.... Annual Bulletin

Da Afghanistan Bank
(Central Bank)

Annual Economic & Statistical Bulletin

AESB

1387 (2008–2009)

Design by Rahmatullah Haidari
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1387 (2008-2009)

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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 Annual Bulletin covers developments in the year 1387 which is equivalent March 22, 2008 – March 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 Annual Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for 1387. This annual 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 year 1387 was not an easy year for Afghanistan with real GDP growth declining to 3.5 percent and inflation reaching double digits as a result of exogenous price shocks. The world economy was in the midst of its deepest recession for more than 50 years driven by a severe financial crisis and a strong decline in world demand. World output is projected by OECD to have grown by 2.2 percent in 2008 and to contract by 2.7 percent in 2009. The global economy will continue to experience a recession through the beginning of 2010, and is only to get closer to its potential growth by end-2010.

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. In Afghanistan headline inflation, as measured by year-on-year percentage changes in Kabul CPI decreased to 3.2 percent, down from 20.7 percent in the previous year. The main driver of the CPI was decrease in the prices of food and oil. The food price index fell dramatically to 0.9 percent because of a decrease in demand in the international markets and measures taken by the government in response to the shortage of wheat supply. However, non-food inflation which could be a more real representation of inflation due to economic activity remained high at 7.4 percent.

On the fiscal side, government finances remained on track to meet revenue and spending targets. Total expenditures increased to AF 112,382 million at the end of the year 1387 from AF 95,710 million at the end of 1386, this represents 17 percent increment. Total expenditures accounted for 18 percent of GDP. Total expenditures are composed of development and operating expenditures.

Development expenditures declined to AF 42,743 million in the year under review from AF 45,043 million in 1386, this represents a 5 percent decline.

On the other hand operating expenditures increased to AF 69,639 million in the year under review from AF 50,667 million in the previous year. This reveals a 37 percent increase.

Reserve Money increased by 65 percent in the year 1387 up from 14.4 percent in 1386. Bank deposits with the central bank which is a component of reserve money increased significantly by 433 percent in the 1387.

Narrow Money (M1) grew by 38 percent in the year under review up from 29 percent in the previous year. Currency outside depository Corporations (CODC) which is the component of Narrow Money grew by 28 percent which is up from 16 percent in 1386. Further, the Demand Deposits the other component of M1 increased by 48 percent in the year 1387 in contrast to 44 percent in 1386. Quasi money (a component of the broad money) declined by 24 percent in the year under review from 165 percent in the previous year. Net Domestic Assets (NDA) which is a determinant of monetary growth declined to -37 percent in the year under review. Another determinant of monetary growth is Net Foreign Assets (NFA) which increased by 17 percent in the year 1387.

The banking system continued to perform satisfactorily. Total assets of the banking system increased to AF 145 billion (USD 2.28 billion) at the end of year 1387 (March 2009), up by 73.37 percent or AF 61 billion since March 2008. Loans amounted to AF 50 billion (USD 981 million) representing an increase of AF 10 billion (USD 200 million) or 26 percent since March 2008. Deposits stood at AF 118 billion (USD 2.28 billion) over the period under review - an 84 percent increase since March 2008. Deposits were largely denominated in USD (55 percent) with Afghani denominated deposits lagging at 42 percent. However, the AF-denominated deposits increased to AF 49.02 billion (USD 952 million) compared to AF 13.45 billion (USD 269 million) in the previous year. Total capital of the banking system stood at AF 19.10 billion (USD 375 million).

On the external sector, the balance of payments (BoP) reveals a surplus of USD 360 million at the end of the year under review down from a surplus of USD 480 million in 1386. The decline in surplus in the year under review can be attributed to trade deficit of almost 11 percent from USD 6,002 million in 1386 to USD 6,658 million in the year under review.

The balance of trade is the difference of monetary value of exports and imports of goods and services. Exports increased to USD 2145 million in the year under review compare to USD 1835 million in 1386, this represents almost 17 percent increase. The export data recorded in 1387 is almost 18 percent of GDP.

Imports jumped by 12.3 percent to USD 8,803 million in the year under review, which shows a growing domestic demand for foreign goods. The imports are mainly dominated by capital goods and others (USD 1527.5 million) which show higher domestic demand for imported capital goods and machinery for the developmental needs, mainly for industrial and agricultural sectors.

The macroeconomic outlook for SY1388 is expected to be positive with real GDP growth expected to rebound to 15.7 percent by year end driven by resurgence in agricultural output. Inflation is projected to decline to single digits as the economy shrugs off the effects of high food and oil prices from SY1387. Downside risks to the macroeconomic outlook include heightened political uncertainty due to the August presidential elections that could reduce inflows of Foreign Direct Investment (FDI), security concerns that could hamper economic activity and poor rainfall. The central bank remains committed to ensuring sound monetary and financial policies in support of sustainable economic growth.

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)

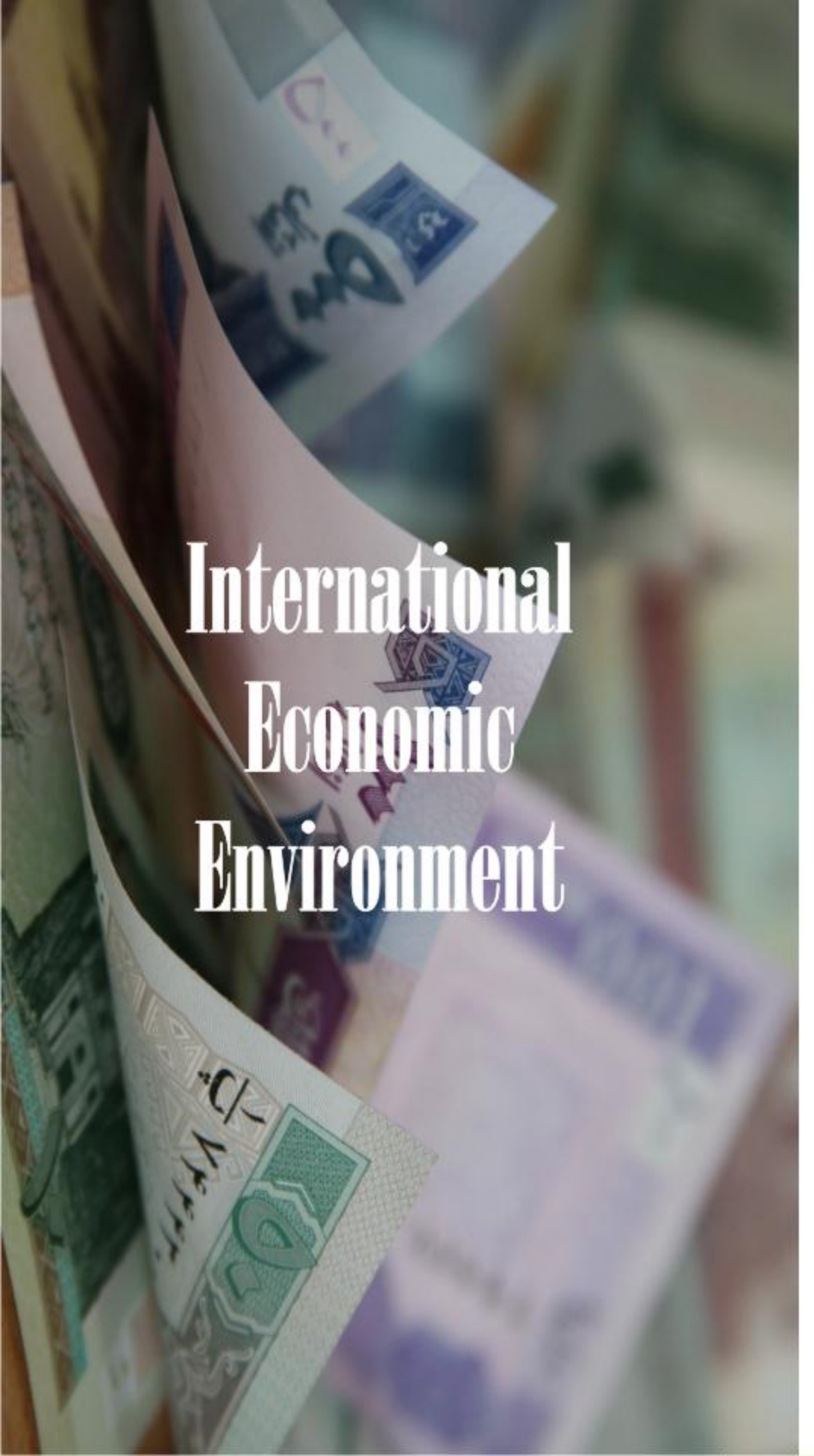
SENIOR MANAGEMENT

From left to right:

Mr. Mohibullah Safi, First Deputy Governor

H.E. Abdul Qadeer Fitrat, Governor

Alhaj Mohammad Issa Turab, Second Deputy Governor



International Economic Environment

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INTERNATIONAL ECONOMIC ENVIRONMENT

SUMMARY

The world economy is in the midst of its deepest recession for more than 50 years driven by a severe financial crisis and a strong decline in world demand. The world output is projected by OECD to have grown by 2.2 percent in 2008 and to contract by 2.7 percent in 2009. The global economy will continue to experience a recession through the beginning of 2010, and is only to get closer to its potential growth by end-2010.

The financial sector remains under stress in advanced economies. The financial turmoil intensified in 2008 making lending conditions more difficult and creating liquidity and solvency concerns for major financial institutions. Panic in the financial sector influenced consumer confidence as asset and equity prices dropped sharply. Tight credit conditions and weak domestic and external demand affected economic activity in advanced economies. Initially it seemed that developing economies were safe from the financial turmoil in the advanced economies, because financial institutions in developing economies had not invested in U.S securitized assets. However, since September 2008 the crisis has spread quickly to developing and Asian economies through a sharp decline in world trade. Demand for consumer durable goods and capital goods in advanced economies collapsed which affected the export-dependent developing economies. Many countries in south and south-east Asia saw their exports decline as demand in advanced economies for their products collapsed.

The volume of world trade increased by only 2.5 percent in 2008 compared to 6.9 percent in 2007 and is forecast to contract by almost 13 percent in 2009. In the last quarter of 2008 and first quarter of 2009, world trade declined at an average annualised rate of more than 20 percent,

an unprecedented rate of decline in the last four decades.

Inflation picked up all over the world in the third quarter of 2008 due to a surge in food and fuel prices. Commodity prices reached their peak in the beginning of the third quarter but dropped sharply in the final quarter. While inflation was a major concern in mid-2008, deflation is now a rising threat, mostly for the United States and Japan. Consumer prices for the world economy are expected to enter a negative territory in 2009. Headline inflation will decline to -2 percent in 2009 down from 3.4 percent in 2008.

The fiscal deficit in advanced economies is projected to jump to 10.5 percent of GDP in 2009 up from less than 2 percent in 2007. The fiscal deficit in emerging and developing economies will reach 4 percent of GDP in 2009 (compared with a small overall surplus in 2007), resulting mostly from declining commodity and asset prices.

1. ADVANCED ECONOMIES

The SY 1387 (21 Mar, 2008 – 20 Mar, 2009) was marked by severe financial turmoil generated by the outbreak of the U.S subprime mortgage crisis back in early 1386. Economic activity slowed down due to tightening credit conditions, and business and consumer confidence dropped significantly. Concerns over losses from bad assets raised questions about the solvency and funding of core financial institutions.

The situation in the financial sector was aggravated in mid-1387 following the bankruptcy filing of a large U.S investment bank (Lehman Brothers). Major financial institutions in the U.S and Europe faced large write-downs. The total losses suffered by 70 major banks globally reached USD 835 billion. Consequently, banks tightened lending conditions, equity prices dropped sharply, liquid assets were sold at very high prices, capital flows were restrained, and pressures in the exchange rate markets rose.

In response to all these disruptions in the financial sector, policy makers tried to ease the situation by purchasing illiquid and bad assets, injecting capital in the banking system (capital injections were commensurate with the losses and write-downs), providing solvency support, increasing deposit insurance coverage, and cutting the interest rates to nearly zero to enhance liquidity in the market.

Business and consumer confidence was severely hit by falling asset prices and tightening credit conditions. Major layoffs were announced by large industries in the U.S, and the three giant U.S carmakers (GM, Ford, and Chrysler) announced huge losses due to a fall in their sales. As a result, the U.S Congress approved USD 700 billion bail-out fund in October 2008 to assist the financial institutions and the auto industry. As unemployment was rising and demand was declining, stimulus packages were provided by several governments around the world to boost the domestic demand.

Growth in advanced economies, as shown in Table 1.1, slowed to 0.9 percent in 2008 compared to 2.7 percent in 2007. Advanced economies are expected to contract in 2009 by 3.8 percent, with Japan experiencing the largest economic contraction (-6.6 percent). However, zero growth is projected in 2010 for the advanced economies.

Table1.1: Main economic indicators in advanced economies

	2007			2008			2009		
	Real GDP	CPI	Unemployment	Real GDP	CPI	Unemployment	Real GDP	CPI	Unemployment
World	4.1	4.0		2.2	6.0		-2.7	2.5	
Advanced economies	2.7	2.2	5.4	0.9	3.4	5.8	-3.8	-0.2	8.1
United States	2.0	2.9	4.6	1.1	3.8	5.8	-4	-0.4	9.1
Euro area	2.7	2.1	7.4	0.8	3.3	7.5	-4.1	0.6	10.1
Germany	2.5	2.3	8.3	1.3	2.6	7.3	-5.3	0.6	8.9
France	2.2	1.5	8	0.8	2.8	7.4	-3.3	0.4	9.9
Italy	1.6	1.8	6.2	-1.1	3.3	6.8	-4.3	0.7	9.2
Spain	3.7	2.8	8.3	1.2	4.1	11.3			
Japan	2.4	0.1	3.9	-0.6	1.4	4	-6.6	-1.2	4.9
United Kingdom	6.0	2.3	5.4	0.7	3.6	5.7	-3.7	2	7.7

Source: OECD, IMF and Eurostat

1.1 United States

The United States economy grew by 1.1 percent in 2008. This was the slowest pace of growth in the U.S economy since 2001 recession. The major drag on GDP was a decline in gross fixed investment which decreased by 3.4 percent in 2008. The decline in gross fixed investment was mostly led by a strong decrease in residential investment which contracted by 20.7 percent in 2008 compared to a contraction of 17.9 percent in 2007. Private consumption had also a very

minor growth in 2008. It grew by only 0.2 percent in 2008 compared to a much stronger growth in 2007 which was around 2.8 percent.

Imports decreased in 2008 due to weakening domestic demand. It declined by 3.4 percent in 2008 while it had a positive growth of 2.2 percent a year before. Although exports grew by 6.2 percent in 2008, they are forecast to decline by 11 percent in 2009. The causes of such a strong decline in exports in 2009 are weakening demand at the global level and declining industrial production in the domestic market.

CPI inflation went up by 3.8 percent in 2008 compared to 2.9 percent in the previous year. However, headline inflation is expected to enter negative territory in 2009, bringing deflation to -0.4 percent.

Unemployment which increased from 4.6 percent in 2007 to 5.8 percent in 2008 is projected to eventually jump to 9.1 percent in 2009. Major companies and industries saw their profits decline in 2008 and a large number of them announced significant losses. As a consequence, the number of layoffs kept increasing in the U.S in 2008 pushing the unemployment rate in 2009 even higher.

The overall economic and financial climate remained under stress in the fourth quarter of 2008 and will likely to remain the same in 2009. Even though aggressive policy actions have revived some key financial markets, credit conditions remain extremely tight for both households and firms. Declines in housing and equity prices have lowered household income. Worsening labour market conditions will further affect the households and consumer spending will remain weak for at least a couple of years.

Business investment is strongly depressed due to tight credit conditions, declining demand and falling exports, and is only to be revived when conditions in the financial sector are enhanced and the demand in the economy strengthens.

The Federal Reserve cut its funds rate from 2 percent to nearly zero in order to ease credit and liquidity conditions in the market. The Fed expanded its balance sheet by purchasing illiquid and "bad assets" and provided solvency support to financial institutions.

On the other hand, the new Administration in the White House enacted the fiscal stimulus "American Recovery and Reinvestment Act" to help re-boost demand in the economy. The

stimulus plan includes discretionary measures worth USD 787 billion or an estimated 2.1 percent and 2.4 percent of GDP in 2009 and 2010. The Act includes federal tax relief, expansion of unemployment benefits, and domestic spending in education, health care, infrastructure and energy.

The outlook for 2009 remains bleak. The U.S economy is projected to contract by 4 percent in 2009 and to have a zero growth in 2010. Private consumption will decline by 2.4 percent in 2009 and gross fixed investment will decrease by 14.3 percent. Exports & imports are expected to drop by 11.3 and 10.1 percent respectively.

A gradual recovery is envisaged to take hold in 2010 as financial conditions improve and macroeconomic policies generate a positive growth.

1.2 Western Europe

1.2.1 Euro area

The euro area real GDP growth declined from 2.6 percent in 2007 to 0.7 percent in 2008. The economy is projected to contract by 4.1 percent in 2009 led by significant declines in domestic demand (-2.8 percent in 2009), exports and industrial production.

The German economy, the largest in the euro area contracted by 6.9 percent in the first quarter of 2009. France and Italy's real GDP contracted in the first quarter of 2009 by 3.2 percent and 5.9 percent respectively (See Figure 1.1).

Industrial production in the euro area declined by an annualized rate of 20.2 percent in March 2009. Total industrial output in Germany dropped by 21.7 percent, while it declined by 15.9 and 23.8 percent in France and Italy respectively.

Inflation in the euro area as measured by the harmonized index of consumer prices (HICP), increased from 2.1 percent in 2007 to 3.3 percent in 2008, but is expected to decline to 0.6 percent in 2009. Headline inflation in Spain, Portugal, and Ireland entered negative territory in March 2009, while other euro area members experienced positive growth in their year-on-year CPI/HICP change.

Unemployment is a much greater concern for euro area members compared to other advanced economies. Although euro area members were able to bring their unemployment rate down to around 7.5 percent in 2007, it will again jump to 1994-levels in 2009 which would be 10.1 percent. As usual, Spain has the highest unemployment rate among euro area

members. The unemployment rate in Spain increased to 16.5 percent in the first quarter of 2009 up from 13.9 percent in the final quarter of 2008.

Financial conditions in the euro area have been as depressed as they have been in the United States. The European Central Bank reduced its policy rate by 275 basis points from September to December 2008. However, the financial turmoil has dampened the transmission of lower policy rates to money market. Possible deflationary pressures in 2009 will curtail the scope and effect of lower policy rates, since real interest rates could rise as deflation intensifies.

The consensus is that broad-based economic recovery in the euro area will not be achieved for at least a year. A gradual recovery, if preceded and accompanied by effective policy support and enhanced financial conditions, is expected only in the second quarter of 2010. Yet the overall economic growth in the euro area for 2010 is projected to be negative (-0.3 percent).

1.2.2 United Kingdom

Real GDP growth in the United Kingdom decelerated from 3 percent in 2007 to 0.7 percent in 2008. Private consumption moderated from a growth of 3.1 percent in 2007 to 1.7 percent in 2008 and gross fixed investment declined by 4.3 percent in 2008 due to a large decrease in residential investment (-20.2 percent).

Exports kept declining during 2008 despite the fact that the pound sterling depreciated by around 20 percent in effective terms from the end of 2007. This gain in competitiveness has so far been offset by substantial declines in external demand.

Inflation as measured by HICP rose to 3.6 percent in 2008 due to a surge in food and commodity prices and is expected to drop to 2 percent in 2009. Unemployment, on the other hand, is projected to augment to 7.7 percent in 2009 up from 5.7 percent in 2008.

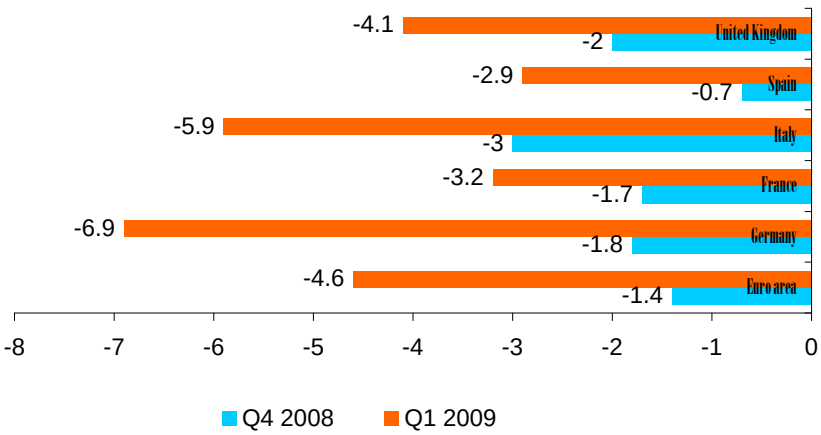
As the financial crisis took hold in the U.K, the Bank of England cut the bank rate dramatically from 5 percent in October 2008 to 0.5 percent in March 2009 – the lowest level in the 300 year-history of the institution. In addition, the Banking Act 2009 has been put forward to enhance the overall financial stability and strengthen the regulation in the financial sector. The Act facilitates faster deposit insurance payouts and provides a clear

financial stability objective for the Bank of England.

As interest rates are effectively at the zero bound, policy makers have limited room for fiscal manoeuvre. The fiscal stimulus packages will amount to 1.4 percent of GDP in 2009. The main elements of the stimulus package which was announced in November 2008 were a temporary 2.5 percentage point cut in the VAT and a £3 billion extra budget for capital investment. The fiscal deficit is projected to increase to over 9 percent of GDP in 2009 and even higher in 2010 due to large stimulus packages and contraction of revenue-rich sectors.

The outlook for 2009 is set to be poor as private consumption is projected to decline by 2.2 percent, gross fixed investment by 12.5 percent and exports by more than 9 percent. The real GDP growth is forecasted by OECD at -3.7 percent for 2009, less significant than the economic contractions in the U.S and the Euro area.

Figure 1.1 Real GDP Growth in European Economies



Source: Eurostat

1.2.3 Japan

The economic downturn in Japan is projected to be the most severe among advanced economies. The economic contraction is estimated at 0.6 percent in 2008 but will exacerbate in 2009 to 6.6 percent. This will be led by a huge drop in exports and business investment.

Private consumption which grew by 0.5 percent in 2008 will register negative growth of 1.4 percent in 2009, and the decline in gross fixed investment will accelerate from -4.6 percent in 2008 to -10.5 in 2009.

Exports which had a positive growth in 2008 are forecast to decline by 26.4 percent in 2009. This will be the driver of the contraction in Japan's export-dependent economy in 2009. A decline in the external demand for Japanese products, especially weak demand in south-east Asian countries, and the appreciation of the yen contributed to the fall in exports. More alarmingly, profitability in the private sector decreased with major industrial companies (Toyota, Sony, etc) recording their first losses in five decades and leading equity prices dropped by half. In consequence, the number of bankruptcies is increasing and the lending attitude of financial institutions for SMEs is being tightened.

Average wages have been declining in Japan since late 2008 as a result of declining hours worked and are affecting severely the household income. Although a decline in wages should increase the competitiveness and profitability of the firms, insufficient domestic and external demand combined with a strong yen is clouding the performance in the private sector.

Deflation is back once again in Japan. Headline inflation entered negative territory in the first quarter of 2009, and it is more likely that deflation will be persistent in Japan for the next couple of years due to the severe economic downturn and weak domestic demand. However, a recovery in domestic demand is expected in mid-2010 which should lift inflation and real GDP growth into positive territories.

On the fiscal side, three successive stimulus packages have been introduced since August 2008 which totals about 2 percent of GDP. Yet lower revenue and additional spending will increase the budget deficit in the coming years.

The Bank of Japan has implemented a number of measures to ease the situation in the financial markets. The bank has announced that it will purchase up to 3 trillion yen of commercial paper, 1 trillion yen of corporate bonds and 1 trillion yen in shares held by eligible banks by April 2010. This is referred to as quantitative easing.

Fiscal and monetary policies have been used aggressively in support of the economic activity; nonetheless more efforts are needed to boost the demand in the economy and to increase business confidence.

Box 1: How do economists determine when a recession has started?

Recession is a period of decline in economic activity. Although there is no official definition of recession as to how strong and how long the decline in economic activity should be or as to which indicator(s) to consider when calling a recession, there is a general consensus among the economists that the term refers to two consecutive quarters of contraction in a country's real gross domestic product.

However, focusing only on GDP can sometimes mislead us and one can fall into a judgemental error when calling a certain period as a recession. The data on real GDP are available only in quarterly basis, which prevents on-time decision-making, and more importantly, the GDP quarterly data are usually revised more than once, sometimes with large margins, which creates a major difficulty in determining the starting date of a recession.

There are private economic research units in some countries which determine the starting date of a recession. For example, the National Bureau of Economic Research (NBER) is the accepted dater of the start and end of recession in the United States, while the U.K based Centre for Economic Policy Research (CEPR) determines the peak and trough of the business cycles for the Euro area. Although the Business Cycle Dating Committees of NBER and CEPR use almost similar definitions for a recession, their methodology and the use of data differ.

The NBER defines a recession as *"a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough."*

The Business Cycle Dating Committee of the NBER outlines three important characteristics of a business cycle, known as three Ds: duration, depth, and diffusion. A recession has to be sufficiently long (duration), it has to involve a substantial decline in output (depth), and it has to affect several sectors of the economy (diffusion).

The NBER committee views real GDP as the single best measure of aggregate economic activity. In determining whether a recession has occurred, the committee also puts particular emphasis on some monthly indicators such as real personal income (less transfers), employment, industrial production, and real sales in manufacturing and wholesale-retail sectors. Moreover, the committee also looks at monthly estimates of real GDP prepared by private consulting firms.

The NBER committee waits long enough so that the existence of a recession is not at all in doubt. It normally takes the committee between 6 to 18 months to announce the peak of the economic activity. For example, on November 28, 2008 (almost 11 months later) the committee determined that the latest peak of economic activity in the U.S occurred in December 2007. The peak marks the end of the expansion which began in November 2001 and the beginning of a recession.

The Euro Area Business Cycle Dating Committee of the CEPR has adopted a definition of a recession similar to that of the NBER. However, the CEPR committee's task is significantly different from that of the NBER. The Euro area groups together a set of different countries. Although subject to a common monetary policy since 1999, they even now have heterogeneous institutions and policies. Moreover, European statistics are of uneven quality, long time series are not available, and data definitions differ across countries and sources.

Unlike NBER, the CEPR committee dates episodes in terms of quarters rather than months. The CEPR committee focuses on quarterly GDP, quarterly employment, monthly industrial production, quarterly business investment, consumption and its main components. In addition, the committee uses country data from the Eurostat and the OECD and monitor Germany, France and Italy systematically.

Having said how economists or institutions determine the start of a recession, forecasting and predicting a recession is however much different. Generally, economists predict a turning point of a business cycle using leading indicators and econometric models.

Leading indicators estimate future performance of the economy in contrast to lagging and coincident indicators which move with a lag or along with the economic activity. Leading indexes which are composed of several leading indicators – considered to be key variables for up and downs in the economic activity – are used to estimate the turning points in economic cycles.

There are several widely-used and well-known leading indicators and/or indexes for the U.S, Euro area and other economies. In the United States, the most well-known predictor of turning points in economic activity is the "Leading Economic Index" (LEI). Until December 1995, the LEI was produced by the Bureau of Economic Analysis at the Department of Commerce. Since then, it has been produced by The Conference Board, a private, nonprofit organization.

The Leading Economic Index is a weighted average of ten leading indicators for the U.S economy. To forecast a recession, economists pay particular attention to turning points in the index: turning points in the index should anticipate turning points in economic activity. A rule is often used to identify turning points in the index: three consecutive declines in the LEI.

There are also other leading economic indicators for the U.S economy such as Index of Consumer Expectations (produced by the University of Michigan), U.S Long Leading Index and Weakly Leading Index (produced by the Economic Research Institute). As for the Euro area, there are several organizations which calculate different types of leading indicators: European Sentiment Indicator (ESI) and Business Climate Indicator (EJ) by the European Commission, Composite Leading Indicators (CLIs) by the OECD, EuroCoin (EC) by the CEPR, and many others.

The leading indicators have been proved quite successful in predicting upcoming recessions. Despite the fact that they are sometimes subjected to showing incorrect signals (for example indicating a future recession while it did not actually happen) or that they fail to predict accurately a turning point, they are widely used among the forecasters and in the press. The leading indicators can only project short-run movements in the economy and the average lead is 6-months.

An alternative tool for predicting turning points in an economic cycle is the econometric model. There are three different major types of econometric models. The first type is a *structural model* which uses a large number of equations, each equation being based on economic theories. Structural models which were developed following the publication of Keynes theories have undergone significant modifications in the last 30 years. The second type of models, which is *non-structural,* is vector autoregressive models (VAR). In vector auto regressions, all variables are endogenous, in contrast to structural models where variables are arbitrarily labelled endogenous or exogenous. Each set of variables is regressed on past values of itself and past values of every other variable in the system, thus cross-variable linkages are automatically

incorporated. The third type which was developed by Sargent and Sims (1977) is called *dynamic factor models*. The dynamic factor models are based on multivariate systems. The essential idea is that some economic shocks are common across sectors, so these common shocks or "factors" produce co-movements and facilitate parsimonious modelling and forecasting of large numbers of variables.

Within the approach of econometric modelling, there are two different ways of tackling the problem of predicting turning points. One way is to rely on statistical models that are built to predict future values of economic variables. The other way is to build a model that focuses directly on predicting the event of interest i.e. turning points. In response to the poor performance of structural and VAR models, some economists intended to directly model the probability of a recession using *a probit* model. In this type of model, the variables included in the model and their respective coefficients are chosen not on the basis of their ability to track past movements in real GDP but on the basis of their ability to indicate the likelihood of past recessions. However, since the probit model focuses on recessions, they cannot be used for policy analysis.

To summarize, determining the start of a recession cannot be solely made by considering the simple definition of "two consecutive quarters of decline in real GDP". Other economic indicators should be paid attention over to make sure the economic activity is declining in all sectors and the slowdown is not just a short temporary misalignment between the demand and the supply. On the other hand, the turning points of a business cycle can be forecasted by looking at the trends in leading economic indices and by using econometric models. Although both of these tools can sometimes demonstrate and/or generate incorrect signals, they remain widely used among the economists and institutions.

Sources: The Conference Board, NBER, CEPR, ECRI, OECD

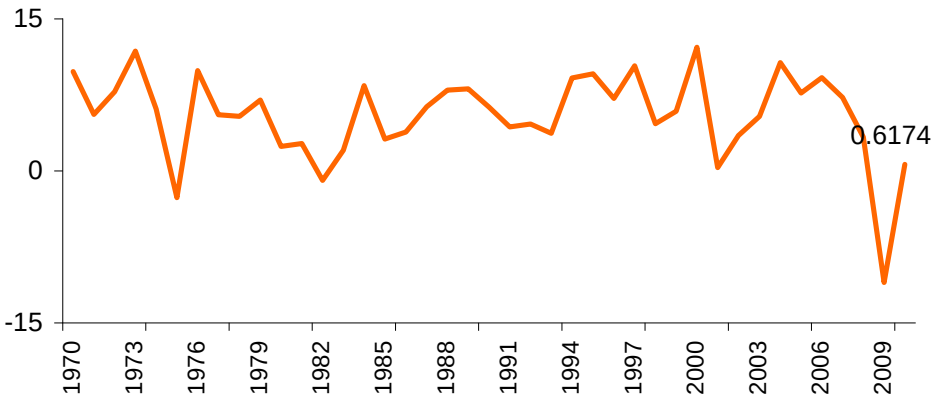
1.3 Regional economies

Regional economies (i.e. South Asia, China, and Iran) were not as severely affected by the financial crisis as the advanced economies since financial institutions in the region were not directly exposed to U.S securitized assets. However, since September 2008 the global economic recession began to affect developing economies in the region through trade channel as external demand

for Asian products declined as the recession deepened in the U.S and Europe.

World trade volume moderated to a 2.5 percent growth in 2008 down from 6.9 percent in 2007 and is forecasted to contract by almost 13 percent in 2009. (See Figure 1.2) Only over the last quarter of 2008 and first quarter of 2009, world trade fell at an average annualised rate of more than 20 percent, a rate of decline not previously experienced in the last four decades.

Figure 1.2: World Trade Volume (goods and services)



Source: International Monetary Fund (IMF)

Parallel to a decline in exports, industrial output also declined in most developing countries. Firms have seen their profits decline and business confidence has been affected in the region. In addition, spillovers from the global financial crisis to domestic financial markets across Asia have been observable. Equity and bond prices have plummeted, currencies have depreciated and real estate markets have remained under pressure in a number of economies.

On the other hand, despite the collapse in exports, the current account surplus for Asia is projected to remain broadly unchanged at about 4.75 percent of GDP. Nonetheless, with the contraction in global capital flows in the fourth quarter of 2008, IMF expects that emerging markets will experience net capital

outflows in 2009 of more than 1 percent of GDP.

Economic growth in developing Asia declined from 9.8 percent in 2007 to 6.8 percent in 2008, as indicated in Table 1.2. The growth is projected to decline by half in 2009 to 3.3 percent. Unlike the advanced economies, developing Asian economies (except for newly industrialized Asian economies and some ASEAN members) will register positive growth in 2009.

Table 1.2: Growth and inflation in selected Asian economies

	Real GDP Growth			CPI Inflation		
	2007	2008	2009	2007	2008	2009
Developing Asia	9.8	6.8	3.3	4.9	7	2.5
China	13	9	6.5	4.8	5.9	0.1
ASEAN-5	6.3	4.9	0	4.3	9.2	3.6
India	9.1	7.1	5.7	4.7	8.3	4.5
Pakistan	6	5.8	2.5	12.0	21.1	19.5
Bangladesh	6.3	5.6	5	9.1	8.4	6.4
Iran	7.8	4.5	3.2	18.4	26	18
Tajikistan	7.8	7.9	2	13.2	20.4	11.9
Uzbekistan	9.5	9	7	12.3	12.7	12.5
Turkmenistan	11.6	9.8	6.9	6.3	15	10

Source: IMF and regional central banks & statistics offices

1.3.1 China

Real GDP growth in China declined to 9 percent in 2008 after five consecutive years of above 10 percent growth. The minor slowdown in economic growth is mainly due to a worse performance in industrial output which increased by 9.5 percent compared to 14.9 percent in the previous year. However, the agriculture sector performed well as cereal output increased by 5.4 percent in 2008 compared to 0.7 percent in 2007.

Economic activity slowed further in the first quarter of 2009. Real GDP grew at an annualized rate of 6.1 percent which was 4.5 percentage points lower than that in the first quarter of 2008. Several factors contributed to the slowdown in economic activity. Growth in industrial output was 11.3 percentage points lower than a year ago and trade saw a significant decline in the first quarter of 2009. Overall trade declined by 24.9 percent at an annualized rate; exports fell by 19.7 percent and imports dropped by 30.9 percent.

Moreover, foreign direct investment was also down in the first quarter of 2009. The total value of FDI was lower by USD 5.6 billion if compared with that of the first quarter of 2008.

Real GDP growth is projected to be 6.5 percent in 2009, as the economy has already shown significant weaknesses in the first quarter of 2009.

CPI inflation increased by 5.9 percent in 2008 compared to 4.8 and 1.6 percent in 2008 and 2007 respectively. Deflation may also affect China in 2009 as CPI inflation is expected to decline by 1 percent in 2009. The slowdown in economic activity, together with steep falls in oil and other commodity prices, pushed the consumer prices into negative territory (-0.6 percent) in the first quarter of 2009.

The banking sector is not significantly exposed to overseas high-risk assets, partly due to capital controls. As a result, bank lending has not been limited by concerns over capital adequacy. However, the central bank cut its policy rates and reserve ratios in 2008 and in consequent bank lending has accelerated sharply since November.

On the fiscal side, the government announced in November 2008 a major investment plan for 2009-10, with total expenditure under this plan amounting to 5.8 percent of GDP. The increase in spending will be more focused on social areas such as healthcare. Moreover, the rate of value added tax on exports and investment is to be cut to zero. Overall, the central government expects a budget deficit of 3 percent of GDP in 2009.

The outlook for the Chinese economy is quite positive. Investment is projected to pick up over the next two years and the current account surplus could rise significantly in 2009 to over 11 percent of GDP mainly due to the recent fall in imports. The increase in foreign reserves will enable China to implement counter-cyclical policies which will help the economy emerge from recession sooner. Economic growth is thus projected to increase to 8.5 percent in 2010.

1.3.2 India

India's economic growth has fallen to a five-year low. Real GDP increased by 7.1 percent in 2008 compared to 9.1 percent in 2007. The slowdown is mainly due to lower domestic demand. Growth in private consumption decelerated from 8.5 percent in 2007 to 6.8 percent in 2008, and growth in gross fixed capital moderated from 12.9 to 8.9 percent.

The decline in global demand has also affected Indian exports. Net exports (goods and services) as a percentage of GDP deteriorated to -7.8 percent in 2008 compared with -4.7 percent in 2007. As a result, industrial production slowed in 2008 and then contracted in January 2009.

Inflation in India, as measured by the wholesale price index (WPI), doubled in 2008 due to a surge in commodity prices. WPI inflation increased from 4.7 percent in 2007 to 8.3 percent in 2008. Prices are expected to fall in 2009 to 2007-levels. Although inflation dropped to 2.4 percent in March 2009 down from 12.5 percent in July 2008, the risk for deflation is at minimum in India.

On the fiscal side, the central government budget deficit in 2008 increased to 6 percent of GDP although it was initially estimated at 2.5 percent. The increase in the deficit was due to unbudgeted expenditures such as public sector pay rises and subsidies to oil companies. The total public sector deficit exceeded 10 percent of GDP.

The Indian economy in 2009 is projected to grow by 5.7 percent due to falling exports and business confidence. According to a survey, business confidence index (BCI) in India declined by 40 percent during the period Nov 2008 – Jan 2009. A gradual recovery is expected in 2010 as world trade stabilizes and business confidence enhances.

1.3.3 Pakistan

Pakistan's economic growth in 2008 was almost at the same level as that of the previous year. Real GDP growth was 5.8 percent in 2008 and is projected to decline to 2.5 percent in 2009.

The economy performed well in 2008 despite a global slowdown and a weakening of external demand. Pakistan's exports, unlike India's, increased in 2008 by 7.4 percent compared to 3.4 percent in 2007. The trade deficit decreased but mostly due to a compression in imports. However, industrial output declined in 2008 by 4.7 percent compared to a 5.2 percent increase in 2007.

The major threat to the economy is risks to the external account. If exports and remittances are affected by the global financial crisis, there will be once again a serious risk to Pakistan's international reserves. Moreover, limited capital inflows to the country will put pressure on its currency which will have negative consequences for inflation and growth.

Pakistan's foreign reserves saw a steep decline in October 2008 as the central bank lost USD 700 million in just a week. Following concerns over Pakistan's reserves, the IMF approved the disbursement of a USD 7.6 billion stand-by arrangement under the economic stabilization program.

Economic growth is expected to decelerate in 2009 to 2.5 percent as business confidence deteriorates due to security concerns.. In addition, spillover effects from the global recession will have an affect on the economy and it is more likely that exports will fall due to weakening global demand.

1.4 Commodity and Asset Prices

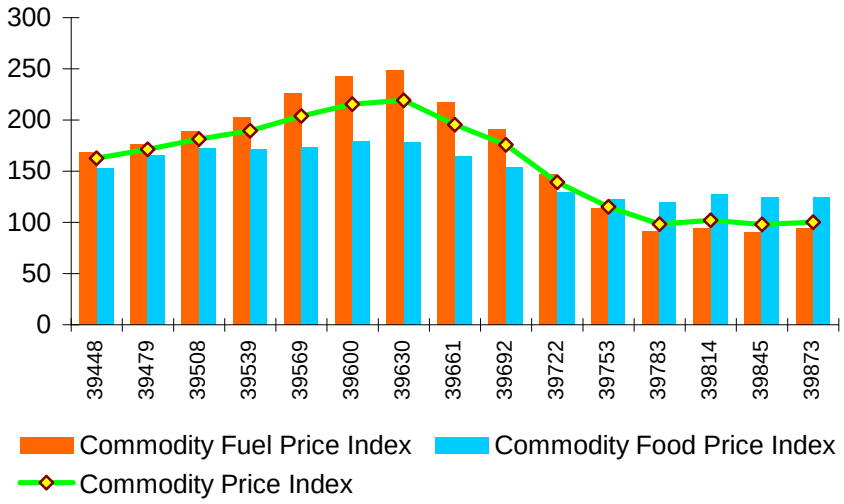
1.4.1 Commodity prices dropped from their peak in July 2008 to a lowest in Feb 2009

Commodity prices reached their peak in July 2008 as the IMF commodity price index rose to 218.9 up from 138.2 in July 2007. During the period of July 2007 – July 2008, fuel and energy prices increased by 83 percent and food prices rose by more than 40 percent.

Commodity prices dropped steeply in the beginning of the fourth quarter of 2008 as prospects for global growth deteriorated and the global financial turmoil aggravated. Commodity prices dropped by 55 percent in December compared with that in July and then stabilized during the first quarter of 2009 (Figure 1.3). Food prices declined by more than 30 percent in December and oil prices fell from an all-time record high of USD 143 a barrel in July to about USD 33 in January 2009. Afterwards, oil prices have gradually increased to around USD 50 a barrel in March.

The IMF expects commodity prices to remain subdued as long as the global economy is in a recession and will pick up again when economic activity accelerates.

Figure 1.3 Commodity Prices in 1387



Source: International Monetary Fund (IMF)

1.4.2 Equity markets

Stock markets performed poorly in 1387 due to global financial crisis. Stock markets collapsed in early October 2008 as the crisis in the financial sector deepened and prospects for world economic growth deteriorated. Furthermore, between March and January 2009, prices had been falling gradually in most of the stock markets. (See Figure 1.4)

In the year 1387 (Mar 21, 2008 – Mar 20, 2009), the Dow Jones Industrial Average was down by more than 40 percent and the Nasdaq Composite Index lost 35 percent of its value. In Europe, the FTSE 100 and Cac 40 lost 31 and 38.6 percent of their values respectively. The Nikkei in Japan was down by 35 percent.

Figure 1.4 Equity Markets Performance in 1387 (Mar 21, 2008 – Mar 20, 2009)

Dow Jones Industrial Average

NASDAQ Composite Index

FTSE 100

DAX

CAC 40

Nikkei

Source: advfn.com

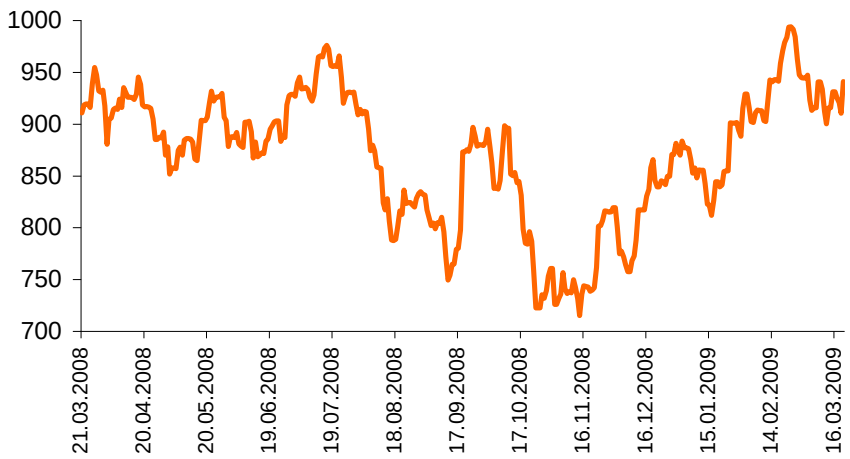
1.4.3 Gold prices

Gold prices opened the year 1387 at USD 910 per oz. The prices were fluctuating within a large band around USD 900 in the beginning of the year until prices began to decline in July. Gold prices dropped from around USD 950 in July to around USD 730 in September.

When stock markets collapsed in early October 2008, gold prices started to pick up in November reaching its maximum level for the period of Mar 21, 2008 – Mar 20, 2009 at USD 993.9 in February 23, 2009. (See Figure 1.4 below) This indicates that following the collapse of equity markets worldwide, investors switched to invest in gold which appreciated its value.

Gold prices closed the year at USD 940 per oz. which shows an appreciation of 3.3 percent for the year 1387. The volatility in gold prices was high during the year 1387; using the standard deviation, we find a volatility of 64.3.

Figure 1.5 Gold prices in U.S dollar



Source: oanda.com

1.4.4 Global exchange rates

The U.S dollar appreciated against major currencies throughout the year 1387. Dollar appreciated by an average 20 percent vis-à-vis euro, pound sterling and Swiss franc.

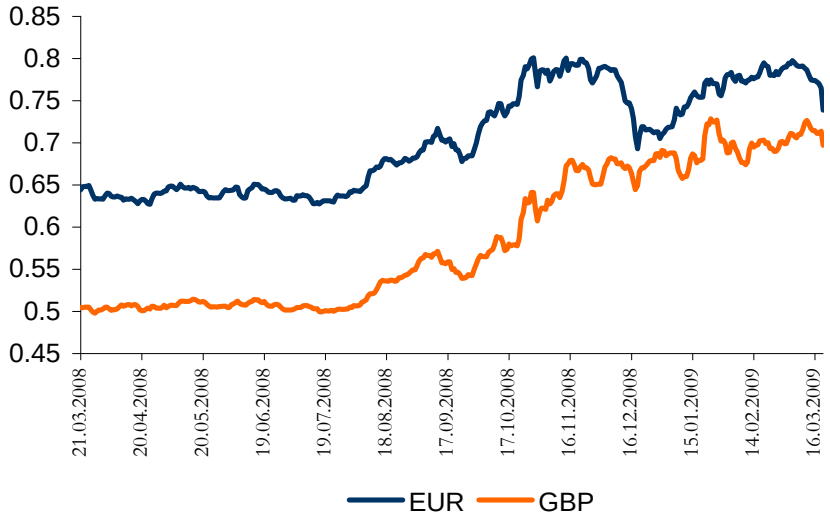
As indicated in Table 1.3, the average exchange rates of U.S dollar against euro, pound sterling, Japanese yen and Swiss franc were 0.70, 0.59, 100.6 and 1.10 respectively.

Table 1.3: US dollar exchange rates against major currencies in 1387

	EUR	GBP	JPY	CHF
Mar 21, 2008	0.64	0.50	99.16	1.01
Mar 20, 2009	0.74	0.70	95.41	1.14
Average	0.70	0.59	100.60	1.10
Max	0.80	0.73	110.56	1.22
Min	0.63	0.50	88.24	0.99

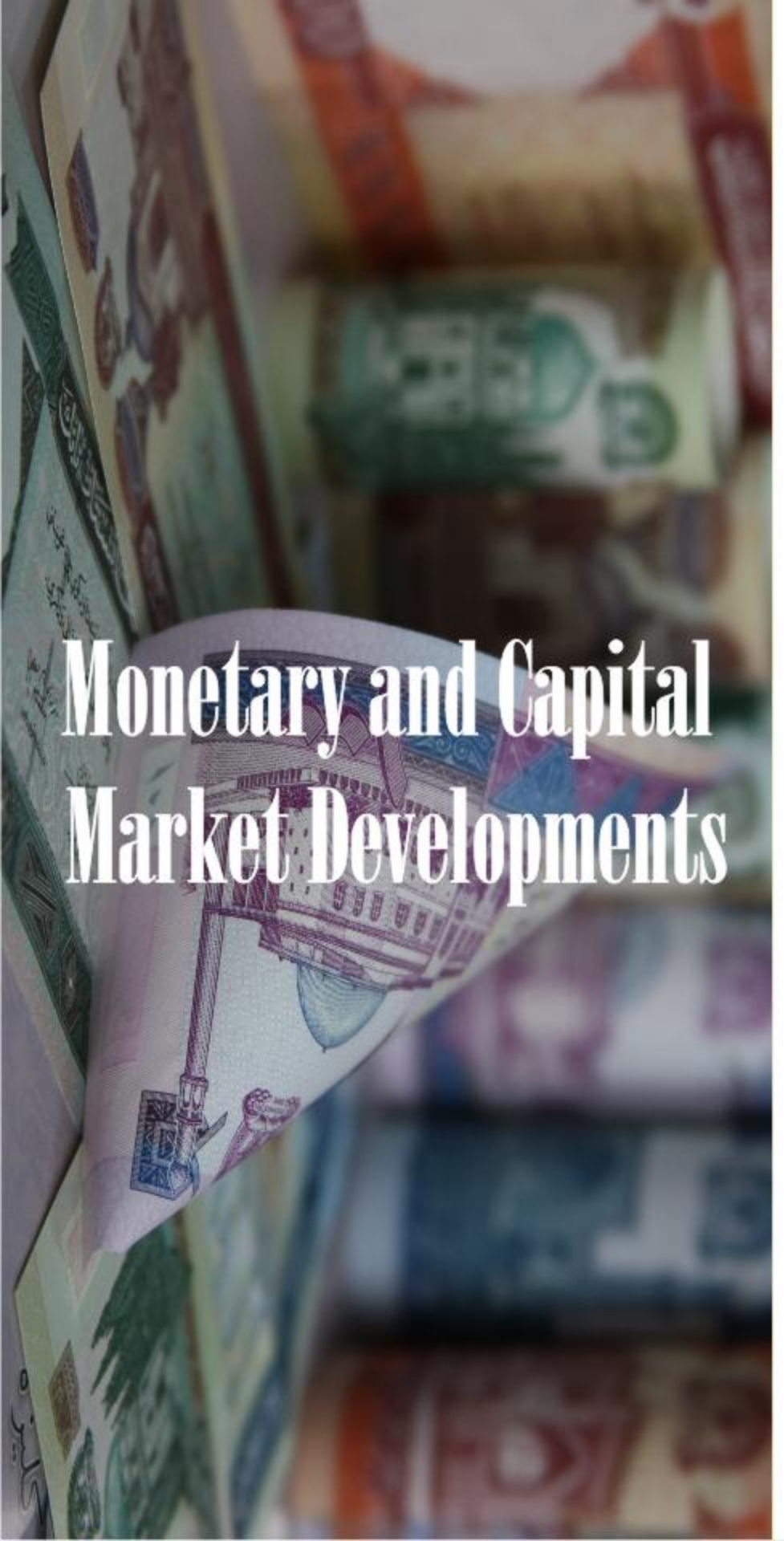
Source: oanda.com

Figure 1.6: Trend in U.S dollar value against euro and pound sterling



Source: oanda.com

Prospects for the world growth are tinged with great uncertainty. It is expected that the global economy will continue to experience recession throughout 2009 and a gradual recovery is expected in mid-2010 as demand increases and world trade recovers. Nonetheless, effective policy measures are needed to enhance the conditions in the financial markets and to increase the consumer and business confidence worldwide.



Monetary and Capital Market Developments

2

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

SUMMARY

The year 1387 witnessed a huge volatility in reserve money which increased by 65 percent compared with 14.4 percent in 1386. Though currency in circulation grew by 30% during this period, however, commercial banks' excess reserves deposited with the Central Bank increased by 433 percent mainly due to huge influx of foreign money.. Excess reserves of the banking sector which constituted only 9 percent of total reserve money jumped to 28 percent by the end of the year.

Under the PRGF (Poverty Reduction and Growth Facility) program with the IMF the ceiling for reserve money was set at 33.5% which envisaged 50 percent growth in the banking sector's deposit during 1387. Reserve money behaved as expected during the first half of the year; in the second half due to massive deposits with commercial banks the volatility of reserve money increased creating problems for the monetary program. By the end of the year, the indicative target on reserve money was missed with a huge margin.

Similarly narrow money (M1) grew by 38 percent in the year under review up from 29 percent in the previous year. M1 is defined as monetary base (reserve money) plus demand deposits of the banking sector. It was expected that afghani-denominated demand deposits of the banking sector will increase by 50 percent in 1387; however, the actual growth of theses deposits was 98 percent though the total deposits (afghani and foreign currency deposits) grew by 52 percent. It is worth mentioning that afghani-denominated demand deposits constituted only 22 percent of transferable deposits in the beginning of the year increasing to 28 percent by the end of the year.

In contrast to narrow money, broad money (M2), defined as narrow money plus quasi money, declined by 24 percent in 1387 while it witnessed a growth of 165 percent in the previous year. The decline was led by foreign currency denominated deposits which actually constitute around 50 percent of quasi money. The reason could be attributed mainly to narrow difference in remuneration rates on transferable deposits and time deposits as the nascent commercial banks compete for attracting more deposits.

1. MONETARY PROGRAM UNDER PRGF

The currency in circulation (CiC) was a performance criteria under PRGF program and its ceiling for the year 1387 was set at 33.1 percent. The target was defined estimating the economic growth to be 7.5 percent and inflation rate to be 24 percent in the fiscal year 1387.

Da Afghanistan Bank achieved all the quarterly targets of CiC in 1387 with the actual year-end growth of currency in circulation closing at AF 76,955 million showing 30.66 percent growth since the beginning of the year.

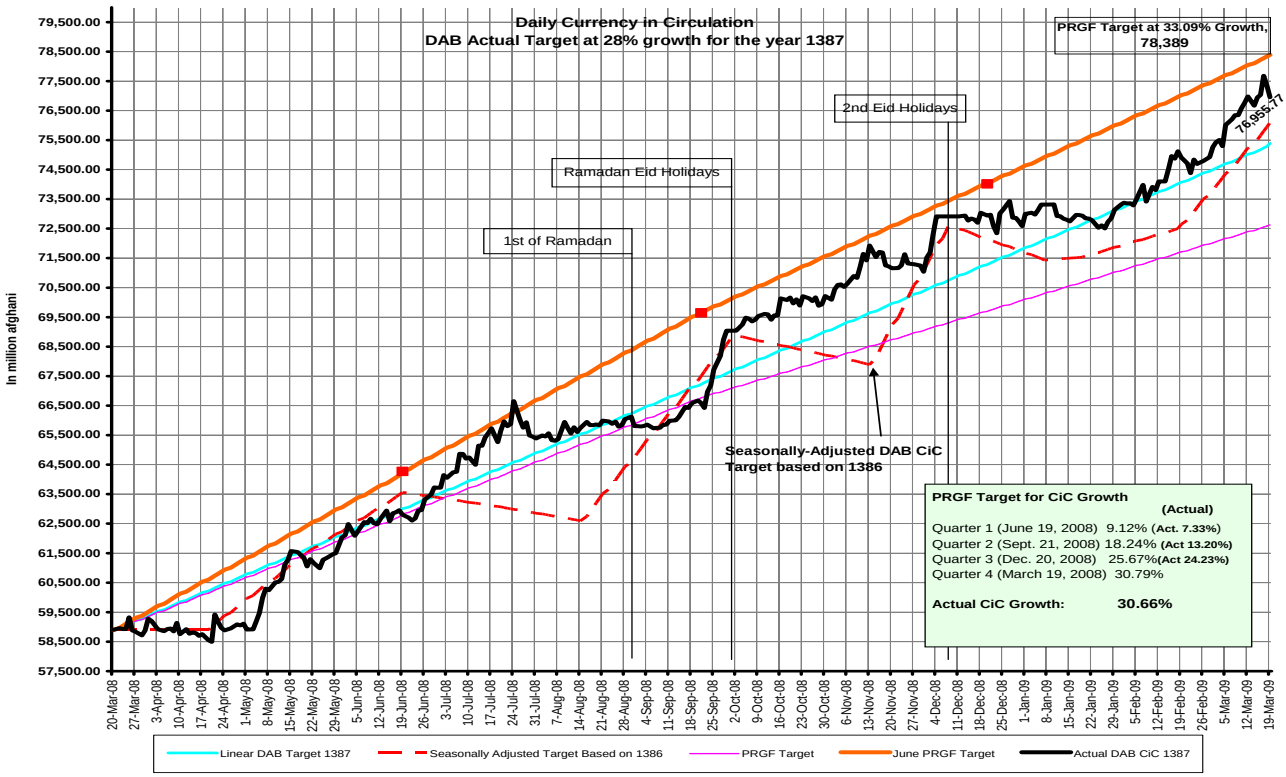
Since FX auction is the primary instrument of monetary policy with the objective of maintaining the CiC growth at or below the growth of nominal GDP, DAB auctioned more than 1.4 billion US dollar in 1387. Figure 2.1 shows the actual daily CiC (black line) growth for the fiscal year 1387.

As stated earlier, the indicative target on reserve money was missed in the year 1387 mainly due to huge influx of deposits by non-residents. (Table 2.1) Net domestic assets of the Central Bank increased by 22 percent mainly because of aggressive mopping up of liquidity through sales of capital notes. This was to contain inflationary pressures building since early 2007 due to high international food and fuel prices surge. The stock of capital notes increased from 9.3 billion afghani in the beginning of the year to 23.2 billion afghani by the end of the year recording 150 percent increase. The PRGF monetary program projected that capital notes would increase by a modest figure of 9.9 percent only.

On the other hand, net claims on general government (it is negative because it is government deposits with the Central Bank without any counter claim by the DAB on government) decreased by 12 percent. The reason behind this deviation of actual from PRGF projection was the

shortfall in revenue collection and increased budget deficit. (Please refer to Section 4 on fiscal developments for more detail.)

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



Net foreign assets increased by 44 percent mainly due to increase in foreign deposits toward the end of the year. Therefore one needs to be cautious in interpreting the increase in NFA as permanent because its counter entry is Central Bank's increased liability to commercial banks. Considering the nature ot these transfers, it is expected that withdrawals of these deposits by commercial banks will definitely lead to proportionate falling net foreign assets.

The following table summarizes Afghanistan's monetary program under the PRGF which uses a vector of fixed exchange rates of December 20, 2008 for the end of 1387.

Table 2.1: Performance of Afghanistan Monetary Program for 1387 (2008/09)

	End 1385 (Mar 20, 07)	End 1386 (Mar 19, 08)	y.o.y Change (1385-1386)	End 1387 (Mar 20 - 2009)		y.o. y Change (1386-1387)	Target
	Actual	Actual		Target	Actual		
1. Net Foreign Assets (a+b)	**99831**	**144611**	45%	**163800**	**181304**	**44%**	**30.0%**
(a) Foreign Assets (i+ii)	103297	149655	45%	170700	186060	42%	30.5%
i. Foreign exchange reserve	97467	139439	43%	159800	178134	48%	32.3%
ii. Other foreign assets	5831	10216	75%	10800	7926	-21%	7.5%
(b) Foreign liabilities	-3467	-5043	45%	-6900	-4756	0%	45.0%
2. Net Domestic Assets (a+b)	**-43529**	**-80186**	84%	**-77800**	**-75045**	**22%**	**26.3%**
(a) Domestic Assets (i+ii)	-33084	-44561	35%	-44200	-53914	22%	-0.1%
(i) Net claims on general government	-27444	-35230	28%	-34000	-30718	-12%	-2.7%
(ii) Other Claims including Capital Notes	-5640	-9332	65%	-10200	-23196	150%	9.9%
(b) Other Items Net	-10445	-35624	241%	-33600	-21131	22%	93.2%
3. Reserve Money (a+b)	**56301**	**64426**	14%	**85983**	**106260**	**65%**	**33.5%**
(a) Currency in Circulation	50329	58899	17%	78389	76807	30%	33.1%
(b) Bank deposits with DAB (only AF)	5972	5526	-7%	7594	29452	433%	37.4%

Source: International Monetary Fund and DAB staff calculations

Note: This table is developed for the evaluation of the monetary program under the PRGF based on the definitions elaborated in the Memorandum of Economic and Financial Polices, and the Technical Memorandum of Understanding between the Government of Afghanistan and the IMF. Definition of items used here is not necessarily the same as monetary and financial statistics manual due to special circumstances prevailing in the Afghanistan when the PRGF program was signed. As only the balance sheet of the Central Bank is used in calculating the figures, therefore, it does not represent the financial sector development.

2. MONETARY AGGREGATES

In the year under review, broad money (M2) increased by more than AF 42 billion ending at AF 162,527 million which represents 35 percent growth. M2 grew by around 32 percent in 1386. However, the quasi money component of M2 contributed negatively to the growth of M2 as time and saving deposits of commercial banks became less attractive to depositors due to the competition among commercial banks which raised the interest paid on current accounts relative to time deposits. Therefore, the growth in the broad money was only due to increase in the components of the narrow money.

Narrow money (M1) grew by 38 percent in 1387 up from 29 percent in the previous year showing an increase of AF 43.6 billion. Currency outside depository

corporations grew by 28 percent as the currency in circulation target was set at 31 percent under the PRGF program. This means that in 1387 more than 16 billion new afghani was issued.

Similarly demand deposits of commercial banks, including both afghani and foreign currency denominated deposits, grew by 52 percent. It is worth mentioning that afghani-denominated deposits grew by 98 percent and foreign currency denominated deposits grew by 40 percent.

Table 2.2: Monetary Aggregates 1387 (2008/09)

	1385	1386	y.o.y Change (1385 - 1386)	Difference (1385 - 1386)	1387	y.o.y Change (1386 - 1387)	Difference (1386 - 1387)
	Amount	Amount			Amount		
Broad Money(M2)	**91,317**	**120,201**	**32%**	**28,884**	**162,527**	**35%**	**42,326**
Narrow Money(M1)	**89,252**	**114,734**	**29%**	**25,482**	**158,376**	**38%**	**43,642**
Currency outside depository corporations	49,566	57,501	16%	7,935	73,842	28%	16,341
Demand Deposits	39,686	57,233	44%	17,547	84,534	48%	27,301
Quasi Money	2,066	5,467	165%	3,402	4,151	-24%	-1,316
In Afghani	754	2,013	167%	1,259	2,164	7%	151
In Foreign currency	1,312	3,454	163%	2,142	1,988	-42%	-1,467
Determinants							
Net Foreign Assets	108,945	159,652	47%	50,707	187,389	17%	27,737
(a) Foreign Assets	115,464	167,988	45%	52,524	217,936	30%	49,948
DAB Foreign exchange reserves	103,407	144,435	40%	41,028	183,861	27%	39,426
Other foreign assets	12,057	23,553	95%	11,496	34,075	45%	10,522
(b) Foreign Liabilities	6,518	8,335	28%	1,817	30,547	266%	22,212
Net Domestic Assets	**-17,628**	**-39,451**	**124%**	**-21,823**	**-24,862**	**-37%**	**14,590**
Net Domestic Credit	-3,103	1,497	-148%	4600	13,574	807%	12,077
(a) Net Claim on General Government	-29,600	-41,478	40%	-11,878	-37,752	-9%	3,726
(b) Claims on other Sectors	26,497	42,975	62%	16,478	51,326	19%	8,350
Capital Account	26,354	51,540	96%	25,186	42,011	-18%	-9,528
Less							
Other Items Net	11,828	10,591	-10%	-1,237	3,576	-66%	-7,015

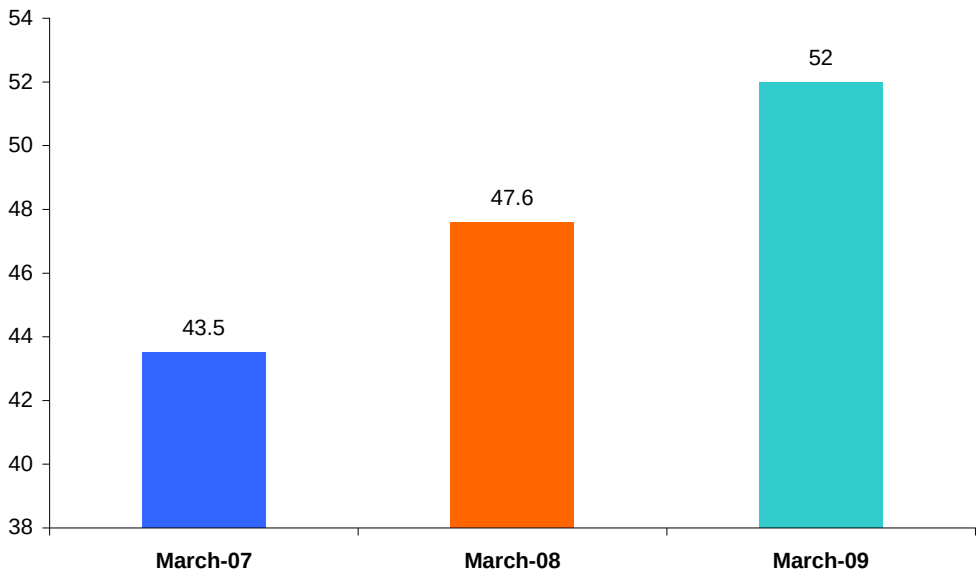
Source: Monetary Policy Department of DAB

Net domestic assets of depository corporations (including the central bank) decreased by 37 percent due to two main reasons: 1- Government deficit increased in 1387 resulting in a 9 percent decrease in its claim on the Da Afghanistan Bank. 2- Commercial banks increased credit mainly to the private sector contributed 19 percent increase in the net domestic assets.

It is worth mentioning that due to nascent banking system and strong external financial support to the government of Afghanistan, general claim of government on depository corporations dominated net domestic assets. However, as the banking sector grows with the external financial support to the government remaining constant, net domestic assets of depository corporations will increase or become less negative initially.

Figure 2.2 shows demand deposits (including transferable deposits with the DAB included in broad money) as a share of broad money was 52 percent in the year 1387 up from 47.60 percent in the previous year.

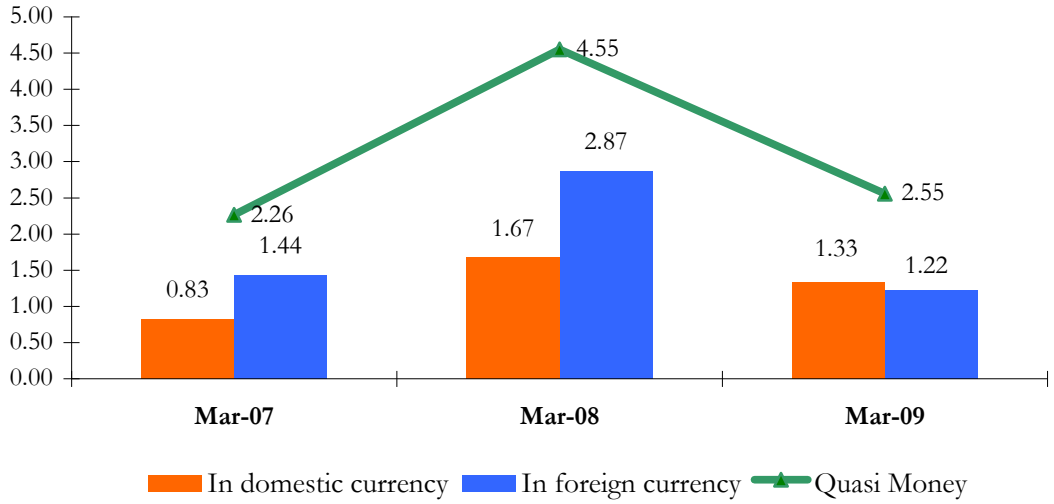
Figure 2.2: Demand Deposits as share of M2(%)



Source: Monetary Policy Department/DAB

On the other hand quasi money as share of broad money was only 2.55 percent down from 4.55 percent in the previous year. This indicates that foreign currency and afghani denominated time and saving deposits declined in 1387 as explained earlier.

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



Source: Monetary Policy Department/DAB

Table 2.3 shows the income velocity and money multiplier for two monetary aggregates, reserve money (RM) and broad money (M2). The income velocity of a monetary aggregate is defined as the ratio of nominal GDP to the aggregate. The income velocity is interpreted as the number of times each unit of nominal money turns over in producing a year's final output.

The income velocity of reserve money declined to 5.6 in 1387 from 7.5 in 1386 and the income velocity of broad money decreased to 3.7 in 1387 from 4.0 in 1386. Interpreting the decline in income velocity of broad money (M2) as a slowdown in demand for afghani cash and a shift towards increased holding of afghani deposits could be misleading. Though indeed this argument could be true up to some extent, but the main reasons for the decline in these numbers are huge influx of foreign money towards the end of 1387 and expansion of currency in circulation by 28 percent.

Velocity is inversely related to the demand for real balances – the higher the demand for money the lower is velocity money balances and the less would be the turnover in the stock of money over the given period of time.

As the demand for money depends on the level of interest rates (opportunity cost of holding money) and GDP, it is clear that changes in either of these two variables will effect the demand for money and hence velocity. If interest rates rise, demand for money falls and hence velocity rises where people hold money balances and money therefore turns over faster.

Since GDP is in the numerator of the expression for velocity, an increase in GDP will raise velocity only if the demand for money increases proportionately less, as a result of the rise in GDP, than the increase in GDP itself. The percentage increase in the demand for money for a given percentage increase in income is determined by the income elasticity of money demand. Hence, velocity will rise if the income elasticity of money demand is less then one.

The last column of table 2.3 calculates the money multiplier which decreased to 1.5 in the year under review from 1.9 in 1386 because of higher growth in reserve money compared to broad money.

Table 2.3: Income Velocity and Money Multiplier (In billion AF)

Year	GDP at current Market Price	Reserve Money (RM)	Broad Money (BM)	Income Velocity of Reserve Money (GDP/RM)	Income velocity of Broad Money (GDP/BM)	Money Multiplier (BM/RM)
1385 (2006-07)	385	56.3	91.3	6.8	4.2	1.6
1386 (2007-08)	481	64.4	120.2	7.5	4.0	1.9
1387 (2008-09)	596	106.3	162.5	5.6	3.7	1.5

Source: IMF and DAB Calculations

2. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

2.1 Capital Note Auctions

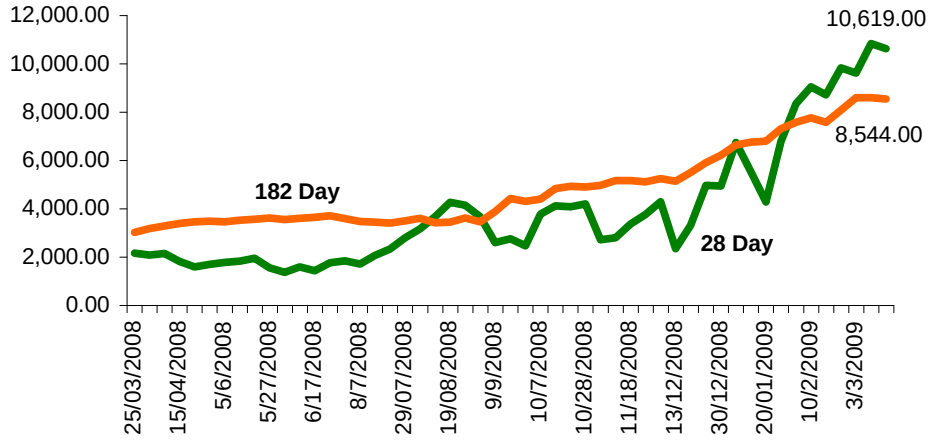
Capital notes are short-term afghani-denominated securities sold by the Central Bank at weekly auctions. Capital notes are discount securities which mean that they are issued and traded at a discount to face value. Discount securities make only one payment – the face value – on the maturity date. The 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 1387 fluctuated between AF 120 million and AF 4.5 billion for 28-day notes and between AF 10 million and AF 900 million for 182-day notes, and the year witnessed a gradual increase in the stock for both maturities. The outstanding stock of 28-day notes increased from AF 2.00 billion at the beginning of the year to AF 10.6 billion at the end of the year, while 182-day CNs increased from AF 2.5 billion to AF 8.5 billion in the same period. .

The total outstanding stock for both maturities stood at AF 19.5 billion at the end of 1387 (see Figure 2.4).

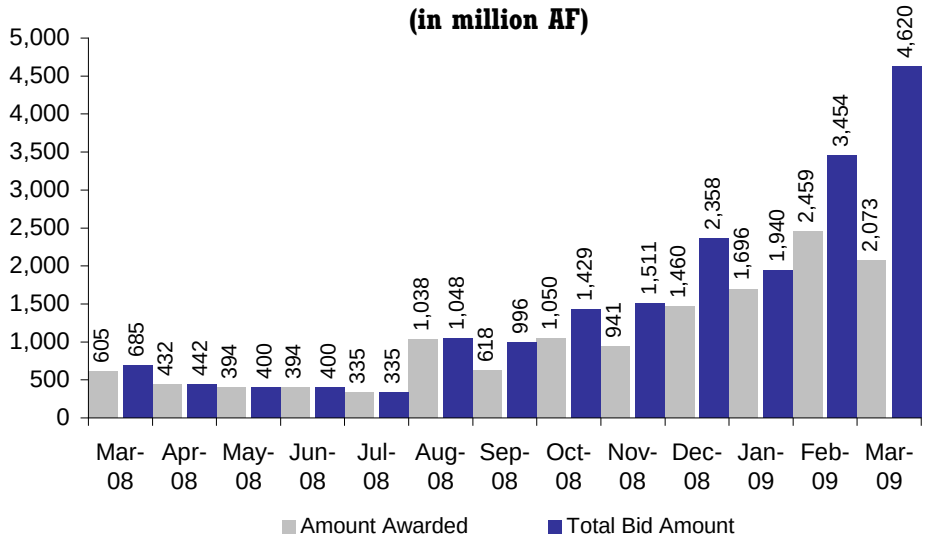
Figur 2.4: Capital Notes Stock Outstanding (in million AF)



Source: Market Operations Department, DAB.

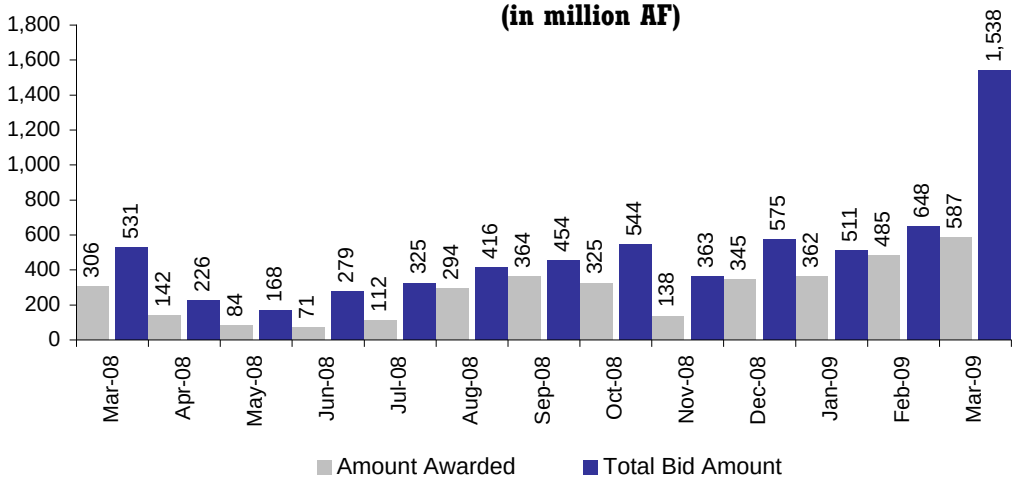
The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the year under review the bid amount for 28-day notes was AF 1,492 million and amount awarded was AF 1,050 million for a cover ratio of 1.42. The bid amount for 182-day note was AF 467.82 million and amount awarded was AF 259.76 million for a cover ratio of 1.8. Comparing the cover ratio in the year 1387 to that in the previous year, the cover ratio for the 28 day notes was 1.7 and for 182 day notes it was 1.7. Although, the awarded amount was much higher than the announced volume, still it oversubscribed by AF 442 million for 28 day notes and AF 203 million for 182 day notes. This reflects that there is still high demand for CNs from commercial banks, despite large amount of supply by DAB. (Figure 2.5 for 28 day CNs and Figure 2.6 for 182 day CNs).

Figur2.5: Demand & Awarded Amount for 28 day Notes
(Monthly average)
(in million AF)



Source: Market Operations Department, DAB

Figur2.6: Demand & Awarded Amount for 182 day Notes
(Monthly average)
(in million AF)

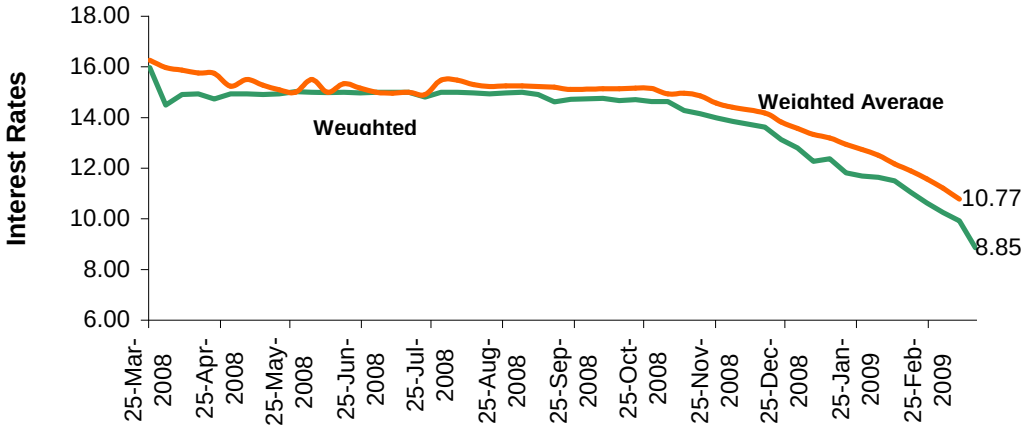


Source: Market Operations Department/ DAB

The weighted average interest rate declined by 710 basis points for 28 day notes and 523 basis points for 182 day notes during the year under review. It

ranged between 15.95 percent and 8.85 percent for 28 day and 16.00 percent to 10.77 percent for 182 day maturity. The weighted average interest rates in the last year were 7.20 percent to 15.00 percent and 7.64 percent to 18.00 percent respectively (Figure2.7).

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



Source: Market Operations Department, DAB

2.2 Term Structure of Interest Rates

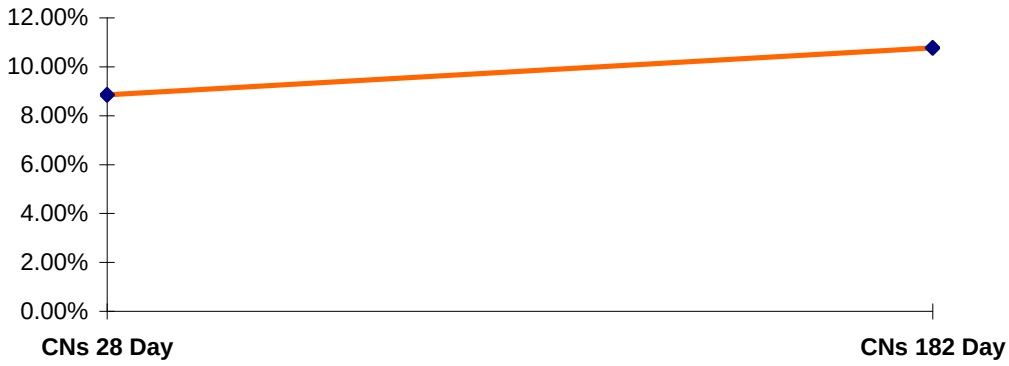
The term structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity on a security. The yield of the capital notes is the annualized percentage increase in the value of the CNs.

The yield curve for March 20, 2009 is upward sloping.

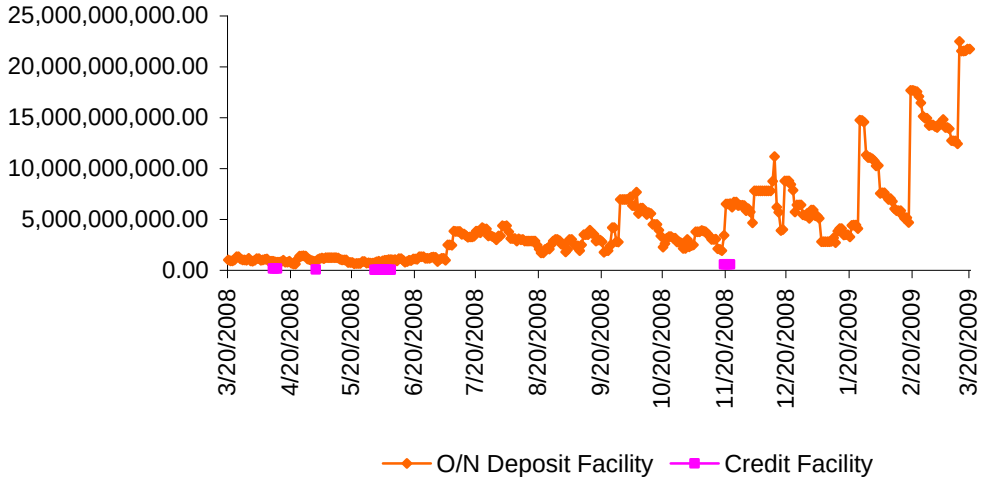
2.3 Required and Excess Reserves

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

Figure 2.8: Term Structure of Interest Rates Yield Curve (20 Mar 2009)



Figur 2.9: Overnight Deposit Balances (Amount in AF)



Source: Market Operations Department, DAB

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 day CNs 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 noticed a record increase of AF 22 billion in the year 1387. The amount of deposit facility account increased from AF 900 million to AF 22 billion during the year under review. The year under review ended with stock outstanding amounting to AF 21.7 billion.

Overnight Credit Facility: This facility is used by banks for short term cash needs. The facility allows banks to borrow afghani from Da Afghanistan Bank on an overnight basis when they face a short fall in cash flow. The rate that the banks are charged for this facility is 350 basis points above the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only (according to the circular of Feb 27, 2007). Three banks benefited from the facility and collateralized AF 803 million worth capital notes. The credit duration was from 1 to 10 days. It is worth mentioning that DAB earned AF 1.2 million from the facility. During the year under review required reserves averaged AF 365,768,380.00 per bank on monthly basis, while excess reserves (including overnight deposits) averaged AF 437,211,286.53 per bank. These figures were AF 253,436.08 thousand and AF 81,372,540.00 respectively during the previous year. During the period under review average excess reserves in the banking sector increased by almost 400 percent as compared to preceding year. As a result, the demand for CNs increased and there were huge surge of fund into Deposit Facility Account which positively affected outstanding amount of CNs and ONDF. (See Figure 2.4 and 2.10)

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

3. FOREIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates

During 1387 the afghani exchange rate depreciated against the US dollar and the euro. The weakness of afghani against US

dollar reflected the appreciation of the US dollar in international foreign exchange markets over the year.

Indeed, as can be seen from the Table 2.4, afghani depreciated by 4.523 percent against the US dollar compared with 1386 and depreciated by 2.268 percent on average to compare with that in 1386. Afghani appreciated by 12.84 percent against euro compared with that in the 1386, while afghani depreciated by 3.5 percent on average compared with that in 1386.

Afghani remained largely stable against Pakistani rupee over the year under review appreciating by 17.68 percent compared with the 1386. This trend however continued with the Pakistani rupee depreciating by 15.7 percent on average compared with that in 1386.

In local foreign exchange markets afghani traded in a relatively range between AF 49.56 and AF 52.67 against the US dollar over the year.

Figure 2.11: Daily Average Exchange Rate (AF/USD): Q3 1387

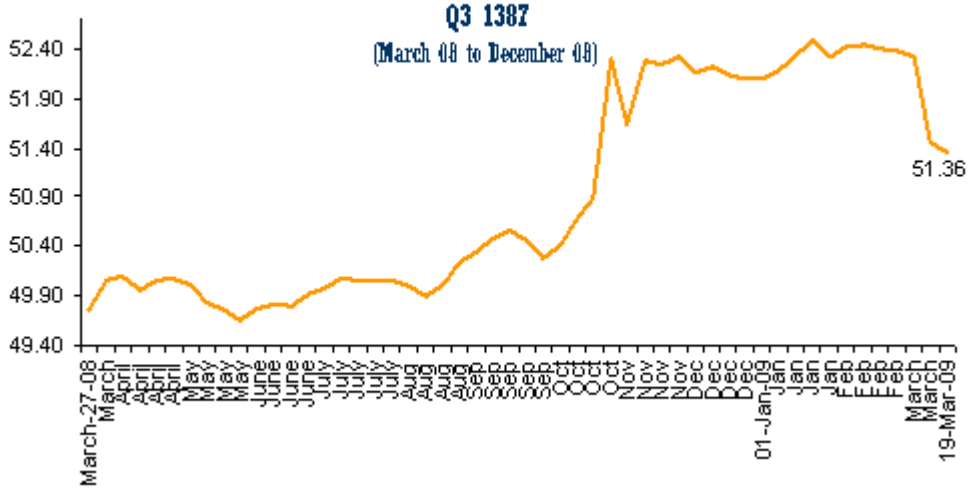
(March 22, 08 to March 19, 09)

Table 2.4: Exchange Rate against selected currencies Q2 1387

Period	USD	PKR	EURO
Average for 1387	50.95	0.6867	72.48
Average for 1386	49.82	0.8146	70.03
% Appreciation (-) or depreciation(+) of AF against respective currency	**2.268**	**-15.701**	**3.498**
Closing rate on March 19, 09	51.76	0.6450	67.55
Closing rate on March 19, 08	49.52	0.7835	77.50
% Appreciation (-) or depreciation(+) of AF against respective currency	**4.523**	**-17.677**	**-12.84**

Source: Monetary Policy Department/ Market operations Department/ DAB

Figure 2.12: Weekly Average Exchange Rate (AF/USD): Q3 1387



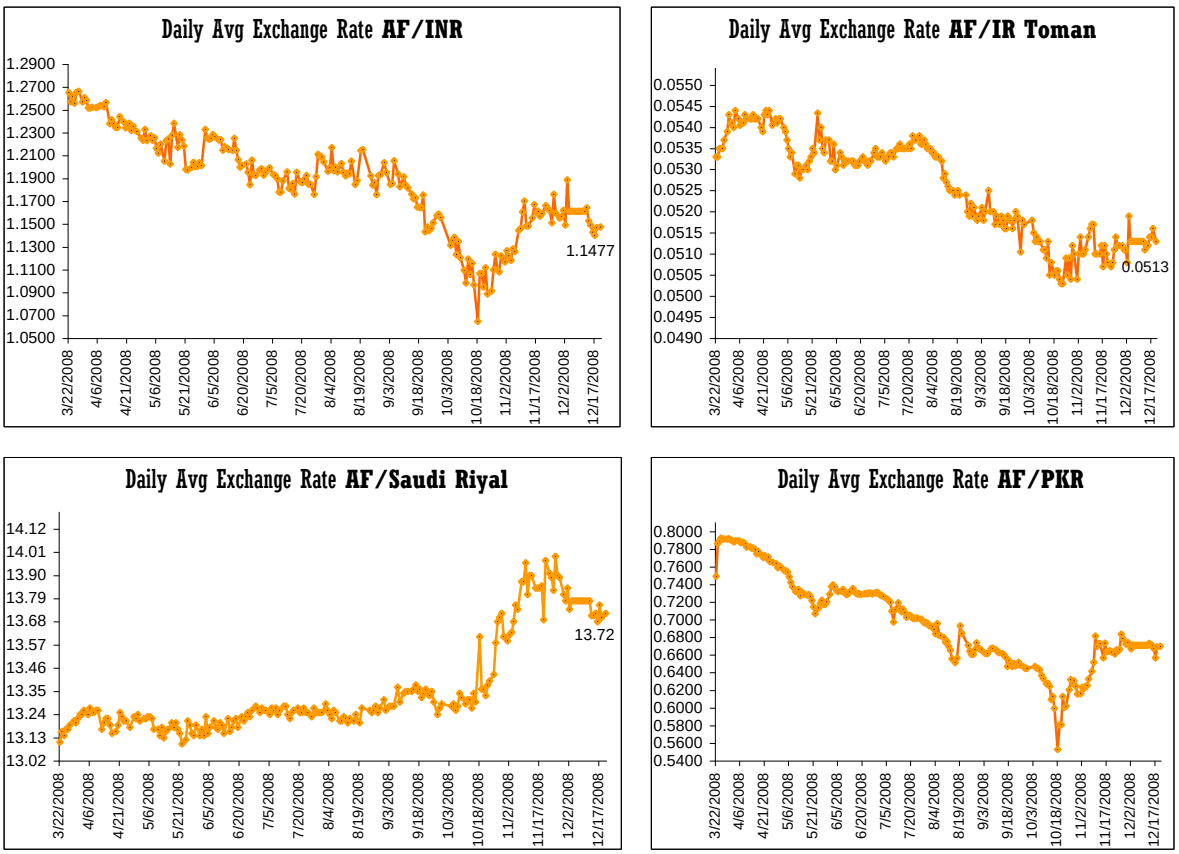
The exchange rate movement on the weekly basis is depicted in Figure 2.12. As can be seen from the Figure 2.12, afghani started depreciating vis-à-vis USD from beginning of October and continued up to the end of October 2008. The main reasons behind this depreciation was excess demand for USD by pilgrimages and the second reason is thought to be appreciation of USD against other currencies in the international exchange markets, especially after the bailout package was approved by the US Senate in response to the financial crises.

The volatility of afghani exchange rate vis-à-vis USD as measured by standard deviation was 1.06 percent in 1387 up from 0.33 percent in 1386. The difference

in the volatility rate between two years shows that exchange rate of afghani against USD was less stable in the year under review.

The comparison of historic review of the daily average exchange rate of Afghani against some other major currencies for 1387 is shown in Figure 1.13

Figure 2.13: Daily Exchange Rate of afghani against some major currencies



Source: Market Operations Department/DAB

Box 2: The choice of exchange rate regime: fixed or flexible?

An exchange rate regime is the way a country manages its currency in respect to other foreign currencies. Under a system of floating exchange rate, the exchange rate is set by market forces and is allowed to fluctuate in response to changing economic conditions. In this case, the exchange rate adjusts to achieve simultaneous equilibrium in the goods market and the money market. While under a fixed exchange rate regime, the value of the domestic currency is fixed against the value of another single currency or a basket of other currencies. The central bank announces a value for the exchange rate and stands ready to buy and sell the domestic currency to keep the exchange rate at its announced rate.

By adopting a fixed exchange rate, monetary authorities aim at stabilizing the value of domestic currency vis-à-vis the currency it is pegged to. The objective is to facilitate trade and investments between the two countries and to control inflation. The monetary authorities usually fix the value of currency relative to that of a low-inflation country in order to achieve price stability. However, by maintaining a fixed exchange rate, a central bank loses its independence and surrenders control of its monetary policy. This can also be viewed in the Mundell-Fleming model, according to which in a fixed exchange rate regime, the monetary policy is ineffective while the fiscal policy is effective.

Although in some situations, fixed exchange rates may be preferable for their greater stability but they are sometimes subjected to huge speculative attacks. Thus, to avoid the possibility of speculative attacks, some economists argue that a fixed exchange rate should be supported by a "currency board". In a currency board arrangement, the domestic currency is backed one by one by foreign reserves. The central bank holds enough foreign currency to back each unit of the domestic currency. On the other hand, in case of a large balance of payments deficit, the foreign exchange value tends to rise, which puts a downward pressure on the domestic currency's value. This obliges the monetary authorities to whether devaluate the currency or to defend the domestic currency by selling their foreign reserves. In these two cases – huge speculative attacks and a balance of payments deficit – most central banks find the situation very uncomfortable and cannot defend their currency till the end. In such cases, floating exchange rate is preferable which can correct the balance of payments deficit without devaluating the currency.

Floating exchange rates serve to automatically adjust the imbalances in balance of payments. When a deficit occurs, higher demand for foreign goods increases the relative value of foreign currency. If the exchange rate is flexible, the foreign currency tends to appreciate and the domestic currency tends to depreciate. The depreciation of the domestic currency raises prices of imported goods and, therefore, the demand for domestic goods will increase, eliminating the imbalance in the balance of payments. Floating exchange rates thus enable a country to dampen the impacts of external shocks and prevent the possibility of having a balance of payments crisis. Sometimes, the volatility in exchange rates becomes so significant that it creates some other serious problems. For the banking system, when liabilities are in foreign currencies, unexpected depreciation of the exchange rate may destabilize the financial sector. For large firms operating at the global level, volatility in exchange rates creates balance sheets problems. Hence, in cases of extreme appreciation and depreciation, a central bank can intervene to stabilize the currency, which such an exchange rate system is known as *managed* floating exchange rate.

In practice, we rarely observe exchange rates that are completely fixed or completely floating. Under both systems, stability of the exchange rate is usually one among many of the objectives of central banks.

According to an IMF report, the choice of an exchange rate regime depends on the macroeconomic performance of a country. Adopting a pegged exchange rate can lead to a lower inflation, but also to a slower productivity growth. Countries facing disinflation may find pegging the exchange rate an important tool. But where growth has been sluggish, a flexible regime might be preferable.

Sources: IMF, *Does the exchange rate regime matter for inflation and growth?* Economic Issues No.2, 1997

Mankiw, N. Gregory; Taylor, Mark P., *Macroeconomics*, 2008

Mishkin, Frederic S., *The Economics of Money, Banking, and Financial Markets*, 2004

3.2 Foreign Exchange Auction

Foreign exchange auctions are the key instrument to smooth fluctuations in the currency in circulation which is a performance criterion under the PRGF program. Da Afghanistan Bank (DAB) has maintained its bi-weekly sterilization policy, to mop up extra liquidity arising principally from government and international organizations' expenditures in Afghanistan. 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 on the other.

In the year under review the announced amount of the auction stood at USD 1,460 million while the awarded amount reached USD 1,409.28. The weighted average of the entire 99 awarded auctions rate (sale price of the USD) was 51.07, covering March 25, 2008 to March 17, 2009 in which the total number of awarded bids were 2,482 compared. In 1386 there were 99 auctions of USD 960.25 million; the weighted average of exchange rate was 49.7 with the 2,418 awarded bids.

Figure 2.14: Bi-weekly Foreign Auction 1387 (in million US dollar)

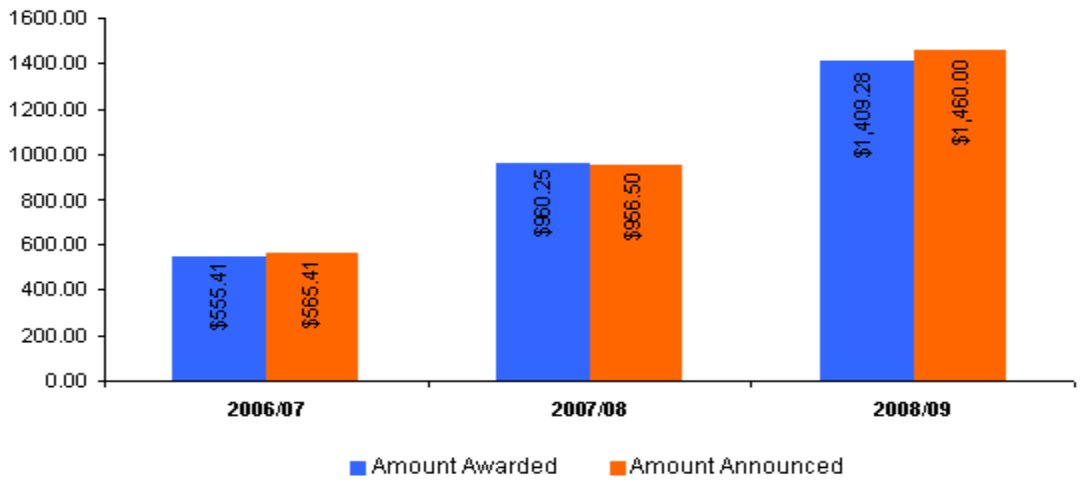


Table 2.5 summarizes the results of DAB foreign exchange auctions during the period from March 25, 2008 to March 17, 2009

Table 2.5: Auction summary

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Mid Rate	Amount Announced	Amount Awarded	No of Awarded Bidders
25-Mar-08	45	49.82	49.50	49.77	49.73	10.00	7.15	10
29-Mar-08	28	50.13	49.85	50.09	49.94	7.50	6.35	9
01-Apr-08	37	50.12	49.90	50.08	50.07	7.50	9.40	16
05-Apr-08	38	50.16	50.00	50.15	50.09	7.50	10.35	15
08-Apr-08	38	50.1610	49.90	50.10	50.12	7.50	8.55	28
12-Apr-08	38	49.94	49.50	49.89	49.89	7.50	7.95	22
15-Apr-08	33	50.01	49.90	50.00	49.98	7.50	8.55	16
19-Apr-08	43	50.02	49.98	49.98	50.02	10.00	9.85	25
22-Apr-08	42	50.09	50.07	50.07	49.98	10.00	7.70	17
29-Apr-08	42	50.09	49.95	50.00	50.09	15.00	12.95	37
03-May-08	40	50.10	49.95	50.03	50.11	10.00	13.65	30
06-May-08	43	50.00	49.80	49.96	50.02	10.00	8.95	27
10-May-08	43	49.95	49.70	49.8	49.92	15.00	18.5	41
13-May-08	43	49.81	49.70	49.71	49.78	15.00	11.65	34
17-May-08	42	49.76	49.59	49.71	49.80	15.00	16.9	35
20-May-08	44	49.76	49.61	49.73	49.80	15.00	15.4	29
24-May-08	42	49.67	49.50	49.61	49.60	10.00	10.25	21
27-May-08	40	49.71	49.60	49.67	49.70	10.00	12.05	28
31-May-08	37	49.68	49.40	49.59	49.65	10.00	10.35	20
03-Jun-08	34	49.84	49.64	49.71	49.85	10.00	11.75	31
07-Jun-08	46	49.82	49.72	49.8	49.80	10.00	11.35	23
10-Jun-08	44	49.86	49.76	49.83	49.85	10.00	12.95	24
14-Jun-08	39	49.80	49.69	49.78	49.80	10.00	12.5	24
17-Jun-08	41	49.78	49.70	49.76	49.80	10.00	10.25	24
21-Jun-08	37	49.87	49.80	49.86	49.83	10.00	10.85	18
24-Jun-08	39	49.99	49.88	49.97	49.91	10.00	8.80	11
28-Jun-08	39	50.01	49.91	49.999	49.95	10.00	7.00	12
01-Jul-08	40	50.01	49.30	49.92	49.98	10.00	13.00	32
05-Jul-08	39	50.00	49.92	49.991	49.98	10.00	9.58	16
08-Jul-08	41	50.17	50.03	50.13	50.11	10.00	12.65	25
12-Jul-08	49	50.13	49.98	50.10	50.13	12.50	16.70	33
15-Jul-08	40	50.01	49.90	49.99	50.04	12.50	10.75	19
19-Jul-08	38	50.05	49.92	50	50.05	12.50	16.1	38
22-Jul-08	39	50.11	49.9050	50.071	50.07	12.50	12.25	16
26-Jul-08	34	50.05	49.91	49.94	50.03	12.50	12.90	30
29-Jul-08	41	50.10	50.00	50.051	50.09	12.50	15.70	29
02-Aug-08	43	50.06	49.93	50.02	50.07	12.50	12.45	21
05-Aug-08	40	49.98	49.88	49.91	49.97	12.50	13.05	6
09-Aug-08	42	49.86	49.71	49.83	49.90	10.00	10.25	24
12-Aug-08	42	49.90	49.71	49.80	49.92	10.00	14.10	36
16-Aug-08	37	49.89	49.34	49.852	49.88	10.00	10.00	21
19-Aug-08	39	50.06	49.75	49.99	50.02	10.00	10.40	23
23-Aug-08	39	50.20	50.00	50.13	50.20	10.00	12.95	26
26-Aug-08	42	50.25	50.00	50.221	50.21	10.00	13.4	25
30-Aug-08	38	50.38	50.23	50.35	50.32	10.00	13.15	21
02-Sep-08	39	50.32	50.21	50.301	50.33	10.00	9.70	15
06-Sep-08	37	50.55	50.11	50.50	50.46	10.00	10.45	16
09-Sep-08	37	50.49	50.30	50.46	50.46	10.00	11.55	19
13-Sep-08	39	50.69	50.56	50.66	50.59	10.00	10.7	15

18-Sep-08	39	50.56	50.20	50.54	50.57	10.00	11.55	26
20-Sep-08	36	50.48	50.25	50.46	50.47	10.00	9.45	17
23-Sep-08	34	50.47	50.32	50.44	50.48	10.00	9.20	19
27-Sep-08	30	50.12	49.96	50.04	50.14	10.00	10.40	23
04-Oct-08	38	50.39	50.16	50.30	50.33	10.00	15.75	30
07-Oct-08	38	50.39	50.16	50.36	50.34	15.00	11.40	30
11-Oct-08	41	50.57	50.21	50.52	50.57	15.00	14.55	21
14-Oct-08	48	50.74	50.10	50.72	50.73	15.00	17.15	21
18-Oct-08	43	50.82	50.55	50.75	50.73	25.00	15.85	22
21-Oct-08	43	50.821	49.71	50.79	50.77	20.00	11.25	19
25-Oct-08	42	51.72	50.45	51.63	50.34	20.00	12.50	20
28-Oct-08	47	53.32	51.50	52.10	52.67	20.00	16.70	39
01-Nov-08	50	50.75	50.30	50.30	50.93	20.00	16.4	29
04-Nov-08	54	51.435	50.63	51.30	51.40	20.00	18.65	21
08-Nov-08	43	52.40	51.15	52.21	52.07	10.00	15.5	17
11-Nov-08	53	52.33	51.90	52.20	52.30	10.00	17.8	38
15-Nov-08	49	52.23	50.04	52.01	52.18	20.00	18.85	32
18-Nov-08	51	52.20	51.70	52.03	52.19	20.00	18.10	34
22-Nov-08	52	52.11	51.75	52.05	52.15	20.00	11.35	20
25-Nov-08	57	52.32	52.05	52.25	52.28	20.00	18.85	24
29-Nov-08	53	52.20	51.8520	52.13	52.21	20.00	15.4	22
02-Dec-08	53	52.05	51.85	52.021	52.03	20.00	18.15	21
13-Dec-08	49	52.30	51.90	52.18	52.26	20.00	25.1	34
16-Dec-08	52	52.133	51.90	52.06	52.13	20.00	24.5	31
20-Dec-08	51	52.12	51.95	52.081	52.14	20.00	17.3	20
23-Dec-08	42	52.05	51.85	52.00	52.14	20.00	13.6	23
27-Dec-08	46	52.05	51.90	52.011	52.07	20.00	14.10	18
30-Dec-08	45	52.092	51.81	52.07	52.07	20.00	12.45	10
03-Jan-09	43	52.171	52.0120	52.141	52.12	20.00	12.80	17
06-Jan-09	41	52.231	52.01	52.21	52.21	20.00	9.50	15
10-Jan-09	53	52.24	52.00	52.211	52.21	20.00	10.90	20
13-Jan-09	47	52.382	52.25	52.352	52.34	20.00	16.60	25
17-Jan-09	46	52.705	52.00	52.610	52.65	20.00	21.15	34
20-Jan-09	47	52.472	52.21	52.412	52.45	20.00	20.2	30
24-Jan-09	46	52.40	52.10	52.3	52.44	25.00	19.5	40
27-Jan-09	48	52.253	52.01	52.22	52.26	25.00	16.2	25
31-Jan-09	49	52.352	52.341	52.341	52.34	20.00	15.20	17
03-Feb-09	48	52.45	52.25	52.4	52.38	20.00	22.3	28
07-Feb-09	47	52.452	52.00	52.412	52.42	20.00	22.60	30
10-Feb-09	52	52.46	52.355	52.424	52.43	20.00	21.60	30
15-Feb-09	36	52.485	52.30	52.42	52.45	20.00	19.65	32
17-Feb-09	41	52.421	52.32	52.33	52.43	20.00	20.35	39
21-Feb-09	41	52.373	52.27	52.341	52.36	20.00	22.90	35
24-Feb-09	53	52.39	52.30	52.36	52.39	20.00	21.55	35
28-Feb-09	46	52.375	52.311	52.34	52.38	20.00	21.20	35
03-Mar-09	42	52.365	52.27	52.27	52.33	20.00	22.35	42
07-Mar-09	39	52.00	51.45	51.45	52.04	25.00	19.05	39
10-Mar-09	41	51.03	50.10	50.30	51.14	25.00	15.05	39
14-Mar-09	51	51.15	50.25	50.83	51.13	20.00	22.35	34
17-Mar-09	51	51.07	50.5	51.00		20.00	20.70	27
Total 1387				**5034.09**		**1460.00**	**1409.28**	**2482**
		Total Amount Sold in US Dollars					**1409.28**	

Source: Market Operations Department (DAB)

Box 3: Real exchange rate competitiveness in Afghanistan

Real effective exchange rate is a key indicator of a country's competitiveness position which has a direct impact on the economy through effects on resource allocation and aggregate demand. Changes in the real effective exchange rate (REER) can influence the performance in the external sector and modify the spending behaviour of consumers in the economy. For a central bank, the importance of the REER is related with the monetary policy stance; since any changes in the REER would lead to fluctuations in short term capital flows which, in their turn, determine the central bank's net foreign assets.

What is a REER and how is it calculated?

The REER can be defined as the nominal effective exchange rate which takes into account the inflation differentials among the countries. The nominal effective exchange rate (NEER) expresses the price of the domestic currency relative to a basket of foreign currencies.

The NEER of a country can be calculated as a weighted average of the domestic currency's exchange rate vis-à-vis the currencies of all or some of its trading partners. The share in trade of each trading partner can be used as a weight for each currency. The weight does not change from year to year and is kept constant for a certain period, since a country's structure of trade does not alter each year and remains quite the same for a longer period of time.

The REER can be calculated in two methods. The first and the most common approach is by integrating in the definition of NEER the ratio of the domestic price level (Pd) to the foreign price level (Pf). The definition of the REER can be mathematically expressed as follw:

$$r = e \times \frac{P^d}{P^f}$$

Where e is the NEER and should be defined here as units of foreign currency per unit of local currency. The equation above shows that if the exchange rate is kept constant, a relatively higher domestic price will appreciate the REER, meaning the country loses its competitiveness by a certain degree.

The second method for estimating the REER takes the relative price of the tradable and non-tradable goods in the country as an indicator of the country's competitiveness level in foreign trade. The rationale behind this method is that the

price of tradable goods is equal all around the world, while the price of non-tradable differs in each country.

$$r = e \times \frac{P_n}{P_t}$$

According to this definition, if the exchange rate is kept constant, a higher relative price of non-tradable results in a deterioration of the country's competitiveness.

Finally, the last thing which should be kept in mind while calculating the REER is the indexation. The values of the REER should be converted into indices by taking a certain year as the base year. The main criterion for the base year is that both the internal and external equilibrium should be met simultaneously in that specific year.

Calculating the real effective exchange rate for Afghanistan

A basket of seven foreign currencies were selected to calculate the real effective exchange rate (REER) for Afghanistan, namely the U.S dollar, Pakistani rupee, Chinese yuan, Japanese yen, Indian rupee, euro and the Iranian toman. The trading weights of 2007 were used for weighting both the exchange rates and the price indices.

Basket of currencies	Weight
Pak. rupee	22.2%
Chinese yuan	18.2%
JP yen	15.0%
Indian rupee	5.0%
Euro	2.7%
Iranian toman	1.9%
USD	35.1%

An exception was given for the U.S dollar considering the prevailing high dollarization in the Afghan economy The weight attributed to the US dollar is the remaining weight in the trade after extracting the weights for the first six currencies.

The year 2003 was selected as the base year since it was the first year after the introduction of the new afghani. The REER was calculated using the consumer price index (CPI) as an indicator of price levels. Table 1 shows the nominal and real effective exchange rates for Afghanistan for the period 2002-2008.

Table 1: Nominal and real effective exchange rates for Afghanistan (2002-2008)

	2002	2003	2004	2005	2006	2007	2008
NEER	109.8	100.0	101.0	99.5	94.2	92.6	91.7
REER	107.0	100.0	109.5	116.5	111.8	118.9	136.6

According to Table 1, afghani slightly appreciated in 2004 but started to depreciate in the following years. In 2008, afghani depreciated by 8.3 percent in effective terms compared to the base year 2003.

The REER of Afghanistan has appreciated by 36.6 percent in 2008 compared with the base year (2003). This indicates that Afghanistan has lost strongly its competitiveness in regard to its trading partners. Only two years are marked with a depreciation of the REER i.e. 2003 and 2006. In these two years, the competitiveness position of Afghanistan has ameliorated by 6.6 and 4.1 percent respectively.

If we examine the performance of exports during this period, we find that the REER and exports are negatively correlated for Afghanistan, which is consistent with oeconomic theories. Table 2 shows the year-on-year changes in the REER and exports volume.

Table 2: Annual percent change in REER and exports volume in Afghanistan

	2003	2004	2005	2006	2007	2008
REER	-6.6	9.3	6.6	-4.1	5.1	15.2
Exports	56.9	-17.8	-8.3	0.9	-12.2	14.5

We can easily observe that in the years 2003 and 2006 the REER depreciated and the exports had a positive growth. While in 2004, 2005 and 2007, the REER increased while the exports declined.

There is an exception in 2008 in which both the REER and the exports increased, and the REER did not capture the overall portrait of the exports. There can be several reasons why the relative increase in domestic prices did not affect the exports. There can be implicit subsidies and unaccounted forecasts for the exporters which could have offset the negative impact of an increase in export prices. For example the elimination of transportation cost – be it implicitly by the government – could have enhanced the exports in 2008. Nevertheless, the appreciation of REER in 2008 may likely to have a J-curve effect with a lagged response on the exports. (Magee, 1973; McKinnon, 1979)

The REER is projected to depreciate by 5 percent in 2009 due to a slight depreciation of the nominal exchange rate and a moderate level of domestic inflation which would not evade the price level of Afghanistan's trading partners.

The REER and policy implications

There is a significant economic literature that relates income per capita growth rates to real exchange rate levels. Numerous studies have found a negative correlation between the exchange rate misalignment and real GDP growth for a long list of developing countries since the 1970s; the higher the real exchange rate, the lower the per capita growth rates.

Competitive real exchange rates have been a key factor in most East and Southeast Asian countries for their successful growth strategies in the last 30 years. On the other hand, most Latin American and African countries have suffered from severe balance of payments crises due to overvalued exchange rates.

Moreover, higher real exchange rates can squeeze the profits in the tradable sector – through Dutch Disease effect – which brings the investment rates down. In contrast, lower exchange rates are associated with higher investment levels at the macro level.

The REER influences the economy through many channels. A relatively appreciated exchange rate increases the prices of exports (the volume of exports decline), the level of real wages increases, thus lower profit margins, higher consumption, lower investment and finally higher unemployment. And a relatively depreciated exchange rate decreases the prices of exports (which enhance the export volume), the level of real wages are lowered, thus higher profit margins, lower consumption (due to higher prices of imported goods), higher investment in the economy and finally lower unemployment.

The REER is a highly important macroeconomic variable for the policy makers since it has a direct impact on the economy, and any change in the REER influences the short-term capital flow which is a major concern of the central bankers. Thus a prudent policy should be undertaken to manage efficiently the real exchange rate.

However, the case of Afghanistan is even more complex. The trade deficit (goods & services) represents almost 40 percent of the GDP on average, which is tangible. On the other hand, the REER in Afghanistan has appreciated by more than 35 percent in the last six years which is also notable. By analyzing the trends in Afghanistan's REER, we find that the main driver of the appreciation is mainly the domestic inflation. The nominal exchange rate of afghani did not have huge fluctuations and have been so far stable. In addition, a gradual nominal depreciation of afghani in the

last seven years of almost 16 percent should have enhanced the competitiveness of Afghanistan; but it has not done so due to higher domestic inflation.

The real exchange rate policy should be well managed in order to enhance the exports and reduce the trade deficit in Afghanistan. The government should focus on medium- and long-term policies and should determine specific policy instruments to control the real exchange rate. A successful policy instrument for managing the REER in Afghanistan would be controlling the domestic price level i.e. inflation. The monetary policy should be strengthened and more effective monetary instruments should be used so that the inflation is kept at a moderate level.

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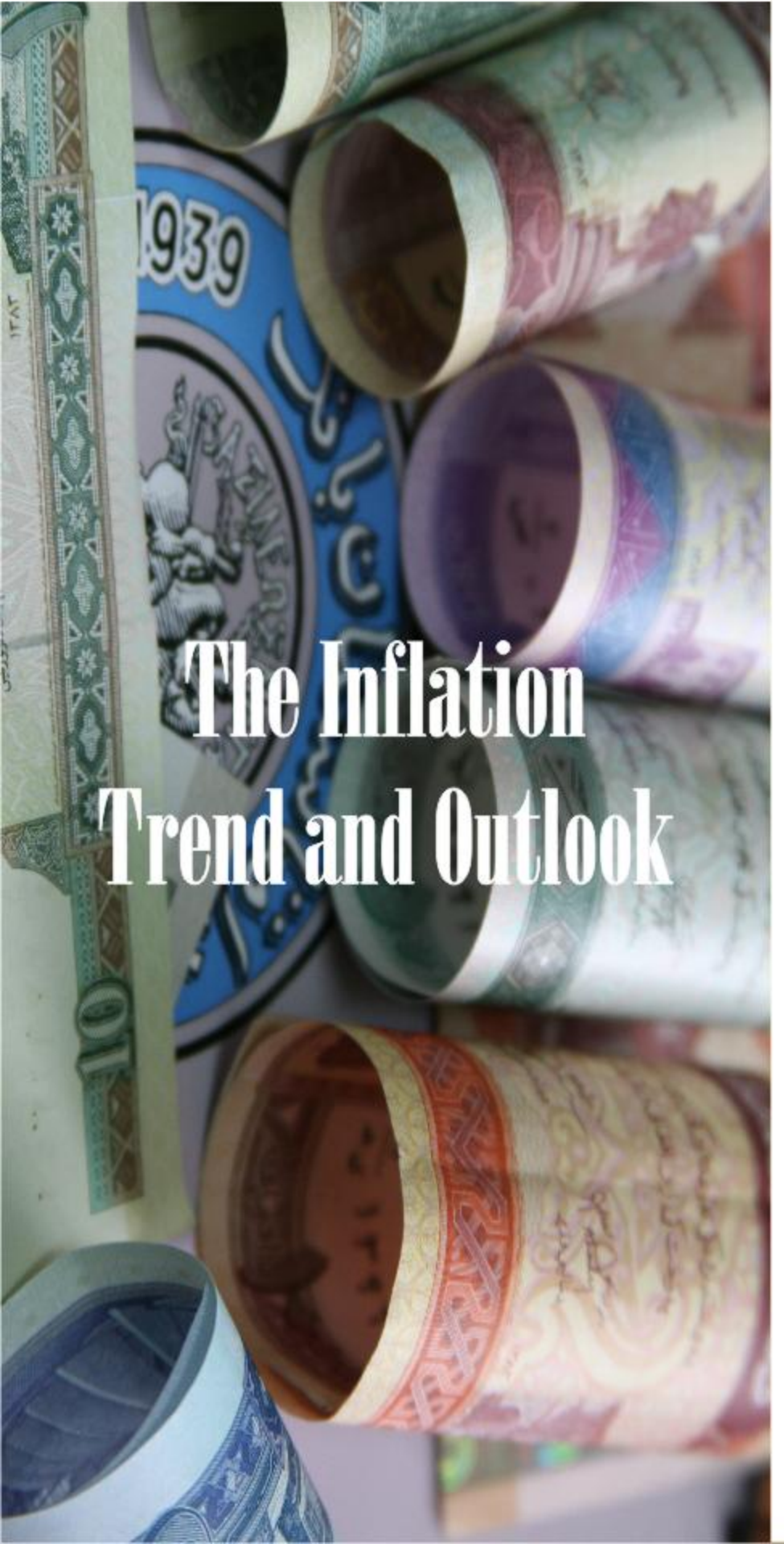


The Inflation Trend and Outlook

3

3

THE INFLATION TRENDS AND OUTLOOK

SUMMARY

Headline consumer price index (CPI) the broadest measure of the rise in the general price level stood at 164.3 at the end of the year under review representing an inflation rate of 3.2 percent (y-o-y changes) down from its peak of 43.2 percent at the beginning of the year. The period average inflation rose to 26.8 percent up from 12.9 percent a year ago.

The decrease in the CPI was mainly attributed to decreases in the prices of food and oil. The food price index fell dramatically to 0.9 percent because of a decrease in demand in the international markets and measures taken by the government in response to the shortage of wheat supply. However, non-food inflation which could be a more real representation of inflation due to economic activity remained high at 7.4 percent.

Core inflation as measured by the trimmed mean increased to 7.6 percent in 1387 from 5.9 percent in 1386.

The analysis shows that Kabul and national headline CPIs are remarkably similar over the period, especially during 1386 and 1387.

1. INFLATION HITS SINGLE DIGIT AGAIN

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation as measured by year-on-year percentage changes in Kabul CPI, decreased to 3.2 percent at the end of 1387 from 20.7 percent in the previous year. The CPI measures the average price of a fixed set (or basket) of goods. The basket of goods 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 typical household's current cost of living.

Table 3.1: Breakdown of Kabul Headline CPI
(Percent changes year on year)
Consumer Price Index
(March 2004 = 100)

	Weight	1384 (2005 – 06)	1385 (2006 – 07)	1386 (2007 – 08)	1387 (2008 – 09)
Headline	**100**	**9.5**	**4.8**	**20.7**	**3.2**
Food and Beverages	**61.3**	**6.2**	**6.3**	**30.6**	**0.9**
Bread and Cereal	28	7	3.6	51.8	-3.6
Milk and cheese	5.6	2.4	6.8	21.7	9.7
Oil and Fat	5.3	-4.1	17	45.2	-14.1
Non – Food	**38.7**	**14.4**	**2.5**	**6.9**	**7.4**
Housing	17.2	22.6	-1	6.5	7.2
Rents	7.1	24.9	-27.1	1.8	9.1
Construction materials	3.2	10.4	-11.3	17.9	4.2
Fuel and Electricity	6.8	25.1	51.4	7.5	6.6
Core Inflation (measured by Trimmed Mean)		**6.2**	**6.4**	**5.9**	**7.6**

Source: Central Statistics Office and DAB staff calculations.

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 3.2 percent in 1387 from 20.7 percent in 1386 was largely due to the following factors:

- **The food sub-index accounts for 61.3 percent of the CPI basket** and this price index fell sharply to 0.9 percent in 1387 from 30.6 percent in 1386. The main factors pushing inflation at the beginning of the year were the food and fuel prices surge in the international markets. The main factors contributing to the decline in inflation could be the measures taken by the Afghan government in response to the shortage of wheat supply, and the domestic harvest which drove the food prices down. In addition, due to global economic

slow down and recession which led to lower demand for oil in the international markets, the prices of food and fuel declined considerably offsetting the initial price hikes.

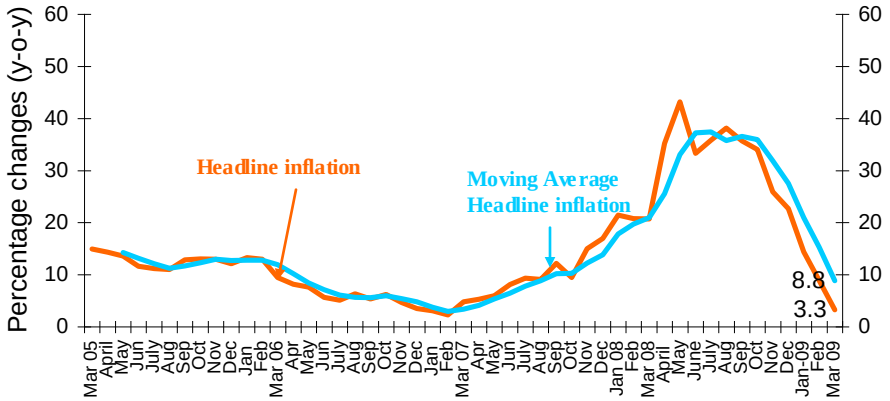
- **Bread and cereals, milk and cheese, oils and fats'** price indexes fell to 0.9 percent, 9.7 percent and -14.1 percent respectively.
- **The non-food sub-index accounts for 38.7 percent for the CPI basket.** This sub-index which could be a more real representation of inflation due to economic activities was largely stable as it rose to 7.4 percent in the year 1387 from 6.9 percent in the previous year. The main drivers behind this increase are the prices of housing and rents sub-indexes.
- **The housing sub-index accounts for 17.2 percent of the CPI basket.** This sub-index rose to 7.4 percent in the year under review from 6.9 percent in the previous year. The main reason behind this increase could be the increase in the prices of rents sub-index.
- **The rent sub-index accounts for 7.1 percent of the CPI basket,** this sub-index rose to 9.1 percent in the year under review from 1.8 percent a year ago. The main forces pushing this sub-index go up could be attributed to the increasing demand for housing as a result of growing population in Kabul, compulsory repatriation of Afghan refugees from the neighboring countries, especially Iran and Pakistan.

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

- **The construction materials sub-index accounts for 3.2 percent for the CPI basket,** this sub-index declined to 4.3 percent in the year under review compared to 17.9 percent in the previous year as a result of boom in domestic production of constriction materials by the private sector as well as expansion in the supply of cement from neighboring countries could be the main reasons behind this decline

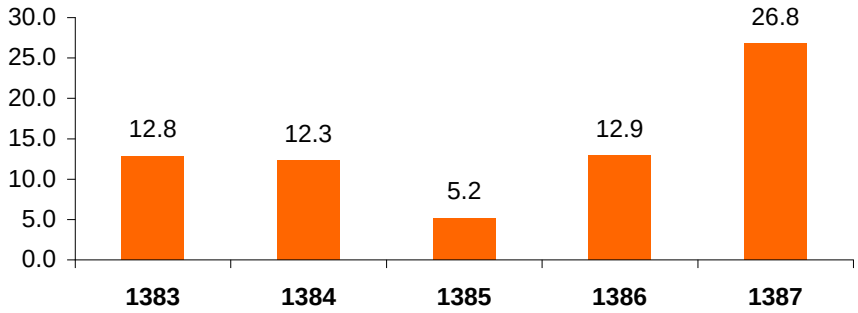
- **The fuel and electricity sub-index accounts for 6.8 percent of the CPI basket,** this sub-index declined slightly to 6.6 percent in 1387 compared to 7.5 percent a year ago.

Figure 3.1: Headline inflation: Kabul CPI



Source: Central Statistics Office and DAB staff calculations.

Table 3.2: Period Average: Kabul Headline CPI



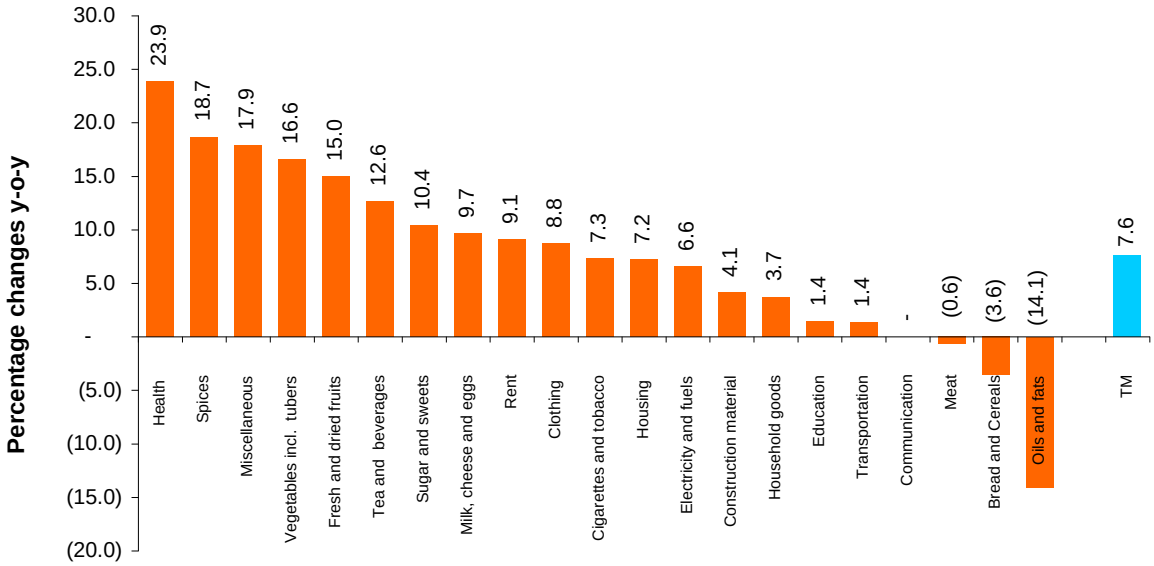
Source: Central Statistics Office and DAB staff calculations.

The volatility in Kabul inflation measured by its standard deviation was 12.7 percent in 1387 up from 5.9 percent in 1386. The high volatility in inflation remains a concern for monetary policy.

The analysis of inflation trend 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 rent may cause a price index to rise. For this reason measure of core inflation which removes from overall CPI inflation the components with high volatility rate from the CPI basket. Core inflation is also often interpreted as measuring the long run or component of the index.

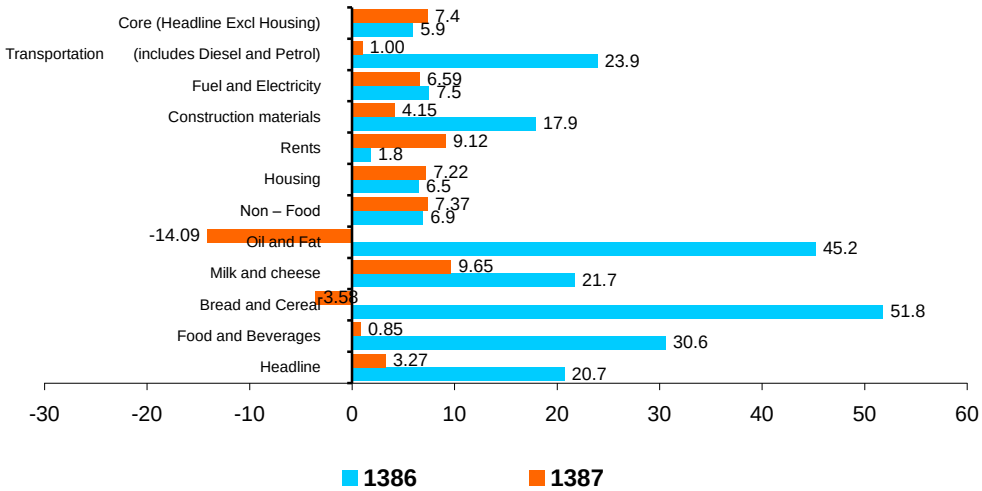
There is no firm theoretical basis, no agreed approach to measure core inflation. One of the common approaches to calculate core inflation is the trimmed mean which removes from the overall CPI inflation all large relative price changes in each month, with the set of excluded components changing from month to month. In particular, the trimmed mean excludes the percent changes in price that rank among the smallest or largest (in numerical terms changes for the month). Considering the total number of components in the CPI basket, 28 percent (6 items) should be trimmed: 3 items from the top and 3 items from the bottom. Trimmed mean CPI inflation increased slightly to 7.6 percent at the end of the year under review from 7.2 percent in the same period a year ago.

Figure 3.3: 28% Trimmed Mean (March 2009)



Source: Central Statistics Office and DAB Staff calculations

Figure 3.4: Contribution to Kabul CPI inflation



Source: Central Statistics Office and DAB Staff calculations

1.2 Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis. The national CPI includes survey of prices in six major provinces representing the regions of Kabul, Herat, Kandahar, Jalalabad, Mazar-e-Sharif and Khost.

Headline inflation as measured by year-on-year percentage changes in national CPI decreased to 4.8 percent in the year under review from 24.3 percent in 1386. The breakdown of national CPI into its respective components is presented in Table 3.2 and illustrated in Figure 3.5.

Table 3.2: Breakdown of national CPI
(Percentage changes y-o-y)
Consumer Price Index
(March 2004=100)

	Weight	1384 (2005 – 06)	1385 (2006 – 07)	1386 (2007 – 08)	1387 (2008 – 09)
Headline	**100**	**9.8**	**3.8**	**24.3**	**4.8**
Food and Beverages	**61.3**	**9.1**	**4.9**	**31.9**	**4.3**
Bread and Cereal	28	10.8	3	50	3.0
Milk and cheese	5.6	9.5	6.6	15.6	8.8
Oil and Fat	5.3	2.4	3.2	52.3	-18.8
Non – Food	**38.7**	**10.9**	**2.2**	**12.2**	**5.9**
Housing	17.2	16.4	-1.5	13.3	3.8
Rents	7.1	14.9	-20	11.7	3.3
Construction materials	3.2	8.2	-4.5	13.4	6.3
Fuel and Electricity	6.8	22.7	25.3	14.8	3.4
Core Inflation (measured by trimmed mean)		**8.2**	**4.5**	**7.2**	**7.6**

Source: Central Statistics Office and DAB Staff calculations

The decline of the national headline CPI to 4.8 percent in 1387 from 24.3 percent in 1386 was mainly attributed to the following factors:

The food sub-index accounts for 61.3 percent of the CPI basket. This price index fell sharply to 4.3 percent at the end of the year under review from 31.9 percent at the end of 1386. The main reasons behind this decrease are thought to be the measures taken by the Afghan government in response to the shortage of

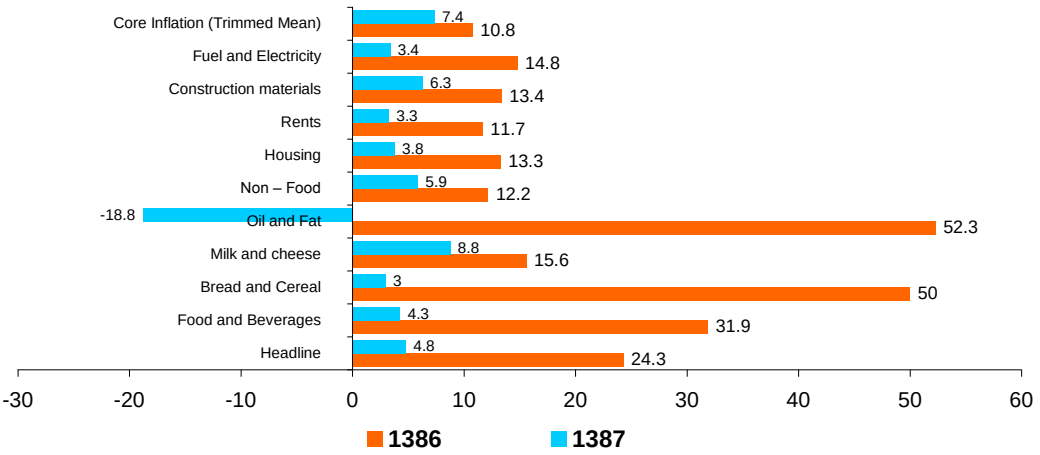
wheat supply; in addition the world economic slowdown and recession led to lower demand for oil in the international markets, the price of food and fuel declined considerably.

The non-food sub-index accounts for 38.7 percent of the CPI basket. This sub-index fell to 5.9 percent at the end of the year under review from 12.2 percent in 1386, as a result of a decrease in oil prices. Non-food inflation could be a more real representation of inflation due to economic activities.

The housing sub-index accounts for 17.2 percent of the CPI basket. This sub-index fell to 3.8 percent at the end of the year 1387 from 13.3 percent at the end of the 1386 as a result of decrease in the rents, construction materials and fuel and electricity sub-indexes.

The rents sub-index accounts for 7.1 percent of the CPI basket. This sub-index fell by 3.3 percent at the end of 1387 down from 11.7 percent at the end of 1386.

Figure 3.5: Contribution to national CPI inflation

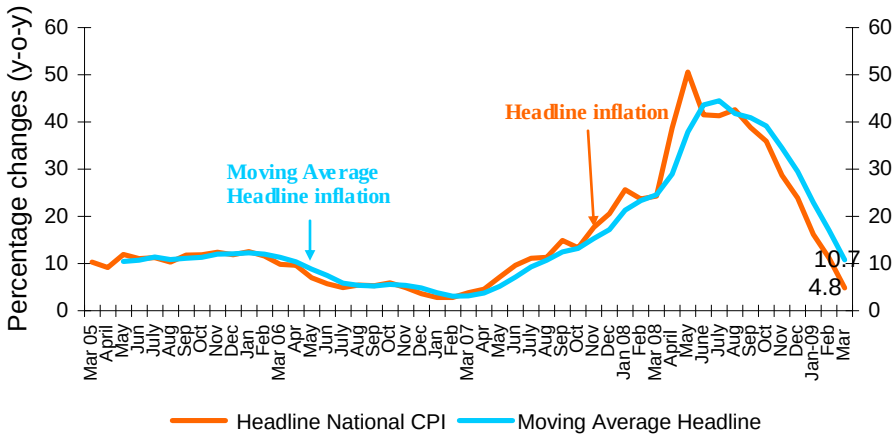


Source: Central Statistics Office and DAB staff calculations.

The volatility of inflation for national CPI measured by its standard deviation in 1387 was 14.2 percent up from 7 percent in 1386.

The high volatility of inflation remains a concern for monetary policy. The inflation trend for both Kabul and national shows a remarkable similarity over the period.

Figure 3.6: Headline inflation: National CPI



Source: Central Statistics Office and DAB Staff calculations

Box 4: Falling inflation is providing relief to Asian economies

Inflationary pressures, which in the middle of 2008 were viewed as the biggest threat to Asia's growth prospects, have eased tremendously across the region. This development though of course not the global economic crisis that has contributed to it is mostly good news. It will lead to a rise in consumers' purchasing power and has allowed central banks to cut interest rates. However, with inflation falling rapidly in so many countries, deflation is emerging as a threat.

According to the Economist Intelligence Unit's latest forecasts, average inflation in Asia and Australasia (excluding Japan) will fall to just 1.6 percent in 2009, compared with 7 percent in 2008 and 4.7 percent in 2007. The decline has been most dramatic in Thailand, where the year-on-year rate of inflation has fallen from 9.2 percent in July 2008 to -0.4 percent in January 2009. Other countries have also experienced big drops in inflation. In China, inflation fell to just 1 percent last month, down from nearly 9 percent in February 2008. In Vietnam, inflation eased to 17.5 percent in January, down from over 28 percent in the middle of last year. In Japan, which is now heading back towards deflation, inflation was just 0.4 percent in December, the lowest rate in 13 months.

The main cause of the fall in inflation has been the collapse in food and fuel prices since mid 2008. Food and fuel prices account for a relatively large share of the consumer price basket in most Asian countries, and so the overall rate of inflation across Asia is especially sensitive to changes in these prices.

Given that price pressures are falling rapidly in many countries, deflation is now a bigger risk than inflation. Of the 17 Asian and Australasian economies covered by our Country Forecast reports, we expect six (China, Japan, Malaysia, South Korea, Taiwan and Thailand) to experience negative average annual inflation in 2009, while Singapore will have full-year inflation of just 0.4 percent.

Falling inflation is providing a welcome boost to Asia's badly faltering economies. Most importantly, it has given the region's central banks room to cut interest rates, which should boost growth prospects. A number of central banks raised interest rates in the first half of 2008 to combat rising inflation. This tightening of monetary policy

crimped domestic consumption and investment at a time when exports were just starting to suffer. Interest rates have now been slashed across the region. Although the credit crunch has reduced the effectiveness of interest-rate cuts as banks have become reluctant to lend, falling interest rates will still help to support demand. In addition, reduced food and oil prices have boosted consumers' real disposable income. This should mitigate the many negative factors, from rising fears of unemployment to plunging GDP, that are discouraging consumer spending in many countries, although it will not offset their impact.

At the moment there seems to be little danger that Asia, with the exception of Japan, will fall into a sustained deflationary spiral of falling production and prices. We forecast an increase in global oil and food prices in 2010, so the falling prices that many economies will experience this year should be temporary. However, this forecast is based on the assumption that central banks will continue to make bold cuts in interest rates in 2009 and that global GDP growth will resume in 2010 (which would put upward pressure on commodity prices).

Entrenched deflation across Asia would seriously aggravate the economic crisis. If consumers became used to the idea of falling prices, they might delay major purchases in the expectation that prices would fall further. This would further depress consumer demand at exactly the time when many governments need consumers to start spending more. Deflation would also make it impossible for central banks to set negative real interest rates, which are sometimes desirable for boosting economic growth when the outlook is very bleak.

In addition, deflation increases the real value of debt. Government debt as a share of GDP is low in most Asian countries (Japan, India, the Philippines and Sri Lanka are the main exceptions). However, the situation could deteriorate sharply in the next couple of years if governments continue to run budget deficits and if growth prospects do not improve. If deflation became entrenched, a dangerous debt-deflationary spiral of the kind suffered by Japan from the early 1990s where government debt as a share of GDP almost tripled in less than 20 years could ensue.

Source: Economist Intelligence Unit ViewsWire

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 fourth quarter of 1387 fell to -11.7 percent from -4.3 percent in the third quarter. The decrease in quarter-on-quarter inflation can be attributed to the following major categories:

- **Food and beverages:** This price index fell to -16 percent in fourth quarter of 1387 from -6.6 percent in the third quarter with a contribution of -27.1 percent by bread and cereals, -1 percent by meat, -3.6 percent by oil and fats and -4.9 percent by vegetables sub-indexes respectively.
- **Non-food:** This price index fell by -3.2 percent at the end of the fourth quarter of 1387 form 0.5 percent at the end of third quarter with a contribution of -5 percent by housing sub-index, -9.3 percent by fuel and electricity sub-index and -12.8 percent by transportation sub-index respectively.

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

	Weight	1385				1386				1387			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	**100**	**-0.7**	**2.2**	**1.6**	**1.7**	**2.4**	**6.0**	**5.9**	**5.0**	**13.1**	**8.0**	**-4.3**	**-11.7**
Food and Beverages	**61.3**	**-0.4**	**1.6**	**0.8**	**4.2**	**4.7**	**5.3**	**9.4**	**8.3**	**19.1**	**8.1**	**-6.6**	**-16.2**
Bread and Cereal	28	-3.1	0.7	-0.3	6.5	5.7	8.2	17.0	13.4	33.3	8.6	-8.6	-27.1
Meat	6	0.5	2.6	-0.3	1.5	-2.6	-4.6	5.1	6.6	-1.0	0.0	1.4	-1.0
Oil and Fat	5.3	0.7	3.5	3.9	8.2	23.0	-1.1	8.3	10.2	1.8	4.5	-16.2	-3.6
Vegetables	4.9	10.1	2.4	4.3	3.2	-5.7	11.5	0.2	0.6	13.5	12.2	-3.7	-4.9
Tea and beverages	2	2.3	2.2	0.5	-0.7	1.4	2.3	-1.5	1.7	10.6	4.5	-0.3	-2.2
Non – Food	**38.7**	**-1.2**	**3.0**	**2.5**	**-1.7**	**-0.7**	**7.1**	**0.8**	**-0.3**	**2.5**	**7.7**	**0.5**	**-3.2**
Housing	17.2	-5.1	2.8	5.1	-3.3	-2.9	11.5	0.6	-2.3	0.6	11.1	1.0	-5.0
Construction materials	3.2	-2.7	-2.9	-6.3	0.1	3.9	11.5	0.9	0.9	1.8	13.2	-4.3	-5.5
Fuel and Electricity	6.8	-4.8	12.3	47.2	-3.7	-4.0	16.4	1.7	-5.4	-0.1	13.9	3.3	-9.3
Transportation	2.3	18.0	19.8	-4.2	-3.1	4.3	12.0	1.3	4.3	18.8	0.3	-2.4	-12.8
Health	2	2.8	0.8	0.5	3.0	0.1	0.7	0.0	2.5	4.5	11.4	1.8	4.7

Source: Central Statistics Offices and DAB staff calculations

1.4. Quarterly changes in national headline CPI

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

The downward trend in national headline CPI continued in the fourth quarter of 1387 falling to -11.6 percent compared to -4.6 percent in the third quarter. The decrease in quarter-on-quarter inflation can be attributed to the following major categories:

- **Food and Beverages:** This price index continued its negative trend in the fourth quarter of 1387 and decreased to -15.8 percent compared to -7 percent in the third quarter. Bread and cereals sub-index decreased to -24.5 percent, milk and cheese sub-index decreased to 0.2 percent and oil and fats decreased to -12 percent respectively. The reason behind this decrease is thought to be the ease in the total demand for fuel in the international markets, measures taken by the Afghan government in response to the shortage in the wheat supply and finally low demand for meat which had increased during the third quarter due to Eid ul Adha.
- **Non Food:** This price index fell to 1.5 percent with the contribution of housing sub-index decreasing to -1 percent, rents -1 percent and fuel and electricity 1 percent respectively.

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

Table 3.4: Quarter on Quarter Changes in national headline CPI

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

	Weight	1385				1386				1387			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	100	**-1.7**	**2.2**	**1.9**	**1.3**	**3.8**	**7.2**	**7.0**	**4.4**	**18.2**	**5.2**	**-4.6**	**-11.6**
Food and Beverages	61.3	**-1.8**	**2.3**	**1.1**	**3.3**	**5.8**	**5.8**	**10.0**	**7.2**	**26.7**	**5.0**	**-7**	**-15.8**
Bread and Cereal	28	-4.0	2.9	-0.7	4.9	8.3	6.9	16.7	11.0	44.7	5.3	-10.4	-24.5
Milk and cheese	5.6	-0.2	1.6	4.0	1.1	3.9	5.4	3.6	1.9	3.1	4.4	0.8	0.2
Oil and fat	5.3	-4.6	-0.5	7.1	1.5	15.2	12.0	8.5	8.7	6.4	1.5	-14.6	-12
Non – Food	**38.7**	**-1.5**	**2.2**	**3.1**	**-1.5**	**0.6**	**9.5**	**2.3**	**-0.4**	**2.8**	**5.6**	**4.9**	**1.5**
Housing	17.2	-4.9	1.8	5.1	-3.3	0.2	13.0	2.5	-2.3	0.7	8.5	1.3	-1
Rents	7.1	-6.3	-1.6	-7.4	-6.3	2.1	8.7	0.6	0.0	-0.3	3.2	-2.6	-1.5
Fuel and Electricity	6.8	-5.5	8.5	24.2	-1.6	-3.1	18.6	5.0	-4.8	0.2	14.2	1.2	1
Transportation	2.3	14.5	12.1	-1.3	-4.4	5.6	11.5	7.0	1.5	12.6	4.6	0	0

Source: Central Statistics Office and DAB staff calculations.

2. GDP PRICE DEFLATOR

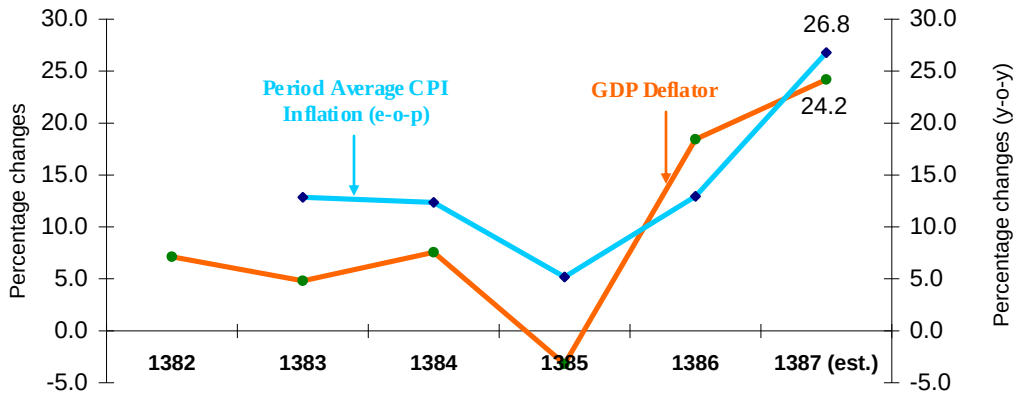
The GDP deflator (implicit price deflator for GDP) is a measure of the level of prices of all new, domestically produced, final goods and services in an economy. GDP deflator is an economic metric that accounts for inflation by covering output measured at current prices into constant GDP. It shows how much a change in the base year's GDP relies upon changes in the price level. Because it is not based on a fixed basket of goods and services, the GDP deflator has an advantage over the consumer price index (CPI). Changes in consumption patterns or the introduction of new goods and services are automatically reflected in the deflator. The GDP deflator has been calculated for the past six years and has been shown in Table 3.5.

Table 3.5: Percentage changes in price levels: GDP deflator/CPI

Years	NGDP (million AF)	RGDP (million AF)	GDP Deflator	GDP Deflator Percentage changes	CPI Period Average changes
1381	181,016	108,116	100.0		
1382	239,961	224,053	107.1	7.1	
1383	261,249	232,780	112.2	4.8	12.8
1384	321,409	266,310	120.7	7.5	12.3
1385	346,156	296,366	116.8	-3.2	5.2
1386	460,102	332,684	138.3	18.4	12.9
1387 (est.)	614,236	357,635	171.7	24.2	26.8

Source: Central Statistics Office and DAB staff calculations

Figure 3.7: Period Average Inflation and GDP Deflator



Source: Central Statistics Office and DAB staff calculations

Box 5: Deflation in the world

Deflation in the World is a common phenomenon in recent times. As a common economic occurrence, deflation in the world was missing for more than half a century, after which it has re-appeared and begun knocking at the doors of the central banks and the finance ministries in the contemporary industrial world.

Deflationary trends were noticed recently, towards the end of 2002, when the possibilities of long-term development of worldwide capitalist economy became complicated. It was at this time that deflation started affecting the 3 main determinants of global economy, namely the United States of America, Japan and the European Union.

Deflation in United States of America

With respect to deflation in United States, its expenditures are already 5 percent more than its income. This difference gets revealed in the American balance of payment deficit. Currently, this deficit needs a cash inflow worth USD 1.4 billion to USD 2 billion on a regular basis, in the form of foreign finances, if such situation persists. Since the global economy is dependent on the economic performance of America, the U.S. Federal Reserve had decreased the rate of interest in November, by 0.5 percentage points more; in order to assure that any slackening down will not amount to loss in the consumer demand or investor's faith. However, if payment deficit persists in United States at the current rate of 5 percent of the gross domestic product (GDP), the current net American liabilities which is more than 20 percent of the GDP is expected to rise up to 50 percent within the coming 5 years.

Deflationary trends in Japan

Deflationary trends in Japan are in its full and disastrous form, reaching a stage where the Japanese economy is virtually on the verge of collapse. Looking at the present condition of Japan's economy, it seems like deflation is more or less a permanent phenomenon here and there is very little scope for improvement. All types of wholesale and consumer prices, starting from 3-piece suits to compact discs, are

going down tremendously for the past two years, indicating no signs of halting. In fact, it is quite difficult for the nation to evade from the deflationary trend which is on constant rise.

In fact, deflation in Japan had originated from the stock market, to exert the greatest impact on the national economy. Several other factors have also contributed towards the development of deflation in Japan. The situation has made the Japanese consumers apprehensive, and they have become reluctant to make purchases. Moreover, the overbuilt Japanese industries are making the prices of their products dynamic, and cheap Chinese and Asian imports are flooding the Japanese market. The outcome is that the progress of the commercial activities of different Japanese sectors like building and housing, food, consumer electronics and apparels are being severely hampered. However, according to the common view regarding global economy, Japan is expected to increase its economic growth by a small 2 percent in times to come.

Deflation and the European Union

The European Union countries are also equally affected by deflation. Owing to the existing deflationary tends in the European Union economy, its effect are evident in the commercial activities of the EU. Riksbank of Sweden had decreased its interest rates from 2 percent to 5 percent recently, confirming the fast decline of the economic condition of EU. Deflation in European Union is characterized by lowering of the investor's confidence and consumer expenditure levels, followed by high unemployment rates and organizational restiveness. Similar conditions also are prevalent in other European nations like France, Italy and Germany, taking the continent to the pinnacles of severe deflation.

Source: www.economuwatch.com

3. THE DYNAMICS OF INFLATION

This section takes a closer look at trends in inflation by relaxing the assumption of fixed weights in the CPI basket. To understand better the dynamics of CPI it is useful to look beyond nominal Laspyere-based fixed weighting in which food has an overall weight in the index of about 61 percent, non-food 39 percent and analyze trends in the effective weights. These are based on the relative share of point's contribution of each sub-index to the total Kabul index.

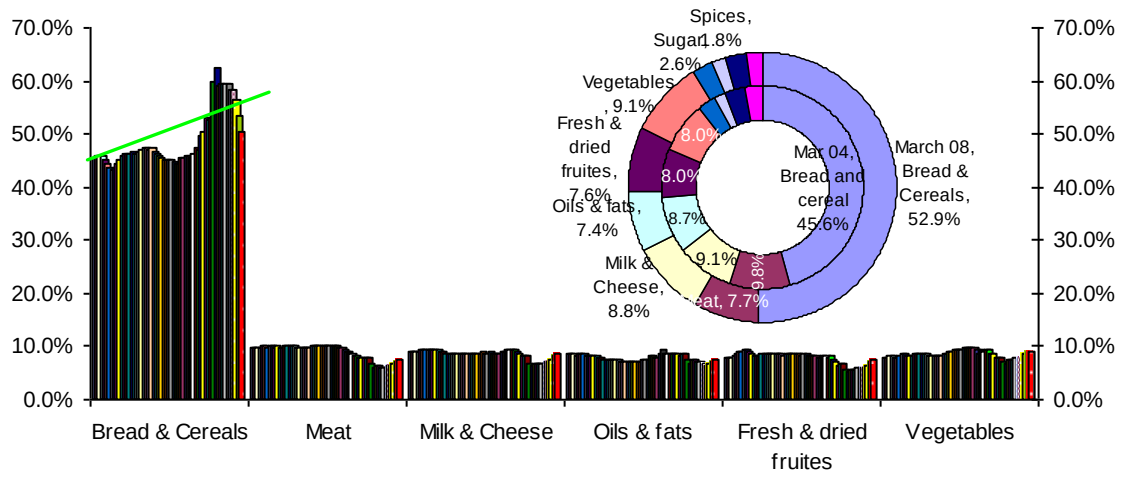
Effective weights are calculated as the proportion of point's contribution to the all groups index. If prices are changing more significantly within one sub-index than in the other, then the effective weights will shift over time. In simple terms, stronger price movements in a sub-item will exert more influence on the overall index than what its basic weighting would suggest. This is important because prices react to shifts in demand and supply in the market and it gives an early indication of a move away from the basic Laspyere-based fixed weight regimen that underlies the CPI index.

An analysis of the effective weight shows that following a decrease occurred in effective weight of food between March 2004 and October 07; the effective weight began to increase again from Nov 07, and reached at its highest of 69.2 percent in May 08, when the headline inflation recorded its highest of 43.2 due to food and oil price shocks in the international markets. An increase/decrease in the effective weight can either be affected by upwards or downwards movements in prices, the key is that it shows us the strength of the price movement.

It is clear that non-food items and their price movements are responsible for pushing back the relative weighting of food items. The share of sub-indexes of food is shown in Figure 3.8.

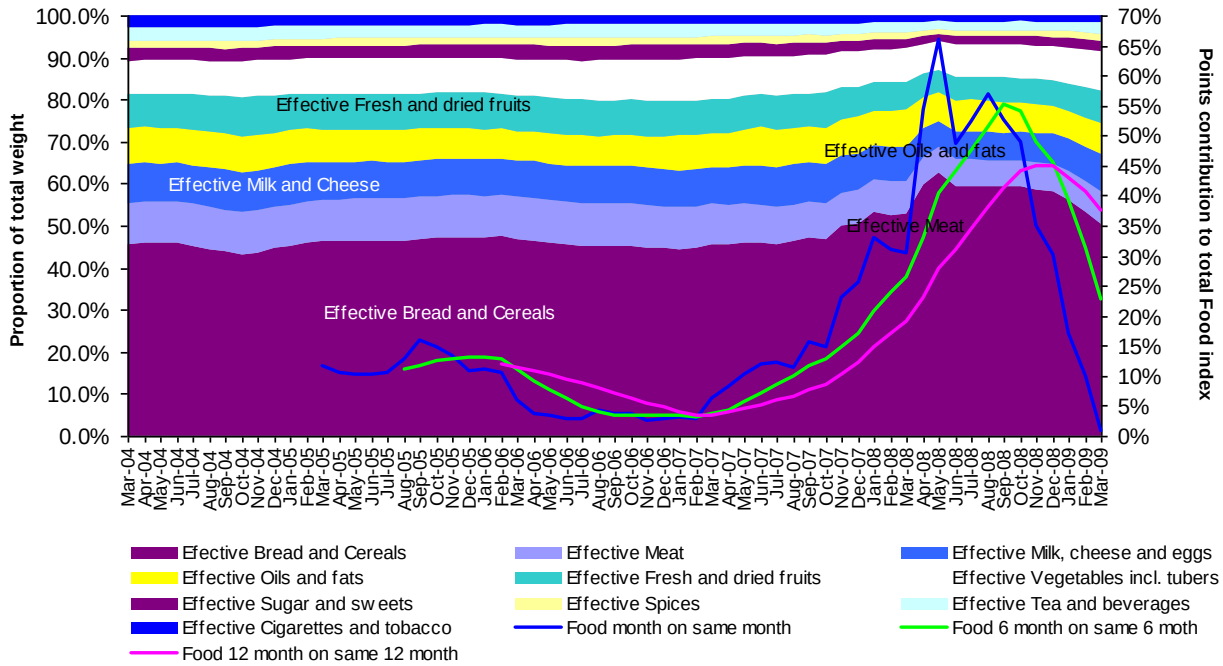
The relative effective weight for food sub-items is shown in Figure 3.9. As can be seen from the figure, the effective weight for bread and cereals increased to 62.6 percent in May 08 and decreased to 50.6 percent in March 09, shown by the increased area shaded purple in Figure 3.9.

Figure 3.8: Effective weighting within the Kabul Food Price Index
(Mar-04 to March - 09)



Source: Central Statics Office and DAB staff calculations

Figure 3.9 : Analysis of change - Food index by sub-items



Source: Central Statistics Office and DAB staff calculations.

4. INFLATIONARY OUTLOOK

Headline inflation hit its highest level at the beginning of 1387 and eased to its lowest level at the end of the year in recent history. Based on the dramatically declining trend of headline inflation in the past two-three months, it is expected that headline inflation will continue its downward trend in the first months of 1388. There is concern that year-on-year headline inflation may turn negative in the first month of 1388 due to falling food and oil prices. Easing supply side pressures, measures taken by the Afghan government and moderate demand lend further support to the benign inflation outlook.

4.1 Demand conditions are subdued

Demand side pressures remain subdued as various economic indicators exhibited mixed trends. On the one hand, recent data indicate improvements in demand conditions such as increases in housing and rental prices and tightness in demand for skilled employment.

4.2 Supply conditions eased

Supply side conditions remained mixed with positive developments on the supply side expected to help prices pressures keep low. This includes the fact that food prices are expected to continue downward trend due to favorable winter rains as well as recent rainfalls at the end of the year, which will affect positively wheat production in the rain-fed areas. In addition, international oil prices eased in the fourth quarter of 1387 to compare with that in the previous quarter. The recent measures taken by the Afghan government to facilitate trade at border points will also support supply side in the country. Nonetheless the general strength of the afghani currency may help keep the domestic prices of imported commodities steady.

However, a key source of possible negative developments on the supply side is the disruption in import of staples (wheat and rice) from Central Asian and other trading partners. Any interruption in supply is likely to be passed through to higher prices.

Fiscal Developments

4

4

FISCAL DEVELOPMETNS

SUMMARY

The overall fiscal development in the FY1387 showed a mixed trend with some of the fiscal indicators showing good performance while the others did not

On the positive side the income taxes increased to AF 4,517 million in the year under review compared to AF 2,433 million in the previous year. This represents 86 percent increment. Excise taxes increased to AF 243 million in the year under review from AF 67 million in 1386. This reveals 264 percent increase. Income from capital property increased to AF 4,406 million in the year under review from AF 435 million in the previous year. This shows 912 percent increase.

On the negative side the budget deficit in the year 1387 stood at AF 66,872 million compared to the budget deficit of AF 62,197 million in the previous year. The reason behind this increase is thought to be the inclusion of ongoing projects of 1386 and inclusion of new development projects.

Total domestic revenues increased to AF 45,510 million in the year under review from AF 33,513 million in the previous year, this represents a 36 percent increment and is a good sign of the fiscal performance of the government. Total domestic revenues accounted for 7 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 28,777 million in the year under review from AF 24,994 million in 1386. This represents 15 percent increment.

On the other hand non-tax revenue increased to AF 16,733 million in the year under review from AF 8,519 million in

1386. This represents an increase of 96 percent.

On the spending side total expenditures increased to AF 112,382 million in the year under review from AF 95,710 million in 1386, this represents 17 percent increment. Total expenditures accounted for 18 percent of GDP.

Total expenditures are composed of development and operating expenditures.

Development expenditures declined to AF 42,743 million in the year under review from AF 45,043 million in 1386, this represents a 5 percent decline.

On the other hand operating expenditures increased to AF 69,639 million in the year under review from AF 50,667 million in the previous year. This reveals a 37 percent increase.

The total donor contribution allotted to the operating expenditures increased to AF 30,428 million in the year under review from AF 25,865 million in 1386. This represents 18 percent increase.

On the other hand total donor contribution allotted to the development expenditures declined to AF 26,457 million in the year under review from AF 36,174 million in 1386. This represents 27 percent decline.

ARTF, LOTFA, ADB, EC, World Bank, CNTF and others remained the main contributes to all these expenditures.

1. REVENUES

There are some common features associated with a low tax base in Afghanistan economy such as: (i) extremely low level of development; (ii) a large informal sector implying a narrow tax base; (iii) the dominance of agriculture which is hard to tax; and (iv) capacity constraints hindering the ability of the Government to collect taxes and of taxpayers to comply with tax regulations.

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 properties, sale of goods and services, royalties, non tax fines and penalties, sale of land and buildings) and donors' contributions (see Table 4.3).

Total domestic revenues increased to AF 45,510 million in the year under review from AF 33,513 million in 1386. This represents a 36 percent increase, which is a sign of improvement in the economic performances.

Total domestic revenues accounted for 7 percent of GDP which is well below the regional average. Thus sustained rapid growth of revenue and a rising revenue-to-GDP ratio are imperative, While in industrialized countries the revenue to GDP ratio is typically around 45-55 percent, for the least developed countries it is closer to 20 percent, Afghanistan is an outlier in this group.

Total domestic revenues are composed of tax and non-tax revenues. Tax revenues increased to AF 28,777 million in the year under review from AF 24,994 million in 1386, this represents 15 percent increment (see Table 4.1).

On the other hand non-tax revenue increased from AF 8,519 million in 1386 to AF 16,733 million in the year under review. This represents an increase of 96 percent.

The total donor contribution allotted to the operating expenditures increased to AF 30,428 million in the year under review from AF 25,865 million in 1386. This represents 18 percent increase.

On the other hand total donor contribution allotted to the development expenditures declined to AF 26,457 million in the year under review from AF 36,174 million in the previous year, this represents a 27 percent decline.

Domestic taxes have been increasing steadily form 1382 to 1387 as a result of improvements in the tax collection efforts as well as expansion in the overall economy. Key contributors to the tax revenues in the year under review were the Large Taxpayer Office (LTO) and Medium Tax Payer Offices (MTO) located in Kabul.

More than 50 percent of the tax revenues came only from Kabul city, which is due to the fact that a large number of population live in Kabul, existence of industries, companies, large businesses and financial institutions are situated in Kabul besides the relatively strong central government. In terms of geographical distribution of customs revenues, Nangarhar, Balkh, Herat and others remained the major contributors to the total customs revenues in the year under review.

Revenues from customs duties declined slightly by 1 percent from AF 12,947 million in 1386 to AF 12,819 million in the year under review. Customs revenues are the key contributors to the total domestic revenues in Afghanistan having a 50 percent share in total revenues. Sales

tax revenues declined by 2 percent from AF 6,409 million in 1386 to AF 6,253 million in the year under review. Excise taxes increased by 264 percent from AF 67 millions in 1386 to AF 243 million in the year under review. Income taxes increased by 86 percent from almost AF 2,433 million in 1386 to AF 4,516 million in the year under review. Fixed taxes increased by 63 percent from almost AF 2,242 million in 1386 to AF 3,649 million in the FY1387.

Total social contribution increased by 54 percent from AF 436 million in 1386 to AF 670 millions in the year under review (see Table 4.3).

Sales of land and buildings declined by 39 percent from AF 74 million in 1386 to AF 45 million in the year under review. Royalties increased by 67 percent from AF 37 million in 1386 to AF 61 million in the year under review. Income from capital property increased by 912 percent from AF 435 million in 1386 to AF 4,406 million in the year under review (See Table 4.3)

Table 4.1: Revenue Collection: 1387 (in million AF)

	1386 Revenue Actual	1387 Revenue Actual	% Δ from 1386 to 1387
Total Domestic Revenues (Tax and Non Tax)	33,513	45,510	36%
Tax Revenues	24,994	28,777	15%
Non Tax Revenues	8,519	16,733	96%

Source: MoF website and DAB staff estimation

Table 4.2: Total Revenue in million USD

	1386	1387
Total Revenue (Tax & non- Tax revenue)	644.5	910.2
Tax Revenue	480.7	575.5
Non Tax Rev	163.8	334.7

Figure 4.1: Total Revenues (in million USD)

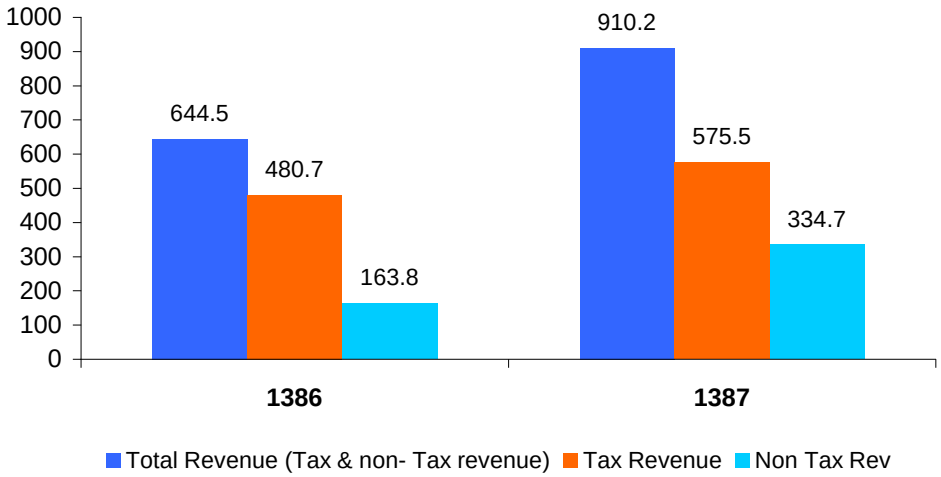


Table 4.3: Breakdown of total domestic tax and non-tax revenues (in million AF)

Tax and non-Tax Revenues	1387	1386	% Δ 1386 to 1387
Taxation & Customs Revenues			
Fixed Taxes	3,649	2,242	63%
Income Taxes	4,517	2,433	86%
Property Taxes	111	106	5%
Sales Taxes	6,253	6,409	-2%
Excise Taxes	243	67	263%
Other Taxes	1,062	564	88%
Tax Penalties and Fines	366	292	25%
Customs duties	12,819	12,948	-1%
Total taxation revenues	**28,777**	**24,998**	**15%**
Social contributions			
Retirement contributions	670	436	54%
Total social contributions	**670**	**436**	**54%**
Other revenue			
Income from Capital Property	4,406	435	913%
Sales of Goods and Services	2,123	1,896	12%
Administrative Fees	5,942	4,599	29%
Royalties	61	37	65%
Non Tax Fines and Penalties	157	159	-1%
Miscellaneous Revenue	3,328	883	277%
Sale of Land and Buildings	45	74	-39%
Total other revenue	**16,062**	**8,083**	**99%**

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). ANDS is a documented five years plan and all the expenditures will be channeled to the line ministries and other institutions through this plan in the coming five years.

Total expenditures increased to AF 112,382 million in the year under review from AF 95,710 million in the previous year, this reveals 17 percent increment. Total expenditures accounted for 18 percent of GDP.

Total expenditures are composed of development and operating expenditures.

Development expenditures declined to AF 42,743 million in the year under review from AF 45,043 million in 1386. This represents a 5 percent decline.

On the other hand operating expenditures increased to AF 69,639 million in the year under review from AF 50,667 million in 1386, this reveals a 37 percent increase. Increase in the operating expenditures reflects the growing need for core sectors such as security and education (see table 4.4).

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,

The total employee's expenditures increased by 41 percent from AF 33,607 million in 1386 to AF 47,429 million in the year under review.

Total supplier expenses increased by 25 percent from AF 25,554 million in 1386 to AF 32,049 million in the year under review. Total subsidies, grants, contribution and pension expenses increased by 40 percent from AF 2,882 million in the previous year to AF 4,048 million in the year under review.

Total capital expenditures declined by 14 percent from AF 33,559 million in 1386 to AF 28,758 million in the year under review..

Expenditures on interest payments declined by 3 percent from AF 107 million in the previous year to AF 103 million in the year under review (see table: 3.3).

Overall development expenditures increased significantly all over the country in the year under review to compare with that in the previous year. Development expenditures of some provinces are as follow: Kabul increased by 38 percent from AF 10,267 million in 1386 to AF 16,498 million in the year under review. Bamyan, increased significantly by 1174 percent from AF 103 million in 1386 to AF 1,307 million in the year under review. Kunduz increased sharply by 1533 percent from AF 47 million in the previous year to AF 765 million in the year under review. In Paktika province development expenditures stood at AF 214 million in the year under review compared to AF 43 million in the previous year, this represents 394 percent increase. Samangan, increased significantly by 1159 percent from AF 62 million in the previous year to AF 777 million in the year under review. In Balkh province the development expenditures stood at AF 1,706 million in the year under review compared to AF 230 million in the previous year, this shows 641 percent increase. Nangarhar, increased by 173 percent from AF 299 million in 1386 to AF 816 million in the year under review. In the Helmand province, the development expenditures stood at AF 482 million compared to AF 65 million in the previous year, this represents 639 percent increase. In Heart, the development expenditures increased sharply by 2279 percent from AF 79 million in the previous year to AF 1,879 million in the year under review.

Central ministries development expenditures stood at AF 15,345 million in the year under review compared to AF 17,705 million in 1386, this represents 13 percent decline (see Table 4.4).

Table 4.4: Core Expenditures 1387 (in million AF)

Particulars	1386 Expenditure Actual	1387 Expenditure Actual	% Δ from 1386 to 1387
Total Expenditures(Development and Operating)	95,710	112,382	17%
Development Expenditures	45,043	42,743	-5%
Operating Expenditures	50,667	69,639	37%

Source: Ministry of Finance website and DAB staff estimation

Table 4.5: Core Expenditures (in million USD)

	1386	1387
Total Expenditures	1,841	2,248
Development Expenditures	866	855
Operating Expenditures	974	1393

Figure 4.2: Core Expenditures (in million USD)

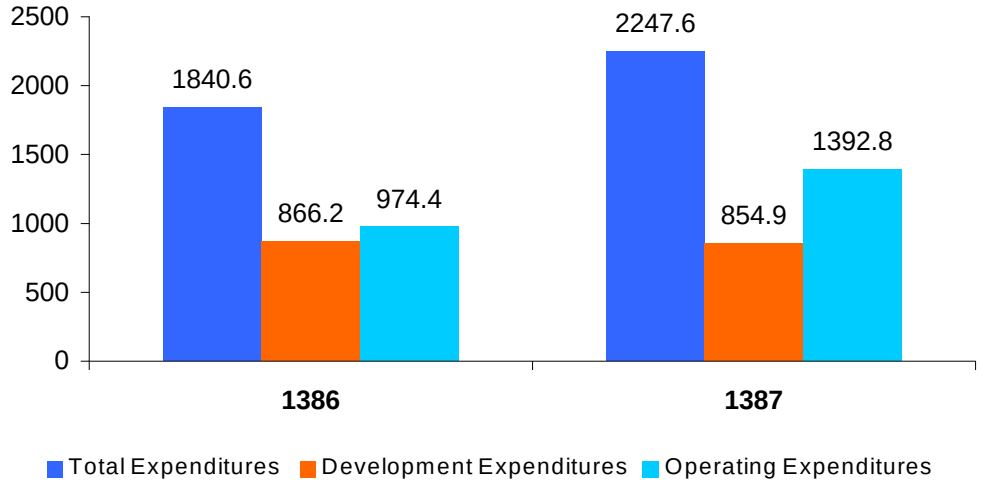


Table 4.6: Total Core Expenditures (Development & Operating) (in million AF)

Expenditure Splits	1387	1386	%Δ 1386 to 1387
Employees			
Salaries in cash	38,374,280	27,855,213	38%
Salaries in kind	8,527,030	5,235,401	63%
Salaries and wages advance	94,551	129,816	-27%
Social benefits in cash	433,279	387,226	12%
Social benefits - in kind	41	22	91%
Total employee expenditure	**47,429,181**	**33,607,677**	**41%**
Supplier Expenditure	**-**	**-**	
Travel	1,296,372	1,056,307	23%
Communications	528,548	433,633	22%
Contracted services	12,720,598	9,384,761	36%
Repairs and maintenance	2,987,820	2,846,134	5%
Utilities	791,487	746,292	6%
Fuel	2,966,972	3,087,224	-4%
Tools and materials	4,868,782	4,253,319	14%
Other	1,788,171	2,368,902	-25%
Advances and return of expenditure	4,100,221	1,377,801	198%
Total supplier expenses	**32,048,970**	**25,554,372**	**25%**
Subsidies, grants, contributions and pensions	**-**	**-**	
Grants	19,088	19,620	-3%
Grants to foreign government a	218,245	-	
Social security benefits cash	2,964,247	2,420,642	22%
Social assist benefit in cash	352,047	408,447	-14%
Advance Subsides Grants	494,608	33,039	1397%
Total subsidies, grants, contributions and pensions expenditure	**4,048,235**	**2,881,748**	**40%**
Capital expenditure	**-**	**-**	
Buildings and structures	17,786,751	20,927,770	-15%
Machinery and equip (>50,000)	8,479,921	12,349,753	-31%
Valuables	10,480	1,632	542%
Land	400,669	57,236	600%
Capital advance payments	2,074,364	223,231	829%
Total capital expenditure	**28,752,184**	**33,559,622**	**-14%**
Interest	**-**	**-**	
Interest	103,089	106,723	-3%
Total interest expenditure	**103,089**	**106,723**	**-3%**

Source: Ministry of Finance website and DAB staff estimation

Table 4.7: Total Operating & Development Budget to Provinces (in million AF)

Provinces	1387		1386		%Δ 1386 - 1387 Op. Exp	%Δ 1386 - 1397 Dev. Exp
	Operating Budget	Develop. Budget	Operating Budget	Development Budget		
Kabul	1,161,091	10,267,517	889,047	16,498,048	31%	-38%
Parwan	965,087	367,378	457,820	70,800	111%	419%
Wardak	526,946	591,594	726,625	135,699	-27%	336%
Logar	474,055	199,301	383,008	192,006	24%	4%
Ghazni	697,379	264,133	332,257	52,079	110%	407%
Paktiya	2,253,931	325,146	602,218	84,772	274%	284%
Paktika	559,057	213,797	1,289,008	43,277	-57%	394%
Khost	722,940	355,188	1,377,984	2,321,271	-48%	-85%
Pangsher	298,836	143,020	385,650	128,659	-23%	11%
Samangan	397,530	777,057	457,788	61,711	-13%	1159%
Balkh	2,915,331	1,706,334	1,058,270	230,176	175%	641%
Jawzjan	780,136	467,252	790,384	515,305	-1%	-9%
Faryab	859,406	2,049,374	809,045	218,046	6%	840%
Bamyan	339,308	1,307,843	638,723	102,696	-47%	1174%
Saripul	467,989	554,825	296,747	1,824,786	58%	-70%
Kapisa	621,469	450,001	1,974,995	552,271	-69%	-19%
Nangarhar	2,028,321	816,090	603,329	299,397	236%	173%
Laghman	535,376	313,533	603,355	161,023	-11%	95%
Kunar	629,641	361,975	317,638	213,426	98%	70%
Nuristan	381,657	113,425	1,880,577	826,858	-80%	-86%
Nimroz	381,293	121,679	436,135	138,504	-13%	-12%
Helmand	572,533	482,336	325,630	65,268	76%	639%
Kandahar	3,730,255	619,090	559,522	469,312	567%	32%
Zabul	305,619	106,071	2,437,923	274,774	-87%	-61%
Uruzgan	310,155	174,111	307,489	66,688	1%	161%
Dikondy	346,421	215,217	275,925	99,265	26%	117%
Badakhshan	1,316,964	775,430	387,584	82,851	240%	836%
Takhar	953,858	1,134,054	325,988	464,788	193%	144%
Baghlan	1,140,834	737,716	412,580	106,864	177%	590%
Kunduz	882,440	765,577	245,027	46,895	260%	1533%
Badghis	452,885	340,452	346,667	839,941	31%	-59%
Herat	2,954,692	1,879,929	569,254	79,032	419%	2279%
Farah	613,757	357,703	225,004	39,381	173%	808%
Ghor	561,676	530,539	246,414	31,440	128%	1587%
Central Ministries	37,499,949	15,344,627	27,691,616	17,705,607	35%	-13%
Total	**69,638,817**	**45,229,312**	**50,667,226**	**45,042,916**	**37%**	**0.4%**

Source: Ministry of Finance website & DAB staff estimation

Table: 4.8: Donor Contribution, Grants and Loans 1387

Donor contributions	Operating	Development	Total Grants
Afghanistan reconstruction trust fund	15,903,295	12,392,575	28,295,870
Law and order trust fund - Afghanistan	9,895,443		9,895,443
CSTC - MoD	2,834,601		2,834,601
Foreign loans			-
World Bank		845,997	845,997
Asian Development Bank		2,863,699	2,863,699
Other		13,962	13,962
Donor revenue			-
World Bank		5,082,307	5,082,307
European Commission		26,833	26,833
ADB		1,020,236	1,020,236
CNTF		546,602	546,602
Others	873,406	3,664,664	4,538,070
Total donor contributions	**29,506,745**	**26,456,876**	**55,963,620**
Loan from IMF	**921,420**		**921,420**

Source: Ministry of Finance website and DAB staff estimation

Table: 4.9: Donor Contribution, Grants and Loans 1386

Donor contributions	Operating	Development	Total Grants
Afghanistan reconstruction trust fund	14,461,489	9,935,388	24,396,878
Law and order trust fund - Afghanistan	7,146,435		7,146,435
CSTC - MoD	1,601,537		1,601,537
Foreign loans			-
World Bank		1,574,956	1,574,956
Asian Development Bank		4,446,550	4,446,550
Other		20,528	20,528
Donor revenue			-
World Bank		13,966,916	13,966,916
European Commission		236,660	236,660
ADB		1,697,744	1,697,744
CNTF		258,415	258,415
Others	119,382	4,036,369	4,155,751
Total donor contributions	**23,328,844**	**36,173,526**	**59,502,371**
Loan from IMF	**2,535,939**		**2,535,939**

Source: Ministry of Finance website and DAB staff estimation

Banking System Performance

5

5

BANKING SYSTEM PERFORMANCE

SUMMARY

Total assets of the banking system increased to AF 145 billion (USD 2.28 billion) at the end of year 1387 (March 2009), up by 73.37 percent or AF 61 billion since March 2008. Loans amounted to AF 50 billion (USD 981 million) representing an increase of AF 10 billion (USD 200 million) or 26 percent since March 2008. Deposits stood at AF 118 billion (USD 2.28 billion) over the period under review - an 84 percent increase since March 2008. Deposits were largely denominated in USD (55 percent) with afghani denominated deposits lagging at 42 percent. However, the AF-denominated deposits increased to AF 49.02 billion (USD 952 million) compared to AF 13.45 billion (USD 269 million) in the previous year. Total capital of the banking system stood at AF 19.10 billion (USD 375 million).

Overall the banking sector was profitable earning net profit of AF 1.78 billion (USD 34.5 million) since the beginning of 1387. An overall return on assets (ROA) decreased by 0.11 percentage points compared to 1.80 percent in the previous year. The main causes for the decrease in ROA are the increase in average total assets is more than the 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 1387 was AF 145 billion (USD 2.28 billion) up by 73.37 percent or AF 61 billion (USD 1.18 billion) from March 2008 (Figures 4.1 and 4.2).

The major drivers of this increase were the increases in cash in vault/claims on

DAB up by AF 37.29 billion and loans up by AF 10.31 billion. Moreover, the remaining part is made up of other asset categories such as claims on financial institutions, other assets except interest receivable and net due from (NDF).

The most important components of the system's total asset portfolio are cash in vault/claims on DAB standing at 40 percent, loans at 36 percent, claims on financial institutions at 13 percent, net due from at 5 percent and other assets except interest receivable stood at 3.2 percent.

Figure 5.1: Banking System's Growth Rate

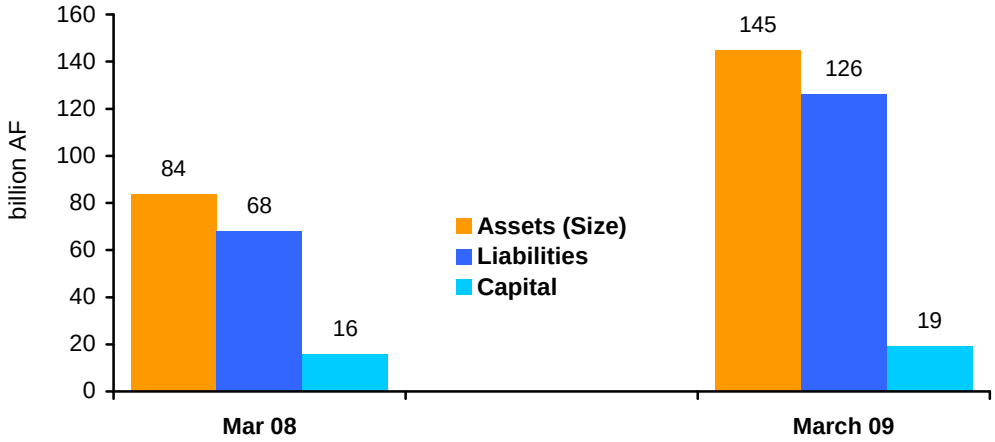
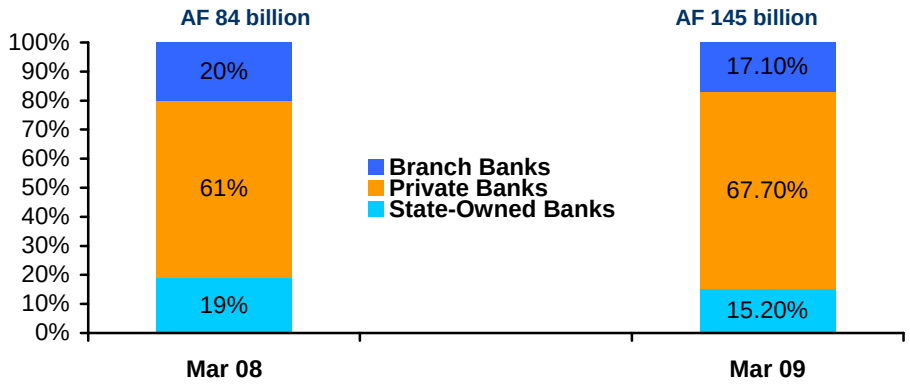


Figure 5.2: Size of Banking Sector (Total assets)
Increased by 73 percent or AF 61 billion



1.1 Claims on Financial Institutions

Claims on financial institutions are the third largest among various asset categories, currently comprising AF 19 billion – a 13 percent of total assets, 48 percent increase since March 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)

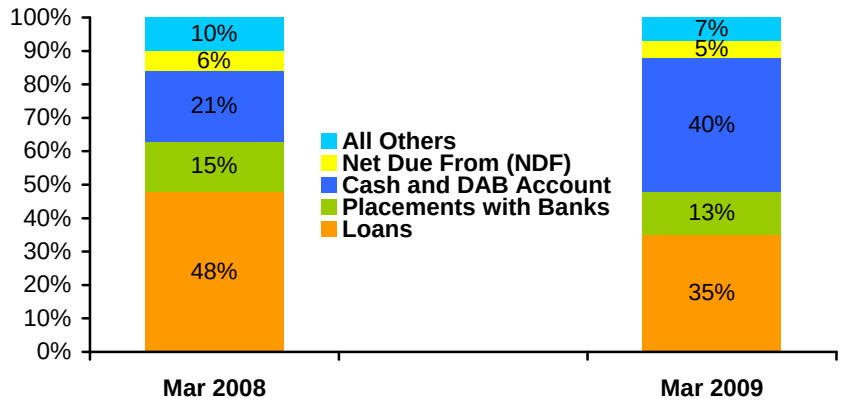
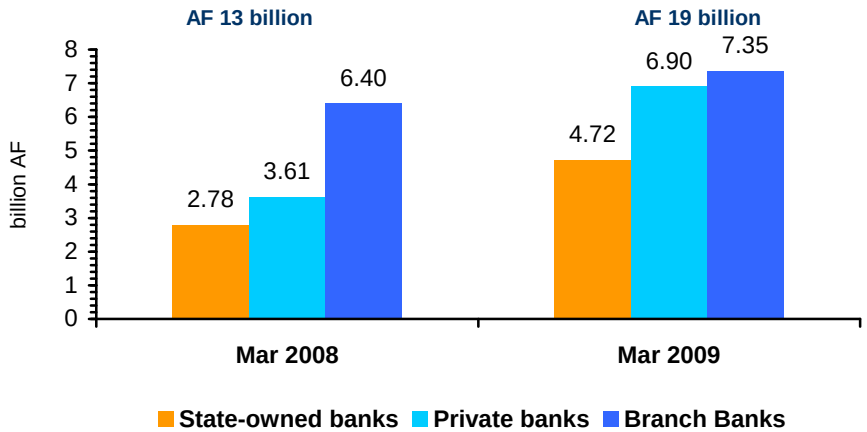


Figure 5.4: Claims on Financial Institutions



Private banking sector is the leading creditors increasing their portfolio both in absolute terms as well as percentage of total loans which are AF 41 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 6.3 billion and AF 2.6 billion respectively.

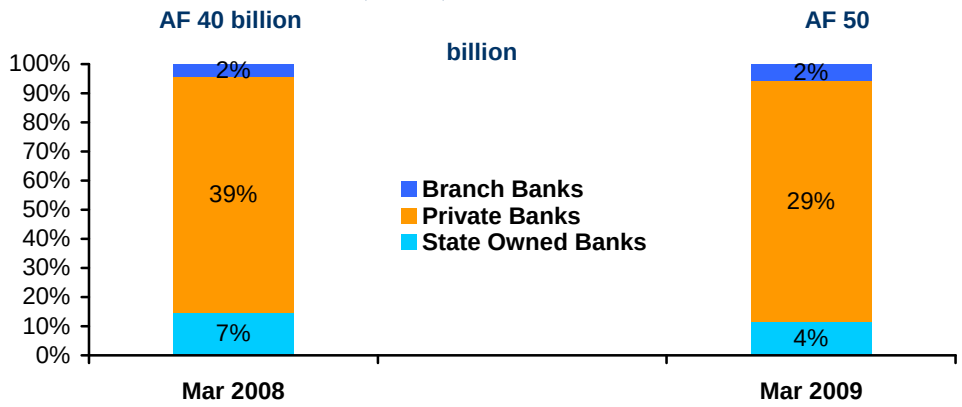
1.2 Net Loans

The loan portfolio continues to grow totaling AF 50 billion (USD 981 million) as of March 31, 2009 – a 25 percent increase since March 2008 or 35 percent of total assets. This represents the second highest amount as well as share of percentage in total assets. 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 83 percent of the growth is still attributable to private banks' group.

By far, the major component of loan portfolio is other commercial loans (39 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend and some other sectors, such as agriculture, has not benefited much from this increase.

Figure 5.5: Loans Portfolio Increased 35 percent

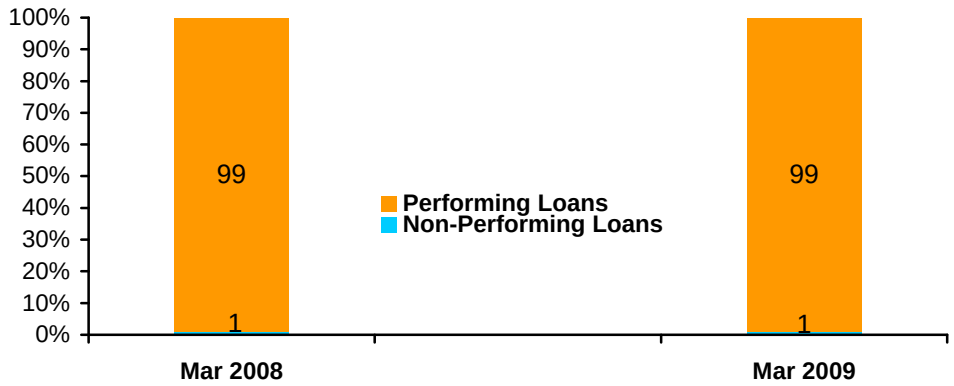
(as of TA) or AF 10 billion



1.3 Non-performing loans

The banking system's non-performing loans consists 1.15 percent of gross loans and has increased to AF 599 million up from AF 319 million since March 2008. The ratio of non-performing loans to total loans has increased to 1.2 percent which was 0.7 percent in the previous period (March 2008). Although the ratio is not alarming but the trend is of concern.

Figure 5.6: Quality of Loan Portfolio



1.4 Adversely-classified loans

Adversely-classified loans increased to AF 1.9 billion at the end of the year 1387 from 0.644 billion at the end of previous year. The percentage share of adversely-classified loans in total loans increased to 3.7 percent which was 2 percent in previous period (March 2008). Loans under "watch" category have increased more than half. This trend should be monitored closely to ensure the quality of loan portfolio. However it is early to say whether this indicates increase in adversely-classified loans or if it is due to more conservative approach of regulatory authorities on loan classification.

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

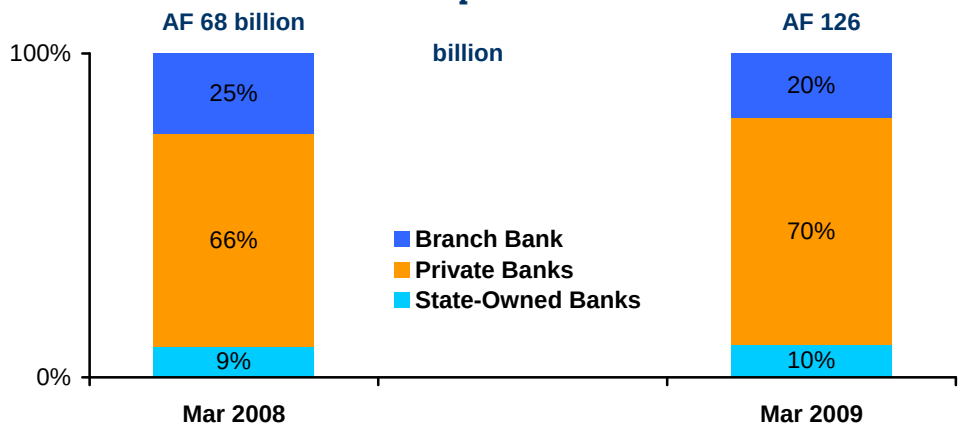
Cash in vault and claims on DAB remains as the largest category of total assets, increasing both in absolute as well as percentage of total assets. The banking sector is considering compliance with

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 126 billion up by 85 percent from March 2008. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Figure 5.7: Liabilities Increased by AF 58 billion or 86 percent



2.1 Deposits

Deposits are the major components of liabilities currently standing at AF 117 billion - an 86 percent or AF 54 billion increases from AF 63 billion in the previous year. The share of state-owned banks increased to AF 8.7 billion in the year under review from AF 5.5 billion in the previous year, this represents 59 percent increase. The share of private banks increased to AF 84.7 billion in the year under review from AF 42.6 billion in the previous year, this represents 99 percent increase. The share of branches of foreign banks stood at AF 24 billion up from AF 15.8 billion in the previous year, this represents 52 percent increase. Increases in deposits of branches were reflected as highly comparable increase in total assets with unrelated parties for the period indicating a shift from a source of

Figure 5.8: Afghani Denominated Deposits

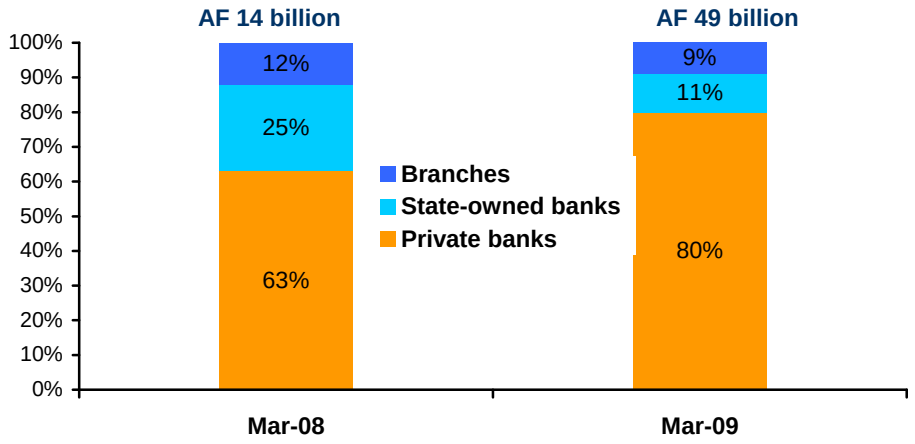
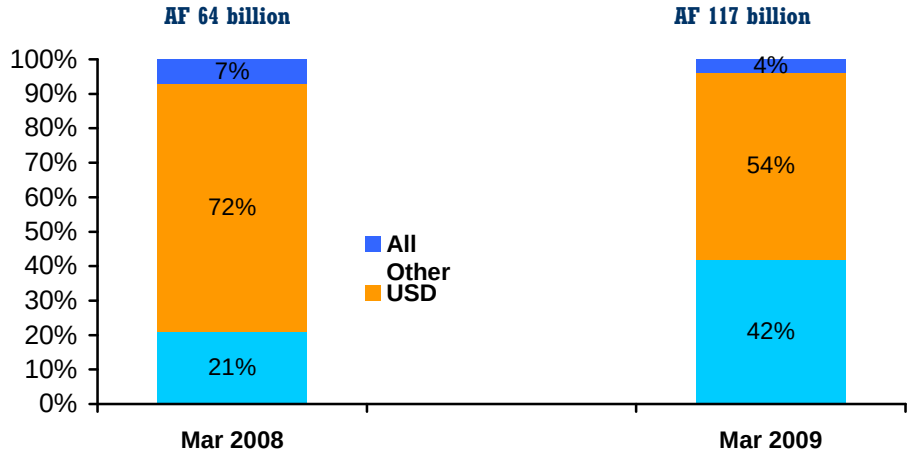


Figure 5.9: Currency Composition of Deposits



funds for the home office towards active engagement in the country.

2.2 Capital

The banking system as a whole is well capitalized. Total financial capital at full-fledged banks is AF 19.1 billion up by 21 percent since March 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 AF 19.1 billion comprises 13.2 percent of AF 145 billion (total assets), which is far below the benchmark, while the total assets of the full-fledged commercial banks are AF 98 billion.

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the net due to related depository institutions (NDT), primarily the home office and other branches of the same bank , while the closest analogue to negative capital is the net due from related depository institutions, primarily the home office and other branches of the same bank (NDF). NDF is probably a normal situation for a foreign branch in the first year of operation 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 position has decreased by 66 percent or AF 369 million and on the other hand NDF positions have increased both in absolute term as well as in percentage by AF 2.4 billion. Two of them are in a favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining three. Put differently, only two banks are 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 three 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 AF 6 billion, up by 60 percent over the year.

2.3 Profitability

The banking sector overall is profitable Total net profit of the banking sector during year 1386 is AF 1.8 billion, resulting in an overall return on assets (ROA) of 1.69. Overall profit in the previous period (March 2008) was AF 1.2

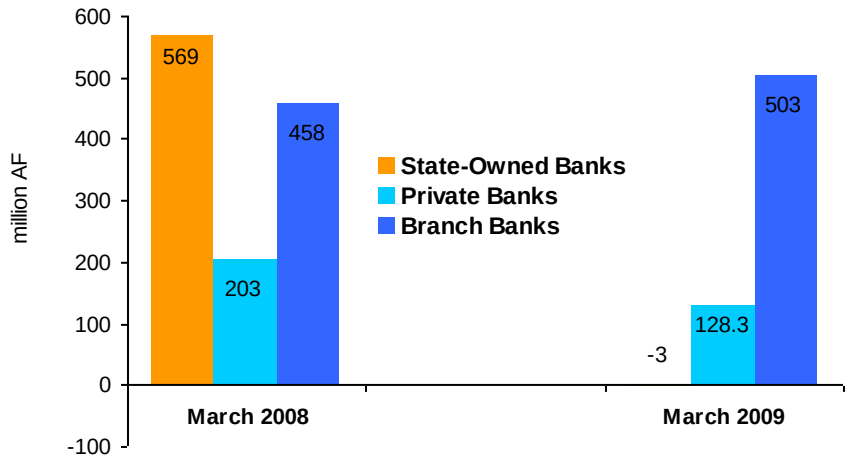
billion resulting in an overall return on assets (ROA) of 1.8.

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 as a group are at loss. The reason for the loss of stat-owned banks is mainly due to high overhead expenses of two banks high credit provision which affected adversely the overall results of the group. 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 AF 7.9 billion, up by 68 percent since March 2008.

Figure 5.11: Profitability



The second major component of income is other Non-Interest Income totaling AF 6.8 billion, AF 1.8 billion increases since March 2008. This was AF 1.3 billion in previous period (March 2008)

The most important component of expense is the Non-Interest Expense (NIE), currently equal to AF 6.8 billion, 72 percent increase compared to previous year.

The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a median stands at 1.54, up by 0.2 percentage Point

since last year. Six banking institutions ended up with lower efficiency ratios.

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.

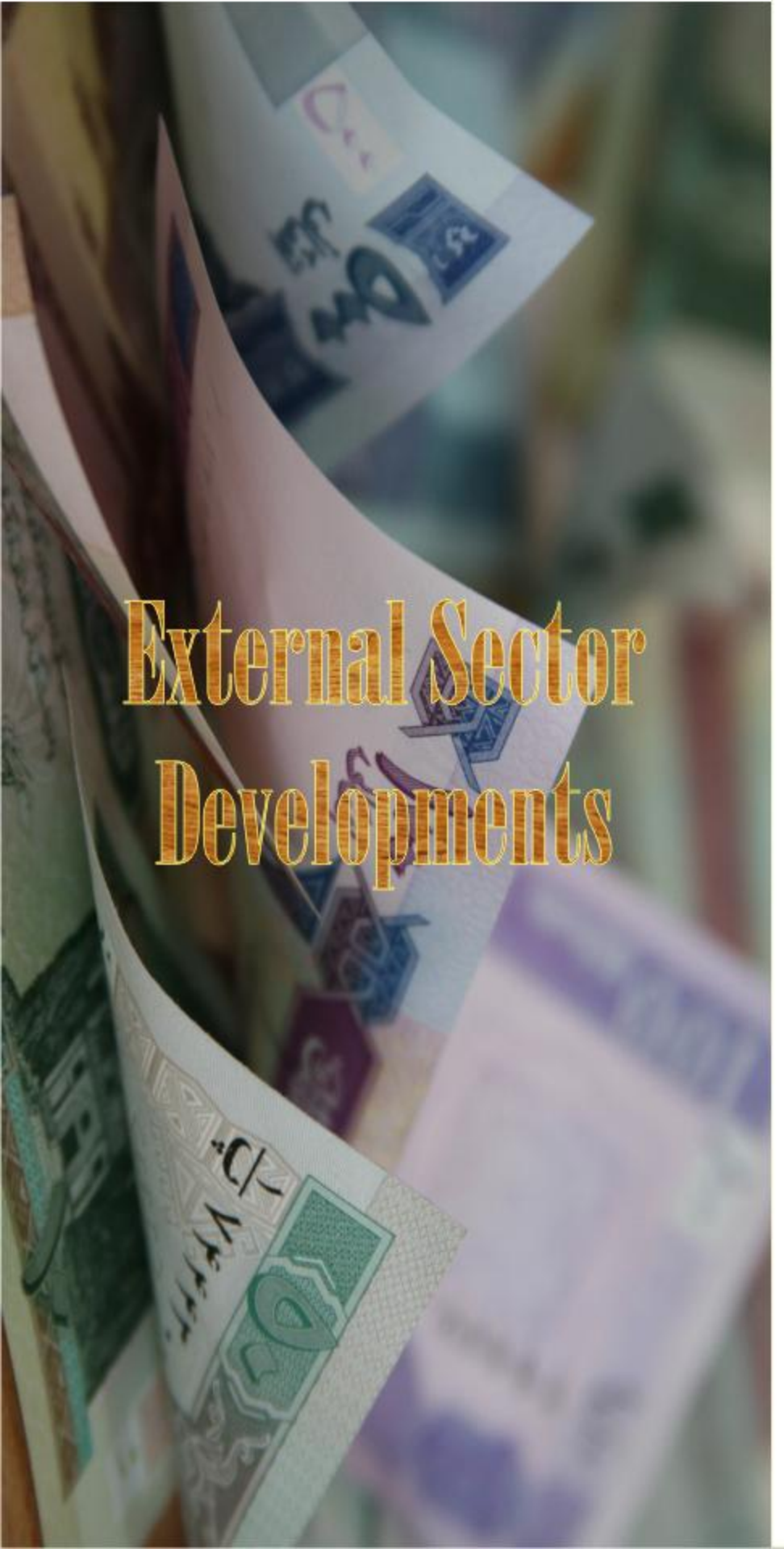
In general, all banking institutions are within the limits set for overall open FX position, except one. Two out of eleven banks are holding open FX position in USD above the maximum regulatory thresholds, but this number is less than previous period (March 2008). This indicates that the number of banks 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 AF 640 million and vice versa. Similarly, a 4 percent change would correspond to AF 128 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 AF 550 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 AF 550 million. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large 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

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EXTERNAL SECTOR DEVELOPMENTS

SUMMARY

The annual balance of payments report analyzes all BoP accounts including current account, financial account and net international reserves (NIR).

The balance of payments for the SY 1387 reveals a surplus of USD 360 million down from a surplus of USD 480 million in SY 1386. The decline in surplus in the year under review can be attributed to trade deficit of almost 11 percent from USD 6,002 million in 1386 to USD 6,658 million in the year under review.

The current account balance, the key measure of an economy's saving and spending behavior recorded a deficit of USD 181 million in 1387 much lower from a surplus of USD 85 million in 1386.

The inflows recorded in capital and financial account are volatile as the economy passes through post-conflict reconstruction. Capital and financial account is recorded at USD 121 million in the year under review from almost USD 25 million in 1386, this represents an increase of 384 percent.

The balance of trade is the difference of monetary value of exports and imports of goods and services. Exports increased to USD 2145 million in the year under review compared to USD 1835 million in 1386, this represents almost 17 percent increase. The export data recorded in 1387 is almost 18 percent of GDP. Exports were mainly dominated by fresh and dry fruit which increased by almost 62 percent in the year under review compared to 1386.

Imports increased noticeably by 12.3 percent to USD 8,803 million in 1387 which shows a growing domestic demand for foreign goods. The imports are mainly dominated by capital goods and others (USD 1527.5 million) which show higher domestic demand for imported capital

goods and machinery for the developmental needs, mainly for industrial and agricultural sectors.

Afghanistan's public and publicly guaranteed external debt prior to traditional debt relief on July 19, 2006 was approximately USD 11,934.40 million in nominal terms as of March 20, 2006. The Paris Club agreed on cancellation of approximately USD 10.4 billion in external debt amounting to a total of approximately 92 percent reduction of Afghanistan's debt to its three Paris Club creditors. The remaining total external debt for Afghanistan is USD 2,142.68 million as of December 20, 2008. The three creditors intended to provide the remaining debt relief under the enhanced Heavily Indebted Poor Country (HIPC).

Net international reserves increased from USD 2,669.23 million in 1386 to USD 3,264.8 million in 1387 representing approximately 22 percent increase. The reserve assets increased from USD 2,784.33 million in 1386 to approximately USD 3,422 million in the year under review. On the other hand the reserves liabilities increased by 36.7 percent from USD 115 million in 1386 to USD 157.20 million in the year under review.

1. BALANCE OF PAYMENTS

The balance of payments (BoP) statistical statement which summarizes transactions in goods, services, primary and secondary income and financial items between residents and nonresidents reveals a surplus of USD 360 million in 1387 down from USD 480 million in 1386. The decline in surplus in the year under review is due to trade deficit of almost 11 percent from USD 6,002 million in 1386 to USD 6,658 million in the year under review, despite the fact that current transfers increased by 6.1 percent from USD 6,510 million in 1386 to USD 6,906 million in 1387. Foreign direct investment had a significant increase of 23 percent from USD 243 million in 1386 to USD 300 million in the year under review which shows inflow of capitals to the country.

The current account balance, the key measure of an economy's saving and spending behavior, recorded a deficit of USD 181 million in 1387 to compare with a surplus of USD 85 million in 1386.

Imports stood at USD 8,803 million in the year under review which represents 12.3 percent increase to compare with that in the previous year. This increase shows a growing domestic demand for foreign

goods. The imports are mainly dominated by capital goods and others (USD 1,527.5 million) which shows higher domestic demand for importing of capital goods and machinery for the developmental needs most commonly in industrial and agricultural sectors, industrial supplies (USD 900.38 million), and foodstuff or consumer items were (USD 658.68 million) in 1387.

Table 6.1: Afghanistan Balance of Payments (in million USD)

	2005/06	2006/07	2007/08	%	2008/09	%
	1384	1385	1386	Change	1387	Change
Current account (including grants)	-182	-379	85	-122.42	-181	-312.94
Current account (excluding grants)	-4880	-5406	-6425	18.86	-7087	10.30
Trade balance	-4335	-4933	-6002	21.67	-6658	10.93
Exports of goods (f.o.b.) 1/	1795	1811	1835	1.32	2145	16.93
Official exports	386	416	482	15.87	603	25.10
Unofficial exports (smuggling and transit trade)	1409	1394	1352	-3.03	1542	14.05
Imports of goods (f.o.b.)	-6130	-6744	-7837	16.21	-8803	12.33
Official imports	-5482	-6049	-7246	19.79	-8273	14.17
Of which: Duty free	-3258	-3579	-4685	30.89	-5455	16.43
Smuggling	-648	-694	-590	-14.96	-529	-10.37
Services and income, net	-545	-473	-423	-10.62	-429	1.54
Of which: Interest due 2/ 3/	-21	-17	-61	258.24	-61	0.16
Current transfers	4698	5027	6510	29.51	6906	6.08
Public	4361	4625	6068	31.20	6381	5.15
Private(Including through licensed money exchangers)	337	401	441	9.92	525	19.05
Capital and financial account	357	194	25	-87.12	121	384.00
Capital Transfer	0	0	0	0.00	0	0.00
Debt forgiveness 3/	0	0	0	0.00	0	0.00
Foreign direct investment	271	238	243	2.27	300	23.46
Official loans (net)	85	155	129	-16.72	121	-6.20
Disbursement	102	164	133	-18.56	125	-6.30
Amortization due 2/ 3/	-16	-9	-4	-55.68	-4	2.56
Other items (net)	...	-198	-347	75.05	-300	-13.62
Errors and omissions (including short-term capital)	223	405	370	-8.64	420	13.51
Overall balance	398	220	480	118.18	360	-25.00
Financing	-398	-220	-480		-360	

Changes in reserve assets of the DAB	-426	-255	-571	-430
Use of Fund resources (net)	0	20	51	17
Exceptional financing	28	15	40	53
Arrears 4/	-1	-132	-11007	-84
Debt rescheduling, of which: 5/	0	117	777	80
Capitalization of interest	0	4	47	48
Multilateral HIPC assistance	0	0	3	5
Debt forgiveness, of which: 3/	29	30	10270	56
HIPC	0	0	0	0
MDRI	0	0	0	0
Financing gap	0	0	0	0
Identified financing (provisional)	0	0	0	0
Of which: IMF PRGF	0	0	0	0
Remaining gap	0	0	0	0
Memorandum Items:				
Gross international reserves	1,662	2,040	2,784	3,103.00
(In months of imports) 6/	7.7	9.6	12.7	11.3
(Relative to external debt service due)	44.3	79.1	42.9	47.6
(Relative to commercial bank foreign currency liabilities)	2.6	2.2	2.2	2
Current account balance (percent of GDP)				
Including grants	-2.8	-4.9	0.9	-1.5
Excluding grants	-75.2	-70	-66.5	-58.8
Total debt service (percent of exports) 7/	5.7	1.6	1.1	1.3
Total debt stock (percent of GDP) 7/	184	155	20.8	18.8

Sources: Afghan authorities; and Fund staff estimates and projections

1/ Excludes opium exports and, due to limited data availability, flows associated with U.S. Army and most ISAF activities.

2/ Debt services projections are based on the total stock of external debt (including estimates of unverified arrears). Interest on overdue obligations represents estimates by Fund staff.

3/ Assumes that Afghanistan will reach the HIPC completion point. Paris Club creditors are assumed to provide 100 percent debt stock reduction

4/ Arrears shown represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations.

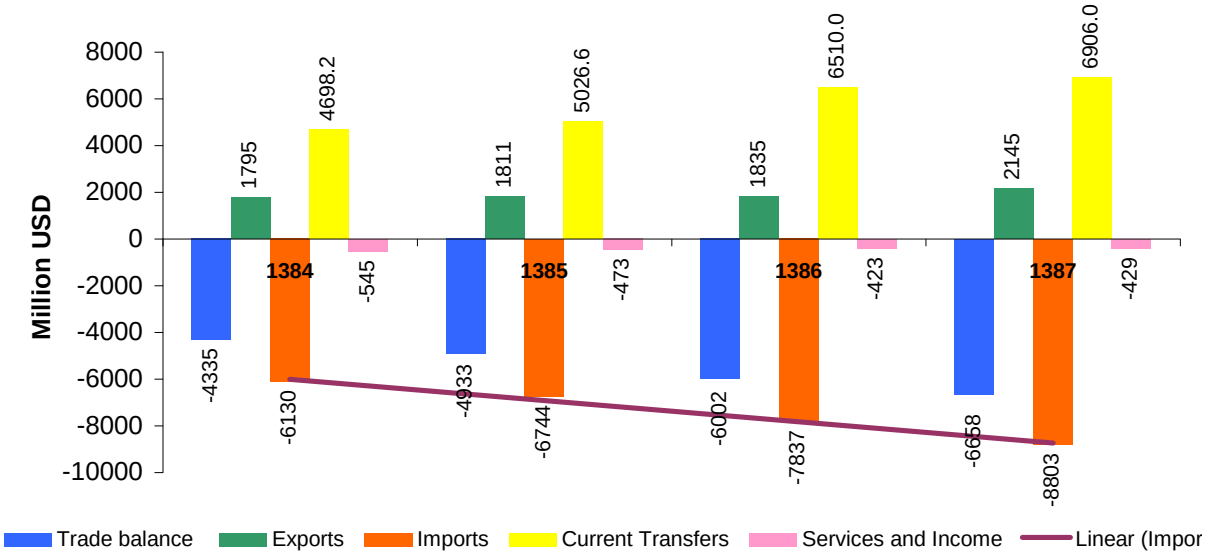
5/ Debt rescheduling includes the capitalization of interest falling due to Paris Club creditors until the completion point, interim assistance from multilateral creditors after the completion point.

6/ Excluding imports from re-exports and duty free imports by donors.

7/ After HIPC and MDRI relief as well as debt relief beyond HIPC from Paris Club creditors. Debt includes obligations to the IMF. The debt stock includes the capitalization of interest to Paris Club creditors until the completion point of the enhanced HIPC initiative.

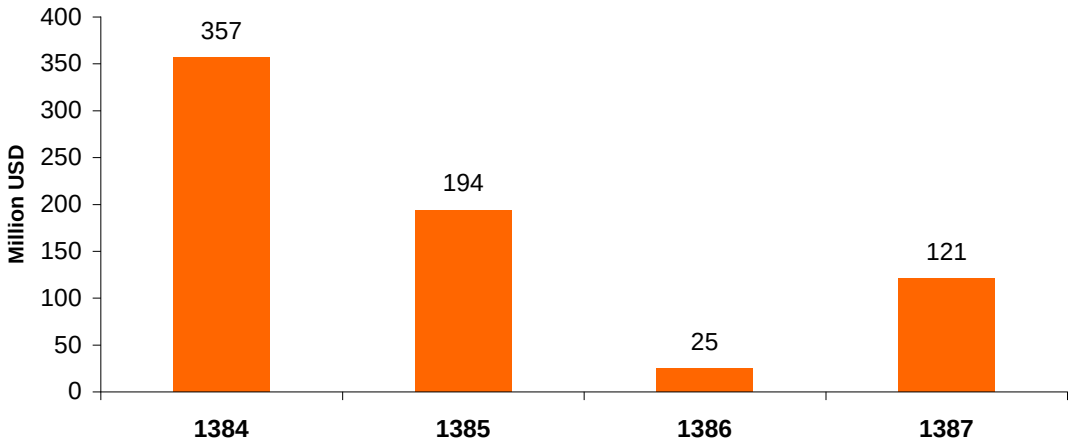
Exports increased by almost 17 percent in the year under review compared to that in 1386. Exports were mainly dominated by food items including fresh and dry fruit which increased by almost 62 percent in 1387 compared to 1386.

Figure 6.1: Current Account



Source:

Figure 6.2: Capital and Financial Account



1.1. Merchandize Trade

The trade deficit stood at USD 2,648 million or 22 percent of GDP at the end of the year under review. Table 6.2 shows merchandise by its main categories, percent changes and the trade deficit in absolute terms and as percentage of GDP from 1382 to 1387. Imports of almost USD 3,195 million were dominated by capital goods and others (USD 1527 million). Exports of USD 547 million were dominated by food items including fresh and dry fruits (almost USD 258 million) and carpets and rugs (almost USD 152 million). The trade deficit is manageable as long as there is continuous donor assistance or the deficit is declining as a percentage of GDP; however, continued struggle is needed to improve export performance, bring import substitution and encourage good quality domestic production in order to make our products more competitive in the regional and world markets.

Table 6.2: Merchandise Trade (In million USD)

Years	1384		1385		1386		1387	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	2,470.74	100	2744.2	100	3021.9	100	3195.39	100.0
Consumer goods	478.63	19.37	1189.11	43.33	1,289	42.7	658.68	20.6
Industrial supplies	541	21.9	68.08	2.48	78	2.6	900.38	28.2
Capital goods & others	1206.5	48.83	1133.05	41.29	1,235	40.9	1527.5	47.8
Fuel & lubricants	244.61	9.9	353.95	12.9	419	13.9	108.83	3.4
Exports	383.72	100	416.46	100	456.48	100	547.49	100
Carpets & Rugs	206.94	53.93	186.57	44.8	211.76	46.39	151.74	27.7
Food items	104.11	27.13	165.15	39.66	157.76	34.56	257.96	47.1
Leather & Wool	36.51	9.51	30.76	7.39	30.42	6.66	28.05	5.1
Medical seeds & others	36.16	9.42	33.98	8.16	56.54	12.39	109.74	20.0
Trade Balance	-2,087.02		-2,327.70		-2,565.38		-2,647.90	
Trade Balance as % of GDP	31.28		-28.19		-26.38		-21.95	

Source: Central Statistics Office and DAB Staff Calculations

Box 6: Export processing zone

Export processing zone (EPZ) is one or more special areas of a country where some normal trade barriers such as tariffs and quotas are eliminated in hope of attracting new business and foreign investments. Export processing zones are areas where raw materials are imported and export finished products. These zones are mostly established in underdeveloped parts of host country and some tax breaks are given as additional incentive. The aim of countries setting up EPZs is to attract investments that would be directed elsewhere if such zones did not exist. The main reasons behind the desire to attract investment are: To create employment, earn foreign currency, boost exports particularly in key sectors, promote the transfer of technologies and skills, develop deprived regions and boost the economy as a whole for many countries, the exports dispatched from EPZs (or passing through them) represent an ever-increasing percentage of their overall export earnings, often accounting for more than 80 percent of the goods exported.

EPZs are often held up as a way for countries to develop their economies, their labor markets and their infrastructure and to obtain vital export earnings. But serious questions remain as to the real benefits of EPZs to development. By its very nature, EPZ investment is precarious and likely to leave the country if it is know that more compliant workforce is on offer somewhere else.

According to ILO's latest figures, the number of EPZs has gone from 79 in 1975 to 3000. While the number of countries with one or more EPZs have gone from 25 in 1975 to 116 in 2002. EPZs had a positively affected employment and created jobs significantly across the Globe. Today, more than 43 million workers are employed in EPZs across the world , of which 30 millions are working in China's ever-growing 2000 special economic zones (SEZ) while employment in EPZs increased in Philippines from 230,000 in 1994 to 820,000 in 2002 and in Costa Rica, it rose from 7000 in 1990 to 34,000 ten years later. It should, however, be noted that the gains generated by EPZs in terms of employment cannot be considered as permanent in any country, and new strategies are constantly required to secure them. For example, in Mexico the number of jobs in the Maquilas increases from 446,000 in 1990 to 1,285,000 in 2000, but then dropped to 1,086,000 in May 2002, partly owing to the growing pressure of

competition from the Chinese EPZs. In Madagascar, the recent political turmoil has led to the provisional layoff of some 70 percent of the workers employed in the EPZs. China's share in the US market (the world's largest textile and apparel market) was 31percent at the beginning of the year 2002, but had already reached 59 percent by the end. The increase in the export of textile and garment was higher than the total increase from all other countries in the world. The growth in Chinese exports (primarily produced in EPZs) is even more spectacular for certain products, such as exports of gloves from China to United states rose by 291percent during the 15 months preceding March 2003, while during the same period, Guatemala's glove exports to the US fell by 65 percent, Bangladesh's by 48 percent and Sri Lanka's by 47percent.

The WTO Agreement on Textiles and Clothing (ATC) is one of the chief factors influencing investments in EPZs, and its expiry in clothing export quotas allocated to developing countries by developed countries. The quotas allocated to highly competitive exporters such as the Korean Republic and the Hong Kong Special Administration Region (China) tend to be restricted, while those allocated to less competitive exporters tend to be higher. This has led clothing exporters to move all over the world in search of the quotas available, contributing to the creation of millions of jobs in countries that previously had only a small clothing export base, or no base at all. Thus in Sri Lanka for example, the earnings from clothing exports went from 623 million dollars in 1990 to over 2.7 billion dollars in 2000, which represented 50 percent of the country's total exports.

The Afghan government needs to create SPZs and enact SEZs Act which should focus on long term stable policy framework with minimal regulations by covering all important legal and regulatory aspects for setting up of SEZs as well as units operating in SEZs. This policy framework will not only be used to attract foreign and domestic investment but also to encourage exports. Afghan government can provide certain incentives and facilities which will encourage foreign and domestic investment. Some of the incentives in SEZs are as follows; allow 100 percent foreign direct investment for townships with residential, education, recreational facilities and franchises for basic telephone services, Afghan government can provide long term tax

holidays (i.e. provide tax holidays of 10 years), duty free imports and maintenance of SEZs, exemption from service tax and central sales tax, full freedom in allocation of space and build up area for approved SEZ units on commercial basis, authorization to provide and maintain services like water, electricity, security, restaurants, recreation centers, etc on commercial lines and exemption from customs duty on import of capital goods, raw materials, consumables and spare parts and exemption from central excise duty on the procurement of capital goods, raw materials, consumables spares, etc. from the domestic market.

Certain disadvantages to Afghan government from SEZs will be the loss of revenues because of the various tax exemptions and most players are interested in setting up SEZs with an eye on the real estate bounty so that they can acquire at cheap rates and create a land bank for themselves

It can be inferred that most of the countries, dominant in the world market, are facilitating SEZs and adopted investment friendly policies which led to their economic prosperity. Therefore, to reduce unemployment, to generate economic activities and to generate foreign demand for domestically produced goods and services, Afghan government needs to create and facilitate SEZs by provide policy framework with minimal regulations so that foreign and domestic investment is encouraged to invest in Afghanistan as well as to have more competitive product in the regional and world markets.

1.2. Direction of trade

Tables 6.3 and 6.4 compare the direction of trade for different countries in the year under review with that in 1386. Pakistan remains Afghanistan's largest export destination with slightly more than 46 percent of exports in 1387 down from 66 percent in 1386. Exports to Pakistan have decreased by 15 percent from approximately USD 300 million in 1386 to USD 254.65 million in 1387. India remains the second major trade partner of Afghanistan and increased its share of trade with Afghanistan by almost 49 percent from USD 61 million in 1386 to around USD 91 million in 1387. India remains the second major export destination for Afghan products. Ex Soviet Commonwealth States had a

growing demand for Afghan products in the year under review. Exports to Ex Soviet Commonwealth States increased from USD 28 million in 1386 to USD 81 million in 1387, a sharp increase of 193 percent.

Table 6.3: Direction of External Trade for 1386 (in million USD)

Country Name	Exports		Imports		
	Million (USD)	Share (%)	Million (USD)	Share (%)	Trade Balance
Pakistan	300.08	66.03	444.5	14.71	-144.42
India	61.23	13.47	164.03	5.43	-102.8
Japan	0.46	0.1	494.99	16.38	-494.53
China	7.01	1.54	611.3	20.23	-604.29
Ex Soviet Commonwealth	27.59	6.07	661	21.87	-633.41
Iran	5.32	1.17	138.3	4.58	-132.98
European Countries	7.01	1.54	66.06	2.19	-59.05
Others	45.79	10.08	441.68	14.62	-395.89
Total	**454.49**	**100**	**3,021.86**	**100**	**2,567.37-**

Table 6.4: Direction of External Trade for 1387 (in million USD)

Country Name	Exports		Imports		Trade Balance
	Million (USD)	Share (%)	Million (USD)	Share (%)	
Pakistan	254.65	46.51	430.90	13.64	-176.25
India	91.18	16.65	98.50	3.12	-7.32
Japan	0.00	0.00	343.78	10.88	-343.78
China	1.97	0.36	406.17	12.85	-404.20
Ex Soviet Commonwealth	80.85	14.77	982.63	31.10	-901.78
Iran	14.90	2.72	209.41	6.63	-194.51
European Countries	0.85	0.16	84.83	2.68	-83.98
Others	103.09	18.83	603.74	19.11	-500.65
Total	**547.49**	**100.00**	**3,159.96**	**100**	**-2612.47**

Figure 6.3: Direction of exports (% share) 1386

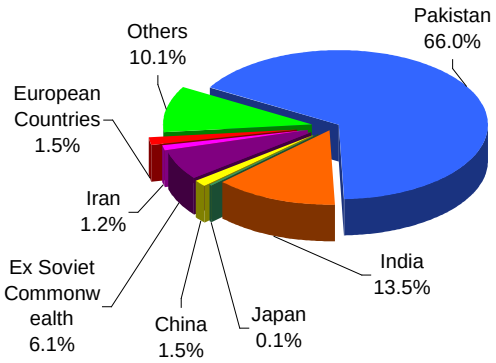
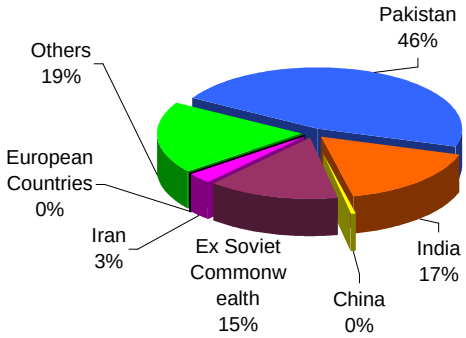


Figure 6.4: Direction of Exports (% share) 1387



1.3. Composition of trade

Figures 6.5 and 6.6 indicate the composition of total imports for 1386 through 1387. The composition of imports in 1387 indicates that imports of others category had the largest share at 27 percent followed by spare parts and transport equipments with 23 percent, fuel items at 17 percent, food and consumer items at 16.5 percent, construction equipments at 11 percent, textile clothing & footwear at 4 percent, and finally fertilizers & chemicals at 0.2 percent.

Analysis of the composition of imports in the year 1386 reveals that imports of others category had the largest share at almost 31 percent followed by spare parts & transport equipments at 25 percent, food & consumer items at 14 percent, construction materials at 12 percent, fuel items at 10 percent, textile clothing & footwear at 7 percent and finally fertilizers & chemicals at 1 percent.

Figure 6.5: Composition of Exports (% share) 1386

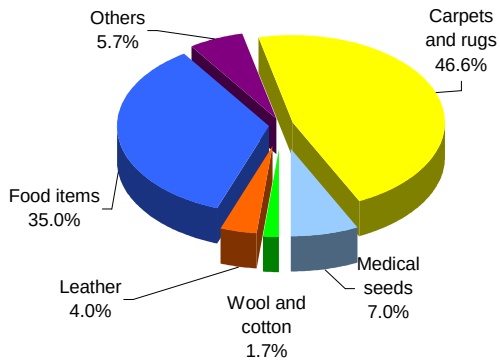
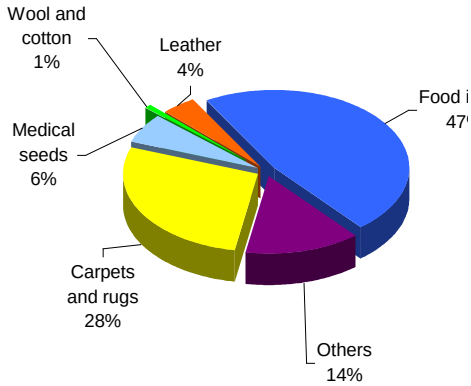


Figure 6.6: Composition of Exports (% share) 1387



Source: Central Statistical Office and DAB staff calculations.

Comparing imports in 1386 with that in 1387 indicates significant variability. The share of others category has significantly decreased to 28 percent in the period under review from 31 percent in 1386. On the other hand the share of spare parts & transport equipments has also decreased to approximately 24 percent in the year under review from 25 percent in the previous year. Fuel items increased to 17 percent in the year under review from 10 percent in 1386, food & consumer items increased to 16 percent from 14 percent in 1386, construction materials decreased to 11 percent in 1387 from 12 percent in 1386, textile, clothing & footwear decreased to 4 percent in the year under review from 7 percent in 1386, fertilizers & Chemicals decreased from 1 percent in 1387 to 0.2 percent in 1386.

Figures 6.7 and 6.8 compare the composition of total exports of 1386 with that of 1387. Figure 6.7 shows the composition of exports for 1386 and is broken down by main commodities and products. Carpets & rugs by 47 percent is the largest export component followed by the food items which constituted 35 percent of total exports, medical seeds stood at 7 percent, others at 6 percent, leather stood at 4 percent and finally wool and cotton exports stood at 2 percent.

Figure 6.8 shows the composition of exports for 1387 and is broken down by main commodities and products. Food

items with 47 percent is the largest export component followed by carpets and rugs which constituted around 28 percent of total exports, others stood at almost 14 percent, medical seeds or plants with almost 6 percent, leather stood around 4 percent and finally wool and cotton stood at 1 percent of total exports in 1387.

Figure 6.7: Composition of imports (% share) 1387

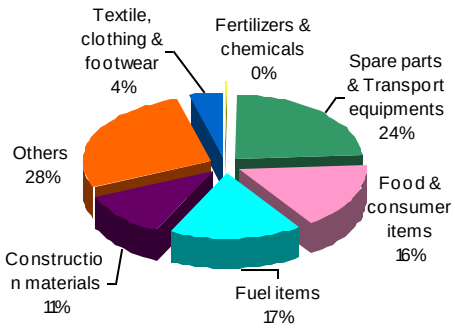
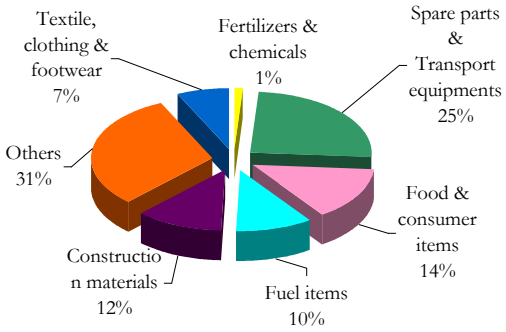


Figure 6.8: Composition of imports (% share) 1386



The comparison of 1386 with that of 1387 on the composition of trade reveals dissimilarity. Demand for domestically produced leather remained the same at 4 percent. The share of food items increased significantly to 47 percent in 1386 from 35 percent in 1386 and the share of others category increased from 6 percent in 1386 to 14 percent in the year under review. On the other hand the share of carpets & rugs declined significantly from 47 percent in 1386 to 28 percent in 1387. Furthermore, the share of medical seeds or plants decreased slightly to 6 percent in 1387 from 7 percent in 1386 and finally the share of wool & cotton declined to 1 percent in 1387 from almost 2 percent in 1387.

Box 7: What does entry into WTO mean to Afghanistan?

WTO (World Trade Organization) is an international organization designed to supervise and liberalize international trade. It is not just about liberalizing trade but in some circumstances its rules support maintaining trade barriers – for example to protect consumers or to prevent the spread of diseases. It deals with the rules of trade at global or near-global level. It is a forum for governments to negotiate trade agreements and settle trade disputes. 153 countries are registered as members which represents 95% of total trade in the world while some of the countries got observer status in WTO including Afghanistan. Main objectives of WTO is to raise standard of living, ensure full employment and growing volume of real income and effective demand, expand production of trade in goods and services and bring sustainable development in full consideration to environment protection. WTO agreements are lengthy and complex because they cover a wide range of activities including Agriculture, banking, government purchases, textile and clothing, telecommunications, industrial standards and food safety, intellectual property, food sanitation regulations and many more.

In WTO agreements, countries should not discriminate between its trading partners (giving them equally most-favored-nation status). It should not discriminate between its own and foreign products, services or nationals (giving them national treatment). Reducing or lowering trade barriers is one of the most obvious means of encouraging trade. The barriers include customs duties (or tariffs) and measures, such as import bans or quotas that restrict quantities selectively and some other issues such as red tape and exchange rate policies. Foreign companies, investors and governments should be confident that trade barriers should not be raised arbitrarily; tariff rates and market opening commitments are bound in WTO. It discourages unfair trade practices such as export subsidies and dumping products at below cost to gain market share. More time, greater flexibility and special privileges are given to less developed countries.

In the process of recovery from the conflict, Afghanistan applied for accession to World Trade Organization (WTO) on November 21, 2004. On December 13, 2004, a working party was created and Afghanistan was given the Observer Status. Since

then, Afghanistan has taken certain strides such as: creation of department of WTO in the Ministry of Commerce and independent government organizations and trainings of WTO accession negotiators, to come closer to the accession.

The key benefits for developing countries and LDCs in the accession of WTO are as following: some of the economic and institutional reforms are required of applicant countries by the accession process, as Afghanistan is already passing through or undergoing under a certain reforms such as custom and taxation system, and legislature, with donor assistance while the technical assistance of WTO can tie Afghanistan into trade-related legislation that may not be in its best interests of donors, but rather Afghanistan should use donor support for internal reforms, so technical assistance of WTO in trade-related legislation and trade facilitation must support the national development priorities of Afghanistan. Another key benefit for the developing countries and LDCs is that they hope their exports will boost due to improved access to international markets. Most of Afghan products do not yet have a competitive advantage in the global economy but it specializes in producing certain commodities such as dry fruit, carpets and rugs and gems. Before it really take advantage of increased market access, Afghanistan first needs to take the time to invest in and develop its local industrial and agricultural sectors, so that it has products to export in significant quantities. The third key benefit the members believe is that WTO offers proof of a business-friendly environment and that this in turn attracts FDI into the export sector. However, recent investment reports from the World Bank show that there is no link between FDI and the signing of WTO membership. The fourth benefit is that Afghanistan will have access to the Dispute Settlement Understanding (DSU) once it is a WTO member. The poor countries have the right to pursue disputes in this forum; they rarely do so, due to a range of financial, logistical and political obstacles, such as lack of technical capacity or political pressure. Therefore, dispute resolution of very limited significance to Afghanistan. The fifth important benefit for developing and LDCs is that they will receive preferential treatments (protectionist policy) from WTO which will boast economic and trade developments.

Some potential risks associate with the accession of WTO to Afghanistan's development prospects are as follows: First Potential risk is that WTO membership usually means increased liberalization of a country's trade regime. Trade liberalization can increase the opportunities for exports. it also exposes local producers to foreign competition that they may be unable to withstand, particularly in poorer countries. Afghanistan will go to the negotiating table with a tariff system that is already extremely liberal, even it may face further pressure to bind these low rates, or lower its applied rate even further. If Afghanistan does not resist this pressure, the flood of cheap imports from neighboring Pakistan and China that is already experiencing will further increase and the devastating impact on the livelihoods of the majority of Afghans who live in poverty, second potential risk is that there are sensitive sectors in Afghanistan that provide essential services vital for welfare, such as water, education, sanitation and electricity supply. If they are privatized then it is less likely to reach poorer citizens as the experience gained from other countries despite the flexibility of General Agreement on Trade in Services (GATS). Afghanistan as less develop country has a right to choose when to liberalize its services sectors, but developing countries and LDCs can come under huge pressure to open up certain sectors, third potential risk is that accession to WTO may divert government funds from pressing development challenges due to the high cost of implementing WTO agreements. According to World Bank estimates, the cost of implementing WTO agreements stands at around $100m per agreement so this cost may be high for a country, such as Afghanistan which is emerging from conflict and whose budgetary priorities lie in sectors linked to poverty reduction. Afghanistan may need support in order to spread the cost of accession over time. Fourth potential risk associated with WTO accession is that the trade would open the infant industry in the country and our domestic sectors will be subject to international competition. But in this case Afghanistan would receive preferential treatment that would secure the infant industry.

In concluding remarks it can be stated that joining WTO too soon may not boost or increase Afghan exports as promised but instead will open some of the sectors of our economy particularly, agricultural and industrial sectors to strong foreign

competition. For temporary basis tariffs and other trade barriers are necessary to protect local industries and rural trades, and to foster economic development. Spending $100m per agreement in WTO will divert government fund from pressing development priorities such as poverty despite the fact that there is no guarantee that the Afghan trade and investment will increase. Employing highly technical labor force and careful preparation and negotiation for accession is the only way for Afghanistan to get the maximum benefit from the WTO. The accession process should reflect developments rather than the demand of existing members. More aid, technical assistance and research work is needed to fully access the pros and cons of WTO to Afghan economy.

2. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt prior to traditional debt relief on July 19, 2006 was approximately USD 11,934.40 million in nominal terms. The group of major official creditors known as Paris Club (Russian Federation, United States and Germany) indicated the intention to provide 100 percent debt relief to Afghanistan in London Conference on January 2006. The members reached an agreement on significant debt reduction with the Government of Afghanistan in Paris Club. The Paris Club agreed on cancellation of approximately 10.4 billion in external debt amounts to a total of approximately 92 percent reduction of Afghanistan's debt to its three Paris Club Creditors. The remaining external debt for Afghanistan is USD 2,142.68 million in December 20, 2008. The three Creditors intended to provide the remaining debt relief under the enhanced Heavily Indebted Poor Country (HIPC). Afghanistan's external debt strategy still continues to focus in brining sustainability of debt while sustainability of debt can be achieved under the HIPC initiative.

The World Bank and the Asian Development Bank provided substantial aid to Afghanistan in previous years in the form of loans and grants. Loans provided to Afghanistan have relaxed repayment terms and lower than normal service charges recognizing Afghanistan's difficult economic environment. However, Afghan Government expects further debt relief from Asian Development Bank in the coming year. Due to cancellation of approximately 92 percent of total external

debt in nominal terms, there is a significant change in the external debt. The Russian Federation held major proportion of total external debt (40.6 percent after the reduction of total external debt by approximately USD 10.4 billion by Paris Club creditors on July 19, 2006. The United States (5.5 percent) and Germany (0.77 percent) are the other Paris Club creditors. Multilateral creditors include International Development Association (IDA) representing 21.06 percent, the Asian Development Bank (ADB) representing 22.18 percent and International Monetary Fund (IMF) representing 4.8 percent of Afghanistan's nominal debt non-Paris Club creditors account for 53.4 percent of total claims respectively.

Table 6.5: External Debt as of December 20th , 2008 (in units indicated)

	In million USD	Percent of total
Total external debt	2,142.68	100.00
Bilateral	1,127.56	52.62
Paris Club/1	996.47	46.51
Russian Federation	862.10	40.23
United States	117.77	5.50
Germany	16.60	0.77
Non-Paris Club	1146.21	53.49
Multilateral	1015.12	47.38
of which: IDA	451.29	21.06
Asian Development Bank	475.23	22.18
International Monetary Fund	87.46	4.08
Memorandum Items:		
NPV	2,163.85	……..
(in percent of exports)/2	457.77	……..

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.

2/ Calculated using a backward-looking three year average of exports of goods and services; excluding transit goods.

3. NET INTERNATIONAL RESERVES

The net international reserves (NIR) held by Da Afghanistan Bank includes holdings of foreign exchange including US dollars, euro, pound sterling, AED and other currencies, gold and holdings of special drawing rights (SDR). Net international reserves increased substantially during the past few years. Net international reserves increased by 22 percent from USD 2,669.23 million in 1386 to USD 3,264.8 million in 1387. The reserves assets had a fairly large increase of approximately 23 percent from USD 2,784.33 million in 1386 to USD 3,422 million at the end of year under review. On the other hand the reserves liabilities increased by 36.7 percent from USD 115 million in 1386 to USD 157.20 million in the year under review which shows that reserve assets are noticeably high than the reserve liabilities.

The net increase in the reserves reflected the fundamentals of the economy with foreign exchange inflows generated mainly from export earnings, foreign direct investment, current transfers, injection of foreign exchange by donors, earnings on foreign exchange deposits in foreign deposit-taking corporations and multi-national forces. A general rule of thumb is that reserves should be equal to at least 3 months of imports. Countries with 6 months coverage of imports enjoy a relatively comfortable reserve position. Adequate reserves are effective in stabilizing exchange rates to provide a more favorable economic environment while the reserves position of the year under review is considerably strong enough to finance 12.3 months of imports.

Table 6.6: Net International Reserve (in million USD)

	1384	1385	1386	% Changes	1387	% Changes
Net International Reserves	1,629.56	1,857.83	2,669.32	43.7	3264.8	22.3
Reserves assets	1,661.90	1,946.22	2,784.33	43.1	3,421.98	22.9
Reserves liabilities	32.34	88.39	115	30.1	157.2	36.7
Commercial bank deposits in foreign currency	28.15	46.56	35.62	-23.5	66.7	87.2
Non resident deposits in foreign currency	4.19	6.19	2.61	-57.9	0.27	-89.6
Use of Fund resources		35.64	76.77	115.4	90.23	17.5
Memorandum items:						
Gross Reserves (in months of imports)	8.1	8.5	11.1	29.9	12.9	16.2
NIRs (in months of imports)	7.9	8.5	10.6	24.6	12.3	15.7

Box 8: The potential of the marble industry in Afghanistan

As result of decades of conflict, internal disturbances and inherent weaknesses all the sectors of our economies faced down turn. Mineral resources that theoretically form a considerable part of the economy were left undeveloped especially the marble with greater supply potential to the regional markets. Despite Afghanistan's wealth of natural resources and critical geographic location, it still has not developed. We must admit the problem has its main roots in the previous economic systems of the country. Explorations and geological studies of only ten percent of the territory have discovered abundant deposits of many precious and semi-precious industrial minerals including marble.

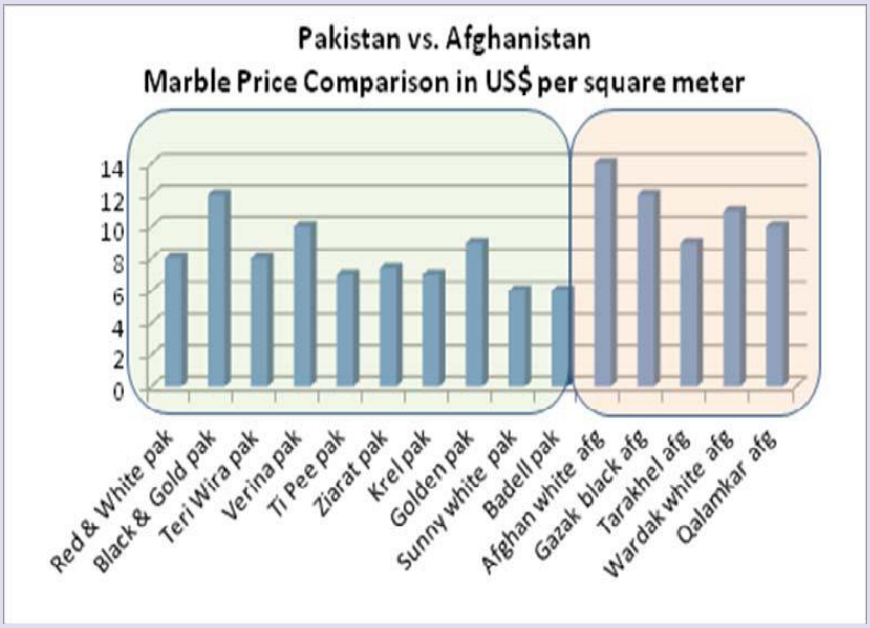
There are 35 known types and varieties of marbles with 40 different colors. The most common color is white but it can be yellow, red or green which are used in sculpture, building materials and 60 known deposits exist in Afghanistan while 21 marble producing units are operating in Afghanistan. The industry remained underdeveloped due to lack of investment, adequate infrastructure, mining capacity and regulatory framework, but still wide variety of marbles are extracted from quarries in Badakhshan, Balkh, Bamyan, Helmand, Herat, Kabul, Kandahar, Logar, Faryab, Wardak, Nangarhar, Paktia, Parwan and Samangan provinces. Onyx marble

quarried from several provinces of Afghanistan is known for its high quality and variety of shades ranging from white to almost all colors. The Chesht and Khogiani marbles are compared to the famous Carrara marble of Italy, one of the finest marbles in the world.

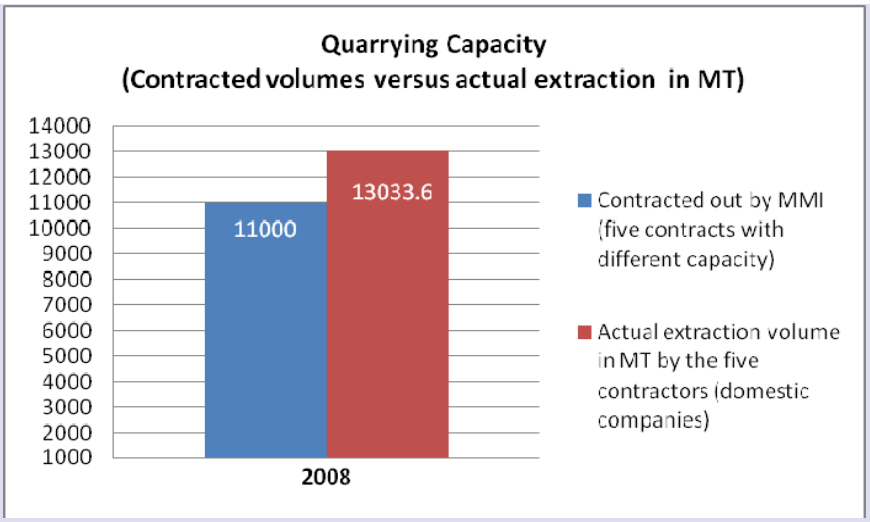
The marble is exported as rough hewn blocks to Pakistan where it is processed and then transported back to Afghanistan. This imported marble dominates the market as local producers are unable to compete with the low prices and high quality. The Afghanistan marble industry suffers from a lack of adequate equipment, has little technical knowledge, and uses poor extraction methods and outdated extraction machinery that often significantly reduces the value of the marble. Extraction is by blasting using 'black powder', typically imported from Pakistan. This causes micro-fracturing throughout the entire quarry and results in up to 50% of wastage at the quarrying stage – in some cases as high as 80% (AISA, 2008). Further wastage occurs at the marble factory where blocks often break up during the cutting and polishing stages of production and transportation cost out of Afghanistan make exports of most types of the marbles unprofitable.

The world production of dimension stone comprising of marble, granite, slate, limestone and sandstone is about 70 million tons (Mumtaz, 2003). In marble, production is dominated by five countries worldwide, Italy, Turkey, Spain, India and China. These countries control over the half of the market. Worldwide the marble industry has been growing strongly since 1990s, and at roughly 8.7% per year since 1999. The industry is expected to continue to grow over 8% per year into 2025. Currently, 55% of the marble quarried is destined for exports. Estimates are that by 2025, 60% of all quarried marble will be exported (the OTF Group, 2006). World marble imports are estimated at $ 2.5 billion (AISA, 2008). Recent market trends indicate a shift away from exports of blocks to more value added products such as slabs and finished goods like tiles, etc. (the OTF Group, 2006). Based on these facts, the overall trend of the marble industry, worldwide, seems to have continuous growth, which makes the industry players optimistic about its future.

Afghan traders import finished goods – in vast quantities – from Pakistan in different colors and sizes. The Afghan marble – due to its high cost of production cannot compete in the Afghan markets.

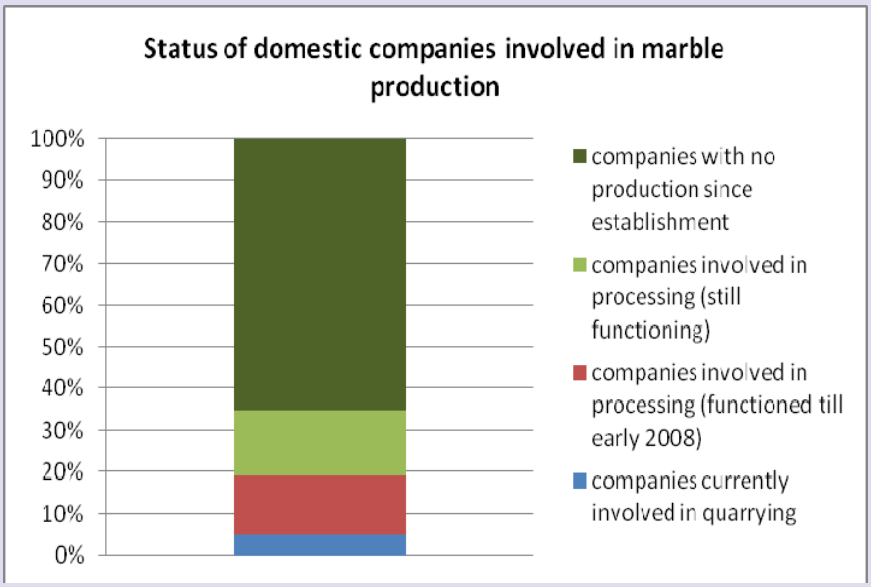


Currently the Afghan marble industry aggregate production capacity – at the quarry sites based on existing contracts with five domestic companies and/or individuals – is supposed to be around 11,000 Metric Tons (MT) for the year 2008 (Quarry Dept. of MMI, 2008). The actual members collected from the factories doing the quarrying operations are lightly different. Look at the chart below:



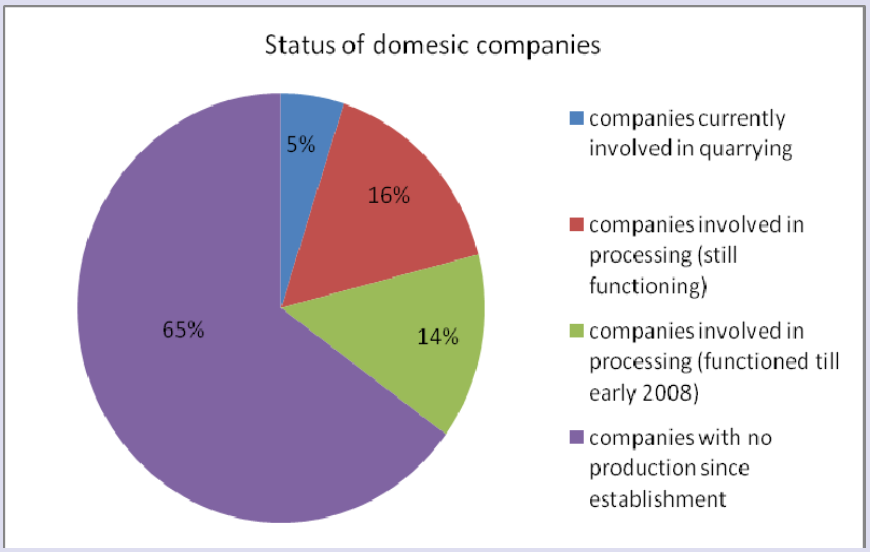
Source: AMGPA and MMI/AGS as of November 2008

There are literally around 130 SMEs nationwide registered to be functioning in the marble industry. But in the real world only around 30% of them have been productive. Of these, very few are involved in the quarrying operations and most in the processing part through the value chain. Take a look at the graph below:



Source: AMGPA and MMI/AGS as of November 2008

Around 130 SMEs are producing marble across the country and overall context for rivalry is not impressive. Therefore, the growth of companies has been going through a declining trend. 65% of companies that were established with the mandate to work in marble industry have not been productive at all. 14% of companies could only continue to produce till early 2008 and went bankrupt afterwards. Only 16% of companies are functioning at the moment and can continue to produce. Five percent of companies are involved in quarrying operations only. The pie chart shows that clearly:



Source: AMGPA and MMI/AGS

Most of the reports and studies conducted in the area do not sufficiently analyze the various factors involved in the process. Therefore, do not give a clear cost/benefit analysis to the investors so that the investors dare to invest in order to avoid wastage in the quarrying stage and guarantee the competitiveness of Afghan marbles. Improvement in some factor conditions, such as skilled labor, new techniques of production, good security condition and better infrastructure, is essential to attract FDI and guarantee competitiveness through low price and high quality of domestic marbles both in domestic and foreign markets.

The Real Economy

7

7

THE REAL ECONOMY

SUMMARY

The Afghan economy experienced its lowest level of growth in 1387 (2008-09) since the beginning of the transitional period in 2002. According to the preliminary data of the Central Statistics Office, real GDP (Gross Domestic Product) including opium grew by 2.3 percent in 1387 compared to 16.2 percent a year earlier, while the IMF (International Monetary Fund) estimated the GDP excluding opium to grow by 3.4 percent down from 12.1 percent in 1386. Unlike other developing countries, such a sharp decline in economic growth is not likely due to the global recession but mainly due to a significant drop in rainfall which affected severely Afghanistan's agriculture-dependent economy.

Agriculture output which makes almost 30 percent of the total GDP declined by 16.5 percent due to insufficient and untimely rainfall in the country. Within the agriculture sector, cereal production dropped by more than 30 percent while fruit and livestock output had positive growths. The industry and services sectors, in contrast, performed well in 1387. In the industrial sector, mining and construction sectors had strong growths of 30 percent and 10 percent, respectively. On the other hand, fast expansions in the sectors of communications and finance elevated the share of services in total GDP from 36.5 percent in 1386 to 40.7 percent in 1387.

Prospects for 1388 remain highly favorable due to adequate and well-distributed rainfall at the beginning of the year. Initial crop-cup surveys by the Ministry of Agriculture, Irrigation and Livestock (MAIL) forecast agriculture output to boost by more than 70 percent in 1388. Therefore, the real GDP growth in 1388 is projected at 15.7 percent while the projection is subjected to some uncertainties if the global recession lasts longer than what is expected because

global spillovers might affect the Afghan economy through trade, current transfers and regional economic cooperation.

1. GROSS DOMESTIC PRODUCT BY SECTORS OF PRODUCTIONS

The real GDP growth (including opium) for the year 1387 was recorded at 2.3 percent, the lowest rate of growth in the last 7 years. The geometric mean of economic growth for the period 1382-1386 is actually 12.9 percent. Such a low level of growth in 1387 is related to the poor performance in the agriculture sector. The value added in agriculture sector (in constant prices) declined by 16.5 percent, bringing the share of agriculture sector in total GDP to 30.6 percent down from 36.4 percent a year earlier.

According to the United States Geological Survey (USGS), the amount of rainfall in 2008 was 36 percent less than that in 2007. As rain-fed area makes more than 50 percent of total cultivated crops area, total cereal production dropped to 3.6 million tones in 1387 down from 5.5 million tones in 1386. The decline in agriculture output was the main drag on GDP. Thanks to the services and industries which partially offset the negative impact of agriculture production.

Industry and services sectors grew by 7 percent and 16 percent, respectively. (See Table 2.3 below) In the industries sector, mining increased by 30 percent but it was less than what it was a year earlier. Manufacturing which makes 62 percent of the total industrial output increased by 4.5 percent in 1387 compared to 5.1 percent in 1386. Among the manufacturing industries, "paper production and publishing" had the strongest growth of 13.4 percent, thanks to a fast expanding market in the country for publications of books, newspapers and magazines.

In the services sector, "whole sale and retail trade" make up the largest share in services of 11 percent. It increased by 10 percent in 1387 which was its highest rate of growth since 2002. Communications had the strongest expansion in the services sector. It increased by 60 percent, though it was half as mush as it was in 1386. Financial services had also a strong growth in 1387 of about 30 percent, thanks to an increasing number of financial institutions and to an ever expanding banking network in the country.

Box 9: Cereal production in 2008 one of the lowest in the latest years

Weather condition during 1387 was been favourable for main crops. Cumulative rainfall from October 2007 to March 2008 in most parts of the country was well below normal. The rainfall for the first crop season started in Badakshan and Kabul in October 2007. All other parts of the country received very little rain in October.

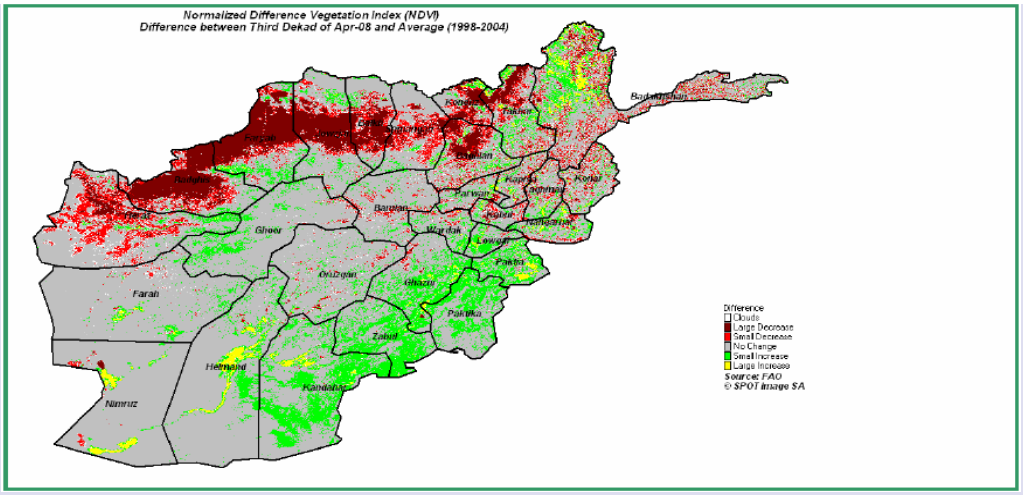
Normal agricultural operations suffered a major setback when November was dry all over. Weather conditions in December 2007 and January 2008 improved, but reduced and erratic precipitation in February and March was experienced in all parts of the country. Well distributed rainfall lacked in spring also.

To summarize, weather condition in the first crop season was not favourable. Firstly, weather condition in November was not conducive to land preparation and sowing of winter wheat and barley in time. Secondly, the late planting of wheat, owing to the late arrival of rain, and heavy snow thereafter, were distinctive features. Due to these, area and yield of rain-fed wheat, in particular, will decrease sharply. Lastly, extreme cold in January and February caused serious damage to fruits and vegetable crops in the main growing areas.

The dry weather condition adversely affected irrigated wheat and livestock as well. Central areas of the country and the western highland received slightly less snow than usual. The south experienced wet winter and benefited. However, this will not be able to revive irrigated wheat to reach the last year's reasonable yield level.

Normalized Difference Vegetation Index (NDVI) is a numerical indicator that can be used to assess the intensity of live green vegetation in a target area. NDVI difference between the last dekad of April (21-30 April) and the average value (for 1998 to 2004) is shown in the graph below. In the graph yellow and green represent better than normal conditions and dark red represents problem areas. It clearly shows that main problem areas this year are parts of north and north-east, and west, where most of wheat is grown.

Rain-fed wheat was not in good condition in all parts of the country as it experienced serious water stress, especially in January to March. The north-east and the west regions of the country accounted for 94% of the total rain-fed wheat area in 2007. Main adverse effect of rain-fed failure in 2008 was a considerable reduction in wheat production in the north and north-east, which are breadbasket of the country. Rain-fed wheat in 2008 failed in the western parts of the country also.



As irrigated wheat area is well distributed across regions, it is less prone to localized unfavourable weather pattern. However, mainly due to reduced irrigation water supply, irrigated wheat production in 2008 in majority of regions was also significantly lower than the last year's production.

Table 1: Percent changes in Area, Yield and Production of wheat in 2008
[Area in '000 ha. yield in tonnes/ha and production in '000 tonnes]

Type of Crop	2007			2008			Percent changes		
	Area	Yield	Prod	Area	Yield	Prod	Area	Yield	Prod
Irrigated wheat	1,071	2.69	2,878	990	2.43	2,406	-7.6	-9.7	-16.4
Rain-fed wheat	1,395	1.05	1,465	1,149	0.19	217	-17.6	-81.9	-85.2
All wheat	2,466	1.76	4,343	2,139	1.23	2,623	-13.3	-30.1	-39.6

Aggregate production of cereals in 2008 was 3.65 million tonnes, which is about 34% lower than in 2007. Year to year variations in cereal production are shown in Table 2.

Table 2: Annual percent change in REER and exports volume in Afghanistan

	2003	2004		2005	2006	2007	2008
Irrigated wheat	2,110	3,017	1,867	2,728	2,604	2,878	2,406
Rain-fed wheat	576	1,345	426	1,538	759	1,465	217
All wheat	**2,686**	**4,362**	**2,293**	**4,266**	**3,363**	**4,343**	**2,623**
Milled rice	260	291	310	325	361	425	410
Maize	298	310	234	315	359	360	280
Barley	345	410	220	337	364	370	333
Total cereals	**3,589**	**5,373**	**3,057**	**5,243**	**4,447**	**5,498**	**3,646**

Source: Agriculture Prospects Report, May 2008, Ministry of Agriculture, Irrigation and Livestock; figures updated according to the Agriculture Prospects Report, May 2009

Table 7.1: Real GDP Growth by Sectors of Production (Figures in percent)

	1383	1384	1385	1386	1387*
Agriculture	-4.9	6.7	0.6	24.6	-16.5
Cereals and other crops	-7.5	9.5	0.0	28.7	-20.2
Fruits and nuts	2.6	0.4	5.0	8.0	5.0
Livestock	10.3	-7.3	2.0	5.0	3.0
Industries	32.1	23.9	20.1	7.3	7.0
Mining and quarrying	92.6	17.6	10.1	37.0	30.0
Manufacturing	21.7	19.5	14.5	5.1	4.5
Food, beverages, & tobacco	22.1	19.5	14.5	5.0	4.5
Textile, wearing apparel & leather	-22.4	77.4	14.4	8.0	4.9
Wood & wood prod, incl. furniture	140.0	0.0	14.9	16.0	8.1
Paper production, printing, & publishing	8.3	15.4	7.6	5.0	13.4
Chemicals, coal, rubber, plastic	22.6	7.8	14.5	4.4	4.0
Nonmetallic mineral except petroleum & coal	16.5	10.9	14.5	6.3	5.2
Metal basic	193.5	11.0	15.0	2.0	11.6
Electricity, gas and water	-6.3	20.2	1.3	6.6	4.0
Construction	56.2	32.3	30.0	10.0	10.0
Services	16.2	14.6	16.9	14.2	16.0
Wholesale & retail trade, restaurants & hotels	5.4	6.7	9.7	5.3	9.8
Wholesale & retail trade	4.1	6.0	8.7	5.0	10.0
Restaurants & hotels	23.4	14.2	20.0	8.0	8.0
Transport, storage and communications	12.9	10.5	26.6	19.3	18.0
Transport, storage	12.4	10.4	22.0	12.0	12.0
Post and telecommunications	31.0	13.1	162.0	120.0	60.0
Finance, insurance, real estate and business	27.6	20.6	22.8	24.8	29.8
Finance	27.8	20.8	23.0	25.0	30.0
Insurance	25.0	0.0	13.7	5.6	6.0
Real estate and business services	11.1	10.0	4.5	10.0	10.1
Ownership of dwellings	4.3	1.3	3.4	3.0	12.0
Community, social and personal services	17.5	10.1	11.4	10.0	10.0
Producers of Government services	17.1	59.9	22.6	22.7	21.6
Other services	103.3	7.1	1.2	2.0	5.0
Gross Domestic Product	**9.4**	**14.5**	**11.2**	**16.2**	**2.3**

* Preliminary data

Source: Central Statistics Office

The nominal GDP (including opium) was 542.2 billion Afghanis or $10.7 billion in 1387. As shown in Table 2.4, agriculture sector makes 30.6 percent, industries make 25.4 percent and services make 40.7 percent of the total GDP.

Table 2.4: Share of Sectors in Total GDP (Figures in percentage, unless otherwise indicate)

	1383 (2004-05)	1384 (2005-06)	1385 (2006-07)	1386 (2007-08)	1387* (2008-09)
Agriculture	40.7	38.2	37.7	36.4	30.6
Industries	22.8	24.5	25.9	24.2	25.4
Services	34.3	34.1	33.6	36.5	40.7
Nominal GDP (billion Afghanis)	**272,707.00**	**338,541.00**	**407,672.00**	**505,629.93**	**542,167.38**

1.1 Gross domestic product by expenditure categories

The low level of growth in 1387 was mainly due to a fall in private consumption which makes 98.1 percent of the total GDP (according to 1386 data). Private consumption declined by 6.2 percent in 1387, as shown in Figure 2.2, as a result of higher prices for consumer goods which affected household purchasing power.

CPI inflation was recorded at an average 26.8 percent in 1387 due to a surge in world food and fuel prices. The Afghan economy is very vulnerable to global price shocks since imports cover 56.6 percent of the GDP (as of 1386). The global surge in food prices at the beginning of 1387 pushed domestic prices to rise to 43.2 percent in May 2008. This affected hugely the purchasing power of households which in turn lowered their consumption by a significant rate. The share of private consumption in GDP dropped from 98.1 percent in 1386 to 89.9 percent in 1387. (Figure 2.1)

Significant improvement in trade balance (net exports of goods and services) in 1387 partially offset the negative impact on GDP of a decline in consumption. The trade balance improved by 15.8 percent which did not let the real GDP to have a negative growth during the year and the economy did not contract. Exports (of good & services) increased by almost 17 percent in 1387 which gives a clear hint that Afghan exports are inelastic towards global demand. Clearly, Afghanistan's export items are either raw agriculture commodities – for which the global demand is less likely to decline – or dry fruits which receive little impact from a decline in global demand due to the small volume of our exports. However, exports of Afghan carpets which are normally classified as luxury goods due to their excessively high prices and distinct quality dropped by almost 30 percent. This indicates that the only exporting item of

Afghanistan which is elastic to the global demand is carpet.

Imports, on the other hand, had a decline of almost 6 percent. The decline in imports can be due to double facts: a decline in domestic demand and higher prices of fuel which made imports more costly. The imports of goods dropped by more than 7 percent in 1387, however, the decline in imports can be attributed only to non-food goods. The imports of food-related items almost doubled in 1387 since the shortage of cereals, especially wheat, was supplied through imports.

Firgure 7.1: Percent Share of total Consumption, Investment and Net Export in GDP

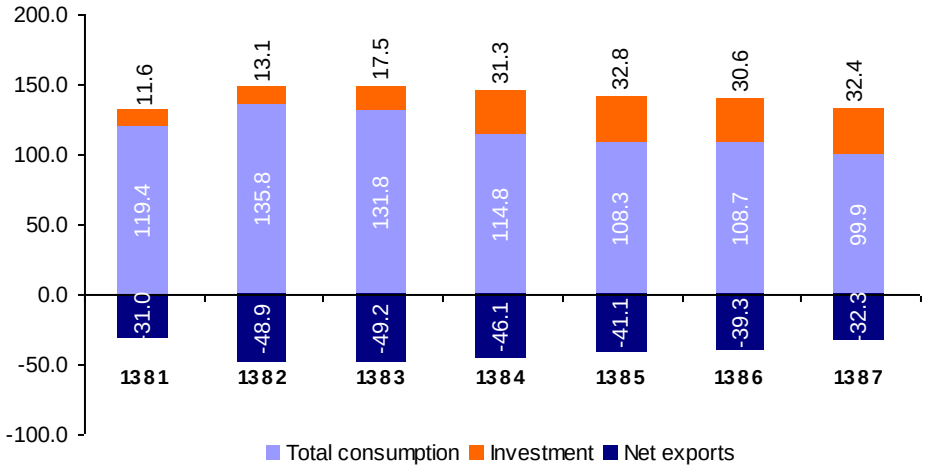
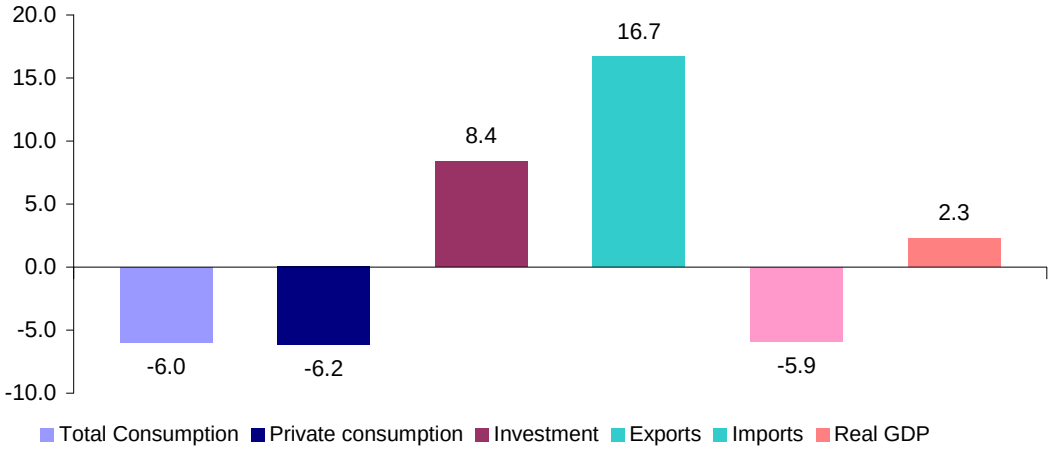


Figure 7.2: Annual Growth of GDP Components in 1387



Box 2.2: What is the likely impact of global recession on the Afghan economy?

Weather condition during 1387 was been favourable for main crops. Cumulative rainfall from October 2007 to March 2008 in most parts of the country was well below normal. The rainfall for the first crop season started in Badakshan and Kabul in October 2007. All other parts of the country received very little rain in October.

Normal agricultural operations suffered a major setback when November was dry all over. Weather conditions in December 2007 and January 2008 improved, but reduced and erratic precipitation in February and March was experienced in all parts of the country. Well distributed rainfall lacked in spring also.

The Afghan economy has been almost untouched by the global recession. The impact of global recession on Afghanistan has been low and almost unobservable. However, if the recession deepens and lasts longer that what is expected, Afghanistan can be affected through trade, foreign direct investment (FDI), foreign aid and finally through the region, especially through Pakistan which is its major trading partner.

Afghanistan – as an oil importing country – has benefited from the global decline in fuel and food prices. Lower fuel prices have made imports cheaper, and transportation costs for Afghan exports which are inelastic to the global demand have declined. Afghanistan is an agricultural commodity exporting country for which the demand always persists even during hard recession periods. The only exporting item which has seen a drop in its exports is the Afghan carpet. Afghan carpets are usually categorized as luxury goods due to their excessively high prices and their distinct quality. In 1387, exports of Afghan carpets declined by around 30 percent and its share in total exports dropped to 27.7 percent.

The spillovers of global recession may be transmitted indirectly to Afghanistan, especially through the region. An economic slowdown in Pakistan is highly likely to affect Afghanistan through trade – imposing trade barriers during political and economic crisis has been a common practice in the region, – and through other economic ties. The expel of thousands of Afghan workers from Iran – though it was more of a political motivation than of an economic incentive – has already affected a large number of Afghan population.

Afghanistan may also get affected through a decline in FDI or privatisation income. Foreign and multinational companies facing severe financial problems in western countries will have fewer incentives to invest in Afghanistan. Moreover, large stimulus packages in western countries have increased budget deficits at record levels. This may also have an impact on donor countries to reduce their foreign aid.

In contrast, the banking sector in Afghanistan has been safe from the financial turmoil in western countries since they had not invested their funds abroad. However, more cautious measures should be taken so that the financial sector remains safe and sound.

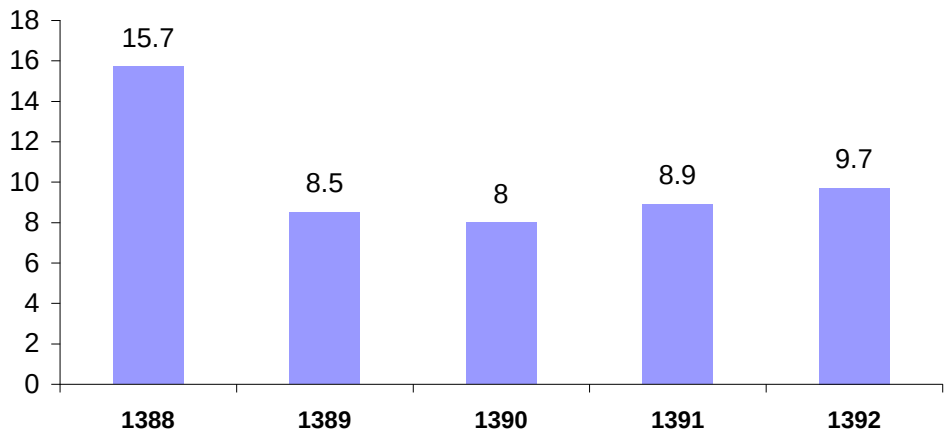
2. MEDIUM-TERM AND SHORT-TERM OUTLOOK REMAINS FAVORABLE

Real GDP is forecasted to grow by 15.7 percent in 1388 and will stabilize between 8 to 9 percent afterwards. The country experienced good amount of rainfall in the beginning of the year 1388 which was well above normal. The timely and well-distributed rainfall was quite favourable for agriculture production. According to the Ministry of Agriculture, Irrigation and Livestock forecast the cereal production will increase by more than 70 percent in 1388. Moreover, campaigns for the presidential elections in 1388 will also have a positive and substantial impact on economic growth.

However, the projection is subjected to strong uncertainties due to worsening security conditions. Insecurity will have negative impact on investment climate and will discourage foreign direct investments in the country. Industries which are mostly located outside the urban areas lack security for their better functioning. Therefore, industrial production is heavily dependent on security climate. On the other hand, consumer spending will likely to increase in 1388 since households have benefited from declining food prices, which has enhanced their purchasing power for the future.

The figure below shows medium-term projections of the IMF staff for the real GDP growth.

Title 7.3: Real GDP Growth Projections (1388-1392)



Appendix I: Monetary Base and Monetary Aggregates (in million AF)

End of period	Monetary Base (M0)			Narrow Money(M1)		
	Currency Issued	Bank Deposits With Central Bank of Afghanistan	Total	Currency in Circulation	Demand deposits	Total
1386						
April	50115	4446	54561	49186	42262	91448
May	50809	3940	54749	49980	43046	93027
June	52307	3520	55827	51196	43200	94395
July	53122	3225	56347	52194	47960	100155
August	54701	3172	57873	53678	47893	101571
September	53970	3787	57757	53045	50735	103780
October	58687	4244	62931	57551	52539	110090
November	57268	3303	60571	56178	54219	110396
December	58547	4692	63239	57220	56920	114139
January	57605	3195	60800	56280	55881	112162
February	57216	2666	59882	55818	56124	111942
March	58899	5557	64457	57501	57233	114734
1387						
April	58547	4521	63068	57149	58221	115369
May	61052	4544	65596	59706	58580	118286
June	62803	5130	67933	61052	60021	121074
July	65963	7496	73459	64170	65418	129588
August	65989	6184	72174	63893	65468	129362
September	66582	6839	73421	64850	70375	135225
October	70104	7230	77334	67697	71052	138749
November	71160	11901	83061	68531	77110	145642
December	72825	14738	87564	70142	76863	147005
January	72934	5877	78811	70124	76256	146380
February	74645	21781	96426	71990	79659	151649
March	76807	25579	102386	73842	84534	158376

Appendix II: Intermediate Money (M2) or Broad Money

End of period	Total (M0)			Intermediate Money(M2) (in Afghan case this is called broad money)			
				Narrow Money(M1)			
	Currency Issued	OMFI balances with Central bank of Afghanistan	Total (M0)	Currency in circulation	Deposits withdrawal on demand		Total (M1)
					Demand	Savings	
1386							
April	50115	-	50114.8	49186	42262	-	91448
May	50809	-	50809.4	49980	43046	-	93027
June	52307	-	52306.9	51196	43200	-	94395
July	53122	-	53121.8	52194	47960	-	100155
August	54701	-	54700.6	53678	47893	-	101571
September	53970	-	53970.0	53045	50735	-	103780
October	58687	-	58687.1	57551	52539	-	110090
November	57268	-	57268.0	56178	54219	-	110396
December	58547	-	58547.1	57220	56920	-	114139
January	57605	-	57604.9	56280	55881	-	112162
February	57216	-	57216.1	55818	56124	-	111942
March	58899	-	58899.3	57501	57233	-	114734
1387							
April	58547	-	58547.4	57149	58221	-	115369
May	61052	-	61051.8	59706	58580	-	118286
June	62803	-	62802.5	61052	60021	-	121074
July	65963	-	65963.2	64170	65418	-	129588
August	65989	-	65989.2	63893	65468	-	129362
September	66582	-	66582.2	64850	70375	-	135225
October	70104	-	70104.1	67697	71052	-	138749
November	71160	-	71160.3	68531	77110	-	145642
December	72825	-	72825.4	70142	76863	-	147005
January	72934	-	72934.4	70124	76256	-	146380
February	74645	-	74644.9	71990	79659	-	151649
March	76807	-	76807.3	73842	84534	-	158376

Appendix III: Currency in Circulation (CiC) (in million AF)

End of period	Currency issued and outstanding			Less Currency held by banking system	Currency in circulation
	Notes	Coins	Total		
1386					
April	50,115	-	50,115	(928.76)	49186
May	50,809	-	50,809	(829.07)	49980
June	52,307	-	52,307	(1,111.22)	51196
July	53,122	-	53,122	(927.35)	52194
August	54,701	-	54,701	(1,022.19)	53678
September	53,970	-	53,970	(924.70)	53045
October	58,687	-	58,687	(1,136.33)	57551
November	57,268	-	57,268	(1,090.38)	56178
December	58,547	-	58,547	(1,327.58)	57220
January	57,605	-	57,605	(1,324.51)	56280
February	57,216	-	57,216	(1,397.63)	55818
March	58,899	-	58,899	(1,398.79)	57501
1387					
April	58,547	-	58,547	(1,398.67)	57149
May	61,052	-	61,052	(1,346.17)	59706
June	62,803	-	62,803	(1,750.05)	61052
July	65,963	-	65,963	(1,793.43)	64170
August	65,989	-	65,989	(2,096.00)	63893
September	66,582	-	66,582	(1,732.09)	64850
October	70,104	-	70,104	(2,407.01)	67697
November	71,160	-	71,160	(2,628.85)	68531
December	72,825	-	72,825	(2,682.96)	70142
January	72,934	-	72,934	(2,809.97)	70124
February	74,645	-	74,645	(2,654.70)	71990
March	76,807	-	76,807	(2,965.73)	73842

Appendix IV: Net Foreign of the Monetary Financial Institutions (in million AF)

End of period	Central Bank of Afghanistan							Total (A)
	Foreign Assets				Foreign liabilities	Net Foreign Asset	Government & parastatal companies	
	Gold	Convertible Currencies	Other Foreign Assets	Total foreign assets				
1386								
April	23217.29	86104	11,491.30	120813	5621	115192	0	115192
May	23217.29	87511	12,014.69	122743	6383	116360	0	116360
June	23217.29	89344	11,885.61	124447	6596	117851	0	117851
July	23217.29	97597	13,703.15	134517	7265	127252	0	127252
August	23217.29	98105	15,188.12	136510	6940	129570	0	129570
September	23217.29	102928	19,865.15	146010	7976	138034	0	138034
October	23217.29	108639	21,245.81	153102	7772	145330	0	145330
November	23217.29	109011	20,353.56	152582	8960	143622	0	143622
December	23217.29	108709	23,130.79	155057	7491	147566	0	147566
January	23217.29	110844	21,885.89	155947	8913	147034	0	147034
February	23217.29	107044	21,797.60	152059	10198	141861	0	141861
March	33368.07	111066	23,553.21	167988	8335	159652	0	159652
1387								
April	33368.07	110988	24272	168629	8363	160266	0	160266
May	33368.07	110562	24993	168923	4885	164038	0	164038
June	33368.07	105304	26425	165098	5912	159186	0	159186
July	33368.07	110474	25662	169504	5095	164409	0	164409
August	33368.07	115679	25292	174340	5084	169255	0	169255
September	33368.07	116161	25916	175445	5482	169963	0	169963
October	33368.07	122095	26715	182178	5292	176885	0	176885
November	33368.07	120500	27721	181589	5374	176215	0	176215
December	33368.07	128364	30839	192571	12949	179622	0	179622
January	33368.07	132068	32160	197596	22181	175415	0	175415
February	33368.07	146929	33789	214086	29445	184641	0	184641
March	33368.07	150493	34075	217936	30547	187389	0	187389

Appendix V: Financial Market

	2007				2008				2009
	March	June	Sep	Dec	March	June	Sep	Dec	March
INTEREST RATES (%)									
Central Bank of Afghanistan									
Rate on overnight deposits	6.61%	6.85%	6.61%	6.95%	13.53%	13.54%	11.38%	10.18%	6.33%
Remuneration on required reserves	6.72%	7.05%	6.85%	9.46%	13.53%	13.54%	11.38%	10.18%	6.33%

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