quarter. Put differently, only one bank is actively seeking investment outlets for the funds they have attracted. The NDF position of three banks has decreased because of the activeness of one bank out of the four which has covered the high NDF position of the other. While the rest are simply sending their acquired funds to their international networks. The largest NDF position by a branch of foreign bank was AFN 7.8 billion, up by 35 percent since last quarter.

2.3 Profitability

The banking sector overall is profitable Total net profit of the banking sector during the quarter ending June (2009) is AFN 446 million, resulting in an overall return on assets (ROA) of 1.3. Overall profit in the previous period (June 2008) was AFN 714 million resulting in an overall return on assets (ROA) of 3.32.

The main causes for the decrease in ROA are significant increases in, expenses, credit provision and decrease in FX revaluation.

Branches of foreign banks and private banks are the most profitable groups. Stat-owned Banks are profitable in the current quarter June (2009), where they were at loss in the last quarter March (2009). The main cause for that loss was high credit provision, which has decreased significantly in the current quarter. The main reasons for profitable operations of the first two peer groups were lower credit provisions and higher net interest income.

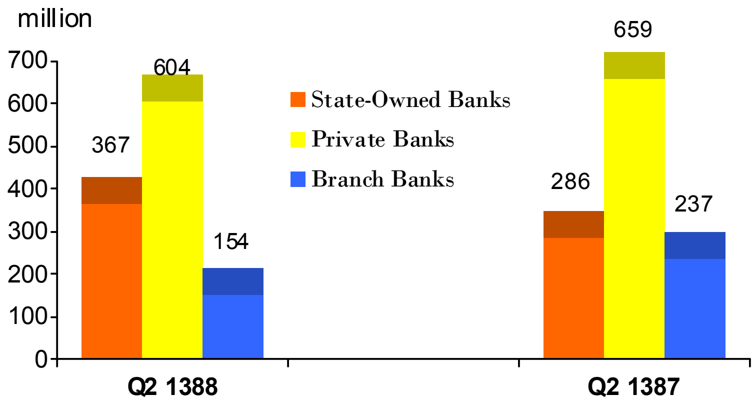
The major component of income was Net Interest Income (NII) with total amount of AFN 1.9 billion, up by 15 percent since June 2008.

The second major component of income is other Non-Interest Income totaling AFN 523 million, AFN 89 million increases since June 2008. This was AFN 434 million in previous period (June 2008)

The most important component of expense is the Non-Interest Expense (NIE), currently equal to AFN 988 million, 18 percent decrease compared to previous year, where it was AFN 1.2 billion. The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a

Median stands at 2.17, up by 0.53 percentage point since last year. Seven banking institutions ended up with lower efficiency ratios.

Figure 5.13: Profitability



2.4 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB.

In general, all banking institutions are within the limits set for overall open FX position. One out of twelve banks is holding open FX position in USD above the maximum regulatory thresholds, but this number is less than previous period (June 2008). In June 2008 four banking institutions were holding open FX position in USD above the maximum regulatory threshold. In the last quarter one bank in overall open FX position and two banks on an individual currency (USD) basis were above the maximum regulatory threshold. This indicates that the number of banks in violation of regulatory limits is on decrease. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by AFN 326 million and vice versa. Similarly, a 4 percent change would correspond to AFN 64 million.

2.5 Interest Rate Risk

Overall banking institution is in interest-rate sensitive position. If the interest- rate increases by 3 percentage points then there will be increase of AFN 544 million in net interest income over the next 12 months. Conversely if the interest-rate decreases by 3 percentage points then the interest income will decline to AFN 544 million. For the two banking institutions if the interest-rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-e excess of 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.

External Sector Developments

6

6

EXTERNAL SECTOR DEVELOPMENTS

SUMMARY

Unlike other parts of Afghan economy, external sector is not immune from the global downturn and recession. This is observable from a sudden and significant contraction in external sector statistics, mainly exports based on the quarter-to-quarter measures for solar years 1387 and 1388.

Balance of payments statistics reflect essential activities in the economy and flows of fund specifically foreign exchange. These flows are reflected in the economy's account for goods and services and consequently affect the measurement of gross domestic product (GDP) and its composition in terms of final demand components.

The merchandise trade, which solely records goods account, experienced huge diminution in the first quarter of SY 1388. The merchandize trade revealed a deficit of USD 418 million or 3 percent of GDP in the quarter under review compared to the deficit of USD 499 million or 4 percent of GDP in the first quarter of 1387. Auspiciously, merchandize trade deficit reduced from USD 499 to USD 418 million.

One of the most important economic fundamentals is solid external sector mainly exports which increase net foreign assets of a country. In the quarter under review, exports decreased by almost 52 percent to USD 54 million from USD 111 million in the first quarter of 1387 . On the positive side, the trade deficit decreased by 16 percent or USD 80 million. This pointed decline in trade deficit can be attributed to the sudden decline in the domestic demand for capital goods imported from abroad. The decline in imports of capital goods was USD 55 million which sizably reduced the trade deficit in the quarter under review. Imports of almost USD 472 million were dominated by capital goods & others (USD 235.1 million) regardless of 19 percent decline in the first quarter of 1388 compared to the same period in 1387. The huge decline in exports can be attributed to a low demand in foreign markets due to global recession and downturn in some exports destinations of Afghanistan. Exports of almost USD 54 million were dominated by carpets & rugs (USD 26.12 million). Despite the fact that exports of carpets & rugs decreased by almost 52 percent, but still dominated exports in the first quarter of 1388.

According to Assets and Debt Management Unit of Ministry of Finance, Afghanistan's public and publicly guaranteed external debts reached USD 2,133.66 million as of June 21st 2009. During the first quarter of 1388, repayments and service charges are paid on the loan received from the International Development Association (IDA). In addition, IDA made some debt forgiveness including principal amount and service charges during the first quarter of 1388.

Another important macroeconomic variable is the international reserves which improved by 18 percent in the first quarter of 1388 compared with the same quarter in 1387. In the quarter under review, the international reserve assets increased to USD 3,198.70 million from USD 2,703.52 million. On the other side, the reserve liabilities including commercial bank deposits in foreign currency, non-resident deposits in foreign currency and use of fund resources increased by 49 percent from USD 108.30 million to USD 161.30 million in the first quarter of 1388. Program exchange rate is used to calculate international reserves for the first quarter of 1388.

1. Merchandise Trade

The external sector faced significant deterioration due to deepening recession in some of Afghanistan's export destinations. The trade in goods covers most movable goods that residents of Afghanistan export to the rest of the world and import from the rest of the world. As mentioned that merchandise trade only records goods account which experienced downturn in the first quarter of SY 1388. However, the merchandize trade revealed a deficit of USD 418 million or 3 percent of GDP in the quarter under review judged against a deficit of USD 499 million or 4 percent of GDP. Auspiciously, trade account deficit reduced from USD 499 million to USD 418 million.

In the quarter under review, both exports and imports contracted rapidly. Exports indicated unconstructive growth rates. Despite the contraction of nearly 52 percent from USD 111 million to almost USD 54 million in the quarter under review, the trade deficit decreased by 16 percent or USD 80 million in the quarter under review. Principally, this sharp decline in trade deficit is strongly attributable to a sudden decline in the domestic demand for capital goods such as spare parts. Similarly, imports data revealed that the capital goods importation pursued parallel pattern and contracted by USD 55 million. As a result, merchandize trade deficit reduced from USD 499 to USD 418 million and had a decrease of 16 percent. However, both exports and imports lowered similarly in the quarter under review.

Table 6.1 shows merchandise trade with its main categories, percentage share and trade deficit from 1384 up to the first quarter of 1388. Imports of USD 472 million were recorded in the quarter under review compared to USD 610 million in the first quarter of 1387. Since import is dominated by capital goods and industrial supplies. Therefore, these commodities are durable, so demand for these items could satiate and satisfy in the quarter under review.

The imports of almost USD 472 million were dominated by capital goods & others (USD 235.1 million) in the first quarter of 1388. On the other hand, there is a sizable decline in exports in the first quarter of 1388 compared to the similar period in 1387 due to reduced income of households mainly, consumers of Afghan products. Exports of almost USD 54 million were dominated by carpets & rugs (USD 26.12 million). Although export of carpets & rugs decreased substantially by almost 52 percent, carpets & rugs still dominated exports in the first quarter of 1388.

Table 6.1: Merchandise Trade (Million USD)

Years	1384		1385		1386		Q1 1387		Q1 1388	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**2,471**	**100**	**2,744**	**100**	**3,022**	**100**	**610.12**	**100**	**471.97**	**100**
Industrial supplies	541	21.9	68	2.48	692.04	22.90	170.57	27.96	158.5	33.58
Capital goods & others	1,207	48.83	1,133	41.29	1,579	52.27	290.45	47.61	235.1	49.81
Fuel & lubricants	245	9.9	354	12.9	108.49	3.59	20.8	3.41	13.4	2.84
Exports	**384**	**100**	**416**	**100**	**454.13**	**100**	**111.25**	**100**	**53.55**	**100**
Carpets & Rugs	207	53.93	187	44.8	211.76	46.63	54.1	48.63	26.12	48.78
Food items	104	27.13	165	39.66	158.86	34.98	27.36	24.59	10.82	20.21
Leather & Wool	37	9.51	31	7.39	25.77	5.67	7.89	7.09	2.5	4.67
Medical seeds & others	36	9.42	34	8.16	57.74	12.71	21.9	19.69	14.11	26.35
Trade Balance	**-2,087.02**		**-2,327.73**		**-2,567.73**		**-498.87**		**-418.42**	
Trade Balance as % of GDP	**31.28**		**-28.19**		**-25.30032516**		**-3.828920101**		**-3.211451378**	

Source: Central Statistics Office and DAB staff calculations

2. Direction of Trade

Direction of trade in the first quarters of 1388 and 1387 is shown in Table 6.2 and 6.3. Afghanistan mainly exports to and imports from Pakistan, India, Iran, Japan, Germany, China, Commonwealth of Independent States (CIS), England and Saudi Arabia. There is a considerable reduction in the value of exports which can be attributed to the recession in some of the export destinations of Afghanistan and had a negative effect on Afghanistan's export to those countries. Therefore, exports earnings faced immediate and instantaneous decline in the quarter under review. Pakistan remained top export destination with nearly 62 percent share of exports in the quarter under review compared to 46 percent share of exports in the first quarter of 1387. In the first quarter of 1388 exports to Pakistan decreased by 36 percent from USD 52 million to USD 33 million in the first quarter of 1387. Exports of carpets and rugs and dry fruits to Pakistan decreased by 38 percent and 31 percent respectively. India was the second largest export destination. Exports to India increased by almost 150 percent from USD 3.2 million in the first quarter of 1387 to USD 8 million in the quarter under review. India demanded more carpets and dry fruits in the quarter under review compared to the first quarter of 1387. Commonwealth of Independent States maintained its third position, though exports to CIS decreased by 73 percent especially in dry fruits, fresh fruits and medical seeds. In the first quarter of 1388, exports to CIS decreased by approximately USD 11 million from USD 15.5 million to USD 4 million compared with the first quarter of 1387.

Table 6.2: Direction of External Trade: Q1- 1387 (Million USD)

Country Name	Exports	% Shares	Imports	% shares	Trade Balance
Pakistan	51.63	46.41%	80.31	13.16%	-28.68
India	3.23	2.90%	29.03	4.76%	-25.80
Iran	1.02	0.92%	40.86	6.70%	-39.84
Japan	0	0.00%	29.78	4.88%	-29.78
Germany	0	0.00%	12.02	1.97%	-12.02
China	0.75	0.67%	76.92	12.61%	-76.17
Common Wealth	15.53	13.96%	199.2	32.65%	-183.67
England	0	0.00%	4	0.66%	-4
Saudi Arabia	0.59	0.53%	0	0.00%	0.59
Other Countries	38.5	34.61%	138	22.62%	-99.5
Total	**111.25**	**100.00%**	**610.12**	**100.00%**	**-498.87**

Table 6.3: Direction of External Trade: Q1- 1388 (Million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	33.16	61.92%	65.63	13.91%	-32.47
India	8.06	15.05%	16.3	3.45%	-8.24
Iran	2.1	3.92%	25.5	5.40%	-23.4
Japan	0	0%	12.2	2.58%	-12.2
Germany	0.1	0.19%	5.2	1.10%	-5.1
China	0.04	0.07%	80.34	17.02%	-80.3
Common Wealth	4.12	7.69%	195.6	41.44%	-191.48
England	0	0%	6.5	1.38%	-6.5
Saudi Arabia	0.36	0.67%	0	0.00%	0.36
Other Countries	5.61	10.48%	64.7	13.71%	-59.09
Total	**53.55**	**100%**	**471.97**	**100%**	**-418.42**

Source: CSO and DAB staff calculations

Figure 6.1: Direction of Exports (% share) Q1-1388

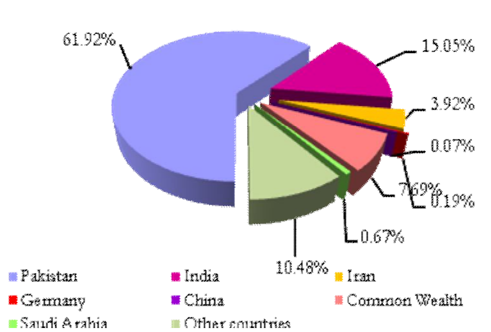
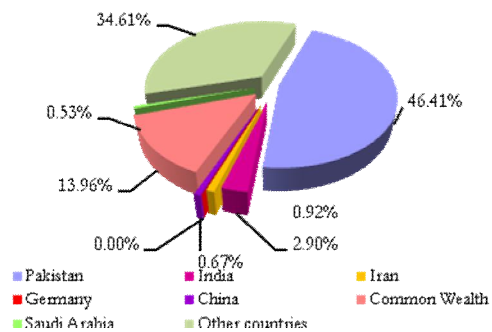


Figure 6.2: Direction of Exports (% share) Q1-1387



Source: CSO and DAB staff calculations

2.1 Composition of Trade

Composition of imports for the first quarter of 1387 and 1388 is presented in Figure 6.3 and Figure 6.4. The two figures show the changes in the composition of imports in the two quarters along with the share each category held relatively. The composition of imports in the first quarter of 1388 shows that imports of capital goods & others had the largest share of 49 percent, Industrial supplies held the second largest share of 34 percent, Consumer goods held 14 percent and Fuel & lubricants 3 percent of imports.

Figure 6.3: Composition of Imports (% share) Q1-1388

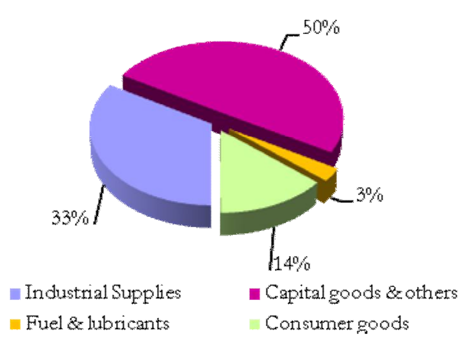
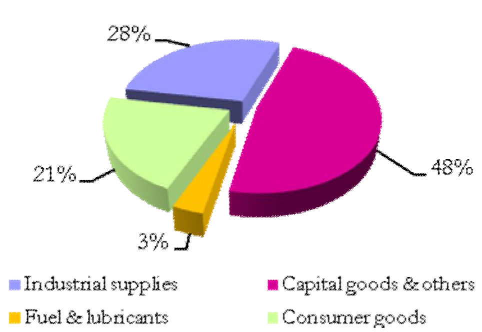


Figure 6.4: Composition of imports (% share) Q1-1387



Source: CSO and DAB staff calculations

The composition of imports in the first quarter of 1388 changed but the categories maintained their positions compared to the first quarter of 1387. Capital goods & others maintained its position by having the highest share of 49 percent in imports compared to 48 percent share in the first quarter of 1387. The share of capital goods & others increased by only 1 percent in the quarter under review. Industrial supplies held the second position by having 34 percent share of imports compared to 28 percent in the first quarter of 1387. The share of industrial supplies increased by 6 percent. On the other side, the share of consumer goods decreased from 21 percent to 14 percent: The share of consumer goods decreased by 7 percent. And fuel & lubricants maintained its share by holding 3 percent share in the quarter under review. The composition of imports in the quarter under review revealed that domestic demand for foreign capital goods and industrial supplies was more compared to other items. The two categories are important for running of development projects and they pave a way for economic growth, development and solid agricultural, industrial and services sectors.

The direction of exports in the first quarters of 1388 and 1387 is shown in figure 6.5 and 6.6. The composition of exports for the first quarter of 1387 is shown by main commodities and products. In the first quarter of 1387, carpets and rugs was the largest export category by having 48 percent share of the exports. foods items was the second largest category by having 25 percent share, medical seeds category was having 20 percent share and Leather & wool was having 7 percent share of exports.

The composition of exports in the quarter under review differs compared to the first quarter of 1387 as shown in Figure 6.5. Carpets & rugs was the largest category by having 49 percent share in the quarter under review followed by medical seeds holding 26 percent share of the exports. Food items was the third largest category by having 20 percent share of exports and Leather & wool was having 5 percent share of the exports.

Figure 6.5: Composition of Exports (% share) Q1-1388

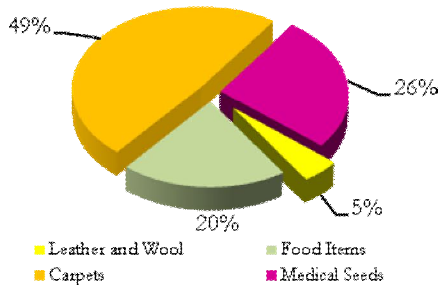
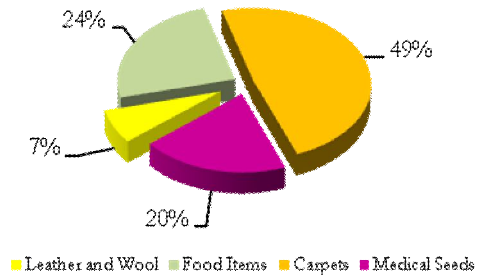


Figure 6.6: Composition of Exports (% share) Q1-1387



Source: CSO and DAB staff calculations

3. External Debt

Afghanistan's public and publicly guaranteed external debt reached to USD 2133.66 million. During the quarter, repayments and service charges are paid on the loan of International Development Association (IDA). In addition, IDA made some debt forgiveness on principal amount and service charges during the period.

Afghanistan had a debt stock of USD 1106.42 million in bilateral debt with Russian Federation, Germany, United States and some other countries. The debts given to Afghanistan are interest based while Saudi Fund for Development is interest free. Afghanistan's debt to the three Paris Club creditors (Russian Federation, United States, and Germany) stood at USD 977.35 million which will be cancelled after the completion of enhanced Heavily Indebted Poor Country (HIPC) initiative. Non-Paris Club credit stood at USD 1156.31 million.

Afghanistan owes to International Development Bank (IDA), Asian Development Bank (ADB), International Monetary Fund (IMF) and Islamic Development Bank (IDB) in multilateral debt. Multilateral debt amounted to USD 1027.25 million after repayment of approximately USD 1 million during the period.

Russian Federation dominated the position as top creditor to Afghanistan by having nearly 40 percent of total debt stock. Asian Development Bank represented 22 percent, World Bank represented 20 percent, and IMF represented 5 percent of Afghanistan's nominal debt.

Bilateral debt amounted to nearly 52 percent of debt stock while multilateral debt amounted to 48 percent of debt stock. Paris Club and Non Paris Club creditors accounted for 52 and 54 percent of debt to Afghanistan respectively.

The changes in debt can be ascribed to the valuation effects, repayments and accrued interest. Furthermore, no new loan was taken in the quarter under review. The loan provided by both bilateral and multilateral creditors has relaxed repayment terms and lower than normal interest charges. In addition, it is worth to be mentioned that IDA provided significant aid to Afghanistan in the previous years in the form of loans and grants.

Table 6.4: External Debt in the first quarter of 1388 (in units indicated)

	In million USD	Percent of total
Total external debt	2,133.66	100.00
Bilateral	1,106.42	51.86
Paris Club/1	977.35	45.81
Russian Federation	844.31	39.57
United States	116.57	5.46
Germany	16.47	0.77
Non-Paris Club	1156.31	54.19
Multilateral	1027.25	48.14
of which: IDA	443.23	20.77
Asian Development Bank	477.15	22.36
International Monetary Fund	105.25	4.93

1/ The cancellation of approximately $10.4 billion in external debt amounts to a total 92% reduction of Afghanistan's debt to its three Paris Club creditors, Germany, the Russian Federation and the United States on July 19, 2006 while the cancellation of the rest of the debt will be made after the completion point of Heavily Indebted Poor Country (HIPC) initiative.

Source: Debt Asset Management Unit, Ministry of Finance, Afghanistan

4. Net International Reserves

Da Afghanistan Bank holds international reserves in foreign exchange including US dollar, EURO, Pound Sterling and other currencies as well as in gold, IMF reserve position and holdings of Special Drawing Rights (SDR). Net International Reserves increased with the fast growing pace over the past few years. Net International Reserves increased by 17 percent from USD 2595.22 million to USD 3037.40 million in the quarter under review.

The official reserve assets amounted to USD 3198.70 million from USD 2703.52 million in the first quarter of 1388; an increase of 18 percent. On the other side, the reserve liabilities including commercial bank deposits in foreign currency, non-resident deposits in foreign currency and use of fund resources increased by 49 percent from USD 108.30 million to USD 161.30 million. The increase in reserves liabilities decreased net international reserves by USD 53 million in the quarter under review. The reserve liabilities are 5 percent of the reserve assets which shows that official reserve assets much higher than the reserve liabilities.

Net international reserves had a significant increase during the period. The increase in net international reserves showed inflows of foreign exchange particularly from export earnings, current transfers, foreign direct investment, injection of foreign exchange by donors, earnings of foreign exchange on the deposits of DAB in foreign deposit-taking corporations and other multinational forces.

The rule of thumb shows that official reserves of a country should finance at least 3 months of imports while countries that covers 6 months of imports enjoy relatively strong reserve position. And higher net international reserves are needed to support domestic currency, increase confidence on domestic currency and stabilize exchange to bring favorable economic environment.

The NIR increased significantly and is strong enough to finance 19 months of imports in the quarter under review compared to nearly 13 months of import financing in the first quarter of 1387.

Figure 6.7: Net International Reserves Q1-1387 to Q1-1388 (million USD)

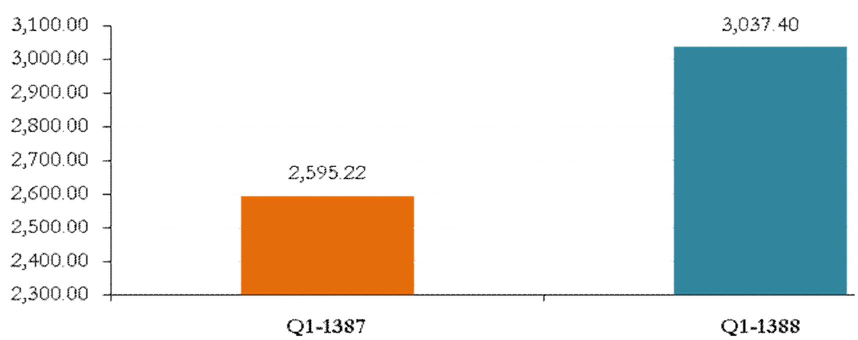


Table 6.5: Net International Reserves, Q1-1388

Changes on the previous quarter	1385 Yearly	1385 % change	1386 Yearly	1386 % change	1387 Q1	1387 % change	1388 Q1	1388 % change
Net international Reserves (million USD)	**1,857.83**	14.01	**2,669.32**	43.68	**2,595.22**	31.63	**3,037.40**	17.04
Reserve assets	**1,946.22**	17.11	**2,784.33**	43.06	**2,703.52**	32.40	**3,198.70**	18.32
Reserve Liabilities	**88.39**	173.30	**115.00**	30.11	**108.30**	53.86	**161.30**	48.93
Commercial bank deposits in foreign currency	**46.56**	65.36	**35.62**	-23.49	**30.31**	5.62	**53.34**	75.96
Nonresident deposits in foreign currency	**6.19**	47.96	**2.61**	-57.90	**1.21**	-79.94	**0.27**	-77.71
Use of Fund resources	**35.64**		**76.77**	115.44	**76.77**	115.44	**107.69**	40.27
Gross Intl. Reserves (in months of import)	**8.51**		**11.06**		**13.29**		**20.33**	
Net Intl. Reserves (in months of import)	**8.12**		**10.60**		**12.76**		**19.31**	

Note: Program Exchange rate is used in Calculations

Box 3: Remittances

Remittance flows are an important source of funds for many developing countries. Remittances are the second largest funds behind foreign direct investment (FDI) and ahead of overseas development assistance (ODA) flowing to the developing countries. International remittances are recorded in balance of payments while some countries record internal remittances for economic analysis.

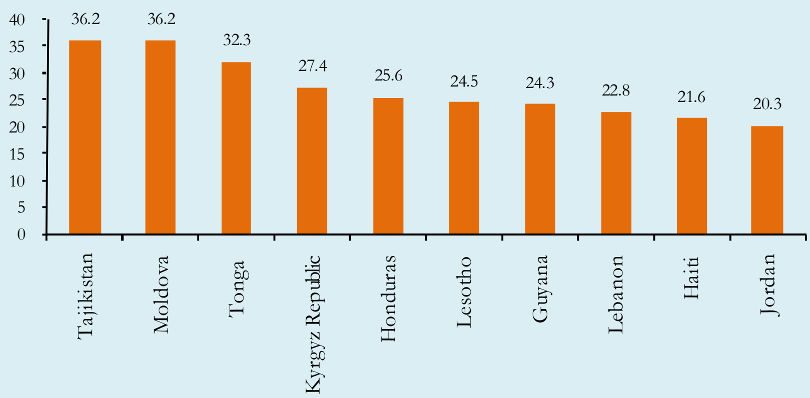
Remittances are not a new phenomenon; some of the countries made significant research efforts in this field and developed new policies for remittances. Italy is one of the examples which enacted a law in 1901 to protect remittances while Spain was the first country to sign an international treaty with Argentina to lower the cost of the remittances received in 1960.

Broadly there are two modalities of sending and receiving remittance. First, formal channels which are captured through commercial banks, money transfer operators and other officially registered institutions are properly recorded by the reporting countries while flows through informal channels are remittance providers that are outside of the financial regulations and supervision but often legal. The channels are not strictly identified as formal or informal. A specific channel may be viewed differently in different countries based on regulatory regime, institutional structure and legal system. The data on remittances is under-estimated because of the unrecorded flows of remittances through informal channels. According Orozco (2003), transaction cost of remitting money across borders using official channels is estimated at approximately 13 percent of the remittance value, while the cost of Hawala transaction is less than 2 percent of the value of the remitting money. This high transaction costs of formal channels directed remittances to flow through small money service providers (MSPs) or Hawala system, but recently more concern about anti-money laundering and countering the financing of terrorism appear to have become a constraint in reducing remittance costs which encourage more remittances to flow through formal channels.

The Majority of remittance flows are from developed countries to the developing countries. As shown in Figure 1, India at first in top 10 ranking of remittance recipients by receiving USD 27 billion in inward remittances in 2007 and China was the second remittance recipient country by receiving USD 25.7 billion while Mexico received approximately USD 25 billion. India, China and Mexico is accounting for nearly one third of remittance received by developing countries in 2007. The list of top 10 recipients includes high-income countries such as France, Spain and United Kingdom-these countries receive income from other high income European countries. In contrast, the top 3 remittance recipients in terms of the share of remittances in GDP in 2006 included Tajikistan (36.2 percent), Moldova (36.2 percent) and Tonga (32.3 percent) as shown in Figure 2.

Figure 1: Top 10 remittance recipients in 2007 (bn USD)

Figure 2: Top remittance recipients in 2006 (% of GDP)

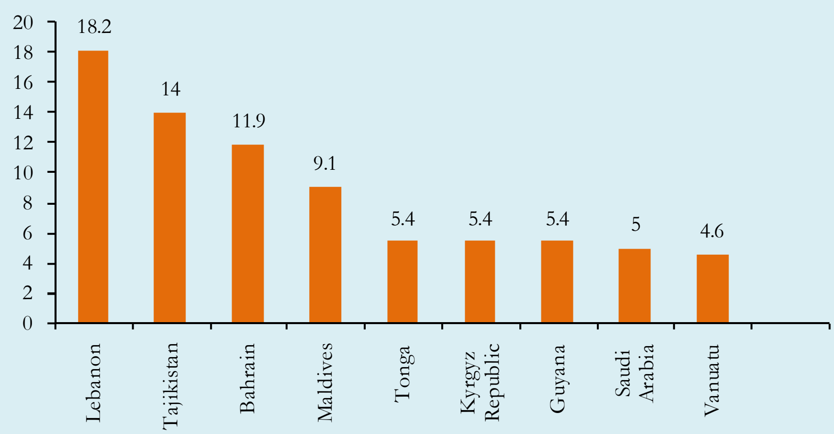


Source: World Bank data and DAB staff calculations

According to Figure 3, United States dominated top 10 ranking of remittance senders by sending USD 42.2 billion remittances in 2006. Saudi Arabia is second in top 10 by having USD 15.6 billion and successively Switzerland sent approximately USD 13.8 billion remittances while Germany, Russian Federation and Spain is also included in the list of top 10 remittance senders. In contrast, the top 3 remittance recipients in 2006 in terms of the share of remittances in GDP in 2006 included Luxembourg (18.2 percent), Lebanon (approximately 18.2 percent) and Tajikistan (14 percent) as shown in Figure 4.

Figure 3: Top 10 remittance senders in 2006 (USD billion)

Figure 4: Top 10 remittance senders in 2006 (% of GDP)



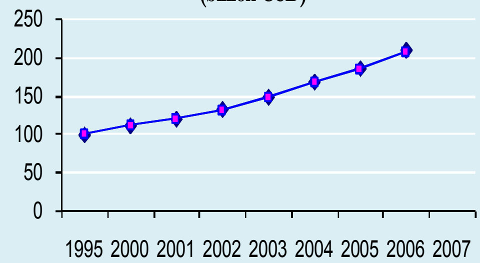
Source: World Bank data and DAB staff calculations

According to World Bank, size of inward remittances including unrecorded through formal and informal channels for all countries were USD 317.7 billion in 2007. Inward remittances increased significantly with an average of 15 percent per year from 1995 to 2007. (See Figure 5) Outward remittances including unrecorded through formal and informal channels for all countries were USD 207 billion in 2006. Outward remittances increased substantially with an average of 11 percent per year from 1995 to 2006 (See Figure 6).

Remittances to developing countries increased substantially in the past years but remittance flows to developing countries slow down significantly in response to a deepening global financial crisis in the third quarter of 2008. Based on the available monthly and quarterly data on remittances for January-August 2008 and World Bank's economic projections for 2008-10, it is estimated that remittances as a share of GDP of the recipient countries has fallen to 1.8 percent in 2008 from 2.0 percent in 2007.

Figure 5: Inward remittance of all countries (USD billion)

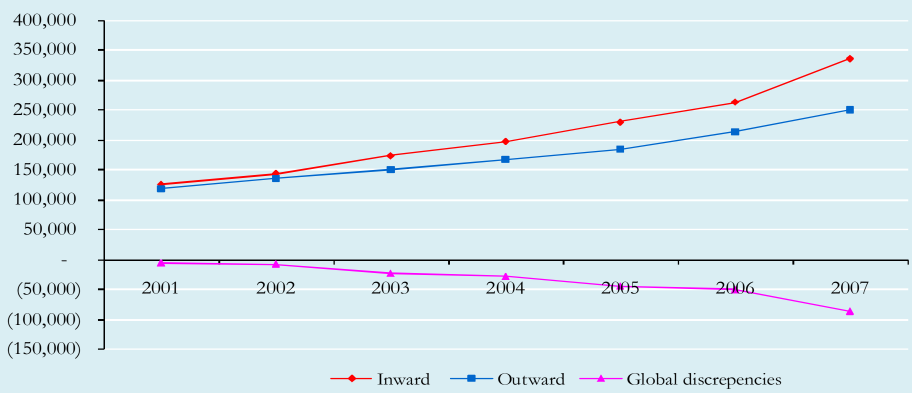
Figure 6: Outward remittances of all countries (billion USD)



Source: World Bank data and DAB staff calculations

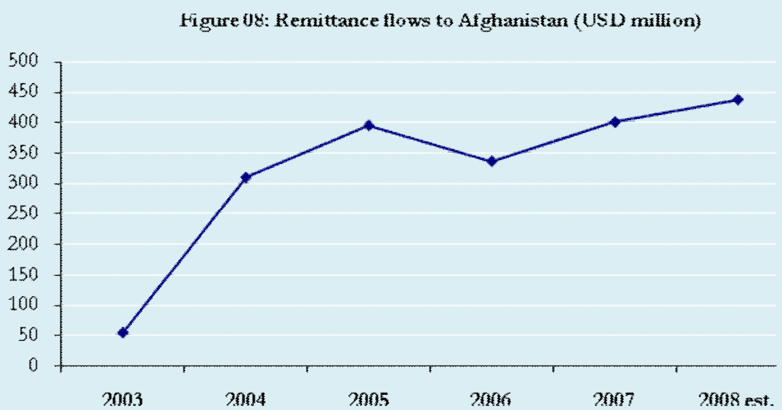
The remittance recorded in balance of payments of IMF member countries is having discrepancies. The inward remittance data is recorded more compared to outward remittances (Figure 7).

Figure 7: Global Discrepencies in remittances (million USD)



Source: IMF data and DAB staff calculations

According to International Development Association (IDA), Remittances to Afghanistan changed significantly over the years. Afghanistan received USD 55 million remittances in 2003, USD 310 million in 2004, USD 395 million in 2005, USD 337 million in 2006 and 401 million in 2007 while estimated remittances in 2008 were USD 438 million. The trend of data shows substantial increase in the remittances (Figure 8).



Source: World Bank Data and DAB staff calculations

Remittances are of greater importance to the countries because of the second largest flow with fast growing trend behind foreign direct investment and ahead of overseas development assistance. In 2001, remittances represented 40 percent of total FDI and approximately 260 percent of ODA. According to the Research Support team of World Bank, remittances reduce poverty meanwhile, increase income inequality. A research paper published (impact of remittances on poverty and income inequality in Ghana) shows that inward remittances decreased poverty by approximately 88 percent in 210 households receiving remittances among 3884 households meanwhile, income inequality rose 17.4 percent. Remittances has negative impact on income distribution because households receiving remittances are not poor in the first place, and with the receipt of remittances they tend to improve their expenditure status much more dramatically than households that does not receive remittances. In another case study conducted in Sub-Sahara Africa by Economics and Finance Department of Middle Tennessee Fayissa University, It is revealed that remittances do positively impact the economic growth of African countries. It is found that a 10 percent increase in remittances of a typical African economy leads to a 0.4 increase in GDP per capita while a 10 percent increase in remittances of African economies will lead to a 0.04 percent increase in their GDP per capita. From these analyses, it is generally understood that inward remittances to an economy have a positive impact on its GDP per capita and economic growth. In addition, remittances also pave a way for the development of formal financial sector which is essential for the economic growth and development.

The impact of remittances on receiving country is also of great importance. Migrating to other countries will increase inward remittances but it will be having a negative impact on the domestic labor market and on some specific sectors such as higher education, government services, science and technology, and the manufacturing and services especially where those migrating to other countries are largely skilled workers who are difficult and expensive to replace.

In conclusion, it can be understood that remittances generally have positive impact on recipient countries and currently forms the second largest capital flow of world. Therefore, international organizations and some countries are having great research efforts in this area and also great efforts are made to find out more accurate and reliable data for further analysis. Remittances play significant role in eradication of poverty, bringing economic growth with higher per capita income and pave a way for the development of formal financial sector which is essential for the economic growth and economic prosperity of a country while still some discrepancies exist in the overall inward and outward remittances reported by IMF member countries which cannot lead as to a proper analysis.

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