

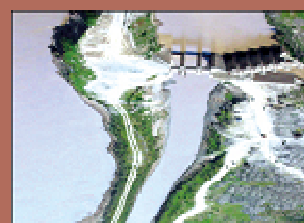
The Afghanistan Bank

Central Bank of Afghanistan

Quarterly Economic and Statistical Bulletin

Fourth Quarter-1386

Dec 2007 - March 2008



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Data Notes

Afghanistan uses the Persian calendar also known as the Jalali calendar, which was introduced on March 15, 1079 by the Seljuk Sultan Jalal-u-ddin Malik Shah I, based on the recommendations of a committee of astronomers, including Omar Khaiyam, at the imperial observatory in his capital city of Isfahan. It is a solar calendar in which each year begins on March 21. This Quarterly Bulletin covers developments in fourth quarter of 1386 which is equivalent December, 2007 – March, 2008 in the Gregorian calendar.

Afghanistan figures are in current Afghani unless otherwise specified.

Billion means 1,000 million

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List of abbreviations:

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



Governor's Statement

I am pleased to present the Fourth Quarterly Economic and Statistics Bulletin for the period December 2007 to March 2008. This Quarterly Bulletin reflects the main developments in the Bank's activities aimed at keeping inflation low, maintaining the stability of the national currency and developing a robust banking sector in support of sustainable economic growth.



The fourth quarter of the solar year was characterized by turbulence in the global economy which had significant implications for Afghanistan—a small open economy. After several years of rapid growth, the world economy faced serious challenges to maintain its robust growth. The sub-prime credit crisis in the United State, the decline of the US dollar against other major currencies, the persistence of large global imbalances and high oil and food prices threatened the sustainability of global economic growth with potentially significant impacts on Afghanistan's macroeconomic stability.

As a result of global developments Afghanistan experienced its sharpest inflationary surge in years, with price increases in the fourth quarter of 1386 coming in well above expectations. Headline inflation, as measured by year-on-year percentage changes in Kabul CPI, continued its upward trend from the previous quarter, increasing to 20.7 percent at the end of the fourth quarter of 1386.

The main drivers of inflation in the fourth quarter of 1386 were the prices of food, energy and construction materials. The food sub-index rose sharply by 30.6 percent at the end of the fourth quarter largely as result of developments in global commodity markets. Construction materials prices rose by 17.9 percent at the end of the quarter under review largely because of boom in housing and construction projects as a result of excess demand driven by a spike in remittances and a record high opium harvest.

On the fiscal side, government finances remained on track to meet revenue and spending targets. Total operating expenditures at the end of fourth quarter 1386 rose to 16.2 billion AF (324 million USD) or about (3.9 percent of GDP). Meanwhile, expenditure in development budget rose to 18.7 billion AF or about 24 percent from the total development budget for the

year 1386. On the revenue side, total domestic revenue at the end of fourth quarter 1386 stood at 9.9 billion AF (198 million USD) or about (2.4 percent of GDP) it has increased about 22 percent compared to the third quarter 1386.

The banking system continued to perform satisfactorily. Total assets of the banking system rose to AF 84 billion (USD 1.68 billion) at the end of the fourth quarter 1386, up by 55 percent or AF 30 billion since the beginning of solar year 1386. Loans amounted to AF 40 billion (USD 805 million) an increase of AF 18 billion (USD 366 million) or 84 percent since March 2007. Deposits stood at AF 64 billion (USD 1.28 million) over the period under review; a 58 percent increase since march 2007. Deposits were largely denominated in USD (72 percent) with AF - denominated deposits were lagging at 23 percent. Total capital of the banking system stood at AF 15.8 billion (USD 316 million). Banking sector overall was profitable earning a year-to-date net profit of AF 1.23 billion (USD 24.6 million) since the beginning of 1386, for an overall return on assets (ROA) of 1.84 percent which was higher than previous year – 0.28 percent.

On the external front, the trade deficit, the difference between exports and imports of goods in the fourth quarter of 1386 increased by 21.35 percent to USD 936.29 million, comparing to USD 771.54 million in the same quarter a year ago. The increase in the deficit was driven by imported inflation and high demand for construction materials and food commodities. The imports increased by 22.8 percent to USD 1090.86 million in the last quarter of 1386, comparing to the same quarter one year ago.

Capital inflows - from exports, foreign direct investment and financial inflows from the donor communities have increased the Net Foreign Assets of Da Afghanistan Bank by 24.83 percent at the end of the fourth quarter of 1386, comparing with the same quarter a year ago.

In conclusion, on an overall assessment, economic performance in the fourth quarter 1386 was satisfactory notwithstanding concerns about the buildup of inflationary pressure due to record oil prices and surges in the prices of wheat in international markets. The central bank remains vigilant against second-order effects of inflation and will conduct monetary policy consistent with overall economic conditions.

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank
(Central Bank of Afghanistan)

1

INTERNATIONAL ECONOMIC ENVIRONMENT

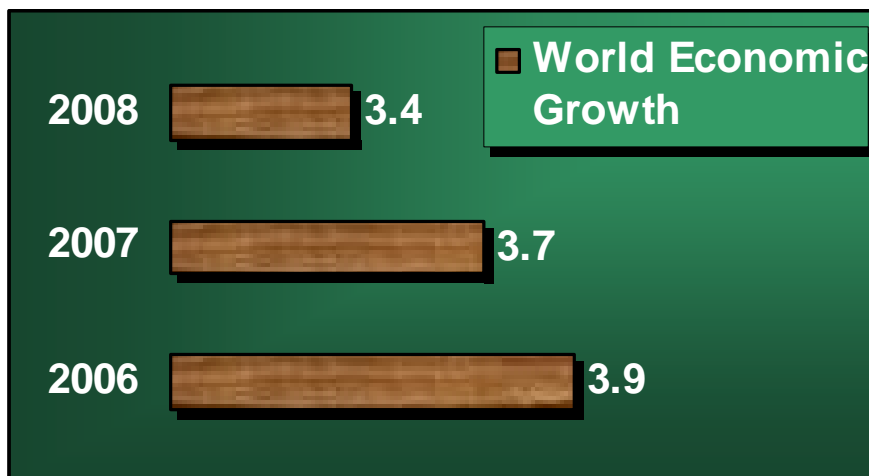
Summary

Following several years of growth, the world economy is facing severe challenges to maintain its robust growth. The sub-prime credit crisis, the decline of USD against other major currencies, the persistence of large global imbalances and high oil and food prices are all threatening the sustainability of global economic growth. These factors have the potential for

severe negative consequences for a small open economy such as Afghanistan.

The growth of world economy is projected to moderate somewhat from 3.9 percent in 2006 to 3.7 percent during 2007. The United Nations world economic growth forecast shows that the world economic growth will slow further to 3.4 percent in 2008.

Figure 1.1: World Economic Growth



Source: Different Official Websites.

1. The US Economy Upgraded Higher Growth

In the United States, Gross Domestic Product, a measure of overall economic

growth, expanded at an annual rate of 0.9 percent in the first three months of 2008, comparing to 0.6 percent in the fourth quarter of 2007. The growth is higher than

the advanced estimate data, released a month ago, which put the growth rate at 0.6 percent. The government revised its figures because imports declined more than expected in the first quarter, narrowing the nation's trade deficit.

Inflation grew by 3.5 percent in the first quarter of 2008, comparing to 3.8 percent in the fourth quarter of 2007. The growth in the prices is backed by the high food and oil prices in the international markets.

2. The U.K Economy Slows Slightly

In the United Kingdom, real GDP grew by 2.5 percent in the first quarter of 2008, comparing to 2.1 percent in the last quarter of the previous year. The growth in the UK was driven by the services sector and consumer spending, given that the retail sales grew by 2.0 percent quarter on quarter.

Consumer Price Index grew by 2.5 percent in the first quarter of 2008, comparing to 2.1 percent in the last quarter of the previous year. The inflation was due to increase in the price of gas, electricity and heating oil.

3. Germany Leads Euro Area to Higher Economic Growth

In the Euro Area, real GDP grew by 2.2 percent in the first quarter of 2008, comparing to 2.1 percent in the last quarter of the previous year. The German economy

grew 1.5 percent in the first quarter of this year, delivering its best performance in over a decade despite the global financial crisis and recessionary fears enveloping the United States. Due to higher consumer demand in Germany, the wholesale and retail sectors both recovered, driven by a more favorable assessment of their current situation but also by improved expectations. Germany accounts for a third of economic output among 15 members of the euro zone.

Surging energy and good prices pushed the yearly inflation rate at a record level of 3.54 percent in the first quarter of 2008, comparing to 2.1 percent in the last quarter of the previous year. Inflation in the euro-zone is now running at the highest since Eurostat started keeping records for each nation in 1996.

4. Fall in Spending Slows Japan's Economy

In Japan, real GDP grew by 1.1 percent in the first quarter of 2008, down from 1.8 percent in the last quarter of the previous year. People were cutting back overall expenses to cope with rising food and energy prices. Food and energy are so vital, and a hike in those prices is directly affecting household spending.

Rising energy and food prices were major factors lifting Japan's consumer price index, which rose by 1 percent in the first

quarter of 2008, up from 0.5 percent in the

5. Developing Economies

In China, despite bad weather conditions (low temperature and ice storms), and due to the growing impact of sub prime; GDP witnessed double digit growth of 10.6 percent in the first quarter of 2008 comparing to 11.4 percent in the last quarter of the previous year. China's economic growth was backed by high consumer demand and high exports.

In China, inflation grew by 5.12 percent in the first quarter of 2008, up from 4.5 percent in the last quarter of 2007. Inflation in China was mainly backed by higher energy and food prices in the world markets.

In India, real GDP grew by 8.8 percent in the first quarter-2008, comparing to 9.6 percent in the last quarter-2007. India's economic growth is mainly driven by

last quarter of the previous year.

strong domestic demand and the growth in exports.

In India, inflation grew by 5.6 percent in first quarter-2008, comparing to 3.4 percent in the last quarter of 2007. The inflation, like other countries, is mainly driven by high food and energy prices.

In Pakistan, economic growth is estimated to be 8 – 9 percent in the first quarter of 2008, comparing to 8.9 percent in the fourth quarter of 2007. But real growth rate data is expected to be lower than the forecasts due to political uncertainties and poor agricultural products.

Table 1.1: World Economic Indicators
(Percentage Change over the same Quarter Previous Year)

	GDP growth		Inflation	
	Q4-07	Q1-08	Q4-07	Q1-08
Developed Countries				
U.S	0.6	0.9*	3.9	3.5
U.K	2.9	2.5	2.1	2.5
Euro Area	2.3	2.2	2.1	3.54
Japan	1.8	1.1	0.5	1
Developing Countries				
China	11.4	10.6	4.5	5.12
India	9.6	8.7	3.4	5.6
Pakistan	7.02	6.0 - 6.5**	8.9	8.0 -9.08*

* Preliminary Data

** Advance Estimates

Source: Different Official Websites.

6. Commodity Prices

6.1. High Food Prices, Affect People around the Globe

The price of wheat doubled, in the first quarter of 2008 (fourth quarter-1386) wheat prices increased by 100.98 percent. Wheat was not the only food stuff trading with

high prices in world food commodity markets.

Rice and coffee prices are running at 10-year highs, and in some countries, prices for milk and meat have more than doubled. The price of rice increased by 52.25 percent in the first quarter of 2008 compare to the same quarter a year ago.

Table 1.2: Food Commodity Prices Q4 1386 (first Quarter 2008)

Date	Wheat USD/MT ¹	Rice USD/MT ²	Beef US cents/pound ³
Jan-08	358	393	121
Feb-08	446	481	128
Mar-08	454	580	107
first Q-2008 Average	419.33	484.67	118.67
Quarterly Annualized %Change	100.96	52.25	0.1

1. US. No2, Hard Red Winter, FOB, Gulf

2. 5% Broken Milled White Rice, Thailand Nominal Price quote,

3. Australian & New Zealand 85% lean forest, FOB U.S. import Price

Note: 1Kg = 2.2 Pounds

Source: UNCTAD

The combination of many factors are pushing food prices up and raising the cost of living for people around the world. One of the factors is the growth in world's population, which is expected to hit 9 billion by the middle of the century. Increases in demand for food commodities (especially from China and India), is another factor driving the food prices high. Climate change and environmental factors are also adding to the prices of food around the world, frequent flooding and changing patterns of rainfall are having significant impact on agricultural products. The shift in agricultural production from food to bio-fuel is another

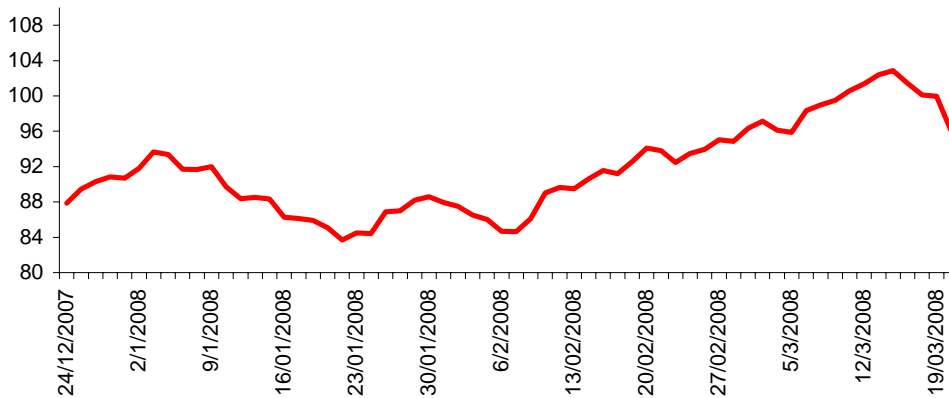
major reason for low supplies of food commodities and causing the prices to further increase. Ethanol production is on course to account for some 30% of the US corn crop by 2010, dramatically curtailing the amount of land available for food crops and pushing up the price of corn flour on international commodity markets. And Euro Area has set the target of converting 10 of its transportation fuel to biofuel by 2020.

6.2. Oil Prices Keep Raising

Oil is a key ingredient which drives economic growth, from production of machinery, transportation to electricity generation. In the fourth quarter of 1386 the OPEC basket price increased by 9.24

percent, comparing to 18.6 percent in the previous quarter of the same year.

Figure 1.2: OPEC Basket Oil Prices - USD/Barrel - Q4-1386



Source: OPEC

Oil prices are increasing due to a combination of weak dollar, supply concerns in some oil producing countries, and tensions in northern Iraq. Since OPEC is trading with USD so weak dollar means less real income from sales of oil. According to the OPEC the rise in oil prices are not due to supply shortage, it's because of the decrease in dollar's value, and shortage of refinery capacity and some political tensions in the world.

Demand is at an all-time high, fuelled by the continued economic expansion of the economies of China and India. China overtook Japan as the world's second-largest consumer of oil in 2003 and is closing in on the US, with demand for oil growing at about 15% a year. Western Europe and Japan are heavily dependent on oil imports as production cannot meet massive domestic demand.

Table 1.3: OPEC Basket Oil Prices*/Barrel
Q 4 1386 (Dec. 24, 07 - Mar. 21, 08)

	USD per Barrel
Avg. Dec.24-Jan.22	89.27
Avg. Jan.22- Feb.21	88.40
Avg. Feb.21-Mar.20	98.13
Average. Q4 - 1386	91.73
% Change	9.24
Lowest Price	83.7
Highest Price	102.88

* Is the combination of 13 Crudes: Saharan Blend (Algeria), Girassol (Angola), Oriente (Ecuador), Minas (Indonesia), Iran Heavy (Islamic Republic of Iran), Basra Light (Iraq), Kuwait Export (Kuwait), Es Sider (Libya), Bonny Light (Nigeria), Qatar Marine (Qatar), Arab Light (Saudi Arabia), Murban (UAE) and BCF 17 (Venezuela).

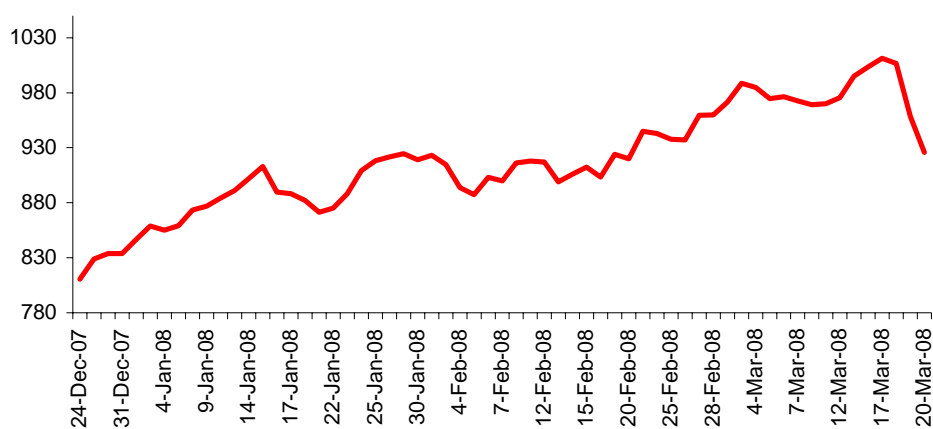
source: OPEC

6.3. Gold Price

The Gold price in 1385 (Mar.06- Mar 07) increased by 20.37 percent comparing to 28.43 percent in 1384 (Mar.05-Mar.06), showing 8.06 percentage points less decrease over the previous year. The average

gold price in 1385 was 624.91 USD per ounce comparing to 472.02 USD per ounce in 1384. Volatility for gold prices, as measured by standard deviation, in 1385 was 32.4 percent comparing to 49.81 percent in 1384.

Figure 1.3: Gold Price Ounce/USD - Q4-1386



Source: Bank of England

The price of gold increased mainly due to high demand for gold since investors believe metals are a sounder investment than shares, bonds or currencies, because of uncertainty about the volatility of interest rates or inflation (investment demand), Demand for jewellery, and speculation that Asian and European central banks may cut US dollar holdings in favor of gold, have also been increasing demand for gold

The prices of commodities like copper, zinc, silver and sugar have also jumped during the quarter under consideration largely due to the increase in demand.

Precious metals are often seen as a shelter when currencies weaken and inflation accelerates because investors are worried about the value of their stocks and bonds being cheapen.

Table 1.4: Gold Price Against USD
Q4 1386 (Dec. 24, 07- Mar. 21, 08)

	1 Ounce Gold
Average. Dec.24-Jan.22	867.99
Average. Jan.22-Feb.21	912.00
Average. Feb.21-Mar.20	971.04
Average Q4-1386	919.33
Quarterly % Change	17.51
Lowest	810.5
Highest	1011.25

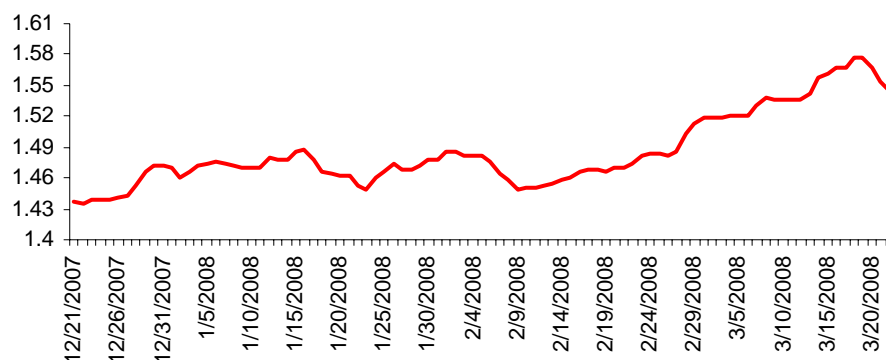
Source: Bank of England

7. Nominal Exchange Rate of Selected Currencies against USD

The nominal value of USD depreciated against Euro by 3.47 percent in the fourth quarter-1386, comparing to depreciation of 5.46 percent in the previous quarter of the same year. Volatility, as measured by standard deviation, in the fourth quarter-1386 is 0.04 percent comparing to 0.02 percent in

the previous quarter of the same year. The Dollar's historical decline began last summer when the scale of the crisis in US mortgage industry started. With weaker USD the American products would be cheaper for other countries; hence, it increases the exports. On the other hand products and trips to other countries would be much expensive to the US citizens travel to Europe.

Figure 1.4: Nominal Exchange Rate, Euro - USD (Q4-1386)

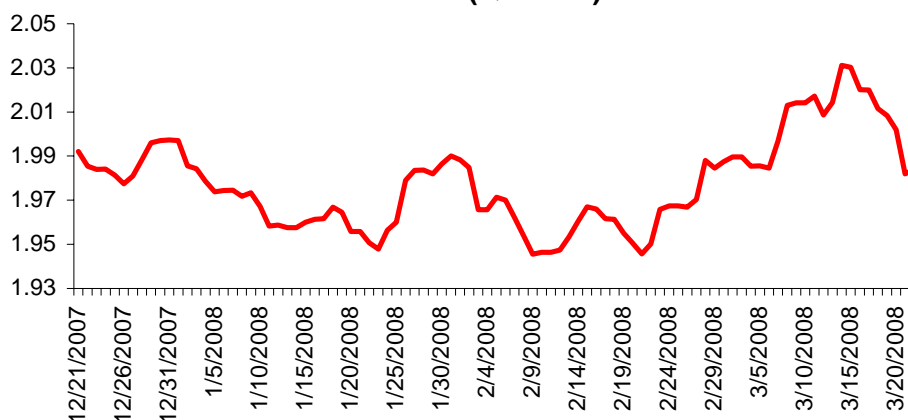


Source: Reuters

The nominal value of USD against Pound Sterling has appreciated by 3.41 percent in the fourth quarter of 1386, comparing to a depreciation of 1.45 percent in the previous quarter of the same year. As

the value of pound decreases against Euro and USD, exporters will benefit but expatriates and tourists traveling in Euro zone countries and US will lose out.

Figure 1.5: Nominal Exchange Rate GBP-USD (Q4-1386)



Source: Reuters

Table 1.5: Exchange Rates of Selected Currencies Against USD Q4 1386 (Dec. 22, 07 - Jan. 21, 08)

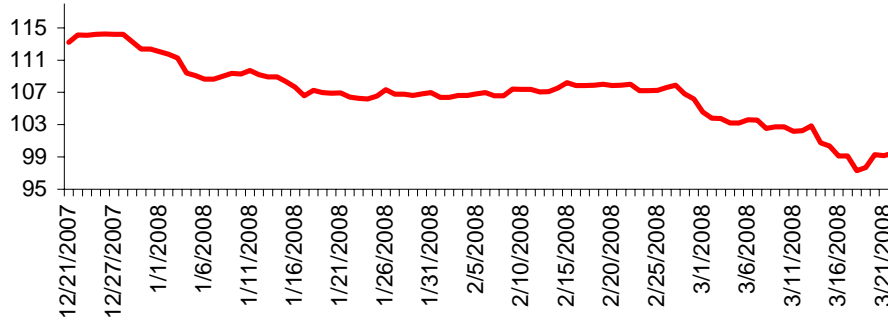
	Euro/\$	GBP/\$	\$/JPY
Average- Dec.21-Jan.22	1.46	1.97	110.26
Average- Jan.22-Feb.21	1.47	1.96	107.09
Average- Feb.21-Mar.22	1.53	2.00	103.05
Average for Q4	1.49	1.98	106.87
Lowest Exchange Rate	1.44	1.95	97.30
Highest Exchange Rate	1.58	2.03	114.23
USD- Appreciation (+)		3.41	
USD- Depreciation (-)	3.47		5.66

Source: Reuters

The nominal value of USD depreciated against Japanese Yen by 5.66 percent in the fourth quarter of 13896, comparing to 4.31 percent depreciation in the previous quarter of the same year. Volatility, as measured by

standard deviation, increased to 3.87 percent in the fourth quarter-1386, from 2.69 percent in the previous quarter of the same year.

**Figure 1.6: Nominal Exchange Rate
JPY-USD (Q4-1386)**



Source: Reuters

Note: As a matter of convention, the dollar-yen exchange rates are expressed in yen per dollar. Hence, an increase in this rate indicates an increase in the value of the dollar versus the yen. In contrast, the euro-dollar exchange rates are expressed in dollars per euro. Thus an increase in this rate indicates a decline in the value of the dollar versus the euro

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

Summary

According to the Monetary Program data, reserve money (RM) decreased by -3 percent in the quarter under review from 11 percent in the previous quarter. Bank deposits with the central bank, which is a component of reserve money, decreased by -22 percent in the fourth quarter 1386.

According to the monetary survey data, Narrow Money (M1) grew by 1 percent in the quarter under review down from 10 percent in the previous quarter. Currency Outside Depository Corporations which is the other component of Narrow Money grew by 0.5 which is down from 8 percent in the previous quarter while Quasi-money grew by 23 percent in the quarter under review from 14 percent in the third quarter 1386. Net Domestic Assets (NDA) which is a determinant of monetary growth declined by -3 percent in the quarter under review. Another determinant of monetary growth is

Net Foreign Assets (NFA) which increased by 10 percent in the fourth quarter 1386.

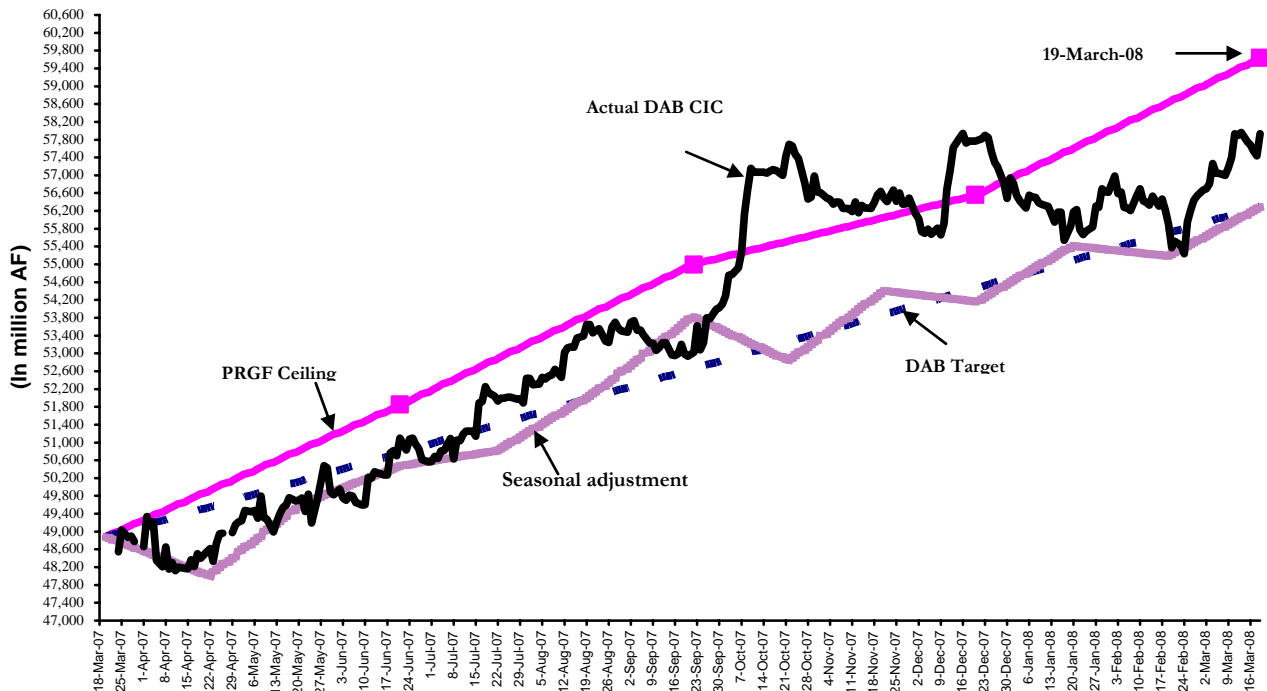
1. PRGF Monetary Program:

Monetary policy remained on target to meet PRGF targets in the fourth quarter of the year. The trend in daily Currency-in-Circulation (CiC) is shown below in the figure 2.1. Actual CiC remained below the PRGF Ceiling over the fourth quarter while it was above the ceiling in the last quarter. It is mostly affected by the bi-weekly foreign exchange auction in the market.

Reserve money declined by -3 percent in the fourth quarter from 11 percent in the third quarter 1386. This is mostly caused by Bank deposits with the central bank which decreased by -22 percent in the quarter under review from 23 percent in previous quarter.

Another reason for the decline of Reserve Money is that currency in circulation grew by 0.4 percent in the quarter under review down from 9 percent in the previous quarter.

Figure 2. 1: Daily Currency in Circulation (DAB Actual, Target, Seasonal Adjustment and PRGF Ceiling)



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

According to the Monetary Program data, which is shown in table 2.1, Net Domestic Assets decreased by -9 percent in the fourth quarter 1386 from -1 percent in the previous quarter. This represents -15 percent deviation from monetary program. This is because of the Other Items Net, which decreased by -3 percent in the quarter

under review from -13 percent in the previous quarter.

Net Foreign Assets increased by 3 percent in the fourth quarter down from 6 percent in the previous quarter, 1386. It is driven by Other Foreign Assets which grew by 33 percent up from 30 percent in the previous quarter.

Table 2.1: Performance of Afghanistan Monetary Program (Q4 1386) (in million AF)

	1386		Quarter Change (Q2-Q3)	1386		Quarter Change (Q3-Q4)	Deviation From Target
	Q2	Q3		Q4			
	Actual	Actual		Target	Actual		
1. Net Foreign Assets (a+b)	115,342	122,168	6%	116,578	125,416	3%	8%
(a) Foreign Assets (i+ii)	119,845	125,832	5%	122,034	129,223	3%	6%
i. Foreign exchange reserve	114,149	118,424	4%	116,936	119,387	1%	2%
ii. Other foreign assets	5,696	7,408	30%	5,098	9,836	33%	93%
(b) Foreign liabilities	-4,503	-3,664	19%	-5,455	-3,807	-4%	30%
2. Net Domestic Assets (a+b)	-54,671	-55,075	-1%	-52,332	-60,214	-9%	-15%
(a) Domestic Assets (i+ii)	-33,608	-31,373	7%	-28,310	-35,893	-14%	-27%
i. Net claims on general government	-33,608	-31,373	7%	-22,142	-35,893	-14%	-62%
ii. Capital Notes and Other Claims	-	-	-	-6,168	-	-	-100%
(b) Other Items Net	-21,064	-23,702	-13%	-24,021	-24,321	-3%	-1%
3. Reserve Money (a+b)	60,671	67,093	11%	64,247	65,202	-3%	1%
(a) Currency in Circulation	53,021	57,721	9%	58,319	57,931	0.4%	-1%
(b) Bank deposits with DAB	7,650	9,372	23%	5,928	7,271	-22%	23%

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

According to the Monetary Survey data which is shown in the below table 2.2, the supply of Broad Money (M2) expanded by 120201 million AF in the quarter under review from 118585 million AF in the previous quarter which shows a difference of 1616 million AF. This shows an increase of 1 percent in the fourth quarter down from 10 percent in the third quarter 1386.

The increase of Broad Money is due to Quasi Money which increased by 23 percent in the quarter under review from 14 percent in the previous quarter.

Narrow Money (M1) grew by 1 percent in the quarter under review from 10 percent in the third quarter 1386 which shows a difference of 594 millions AF. Currency outside depository corporations, which is another component of (M1) grew by 0.5 percent in the fourth quarter from 8 percent in the third quarter. The difference of Currency Outside Depository Corporations in the fourth quarter compared to the third quarter is 281 millions AF.

Table 2.2: Monetary Aggregate , Q4 1386 (in million AF)

	1386		Quarter Change (Q2-Q3)	Difference (Q2 - Q3)	1386		Quarter Change (Q3 - Q4)	Difference (Q3-Q4)
	Q2	Q3			Q4			
	Amount	Amount			Amount			
1- Narrow Money(M1)	103,780	114,139	10%	10,359	114,734	1%	594	
Currency outside depository corporations	53,045	57,220	8%	4,174	57,501	0.5%	281	
Demand Deposits	50,735	56,920	12%	6,185	57,233	1%	313	
2- Quasi Money	3,912	4,445	14%	534	5,467	23%	1,022	
In Afghani	993	1,055	6%	62	2,013	91%	958	
In Foreign currency	2,919	3,391	16%	471	3,454	2%	64	
3- Broad Money(M2)	107,692	118,585	10%	10,893	120,201	1%	1,616	
Determinants								
1- Net Foreign Assets	138,034	147,566	7%	9,532	162,445	10%	14,879	
(a) Foreign Assets	146,010	155,057	6%	9,047	167,978	8%	12,922	
DAB Foreign exchange reserves	126,145	131,926	5%	5,781	144,425	9%	12,499	
Other foreign assets	19,865	23,131	16%	3,266	23,553	2%	422	
(b) Foreign Liabilities	7,976	7,491	-6%	-485	5,534	-26%	-1,957	
2. Net Domestic Assets	-29,891	-28,981	3%	911	-42,244	-3%	-13,263	
(a) Net Domestic Credit	-1,979	861	143%	2,840	1,497	74%	636	
Net Claim on General Government	-36,671	-36,651	0.1%	20	-41,478	-0.1%	-4,827	
Claims on other Sectors	34,692	37,512	8%	2,820	42,975	15%	5,464	
(b) Other Items Net	7,497	5,903	-21%	-1,594	5,709	-3%	-194	
(c) Capital Accounts	35,410	35,745	1%	335	49,450	38%	13,705	

Source: Monetary Survey Section, Monetary Policy Department DAB

Due to change in the exchange rate, the Quarter change (Q2-Q3) differs in this bulletin from the previous bulletin.

Quasi Money, which is another component of (M2,) grew by 23 percent in the fourth quarter 1386 up from 14 percent in the previous quarter.

Net domestic assets which is a determinant of monetary growth decreased by -3 percent in the quarter under review from 3 percent in the previous quarter which shows a difference of -13263 million AF. This is because of the Net Domestic Credit which grew by 74 percent in the

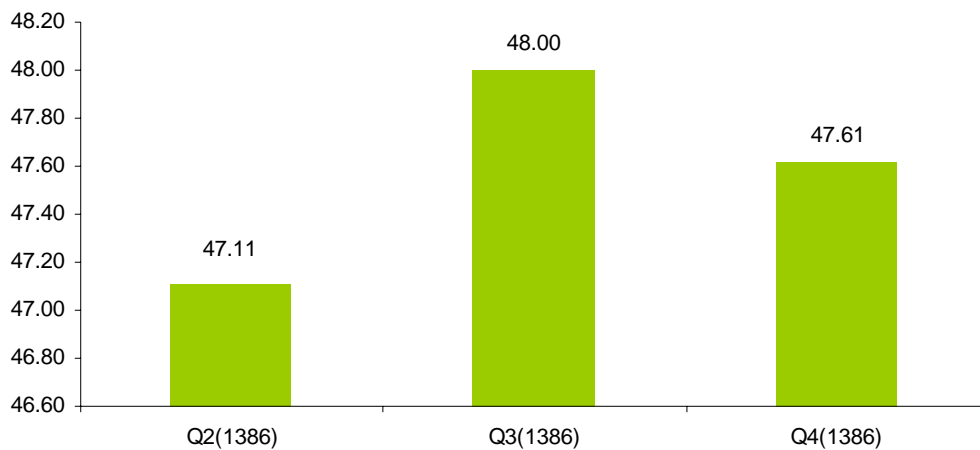
fourth quarter 1386 down from 143 percent in the previous quarter which shows a difference of 636 million AF. Net Claim on General Government a key component of Net Domestic Assets is another reason for decreasing the Net Domestic Assets. It declined by -0.1 percent in the fourth quarter from 0.1 percent in the previous quarter which shows a difference of -4827 million AF.

Claims on Other Sectors, which is another component of Net Domestic Assets grew by 15 percent in the fourth quarter 1386 up from 8 percent in the previous quarter.

According to the figure 2.2, Bank deposits as share of Broad Money grew by 47.61 percent in the fourth quarter 1386 which is less than 48 percent in the previous quarter.

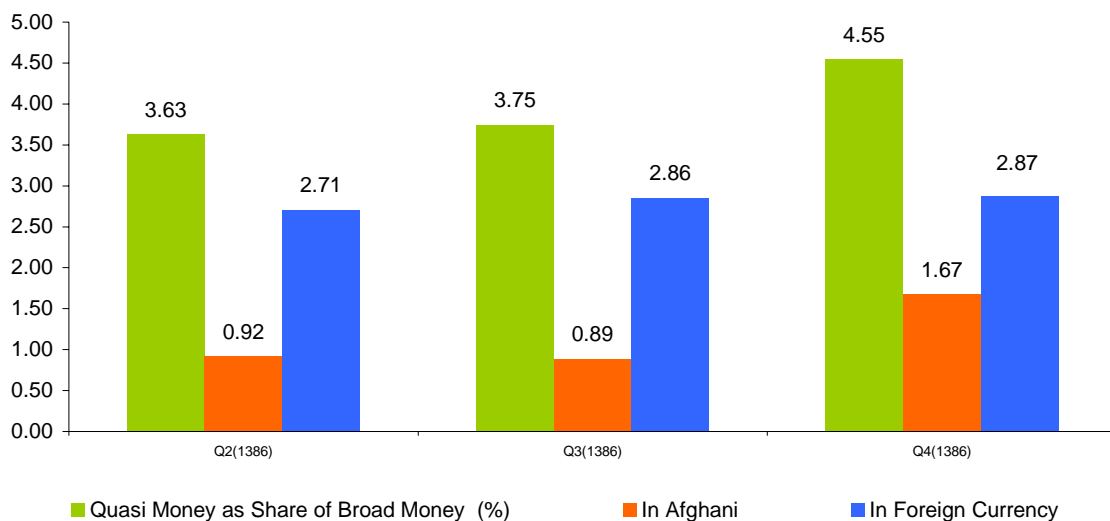
According to figure 2.3; Quasi Money as share of Broad Money increased by 4.55 percent in the quarter under review up from the 3.75 percent in the third quarter 1386. This is due to increase in Foreign Currency which increased by 2.87 percent in the fourth quarter 1386 from 2.86 percent in the third quarter 1386.

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



Source: Monetary Policy Department/DAB

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



Source: Monetary Policy Department/DAB

2. Capital Markets and Liquidity Conditions

2.1 Capital Note Auctions

Capital Notes are short-term Afghani denominated securities sold by the Central Bank at weekly auctions. An investor buys the Notes at a discount and receives payment of face value on the maturity date. 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.

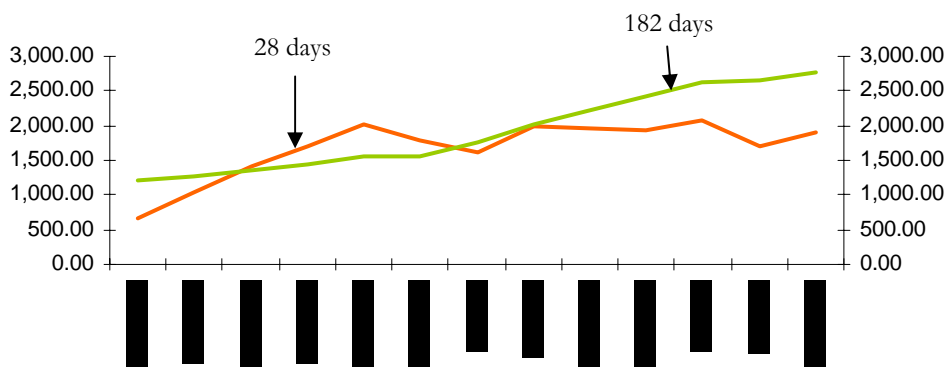
The amount to be auctioned is announced every Monday to the Banks electronically. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the

auction, investors bid to purchase desired values of Capital Notes at different discount prices. Bids have to be submitted before 11:00 am on the auction day.

Both 28 day and 182 day to maturities witnessed noticeable changes in their sizes.

28 day notes volume fluctuated between 260 million AF and 670 millions AF and for 182 days notes the amounts were 50 millions AF to 280 millions AF (these figures were fixed for auctions conducted prior to this quarter). The increase in CNs volume had a significant impact on the stock outstanding notes making it double as compare to the last quarter; the outstanding stock reached to 1,896 billion AF 28 days notes and 2,768 billion AF 182 day notes. It is mentioned that it has been the first time in the CNs history that more than announced volume of CNs have been awarded to the participants. (See figure2.4).

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

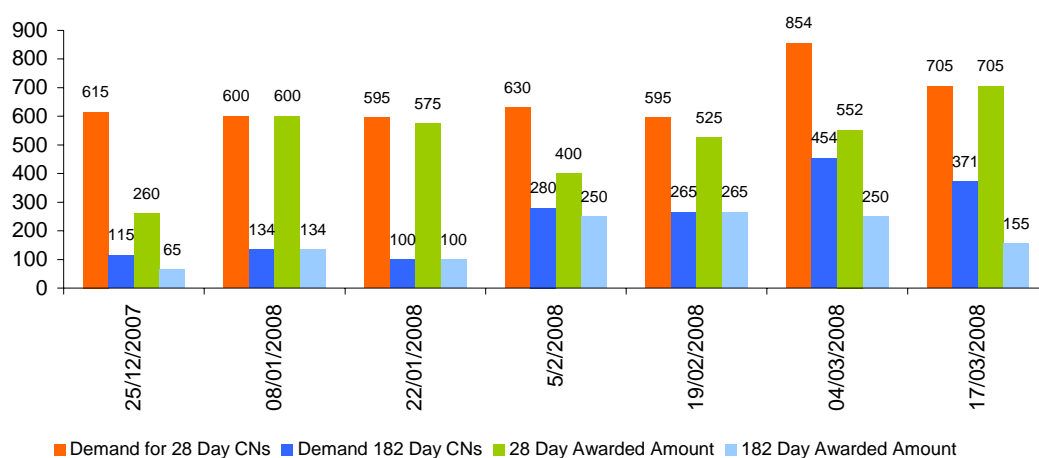


Source: Market Operations Department/ DAB

The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts offered. The bid amount for 28 days notes was 578 million AF and awarded amount was 471 million AF. These figures were 233 million AF and 165 million AF for 182 day notes respectively on an average

basis. In the last quarter the bid amount was 426 million AF 28 day notes and 93 million AF 182 day notes on average basis. During this quarter the awarded amount modestly met the demand for these notes (see figure 2.5 for CNs demand).

Figur 2.5 :Demand for Capital Notes from 25 Dec 07-17 Mar 08
(in million AF)



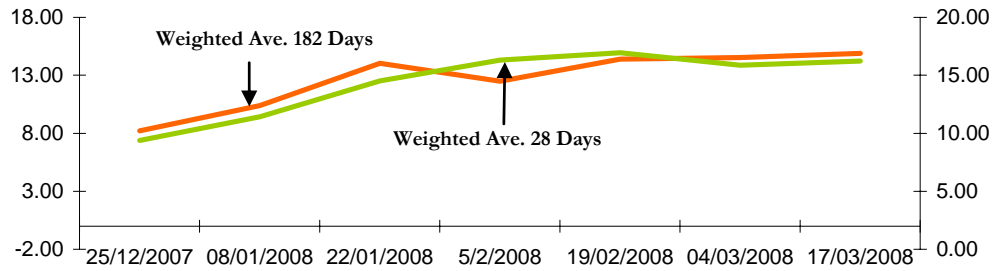
Source: Market Operations Department/ DAB

The increase in CNs interest rates encouraged more banks to participate. The number of participants increased from 5 to 10 for 28 day notes and from 2 to 3 for 182 days notes. (See table 2.3).

The increase in CNs supply resulted in high interest rates. The weighted average

interest rates ranged between 8.20 percent and 15.06 percent 28 day maturity and 9.38 percent to 18.00 percent 182 day to maturity. These figures were 7.31 percent to 8.41 percent and 9.18 to 10.00 percent respectively in the preceding quarter (See figure2.6).

Figure 2.6: Weighted Average of 28 and 182 Day Capital Notes Interest Rates (Dec. 21, 07 - March 20, 08)



Source: Market Operations Department/ DAB

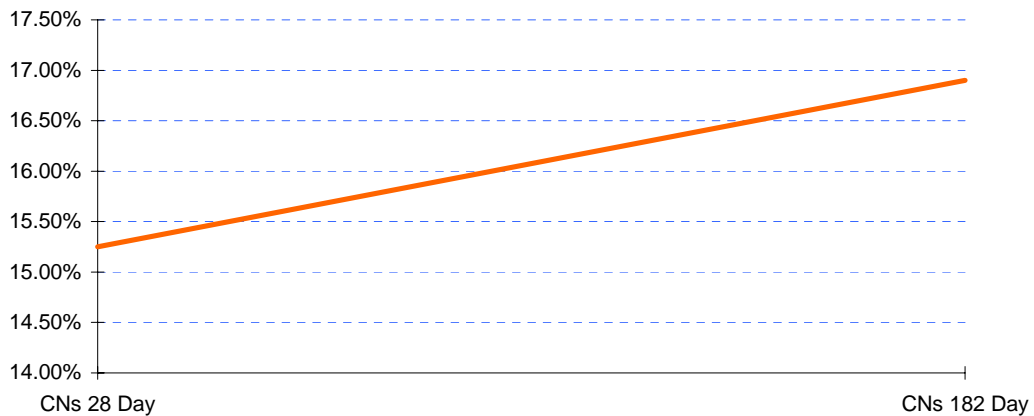
2.2 Term Structure of Interest Rates

The Term Structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity on a security. The

yield of the Capital Notes is the annualized percentage increase in the value of the CN.

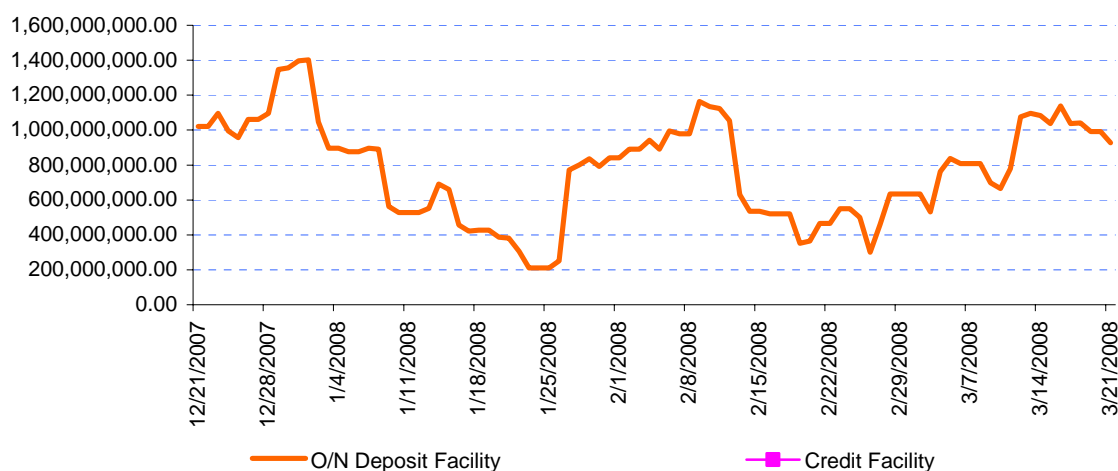
The yield curve for 17th Mar is positive and sloping upward.

Figure 2.7: Term Structure of Interest Rates Yield Curve (Mar 17, 2007)



Source: Market Operations Department/ DAB

Figur 2. 8: Over Night Deposit Balances (amount in AF)



Source: Market Operations Department

2.3 Required and Excess reserves

Overnight Standing Facilities were first introduced at the beginning of the year 1385 (2006-2007) at the initiatives of the banks. The purpose of introduction is to provide commercial banks with products to use them as safety net and to provide them with vehicle where they can invest their excess reserves.

Overnight Standing Deposit Facility: This facility is available for all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted for Required Reserves. The interest rate on overnight deposit facility is now 1.5 percent below 28 auction cut off rate, based on a circular to all banks approved by DAB supreme counsel on 27th Feb 2007. Based on the commercial Banks demand for funds, the outstanding amount of deposit facility balances was subject to

fluctuations, it fluctuated between 1.4 billion AF and 200 million AF. The declination was because of huge auctions of CNs. The quarter ended with stock outstanding amount of 1.00 billion AF (see figure 2.8).

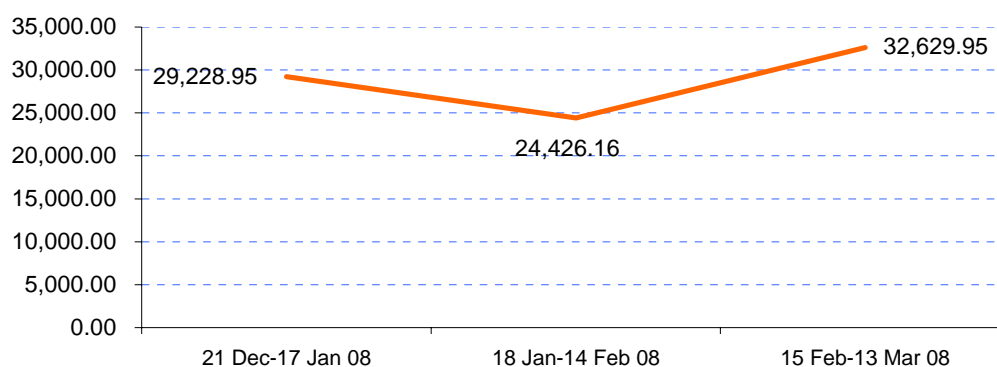
Overnight Standing Credit Facility: This facility is used by banks for short term cash need. The facility allows banks to borrow Afghani from Da Afghanistan Bank on an overnight basis when they face a short fall in cash flow. The rate that the banks are charged for this facility is 1.5 percent above the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only, according to the circular on 27th Feb 2007. It is stated that none of the banks used this facility during this quarter (see figure 2.8).

During the quarter required reserves averaged 291,474,110.00 AF per Bank, while excess reserves (including overnight

deposits) averaged 80,428,898.18 AF per Bank. These figures were 288,673,100.00 AF and 92,408,593.22 AF respectively during the last quarter.

Required reserves were remunerated at 1.5 percent below the cut off rate of 28 days Capital Notes Auction rate or equal to deposit facility rate.

Figure 2.9: Excess Reserves (Deposit Facility not included)
(thousand AF)



Source: Market Operations Department/DAB.

Table 2.3: Auctions of 28 Day Capital Notes

Da Afghanistan Bank, Capital Notes 28 Days Auctions Report (million Afs)									
Date	Auction Amount	Amount awarded	Total Bid Amount	No. of Wining bids	Total No. of Bids	Cut off Rate	Low Bid	Weighted Average	
25/12/2007	260	260	615	5	7	8.34	7.99	8.20	
01/01/2008	400	565	565	7	7	10.50	8.01	9.00	
08/01/2008	400	600	600	7	7	12.50	8.37	10.40	
15/01/2008	400	270	270	3	3	15.00	9.99	13.63	
22/01/2008	400	575	595	9	10	15.50	9.20	14.03	
29/01/2008	400	356	471	6	7	15.50	12.00	14.51	
05/02/2009	200	400	630	5	8	15.49	10.00	12.47	
12/02/2008	200	670	690	7	7	15.40	13.50	15.06	
19/02/2008	200	525	595	6	7	15.25	13.25	14.39	
	5,210	6,371							

Table 2.4: Auctions of 182 Day Capital Notes

Da Afghanistan Bank, Capital Notes 182 Days Auctions Report (million Afs)									
Date	Auction Amount	Amount awarded	Total Bid Amount	No. of Wining Bids	Total No. of bids	Cut of Rate	Low Bid	Weighted Average	
25/12/2007	65	65	115	1	2	9.38	9.38	9.38	
01/01/2008	100	115	115	2	2	11.00	10.00	10.43	
08/01/2008	100	134	134	2	2	13.00	10.49	11.42	
15/01/2008	100	150	150	2	2	15.00	12.50	13.63	
22/01/2008	100	100	100	1	1	14.50	14.50	14.50	
29/01/2008	200	50	150	1	2	18.00	18.00	18.00	
05/02/2008	50	250	280	2	3	18.00	9.80	16.31	
12/02/2008	100	280	280	3	3	18.00	14.00	16.94	
19/02/2008	100	265	265	3	3	18.00	13.50	16.94	
	915	1,409							

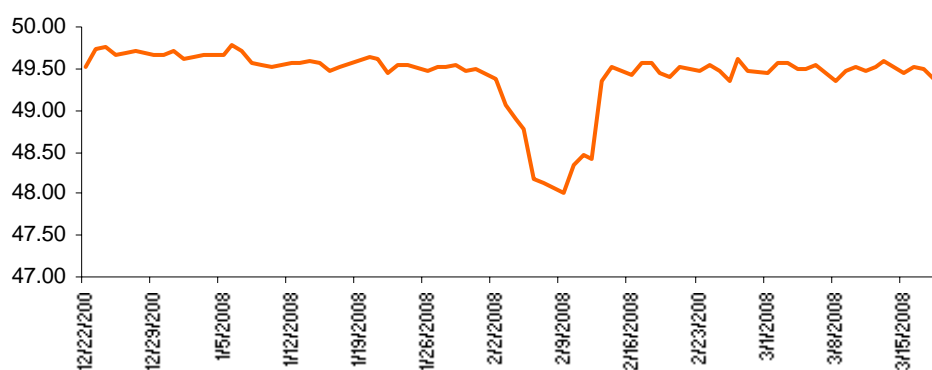
3. Foreign Exchange Market

3.1 Foreign Exchange Rates:

The daily historic review of the exchange rate, AF vis a vis USD, for the fourth quarter of 1386 (22 December, 07 to 19 March, 08) is shown in figure 2.10. As a whole, the exchange rate of Afghani moved in a relatively narrow corridor of AF 48.01 to 49.78 per USD, throughout the quarter under review. On the end quarter basis the

Afghani against USD remained the same as that at the beginning of the quarter (AF 49.52 per USD). On annual basis, the Afghani appreciated by 1.2 per cent in the quarter under review (AF 49.42 per USD) from the same quarter a year ago (AF50.02 per USD). Afghani appreciated against Pk.Rs by 3.737 percent, but depreciated against the Euro by 12.153 percent in the quarter under review. (Table 2.5)

Figure 2.10: Daily Exchange Rate for Q4 1386



Source: Market Operations and Monetary Policy Departments staff calculations/ DAB

Table 2.5: Exchange Rates Against Selected Currencies

Period	USD	Pak.Rs	EURO
Average for Q4 1386	49.42	79.33	73.09
Average for Q4 1385	50.02	82.41	65.17
% Appreciation (-) or depreciation (+) of AF against respective currency	-1.200	-3.737	12.153
Closing rate on March 19, 2008	49.52	82.55	69.18
Closing rate on December 22, 2007	49.52	81.93	66.95
% Appreciation (-) or depreciation (+) of AF against respective currency	0.00	0.757	9.109

Source: MPD/MOP Departments/DAB

3.2 Foreign Exchange Auction:

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

Table 2 summarizes the results of DAB foreign exchange auctions during the period from December 25, 2007 to March 18, 2008.

In the quarter under review (highlighted in blue color) the DAB intervention was USD 342.75 million. The weighted average of all the 24 awarded auctions rate (sale price of the USD) was 49.358, covering Dec. 25, 2007 to March 18, 2008 in which the total number of awarded bidders were 675, compared with the previous quarter in which there were 26 auctions of 259.57 USD million. The weighted average was 49.8 with the participation of 672 bidders.

Table 2.6: Auction summary

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Amount Announced	Amount Awarded	No of Awarded Bidders
7-Sep-18	31	49.92	49.80	49.89	7.50	6.30	22
7-Sep-22	27	49.77	49.60	49.74	5.00	3.55	9
7-Sep-25	28	49.77	49.68	49.77	5.00	1.45	3
7-Sep-29	30	49.77	49.70	49.75	5.00	4.20	15
7-Oct-02	35	49.79	49.66	49.77	5.00	4.30	12
7-Oct-06	32	49.80	49.70	49.78	5.50	2.85	8
7-Oct-09	20	49.92	49.82	49.90	7.00	3.30	11
7-Oct-16	35	49.91	49.75	49.88	8.00	4.35	13
7-Oct-20	32	50.05	49.90	50.02	10.00	5.45	14
7-Oct-23	31	50.24	50.00	50.00	10.00	9.10	31
7-Oct-27	33	50.06	49.90	49.94	9.00	8.20	32
7-Oct-30	41	50.15	50.00	50.01	10.00	11.70	39
7-Nov-03	34	50.05	49.75	49.80	15.00	10.22	33
7-Nov-06	47	50.10	49.81	49.93	10.00	15.85	45
7-Nov-10	38	49.92	49.76	49.79	10.00	11.90	36
7-Nov-13	45	49.93	49.70	49.80	10.00	16.95	39
7-Nov-17	36	49.90	49.73	49.81	15.00	16.00	32
7-Nov-20	44	49.88	49.70	49.81	15.00	15.75	32
7-Nov-24	38	49.86	49.71	49.81	15.00	14.95	32
7-Nov-27	42	49.86	49.76	49.82	15.00	16.45	37
7-Dec-01	39	49.84	49.77	49.81	15.00	16.00	28
7-Dec-04	44	49.73	49.65	49.66	10.00	15.85	40
7-Dec-08	39	49.68	49.60	49.63	10.00	15.55	36
7-Dec-11	34	49.63	49.50	49.58	15.00	13.55	32
7-Dec-15	33	49.61	49.50	49.50	32.00	13.35	33
7-Dec-17	8	49.50	49.38	49.38	15.00	2.45	8
7-Dec-25	42	49.71	49.58	49.63	20.00	22.45	36
7-Dec-29	47	49.67	49.51	49.57	10.00	18.15	40
8-Jan-01	48	49.67	49.53	49.59	15.00	18.95	37
8-Jan-05	47	49.65	49.57	49.62	15.00	14.75	27
8-Jan-08	39	49.56	49.40	49.48	15.00	13.05	26
8-Jan-12	44	49.53	49.33	49.50	15.00	12.75	26
8-Jan-15	44	49.54	49.41	49.49	15.00	15.25	28
8-Jan-22	48	49.52	49.42	49.47	15.00	21.05	38
8-Jan-26	41	49.50	49.37	49.46	10.00	16.50	28
8-Jan-29	41	49.54	49.45	49.47	10.00	19.20	39
8-Feb-02	19	49.28	49.05	49.05	10.00	12.15	19
8-Feb-05	46	48.70	48.30	48.60	17.50	13.35	33
8-Feb-09	41	48.02	47.50	47.90	10.00	8.95	23
8-Feb-12	47	48.50	48.46	48.25	10.00	10.05	17
8-Feb-16	41	49.48	49.08	49.38	15.00	14.85	30
8-Feb-19	46	49.47	49.21	49.37	15.00	15.40	34
8-Feb-23	42	49.58	49.38	49.51	10.00	13.45	24
8-Feb-26	28	49.40	49.13	49.36	10.00	4.80	9
8-Mar-01	44	49.54	49.35	49.50	10.00	5.20	15
8-Mar-04	45	49.54	49.32	49.41	15.00	11.20	33
8-Mar-08	44	49.45	49.32	49.39	15.00	15.10	28
8-Mar-11	47	49.51	49.41	49.47	15.00	14.60	28
8-Mar-15	44	49.60	49.30	49.44	20.00	21.70	39
8-Mar-18	44	49.43	49.30	49.40	10.00	9.85	18
Total Amount Sold in US Dollars						602.32	

3

INFLATION TRENDS AND OUTLOOK

Summary

Headline inflation is currently experiencing its sharpest inflationary surge in years, despite successfully declining to single digits between 2002 and 2007. Headline inflation started to follow an upward trend having declined from a high of 16 percent in March 2005 to a low of 4.8 percent in March 2007. Headline inflation, as measured by year-on-year percentage changes in Kabul CPI, reached 20.7 percent at the end of the fourth quarter of 1386. This is the sharpest inflationary surge in years, with price increases in the fourth quarter of 1386 coming in well above expectations.

The main drivers of inflation in the fourth quarter of 1386 were the prices of food, energy and construction materials. The food sub-index rose sharply by 30.6 percent at the end of the fourth quarter largely as result of developments in global commodity markets. Construction materials prices rose by 17.9 percent at the end of the quarter under review largely because of boom in housing and construction projects

as a result of excess demand driven by remittances and record high opium harvest.

Inflation spiked at the end of fourth quarter 1385

1. Annual Changes in Kabul Headline Inflation

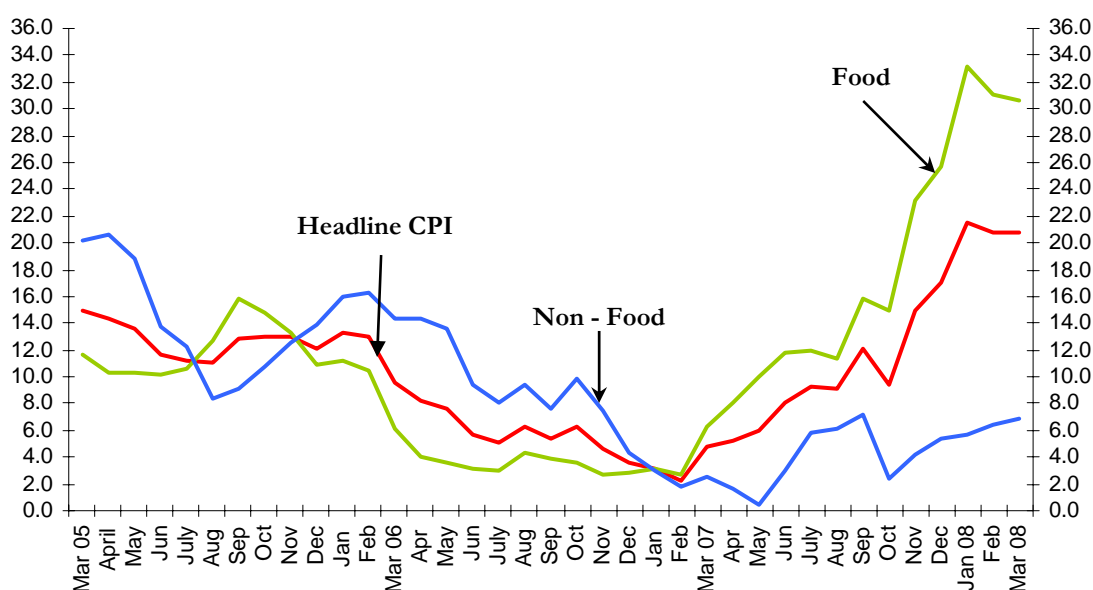
The CPI measures the average price of a fixed set (or basket) of goods. The basket of goods is intended to reflect all of the items a typical family buys to achieve some minimum standard of living in some base period (currently 2004). The CPI does not count the price of each item equally but weights 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 representative household's current cost of living.

Headline inflation, as measured by year-on-year percentage changes in Kabul CPI, displayed a “J-shaped” trend at the end of the fourth quarter of 1386. Looking at the overall index in Figure 3.1, we can see that inflation began to increase at the end of 1385 moving toward double digits.

Headline inflation, as measured by year-on-year percentage changes, increased to 20.7 percent at the end of the fourth quarter of 1386 from 4.8 percent at the end of the

same quarter a year ago. The breakdown of Kabul headline CPI inflation is presented in Table 3.1 and illustrated in Figure 3.2.

Figure 3.1: Inflation trend: Kabul CPI



Source: Central Statistical Office and DAB staff calculations.

Table 3.1: Breakdown of Headline CPI

(percent changes year on year)

Consumer Price Index (March 2004 = 100)

	Weight	1384				1385				1386			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4*
Headline	100	11.6	12.9	12.1	9.5	5.5	5.4	3.5	4.8	8.1	12.1	17	20.7
Food and Beverages	61.3	10.1	14.8	10	6.2	2.9	3.8	2.8	6.3	11.8	15.8	25.6	30.6
Bread and Cereal	28	11.8	24	17.6	7	0.7	-0.2	-3.1	3.6	13	21.5	42.6	51.8
Milk and cheese	5.6	5.7	6.2	3.6		2.3	4.7	4.6	6.8	18.9	22	24.1	21.7
Oil and Fat	5.3	-1.5	0	-1.4	-4.1	-1.2	2.6	6.9	17	43	36.7	42.5	45.2
Non – Food	38.7	13.5	9.1	13.5	14.4	9.4	7.6	4.4	2.5	3	7.1	5.4	6.9
Housing	17.2	20.8	11	18.6	22.6	10.5	6.7	3.3	-1	1.3	10	5.4	6.5
Rents	7.1	34.2	13.3	21.8	24.9	8.6	1	-21.9	-27.1	-25.3	-19.9	-2.8	1.8
Construction material	3.2	7.8	11.8	12.2	10.4	1.8	-5.4	-11.9	-11.3	-5.3	8.7	17.1	17.9
Fuel and Electricity	6.8	7.1	6.5	16.5	25.1	19.4	24.7	54.8	51.4	52.8	58.4	9.5	7.5
Core (Headline Excl Housing)		9.5	13.4	10.3	6.2	4.2	5.1	3.6	6.4	9.9	12.7	20.3	24.5

Source: Central Statistical Office and DAB staff calculations.

* The y-o-y changes at the end of quarter, March - March

The main factor for the increase in Kabul headline CPI to 20.7 percent at the end of the fourth quarter of 1386 from 4.8 percent at the end of the same quarter a year ago are as follows:

First, the food sub-index accounts for 61.3 percent of the CPI basket. This sub-index rose sharply by 30.6 percent at the end of the quarter under review, compared to 6.3 percent at the end of the same quarter a year ago. It is well known that an increase in prices can be generated from either the supply or demand side. On the supply side, there has been a shortage in food production, especially wheat and other grains, in the major food producing countries such as USA, Australia and Canada which pushed up the demand from major importing countries such as China, India, Taiwan and Japan. On the other hand, some countries have banned food exports e.g. Tajikistan, Pakistan, India. Drought is another factor having direct affect on decreasing the food production.

On the demand side, the increase in population and income in some emerging market countries, mainly China and India helped pushed inflation up. Another factor on the demand side is the use of some grains (i.e. corn) for producing bio-fuels.

Second, the non-food sub-index accounts for 38.7 percent for the CPI

basket. This sub-index rose by 6.9 percent at the end of the fourth quarter 1386, compared with 2.5 percent at the end of the same quarter a year ago. The main drivers of the increase are housing, construction material and rents sub-indexes.

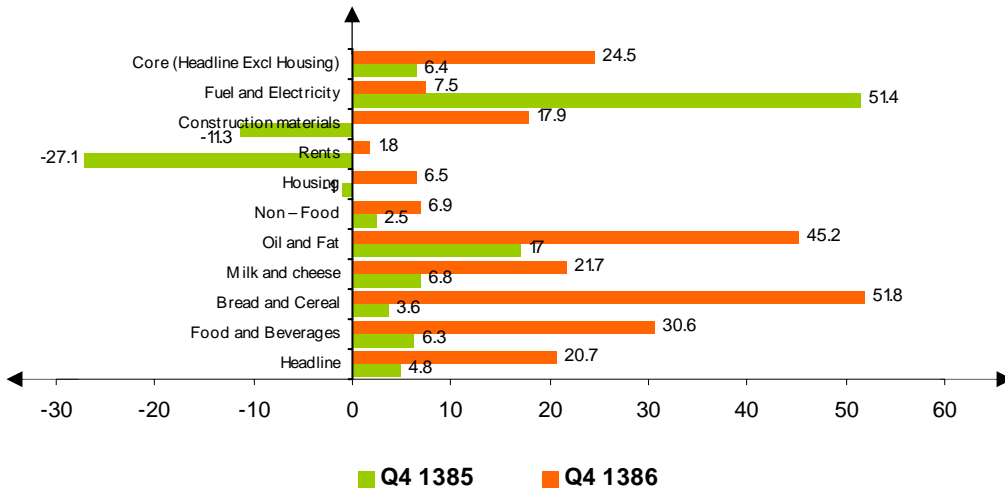
Third, the construction materials sub-index accounts for 3.2 percent for the CPI basket. This sub-index rose by 17.9 percent at the end of the quarter under review, compared to (-11.3) percent at the end of the same quarter a year ago as result of boom in building new construction projects, resident buildings as well as developments in the oil prices, which has affected transportation costs.

Fourth, the housing sub-index accounts for 17.2 percent of the CPI basket. This sub-index rose by 6.5 percent at the end of the quarter under review from (-1) percent at the end of the same quarter a year ago. It is mainly because of the increase in the prices of the sub-indexes such as construction materials.

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

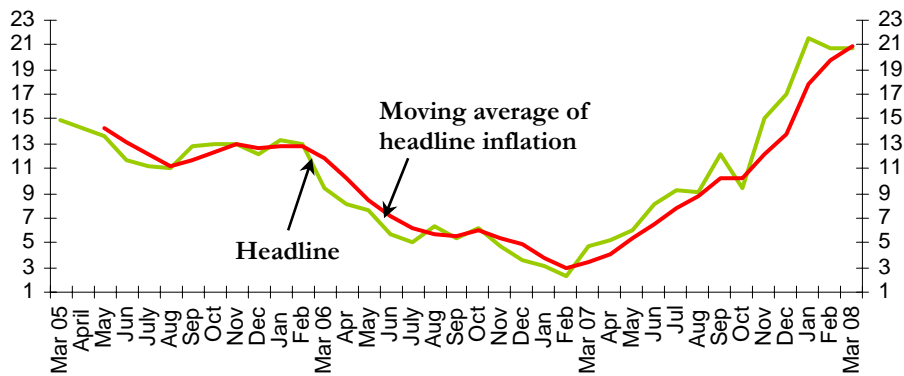
The fuel and electricity sub-index accounts for 6.8 percent of the CPI basket. This sub-index declined by 7.5 percent at the end of the fourth quarter of 1386, compared to 51.4 percent at the end of the same quarter a year ago.

Figure 3.2: Contribution to Kabul CPI inflation



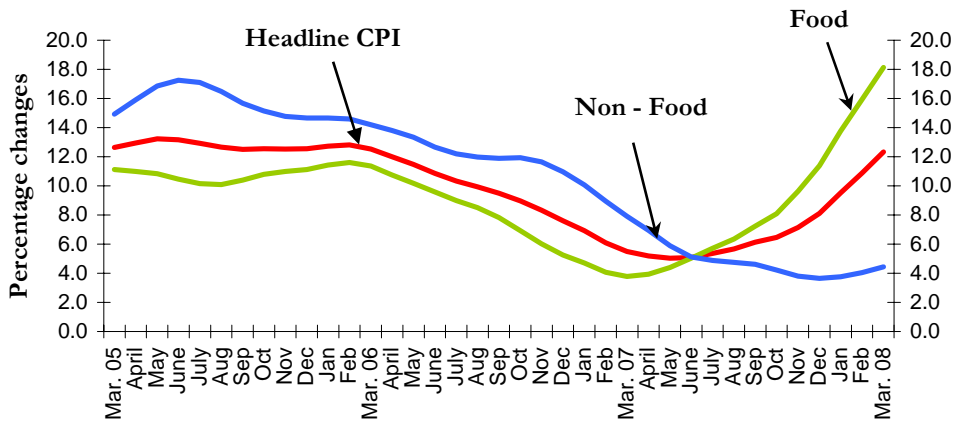
Source: Central Statistical Office and DAB staff calculations.

Figure 3.3: Headline inflation: Kabul CPI (Annual percentage changes)



Source: Central Statistical Office and DAB staff calculations.

Figure 3.4: Period Average CPI Inflation



Source: Central Statistical Office and DAB staff calculations

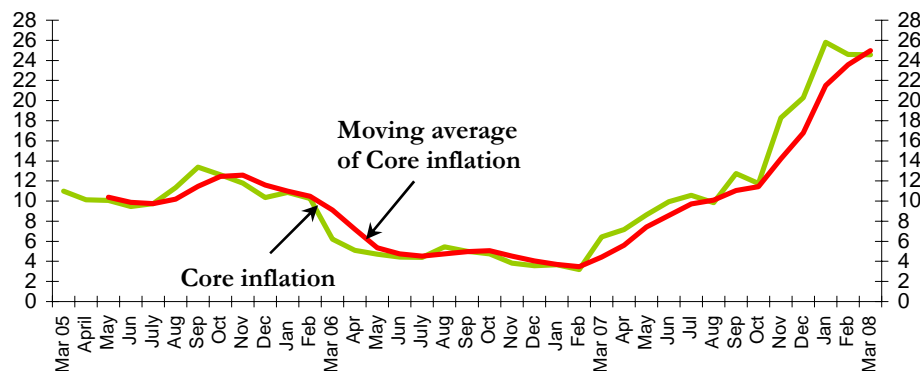
The volatility of Kabul inflation as measured by the standard deviation was 2.0 percent at the end of the fourth quarter of 1386, up from 1 percent at the end of the same quarter a year ago.

In Table 3.1 the breakdown of inflation includes a measure of core inflation because comparing one period's price statistics with some other periods 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, a measure of core inflation, which is CPI excluding rents, construction materials and fuel has been calculated. Core inflation is also often interpreted as measuring the long run or persistent component of the index. Core inflation stood at 24.5 percent at the end of

the fourth quarter of 1386 up from 6.4 percent at the end of the same quarter a year ago. (See Figure 3.4)

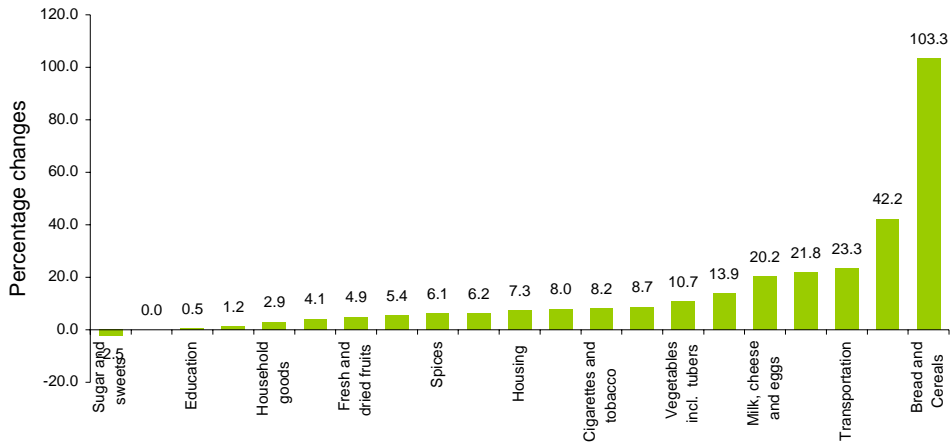
The trimmed mean CPI inflation rate is an alternative measure of core inflation. As can be seen from the figure 3.2 the most volatile item at the end of the fourth quarter of 1385 was housing index, while at the end of fourth quarter of 1386 it has changed to food sub-index. If the housing sub-index is still excluded form headline CPI to calculate the core inflation, it will give us a wrong measure of the core inflation. Through Trimmed mean inflation 25 percent of the most extreme items will be cut from the basket of the CPI, thus the remaining items will reflect the durable or long run inflation, which is under direct control of the Central Bank. (See figure 3.5)

Figure 3.5: Core inflation: Kabul CPI (Annual percentage changes)



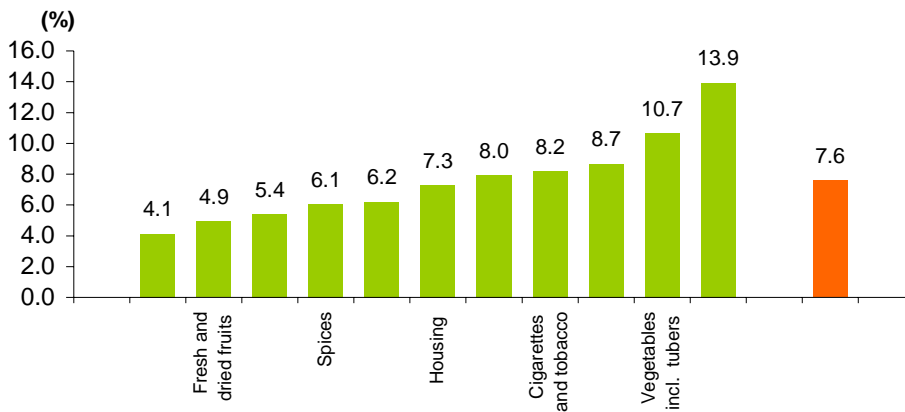
Source: Central Statistical Office and DAB staff calculations.

Figure 3.6: Breakdown of Kabul Headline CPI (March 2008)
(percentage changes y-o-y)



Source: Central Statistical Office and DAB staff calculations.

Figure 3.7: 25% Trimmed Mean of CPI (March 2008)



2. Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis. National CPI includes price measurements for six major cities 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 increased by 24.3 percent at the end of the

fourth quarter of 1386 compared to 3.8 percent at the end of the same quarter a year ago. Table 3.2 and figure 3.8 represent the breakdown of national CPI into its respective components.

The increase in the national CPI to 24.3 percent at the end of the fourth quarter of 1386 from 3.8 percent at the end of the same quarter a year ago was mainly because of the following factors:

The bread and Cereals sub-index accounts for 28 percent of the CPI

basket. This price index rose sharply by 50 percent at the end of quarter under review from 3 percent at the end of the same quarter a year ago. The main reasons behind this increase a decrease in the worldwide food productions in the major food income levels in some emerging countries, such as China and India are another major contributor to increase this sub-index.

In addition, recent political developments in the region, especially in neighboring countries have also caused a shortage in the supply of food items, especially flour, rice and other grains.

The housing sub-index accounts for 17.2 percent of the CPI basket. This sub-index rose by 13.3 percent at the end of the fourth quarter of 1386 from -1.5 percent at the end of the same quarter a year ago. The main reason is thought to be an increase in demand for construction materials, as a

producing countries due to bad weather condition, as well as using the some grains for the bio-fuel is another reason contributes in this decline. On the demand side, population growth and increasing result of boom in construction activities all over the country.

The rents sub-index accounts for 7.1 percent of the CPI basket. This sub-index rose by 11.7 percent at the end of fourth quarter of 1386 from (-20) percent at the end of the same quarter a year ago.

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

The fuel and electricity sub-index accounts for 6.8 percent of the CPI basket. This sub-index shows a decline by 14.8 percent at the end of the quarter under review from 25.3 percent at the end of the same quarter a year ago.

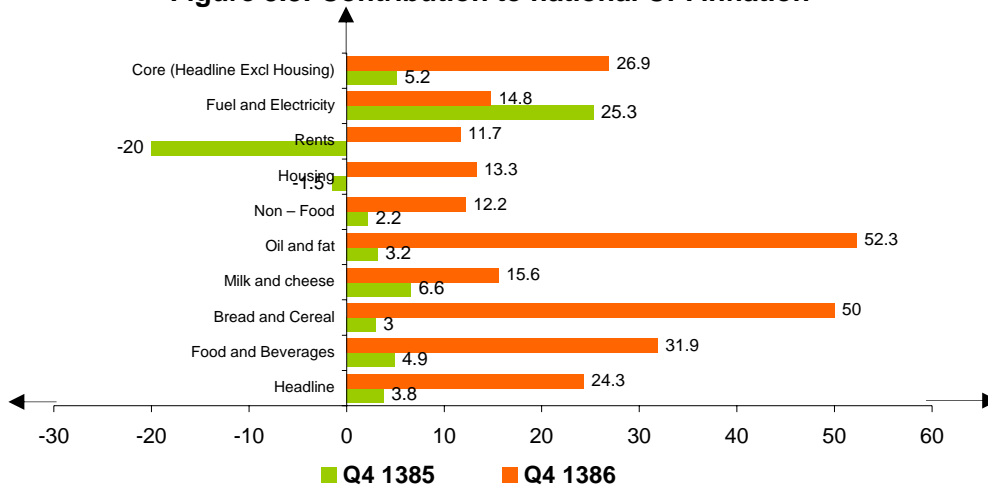
Table 3.2: Breakdown of National Headline CPI
(percent changes year on year)
Consumer Price Index
(March 2004 = 100)

	Weight	1384				1385				1386			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4*
Headline	100	11	11.8	11.9	9.8	5.7	5.3	3.4	3.8	9.6	14.9	20.5	24.3
Food and Beverages	61.3	10.6	14.4	12	9.1	4.1	4.1	3.5	4.9	13	16.8	27.1	31.9
Bread and Cereal	28	16.4	23	18.5	10.8	2.3	1.2	-1.1	3	16.2	20.8	41.8	50
Milk and cheese	5.6	3.6	7.1	8.6	9.5	7.9	6.6	7.1	6.6	10.9	15.1	14.7	15.6
Oil and fat	5.3	-7.4	-3.6	-1.1	2.4	2.5	-0.2	4.9	3.2	24.5	40.3	42.2	52.3
Non – Food	38.7	11.8	8	11.7	10.9	8	7	3.6	2.2	4.4	11.9	11	12.2
Housing	17.2	21.5	13.3	17.1	16.4	8.9	5.1	1.5	-1.5	3.7	15	12.1	13.3
Rents	7.1	37.2	21.6	17.5	14.9	3.3	-4.2	-14.7	-20	-12.8	-3.7	4.7	11.7
Fuel and Electricity	6.8	11.4	5.5	20.3	22.7	17.9	21.8	26.1	25.3	28.6	40.4	18.6	14.8
Core (Headline Excl Housing)		8.8	11.4	10.6	8.2	4.9	5.3	4.1	5.2	11	14.8	22.7	26.9

Source: CSO and DAB staff calculations.

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

Figure 3.8: Contribution to national CPI inflation

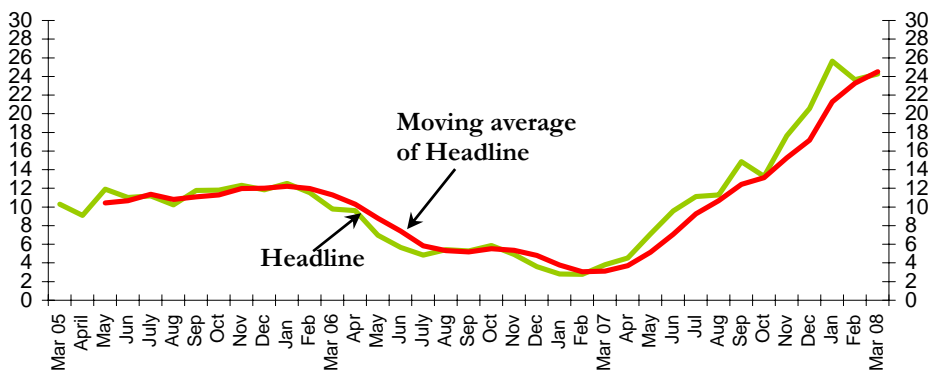


Source: Central Statistical Office and DAB staff calculations.

The volatility of inflation for national CPI as measured by the standard deviation at the end of the fourth quarter was 2.6 percent, up from 0.5 percent at the end of the same quarter last year. The volatility of inflation

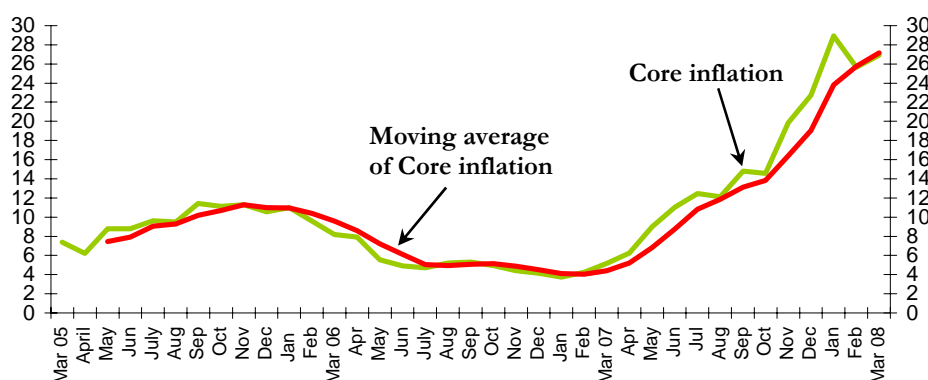
remains a concern for monetary policy, because volatile prices distort market signals making it difficult for business and private individuals to plan appropriately.

Figure 3.9: Headline inflation: National CPI (Annual percentage changes)



Source: Central Statistical Office and DAB staff calculations.

**Figure 3.10: Core inflation: National CPI
(Annual percentage changes)**



Source: Central Statistical Office and DAB staff calculations.

3. Quarterly Changes in Kabul

Headline CPI

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

Overall Kabul CPI declined slightly in the fourth quarter of 1386. Headline CPI shows slightly decrease by 5 percent in the fourth quarter of 1386 from 5.9 percent in the third quarter.

The food and beverages sub-index accounts for 61.3 percent of the CPI basket. This sub-index fell by 8.3 percent in the quarter under review from 9.4 percent in the third quarter of 1386 with a contribution of 13.4 percent by Bread and Cereal and 0.5 percent by milk and cheese sub-indexes. The increase in meat sub-index continued from the third quarter as a result of decrease

in live stock due to draught. Meat sub-index rose by 6.6 percent at the fourth quarter 1386 from 5.1 percent at the third quarter 1386.

The non-food sub-index accounts for 38.7 percent of the CPI basket. This sub-index as a whole shows a decrease by (-0.3) percent at the end of the fourth quarter of 1386 from 0.8 percent at the end of the third quarter.

Housing, fuel and electricity sub-indexes declined by (-2.3) and (-5.4) percent respectively, while rents shows an increase of 0.4 percent.

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

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

(percent changes quarter on quarter)

Consumer Price Index

(March 2004 = 100)

	1384				1385				1386			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	2.87	2.45	3.38	0.5	-0.87	2.33	1.57	1.7	2.4	6	5.9	5
Food and Beverages	2.5	0.96	1.82	0.77	-0.68	1.87	0.83	4.2	4.7	5.3	9.4	8.3
Bread and Cereal	2.9	1.6	2.7	-0.4	-3.1	0.7	-0.3	6.4	5.7	8.2	17	13.4
Milk and Cheese	-1.3	2.1	1.2	0.4	-1.3	4.5	1.1	2.5	9.8	7.2	2.9	0.5
Meat	6.2	-0.6	0.9	2.5	0.5	2.6	-0.3	1.5	-2.6	-4.6	5.1	6.6
Non – Food	3.24	4.75	5.7	0.07	-1.24	3.02	2.5	-1.7	-0.7	7.1	0.8	-0.3
Housing	5.23	6.46	8.47	0.86	-5.12	2.76	5.1	-3.3	-2.9	11.5	0.6	-2.3
Rents	8.1	6.43	5.65	2.67	-5.9	-1	-18	-4.1	-3.6	6.1	-0.9	0.4
Fuel and Electricity	-0.4	7.5	18.58	-1.5	-4.87	12.25	47.19	-3.7	-4	16.4	1.7	-5.4

Source: Central Statistical Office and DAB Staff calculations

4. Quarterly Changes in national Headline CPI

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

The national headline CPI decreased by 4.4 percent in the fourth quarter of 1386 from 7 percent in the third quarter of 1386. The decrease in quarter-on-quarter inflation is mainly contributed by the non-food sub-index. Food sub-index as a whole shows also a decrease with contribution of bread and cereals and milk and cheese sub-indexes, while meat price is witnessed of an increase in the quarter under review. The major categories of the decrease in q-o-q changes in the quarter under review are traced as follow:

The food sub-index accounts for 61.3 percent of the CPI basket. This price index fell by 7.2 percent in the quarter under review from 10 percent in the previous quarter with the contribution of bread and cereals decreasing by 11 percent and milk and cheese sub-indexes decreasing by 1.9 percent respectively.

The non-food sub-index accounts for 38.7 of the CPI basket. This sub-index decreased by (-0.4) percent in the quarter under review from 2.3 percent in the previous quarter with the housing sub-index decreasing by (-2.3) percent, rents decreasing by zero percent and fuel and electricity decreasing by (-4.8) 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)

	1384				1385				1386			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Headline	2.18	2.66	3.54	1.09	-1.7	2.27	1.89	1.3	3.8	7.2	7	4.4
Food and Beverages	2.85	2.32	1.66	1.97	-1.9	2.32	1.09	3.3	5.8	5.8	10	7.2
Bread and Cereal	4	4.1	1.6	0.8	-4	2.9	-0.7	4.9	8.3	6.9	16.7	11
Milk and Cheese	1.3	2.8	3.4	1.6	-0.2	1.6	4	1.6	3.9	5.4	3.6	1.9
Meat	-2.9	1.1	1.7	3.7	-2.2	1.6	2.2	1.1	-1.9	0.2	4.7	6.5
Non – Food	1.24	3.16	6.47	-0.24	-1.4	2.2	3.1	-1.5	0.6	9.5	2.3	-0.4
Housing	1.69	5.54	8.85	-0.34	-4.84	1.82	5.14	-3.3	0.2	13	2.5	-2.3
Rents	4.07	6.21	3.92	-0.06	-6.33	-1.55	-7.43	-6.3	2.1	8.7	0.6	0
Fuel and Electricity	-1.7	5.09	20	-0.99	-5.53	8.54	24.2	-1.6	-3.1	18.6	5	-4.8

Source: Central Statistical Office and DAB staff calculations

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 and 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.

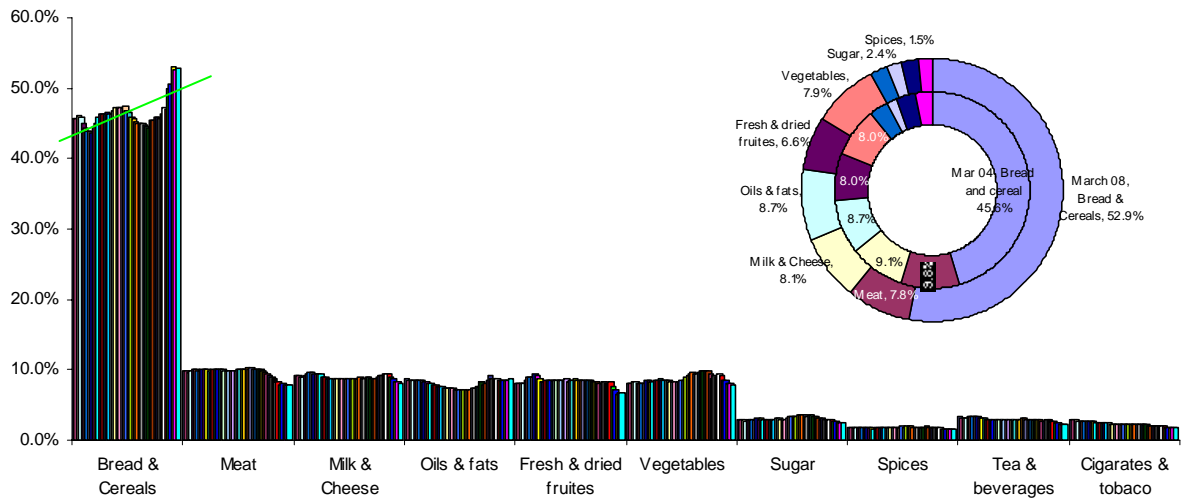
Effective weights are calculated as the proportion of point's contribution to the all groups index. If prices are changing more significantly within one sub-index than in the other, then the effective weights will shift over time. In simple terms, stronger price movements in a sub-item will exert more 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 has reached to 63.4 percent in March 2008. 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 has been shown in Figure 3.11.

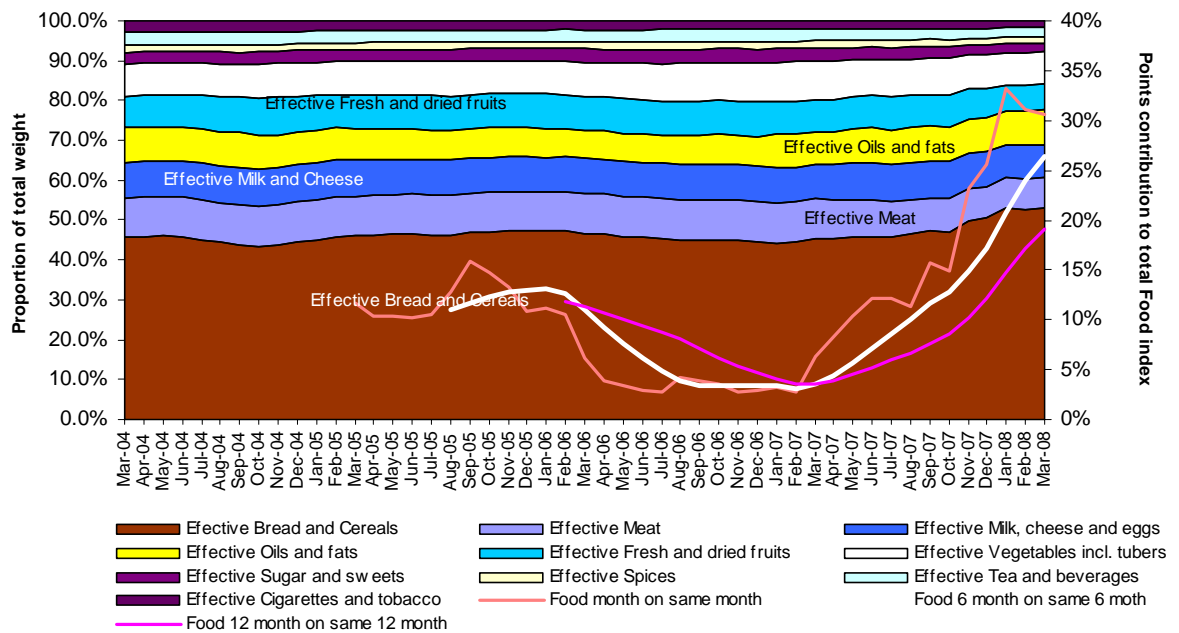
Figure 3.11: Effective weighting within the Kabul Food Price Index (Mar-04 to March - 08)



The relative effective weight for food sub-items is shown in Figure 3.11. As can be seen from the figure, the effective weight

for bread and cereals has increased to 52.9 percent, shown by the increased area shaded red in Figure 3.12 below.

Figure 3.12: Analysis of change – Food index by sub-items



Source: Central Statistical Office and DAB staff calculations.

Inflation Outlook

Afghanistan is suffering from imported inflation caused by higher global commodity prices, domestic-demand inflation caused by excess demand driven by the opium trade. The food inflationary pressure should slow next year (1387) assuming good seasonal (spring) rainfalls. However, the overall inflationary outcome will depend on the extent and duration of high oil prices.

Risks to Inflation Remain

Foreseeable risks to future inflation remain. These risks include further increase

in oil and grain prices and prolonged liquidity surge given expectations of steady foreign exchange inflows from remittances, the illegal opium trade and donor funds.

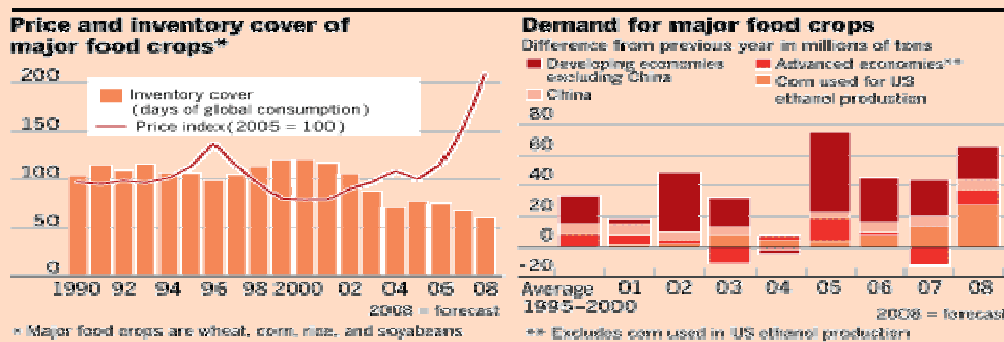
Additional risks include the secondary effects of inflation on asset prices. Inflation will depress real returns to saving, bringing real (inflation-adjusted) deposit rates to negative levels. Negative real interest rates would lead to record high loan growth. A negative interest rates scenario favors borrowers, and risks fuelling asset inflation and sparking a housing property boom.

Box 1: Food crisis is a chance to reform global agriculture

The recent price spikes apply to almost all significant food and feedstuffs (see charts). Yet these jumps are themselves part of a wider range of commodity price rises. Powerful forces are linking prices of energy, industrial raw materials and foodstuffs. Those forces include rapid economic growth in the emerging world, strains on world energy supplies, the weakness of the US dollar and global inflationary pressures.

Yet the food element of this story carries its own significance. As HSBC points out in a recent analysis*, with rice and wheat prices spiking, riots on the streets of the Philippines, Egypt and Haiti and moves by India, Vietnam, Cambodia and China to restrict rice exports, food is suddenly an even hotter issue than normal.

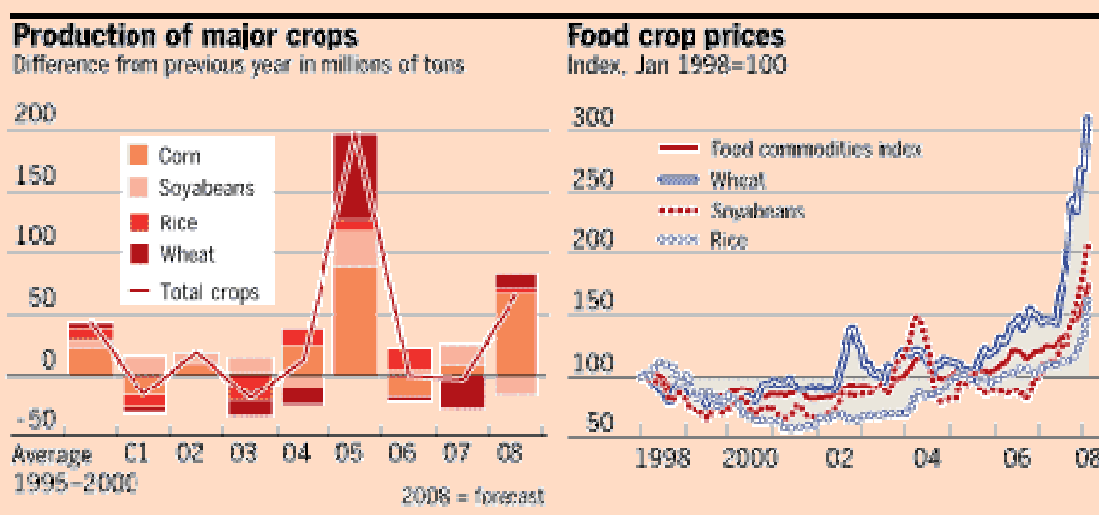
So why have prices of food risen so strongly? Will these higher prices last? What action should be taken in response?



On the demand side, strong rises in incomes per head in China, India and other emerging countries have raised demand for food, notably meat and the related animal feeds. These shifts in land use reduce the supply of cereals available for human consumption.

Furthermore, rising production of subsidized bio-fuels, further stimulated by soaring oil prices, boosts demand for maize, rapeseed oil and the other grains and edible oils that are an alternative to food crops. The latest World Economic Outlook from the International Monetary Fund comments that “although bio-fuels still account for only 1½ per cent of the global liquid fuels supply, they accounted for almost half of the increase in consumption of major food crops in 2006-07, mostly because of corn-based ethanol produced in the US”.

Meanwhile, aggregate production of maize, rice and soybeans stagnated in 2006 and 2007. This was partly the result of drought. Also important, however, have been higher prices of oil, since modern farming is so energy-intensive. With weak growth of supply and strong increases in demand, cereal stocks have fallen to their lowest levels since the early 1980s. Declining stocks undermine the widely shared belief that speculation has driven the rising prices, since stocks would be rising, not falling, if prices were above market-clearing levels.



Vastly more worrying than speculation is the weak medium-term growth of supply. The rapid increases in yields of the 1970s and 1980s, at the time of the “green revolution”, have slowed. Given the stresses on water supplies, longer-term supply prospects would look poor even if diversion of land for production of bio-fuels were not adding to the pressure.

Are prices going to remain high? Two opposing forces are at work. The first is the market, which will tend to bring prices back down as supplies expand and demand shrinks. But the latter is also what we want to avoid, at least in the case of the poor, since reducing their consumption is not so much a solution as a failure. The second force is the current intense pressure on the world’s food system. This is true of both demand and costs of supply.

Prices are likely to remain relatively elevated, by historical standards, unless (or until) energy prices tumble.

This, then, brings us to the big question: what is to be done? The answers fall into three broad categories: humanitarian; trade and other policy interventions; and longer-term productivity and production.

The important point on the first is that higher food prices have powerful distributional effects: they hurt the poorest the most. This is true both among countries and within them. The Food and Agricultural Organization in Rome recently listed 37 countries in substantial need of food assistance. Moreover, according to the World Bank, soaring food prices threaten to make at least 100m more people hungry.

Increases in aid to the vulnerable, either as food or as cash, are vital. Equally important, however, is ensuring that the additional supplies reach those in greatest difficulty. The options depend on the sophistication of a country's bureaucratic machinery. But they include work paid directly with food (which is a good way of screening out the better-off), a rationed supply of cheap food for the poor or cash vouchers. Those most in need will be the landless, both rural and urban, and marginal subsistence farmers.

Now turn to the policy interventions. Protection, subsidies and other such follies distort agriculture more than any other sector. Alas, the opportunity to eliminate protection against imports offered by exceptionally high world prices is not being taken. A host of countries are imposing export taxes instead, thereby fragmenting the world market still more, reducing incentives for increased output and penalizing poor net-importing countries. Meanwhile, rich countries are encouraging, or even forcing, their farmers to grow fuel instead of food.

The present crisis is a golden opportunity to eliminate this plethora of damaging interventions. The political focus of the Doha round on lowering high levels of protection is largely irrelevant. The focus should, instead, be on shifting the farm sector towards the market, while cushioning the impact of high prices on the poor.

Finally, far greater resources need to be devoted to expanding long-run supply. Increased spending on research will be essential, especially into farming in dry-land conditions. The move towards genetically modified food in developing countries is as inevitable as that of the high-income countries towards nuclear power. At least as important will be more efficient use of water, via pricing and additional investment. People will oppose some of these policies. But mass starvation is not a tolerable option.

Source: Financial Times (2008)

4

BANKING SYSTEM PERFORMANCE

Summary

Total assets of the banking system rose to AF 84 billion (USD 1.68 billion) at the end of year 1386, up by 55 percent or AF 30 billion since the beginning of solar year 1386. Loans amounted to AF 40 billion (USD 805 million) an increase of AF 18 billion (USD 366 million) or 84 percent since March 2007. Deposits stood at AF 64 billion (USD 1.28 billion) over the period under review; a 58 percent increase since March 2007. Deposits were largely denominated in USD (72 percent) with AF-denominated deposits were lagging at 23 percent. Total capital of the banking system stood at AF 15.8 billion (USD 316 million). Banking sector overall was profitable earning a year-to-date net profit of AF 1.23 billion (USD 24.6 million) since the beginning of 1386, for an overall return on assets (ROA) of 1.84 percent which was higher than previous year – 0.28 percent. The main causes for the hike in ROA are significant increases in interest income and non-interest income, which more than completely offset notable rises in

overhead expenses. State-owned banks are among top three profitable banking institutions.

1. Assets of the Banking System

The banking system continues to grow at a brisk rate. Total assets (size) of the banking system at the end of the fourth quarter 1386 was AF 84 billion (USD 1.68 billion), up by 55 percent or AF 30 billion (USD 578 million) from the end of the same quarter a year ago. See figures 6.1 and 6.2.

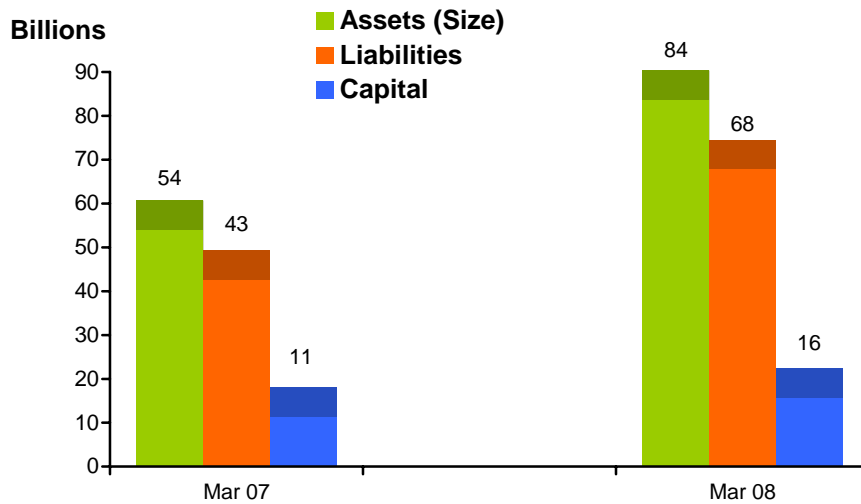
The major components of this increase were increases in loans (up AF 18 billion) and cash in vault/claims on DAB (up AF 7 billion). Moreover, the remaining part is made up of other asset categories such as claims on financial institutions, other assets except interest receivable and Net Due From, (NDF).

The most important components of the banking system's total asset portfolio are loans (48 percent), claims on financial institutions (15 percent), cash in vault/claims on DAB (21 percent), Net Due From (6 percent), and other assets except interest receivable (5 percent). Other

components of total assets are negligible. The rapid increase in the relative importance of loans can be traced to immediate deployment of attracted funds into new

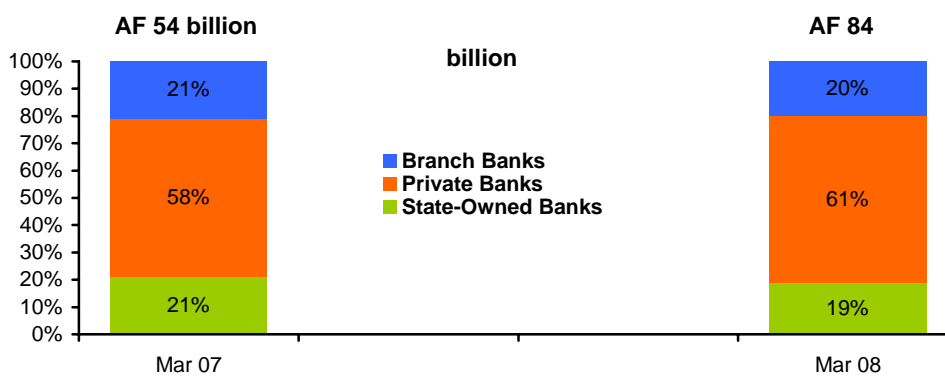
loans (79 percent), while the remaining part was mainly retained in the form of liquid assets.

Figure 4.1: Banking System's Growth Rate
Growth Rate = 55 percent or AF 29 billion



Source: Banking Supervision Department/ DAB

Figure 4.2: Size of Banking Sector (Total assets)
Increased by 55 percent or AF 30 billion



Source: Banking Supervision Department/ DAB

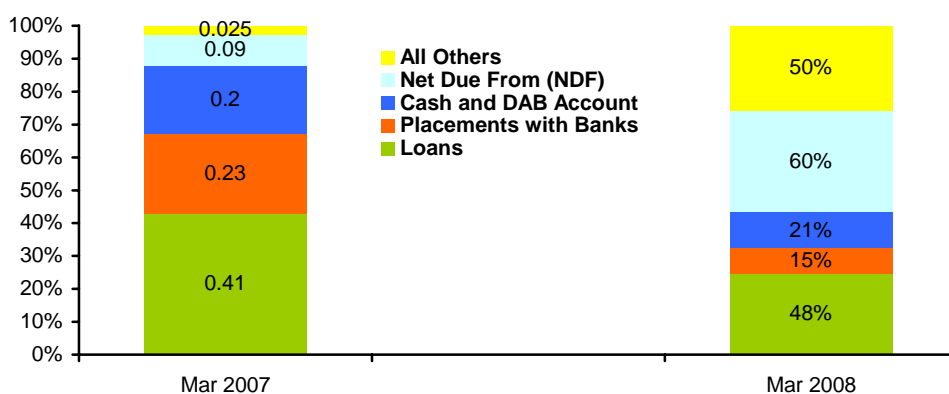
The major components of assets, as a percentage of total assets, are discussed hereafter:

Claims on Financial Institutions:

Claims on financial institutions are the third largest among various asset categories, currently comprising AF 13 billion – a 16 percent increase since March 2007 total – 15

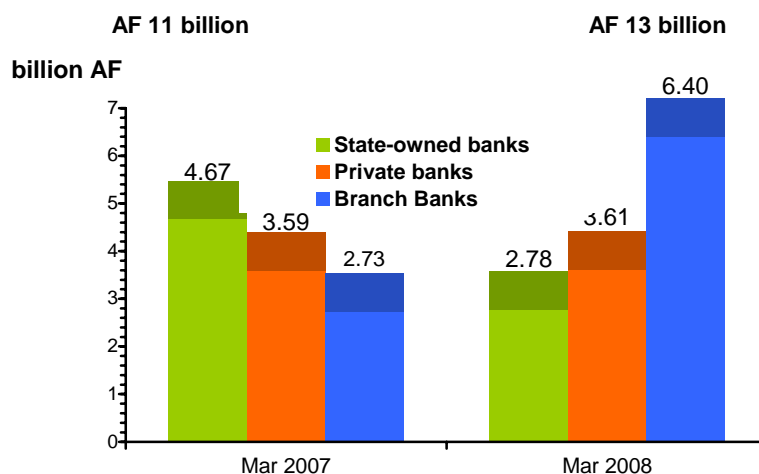
percent of total assets, indicating that the banking sector channeled a portion of its attracted funds as deposits in other financial institution, if credible borrowers were not found. Later on, if needed for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets.

Figure 4.3: Major Asset Categories
(As percentage of Total Assets)



Source: Banking Supervision Department/ DAB

Figure 4.4: Claims on Financial Institutions



Source: Banking Supervision Department/ DAB

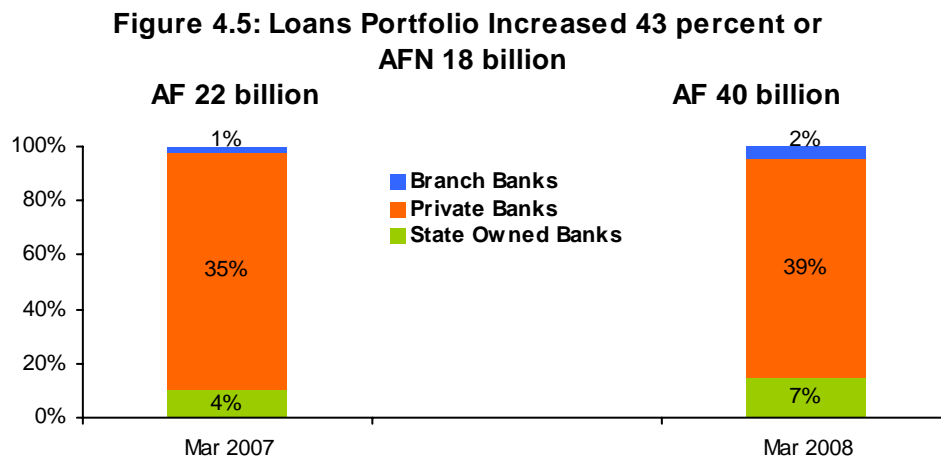
Private Banks are the leading creditors, increasing their portfolio both in absolute terms as well as percentage of total loans, currently at AF 33 billion or 82 percent of total loans. Changes in State-owned banks and branches of foreign banks' share and amount were insignificant.

Net Loans

The loan portfolio continues to grow, totaling AF 40 billion (USD 805 million) as of March 31, 2008 – a 83 percent increase since March 2007 – or 48 percent of total assets; the highest amount as well as share percentage in total assets among different asset categories. The increase occurred in the gross loan portfolio; loss reserves as

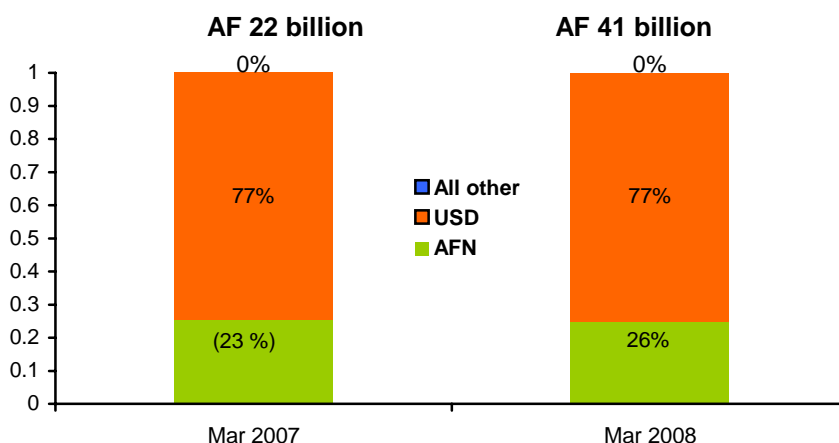
percentage of gross loans remained unchanged at around 1 percent. Increases in lending were observed at all but two of the banking organizations; however more than two-third of the growth is still attributable to private bank's group; and more than half to one banking institution.

By far, the major component of loan portfolio is "other commercial loans (81 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend. Thus, lending is picking up, but still not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture.



Source: Banking Supervision Department/ DAB

Figure 4.6: Currency Composition of Loans



Source: Banking Supervision Department/ DAB

Non-performing loans

The system's non-performing loans consists 0.67 percent of gross loans and has decreased to AF 280 million dropping by 304 million since March 2007. This is an improving sign over the year and the sector's loan administration function is still strong, limiting the NPLs percentage at the lowest possible level.

Adversely-classified loans

Adversely-classified loans increased to AF 644 million from AF 483 million at the end year 2007. However, their share percentage in total loans remained the same and stands at 2 percent. Loans under "Watch" category has doubled and other

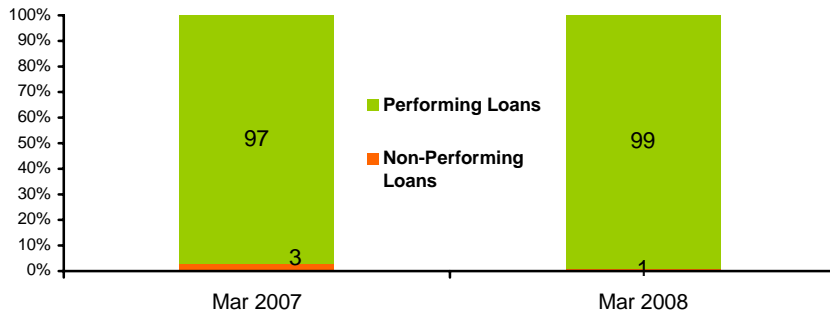
categories remained the same.. This trend should be monitored closely, to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative.

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

Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the second largest category, increasing both in absolute as well as 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.

Figure 4.7: Quality of Loan Portfolio



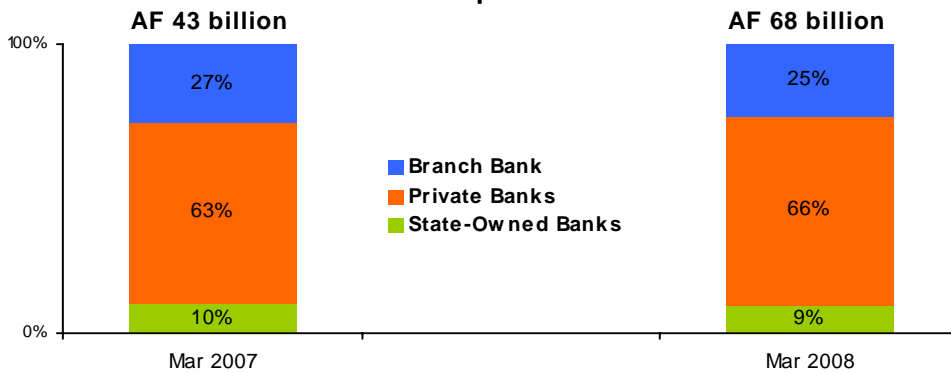
Source: Banking Supervision Department/ DAB

2. Liabilities

Total liabilities of the banking sector were AF 68 billion, up by 59 percent from

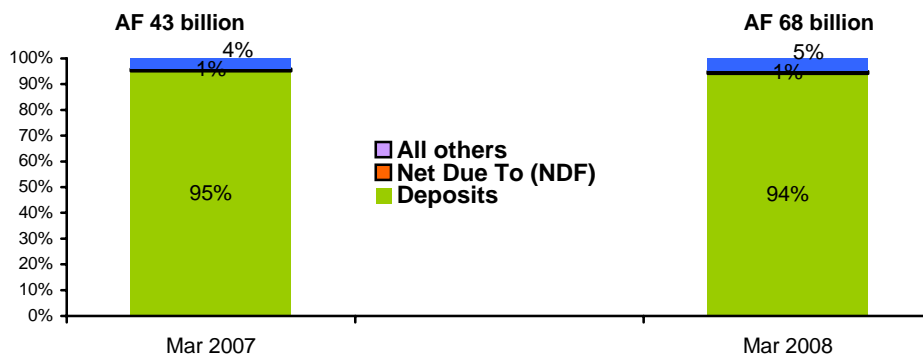
March 2007. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector.

Figure 4.8: Liabilities Increased by AF 25 billion or 59 percent



Source: Banking Supervision Department/ DAB

Figure 4.9: Major Liability Categories



Source: Banking Supervision Department/ DAB

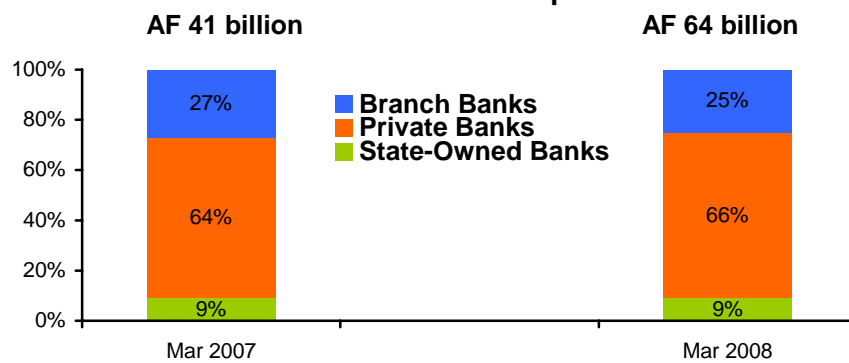
Increases in deposits of branches were reflected as highly comparable increases in total assets with unrelated parties for the period, indicating a shift from a source of funds for the home office towards active engagement in the country.

Deposits

Deposits are the major component of liabilities, currently equal to AF 64 billion, a 58 percent or AF 23 billion increases since March 2007. Private Banks attracted AF 17

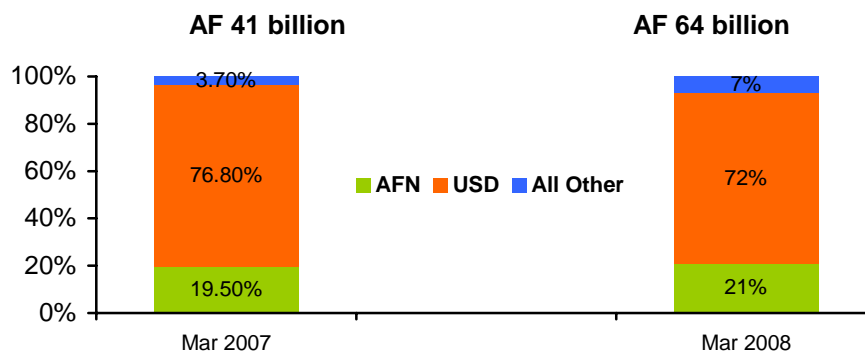
billion more deposits, 63 percent of the total increase. Total deposits increased in absolute terms, as well as percent of total liabilities. Total deposits of private banks also increased both ways. Even though deposits of state-owned banks and branches are expanding in absolute terms, their share in total deposits has lost some ground in favor of private banks.

Figure 4.10: Deposits Increased by AF 23 billion or 57 percent



Source: Banking Supervision Department/ DAB

Figure 4.11: Currency Composition of Deposits

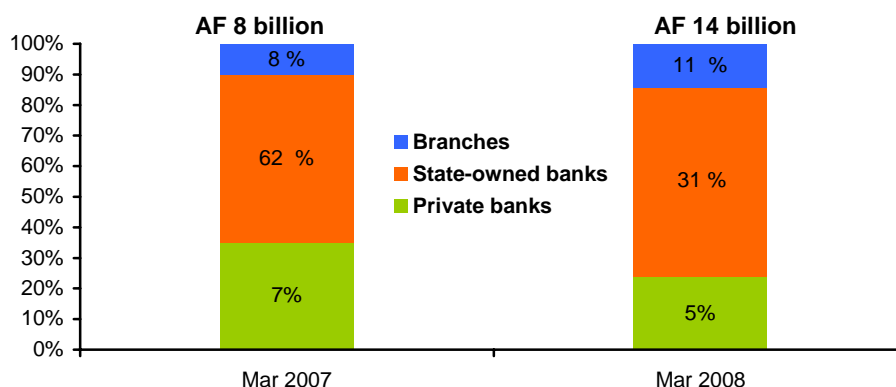


Source: Banking Supervision Department/ DAB

Other liabilities except Interest Payable remain the second major component of

liabilities, up by 69 percent since March 2007, or 3.4 percent of total liabilities.

Figure 4.12: Afghani Denominated Deposits



Source: Banking Supervision Department/ DAB

Capital

The system, as a whole, is well capitalized. Total financial capital at full-fledged banks is AF 15.8 billion, up by 39 percent since March 2007. If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 15.8 billion consists 18.8 percent of AF 84 billion, which is slightly below the benchmark, while total assets of the full-fledged commercial banks are AF 67 billion.

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the Net Due to Related Depository Institutions, primarily the home office and other branches of the same bank (NDT), while the closest analogue to negative capital is the Net Due from Related Depository Institutions,

primarily the home office and other branches of the same bank (NDF). NDF is probably a normal situation for a foreign branch in the first year or so of existence when the branch is establishing itself and seeking loan customers and other investment opportunities. Supervisory action will only be required if the branch persists for another year or two in a NDF position or the bank's overall worldwide condition and performance is deteriorating.

The NDT position has remained unchanged and NDF position has decrease slightly in absolute term as well as in percentage. So, 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 4 billion, up by 26 percent over the year.

Profitability

The banking sector overall is profitable. Total net profit of the banking sector during year 1386 is AF 1.2 billion, resulting in an overall return on assets (ROA) of 1.84, whereas AF 111 million net losses was incurred during year 1385, resulting in an overall return on assets (ROA) of -0.28

The main causes for the increase in ROA are significant increases in net interest income, non-interest income, and gains on FX revaluation which more than completely offset notable hikes in overhead expenses.

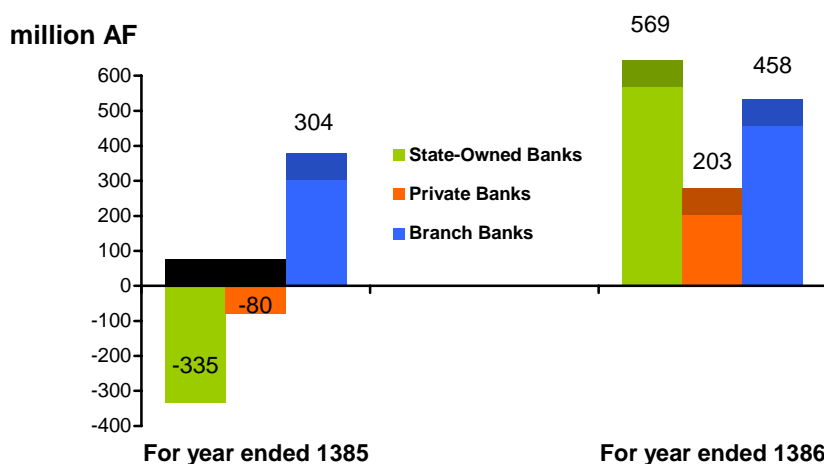
Branches of foreign banks and state-

owned banks are the most profitable groups. Private Banks, as a group, is also profitable. But the reason that their profit is lower than the other two groups is mainly due to high overhead expenses of three banks 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 and non-interest income, which more than completely offset hiking overhead expenses.

The major component of income was Net Interest Income (NII) with total amount of AF 4.75 billion, up by 58 percent since March 2007.

The second major component of income is other Non-Interest Income totaling AF 1.32 billion, a 24 percent increase since March 2007.

The most important component of expense is the Non-Interest Expense (NIE), currently equal to AF 3.99 billion, a 30



Source: Banking supervision Department/ DAB

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 1.34, up by 0.08 percentage point since last year. Four banking institutions ended up with lower efficiency ratios.

Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB, and comparatively lower in case of USD as an individual convertible currency. .

In general, two banks are non-compliant with limits set for overall open FX position, among them one is slightly above the maximum threshold while the second one is the newest bank in the system. However, six out of ten banks are holding open FX position in USD above the maximum regulatory thresholds. This indicates that the number of banks in violation of regulatory limits is on the rise, which warrants prompt corrective action by DAB. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by 3.96 percent or AF 606 million and vice versa. Similarly, a 4 percent change would correspond to 0.79 percent or AF 121 million.

Interest Rate Risk

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

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

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

5

FISCAL DEVELOPMENTS

Summary

Fiscal developments as reflected in government finances remained largely on track to meet annual targets. Total operating and development budget for the solar year 1386 (2007/08) is 130.6 billion AF (2.6 billion USD). However, total development budget stood 77 billion AF (1.5 billion USD), and total operating budget stood 53 billion AF (1.1 billion USD) in the quarter under review. Furthermore, total operating expenditures at the end of fourth quarter 1386 rose to 16.2 billion AF (324 million USD) or about (3.9 percent of GDP) as shown in Table 5.2. Meanwhile, in the development budget, expenditures rose to 18.7 billion AF or about 24 percent from the total development budget for the year 1386. Looking forward to the revenue side, total domestic revenue at the end of fourth quarter 1386 stood at 9.9 billion AF (198 million USD) or about (2.4 percent of GDP) it has increased about 22 percent compared to the third quarter 1386.

1. Government Revenue

Total domestic revenue at the end of third quarter 1386 stood at 9.9 billion AF (2.4 percent of GDP), an increase of 22 percent compared to the third quarter 1386. Moreover, the improved revenue performance in fourth quarter 1386 was reflected in taxes of AF 1.8 billion or about 26 percent higher compared to the third quarter as shown in Table 5.1.

Non-tax revenue performance exhibited a negative trend (AF 29 million below then third quarter 1386). The following reasons are possible factors for sluggish revenue performance in fourth quarter 1386.

- Decision to reduce the customs tariffs applying to one category of fuels, and machinery from 4 percent to 0 percent, raw materials from 5 percent and 10 percent to 1 percent, flour from 2.5 percent to 0 percent, and gee and cooking oil from 3.5 to 2.5 percent.
- Ceasing collection of fixed taxes on exports, and the ban on the importation of older motor vehicles and those with converted steering wheels (e.g. from right hand to left hand) in Herat and

Kandahar. For instance, as previously reported Herat processed about 170 to 200 vehicle imports per day and collected an average of 180 million AF per month before the ban.

- Ongoing presence of anti-corruption investigators in the main revenue collection areas, ongoing lack of

resources dedicated to revenue collection in the provinces.

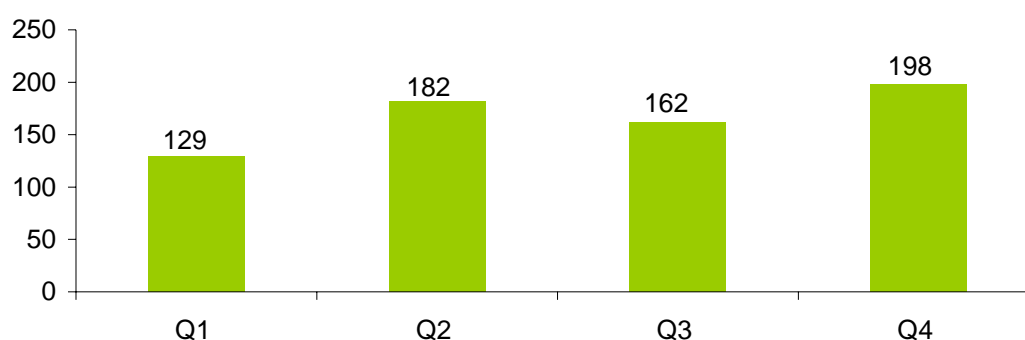
- In this environment, and with delays in implementing new revenue measures due to legal processes, the only way to meet the 1386 target is through increased efforts to improve compliance with existing tax laws by non-compliant sectors, including the airline sector.

Table 5.1: Revenue Collection as Fourth Quarter 1386 (in million AF)

Particulars	Q1 Actual	Q2 Actual	Q3 Actual	Q4 Revenue ¹	% Δ from Q1 to Q2	% Δ from Q2 to Q3	% Δ from Q3 to Q4
Total Domestic Revenues (Tax and Non Tax)	6,441	9,116	8,083	9,888	42 %	-11 %	22 %
Total Tax Revenues	4,614	7,954	6,995	8,828	72 %	-12 %	26 %
Non Tax Revenues	1,828	1,162	1,089	1,060	-36 %	-6 %	-3 %

Source: Ministry of Finance, Revenue Department

Figure 5.1: Revenue Collection for the fiscal year 1386 (million USD)



2. Public Expenditure

Government expenditure in the core budget shows a significant increase in 1386 compared with the same period in the year 1385. Total operating expenditures for the third quarter 1386 was 16.2 billion AF (324

million USD) or about (3.9 percent of GDP), it has raised about 2 percentage points compared to third quarter 1386 as shown in (Table 5.1). The operating expenditure rose due to heavy expenditures

in line ministries specifically on the wages and salaries and acquisition of goods and services for the government better performance and efficiency. Such as, Education, Defense, Interior Affairs, and National Security; from the last few years' the government of Afghanistan still facing security challenges which has led the government to boost the expenditures on securities in order to maintain a stable and strong government and a stable economy.

Therefore, due to security problems, Government of Afghanistan is not capable to utilize and spend all allocated funds for the specified development projects in different part of the country and it has made slow the operation and strategic plans of the government.

Looking at the development budget, which is composed mainly of grants from donors, in which the ARTF (Afghanistan

Reconstruction Fund) and LOTFA (Law and Order Trust Fund) have played a vital role for the infrastructure and development projects.

Total development budget for the year 1386 approved by Ministry of Finance is 77 billion AF (1.5 billion US dollars) as shown in (Table 5.1).

However, at the end of fourth quarter 1386, total development expenditures stood 18.7 billion AF (4.5 percent of GDP) was spend on the current and capital expenditure like acquisition of fixed assets, followed by wages, allowances, goods and services .The expenditure tool raised by 9 percentage points in the fourth quarter 1386 compared to third quarter 1386. However overall government operating and development expenditure rose by 6 percentage points in fourth quarter 1386 (Table 5.2)

Table 5.2: Progress of Expenditures in Core Budget as Fourth Quarter 1386 (in million AF)

Type of Budget	Currency	1386 Budget	Q1 Expenditures	Q2 Expenditures	Q3 Expenditures	Q4 Expenditures ⁱⁱ
Operating Budget	Millions AF	53,600	8,178	11,117	15,253	16,181
	Millions USD	1,072	164	222	305	324
Development Budget	Millions AF	77,008	3,007	11,806	11,585	18,673
	Millions USD	1,540	60	236	232	373
Total AF		130,608	11,185	22,923	26,838	34,854
Total USD		2,612	224	458	537	697

Source: Ministry of Finance and DAB staff calculation

Figure 5.2: Progress of Expenditures in Core Budget for the fiscal year 1386 (in million USD)

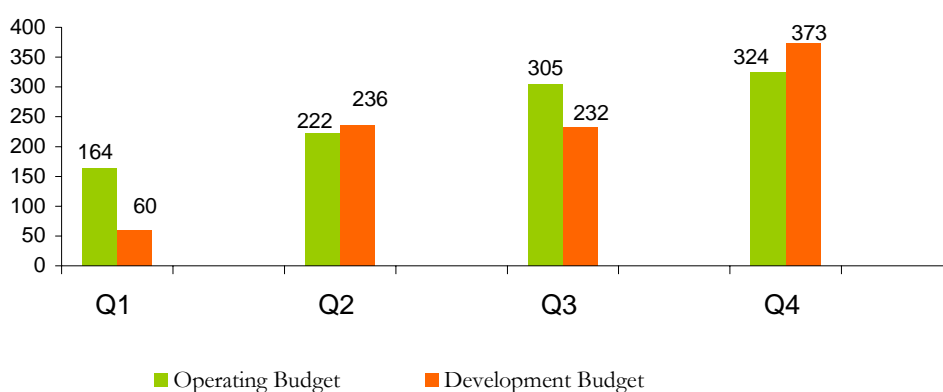


Table 5.3: The Percentage changes from Q1-Q4 1386

Type of Budget	The Percentages of Expenditures from Q1-Q4						
	% Δ from Q1 to Q2	% Δ from Q2 to Q3	% Δ from Q3 to Q4	Q1	Q2	Q3	Q4
Operating Budget	36%	37%	6%	15%	21%	28%	30%
Development Budget	293%	-2%	61%	4%	15%	15%	24%
Percentage from Total Budget	105%	17%	30%	9%	18%	21%	27%

Source: Ministry of Finance and DAB staff calculation

6

EXTERNAL SECTOR DEVELOPMENTS

Summary

Developments in the balance of payment were dominated by donor grants, remittances and the trade balance in the quarter under review. The trade deficit of Afghanistan increased by 21.35 percent to USD 936.29 million in the last quarter of 1386, comparing to USD 771.54 million in the same quarter a year ago. The increase in the deficit was driven by imported inflation and high demand for construction materials and food commodities. The imports increased by 22.8 percent to USD 1090.86 million in the last quarter of 1386, comparing to the same quarter one year ago.

On the other hand the exports have increased by 33 percent to USD 154.57 million in the last quarter of 1386, from USD 116.06 million in the same quarter a year ago. The increase in the export was mainly driven by exports of carpets and dry and fresh fruit.

The external debt of Afghanistan remained unchanged at USD 11939.4 million. The Russian Federation accounts for the vast majority of total external debt (93.4 percent before the application of an

up-front discount on its debt). The United States (0.9 percent) and Germany (0.4 percent) are the other Paris Club creditors.

Increase in the financial inflows-exports, Foreign Direct Investment and financial inflows from donor communities have increased the Net Foreign Assets of Da Afghanistan Bank by 24.83 percent at the end of the fourth quarter of 1386, comparing with the same quarter a year ago.

1. Merchandise Trade

The trade deficit continued to worsen in the fourth quarter of 1386, the deficit stood at USD 936.29 million in the fourth quarter of 1386, comparing to USD 771.54 million in the third quarter of the same year. Showing an increase of 21.35 percent. The high increase of trade deficit was mainly due to imported inflation, since it increases the value of imports and adds to the deficit. The high price and high domestic demand for food commodity and petroleum largely contributed to the trade deficit in the fourthquarter-1386.

The imports have increased by 22.8 percent to USD 1090.86 million in the

fourth quarter of 1386, from 887.6 million in the same quarter of the previous year. The high portion of increase in the imports was high inflation for food commodity and fuel.

The exports have increased by 33 percent to USD 154.57 million in the last

quarter of 1386, from USD 116.06 million in the same quarter of the previous year. The increase in overall exports was mainly due to increase in the exports of carpets and rugs which increased by 55.3 percent in the last quarter-1386 to USD 54.6 million. (Table 6.1)

Table 6.1: Merchandise Trade (In million US\$)

	1384		Fourth Q 1385		Fourth Q 1386		%Change Over Same Quarter previous year
	Total	Share (%)	Total	Share (%)	Total	Share (%)	
Imports	2470.74	100	887.60	100.00	1090.86	100.00	22.90
Consumer goods	478.63	19.37	615.18	69.31	612.24	56.12	-0.48
Industrial supplies	541	21.9	16.44	1.85	8.36	0.77	-49.15
Capital goods & others	1206.5	48.83	253.67	28.58	255.73	23.44	0.81
Fuel & lubricants	244.61	9.9	2.31	0.26	214.53	19.67	9187.01
Exports	383.72	100	170.81	100	154.57	100	-9.51
Carpets & Rugs	206.94	53.93	90.08	52.74	54.90	0.549	-39.05
Food items	104.11	27.13	70.31	41.16	79.62	79.62	13.24
Leather & Wool	36.51	9.51	3.16	1.85	9.88	9.88	212.66
Medical seeds & others	36.16	9.42	7.26	4.25	10.17	10.17	40.08
Trade Balance	-2087.02		-716.79		-936.29		30.62
Trade Balance as % of GDP	31.28		-10.17		-10.74		

Source: Central Statistics Office and DAB staff Calculations

2. Direction of Trade

Pakistan remained Afghanistan's largest export destination. In the fourth quarter of 1386 the exports to Pakistan increased to USD 112.38 million from USD 84.13 million in the same quarter of the previous year, showing an increase of 33.5 percent over the same quarter of previous year. Afghanistan is having a trade surplus of USD 23.22 million with Pakistan, the trade surplus is result of decrease in Imports from

Pakistan due to import restriction of wheat and flour which consists large portion of imports and re-export items. The Exports were driven by increase in exports of carpets and rugs which increased to USD 48.5 million in the last quarter of 1386 from USD 34.7 million in the same quarter of the previous year, showing an increase of 40 percent. The exports of fresh and dry fruit also increased considerably to USD 31.4 million in the last quarter of 1386.

Table 6.2: Direction of External Trade for fourth quarters of 1386 (In million US\$)

Country	Exports		Imports		Trade Balance
	Million (US\$)	Share (%)	Million (US\$)	Share (%)	
Pakistan	112.38	72.70	89.16	8.17	23.22
India	7.3	4.72	32.53	2.98	-25.23
Japan	0	0.00	368.27	33.76	-368.27
China	0.3	0.19	310.35	28.45	-310.05
Ex Soviet Commonwealth	9.06	5.86	177.67	16.29	-168.61
European Countries	0.51	0.33	14.89	1.36	-14.38
Others	25.02	16.19	97.99	8.98	-72.97
Total	154.57	100	1090.86	100	-936.29

Source: CSO and DAB staff calculations

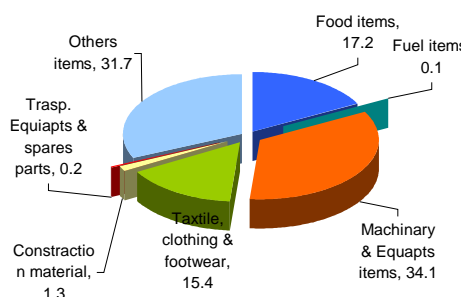
Ex-Soviet Common Wealth Nations and India are the second and third largest export destination for Afghanistan, contributing USD 9.06 and 7.30 million respectively, in the last quarter of 1386.

On the import side of trade balance, in the last quarter of 1386 Japan and China are the largest destination of imports for Afghanistan, consisting USD 368.27 and USD 310.35 million of imports, respectively. Imports from Japan increase by 54 percent; the increase in the imports was driven by high technological and spare parts demand. Followed by Ex Soviet Common Wealth Countries and Pakistan, consisting USD 177.67 and USD 89.16 million of imports, respectively.

3. Composition of Trade

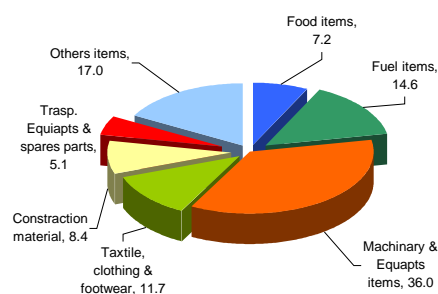
The largest component in imports for the fourth quarter of 1386 is machinery and equipments which consists 36 percent of the imports, followed by “Other Items” (which excludes food items, machinery and equipments, fuel, construction materials, textile, clothing and footwear, transportation equipments and spare parts) which captures 17 percent of the imports, fuel 14.6 percent, and textile, clothing & footwear consists 11.7 percent, construction materials 8.4 percent and food items capture 7.2 percent of imports.

Figure 6.1: Composition of Import (% share) fourth quarter 1385



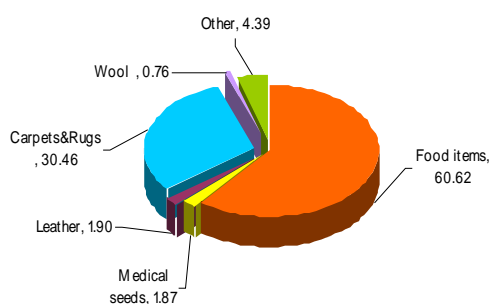
In the fourth quarter of 1386 and 1385, machinery and equipments hold the largest share of imports. It increased by 3.9 percentage points in the fourth quarter of 1386 comparing to the same quarter previous year. Other items is the second largest component of imports in both fourth quarter of 1386 and 1385, but it decreased by 14.7 percentage points in fourth quarter of 1386. Import of fuel increased by 13.3 percentage points in the fourth quarter of

Figure 6.2: Composition of Import (% share) fourth quarter 1386



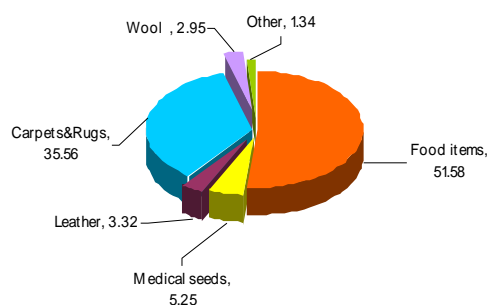
1386 this increased was driven by high domestic demand for fuel and high fuel prices in the last quarter of 1386. High domestic demand for construction materials increased the import by 8 percent. Due to restrictions of wheat import (especially from Pakistan), and its high prices the demand for food items decreased by 10 percentage points in the last quarter of 1386, comparing to the same quarter of previous year.

Figur 6.3: Composition of Export (%share) forth quarter 1385



The export of food items (including dry and fresh fruits) has the largest share in the exports of the country, in both the fourth quarter of 1386 and 1385. The export of food items, in the fourth quarter-1386

Figur 6.4: Composition of Export (%share) forth quarter 1386



consists 51.58 percent of the total exports, down from 60.62 percent in the fourth quarter of the previous year. Carpets and rugs are the second largest component of the exports of the country and its gaining

popularity and the demand for it increases in the western countries. In the fourth quarter of 1386 carpets and rugs had 35.56 percent share in the total exports, up from 3.46 percent in the same quarter of the previous year. Medical seeds, leather and wool are other big components of the exports in the last quarter of 1386.

4. External Debt

Afghanistan's public and publicly guaranteed external debt prior to the application of traditional debt relief mechanisms is estimated at USD 11,939.4 million in nominal terms as of March 20, 2008 (Table). Afghanistan's external debt strategy continues to focus on providing a stable foundation for sustainable debt environment over the longer term. The

mechanism through which external debt sustainability can best be achieved is under the HIPC (Highly Indebted Poor Country) initiative

The Russian Federation accounts for the vast majority of total external debt (93.4 percent before the application of an up-front discount on its debt). The United States (0.9 percent) and Germany (0.4 percent) are the other Paris Club creditors. Multilateral creditors include IDA and the Asian Development Bank (ADB), representing 2.5 percent and 2.1 percent of Afghanistan's nominal debt, and Non-Paris Club creditors account for 0.8 percent of total claims respectively. At the time, there was no outstanding debt to the IMF or commercial creditors.

Table 6.3: External Debt as of March 20, 2008 (in units indicated)

	In million USD	% of total
Total external debt	11,939.40	100
Bilateral	11,382.10	95.4
Paris Club	11,283.50	94.5
Russian Federation/1	11,127.90	93.2
United States	111.7	0.9
Germany	43.9	0.4
Non-Paris Club	98.5	0.8
Multilateral	557.3	4.7
<i>of which:</i> IDA	300.8	2.5
Asian Development Bank	254.6	2.1
Memorandum Items:		
NPV of debt after traditional debt relief/2	1,118.30
(in % of exports)/3	305.8

Source: Data provided by Afghan authorities; and IMF staff estimates.

1/ Before up-front 80 percent discount on Russian debt

2/ After up-front 80 percent discount on Russian debt priority the application of traditional debt relief.

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

5. Net Foreign Assets

The Net Foreign Assets of the Da Afghanistan Bank contains foreign assets, foreign exchange reserves, monetary gold, net domestic assets, and reserve money. The net foreign assets of Dab increased by 24.83 percent in the last quarter of 1386 comparing to the same quarter previous year, from 101269.98 million AF to 12641.33 million AF. Monetary gold increased by 12.44 percent in the last quarter

of 1386 comparing to the same quarter of previous year. Reserve money (currency in circulation and bank deposits DAB and Capital Notes) increased by 22.58 percent, from 49291.97 million AF to 60419.70 AF from the last quarter of 1385 to the last quarter of 1386.

The increase in Net Foreign Assets was mainly driven by increase in exports and financial inflows from donor organizations and countries, and increase in foreign direct investment.

Table 6.4: Net Foreign Assets - Q4 1385 - Q4 1386

	Q4-85	Q1-86	Q2-86	Q3-86	Q4-86	% Change (Q4 1385- Q4 1386)
Net foreign assets	101269.98	104460.17	115030.23	125088.22	126416.33	24.83
Foreign assets	101269.98	104460.17	115030.23	125088.22	126416.33	24.83
Foreign exchange reserves	95678.09	100731.54	110899.52	120665.09	117801.82	23.12
Gold	19230.42	21622.04	21622.04	21622.04	21622.04	12.44
Other	76447.67	79109.50	89277.48	99043.05	96179.78	25.81
Other foreign assets	5039.49	2207.60	5430.89	5890.10	6900.66	36.93
Foreign liabilities	0.00	0.00	0.00	0.00	0.00	
Net domestic assets	-51425.60	-51339.62	-60362.35	-66877.31	-64282.77	25.00
Domestic assets	0.00	0.00	0.00	0.00	0.00	
Net claims on general government	0.00	0.00	0.00	0.00	0.00	
Gross Claims on Government (PRGF disbursements)	0.00	0.00	0.00	0.00	0.00	
Net claims on government in 2002/3-2004/05 (SY 1381-83)	0.00	0.00	0.00	0.00	0.00	
Domestic currency deposits	0.00	0.00	0.00	0.00	0.00	
Foreign currency deposits	0.00	0.00	0.00	0.00	0.00	
Claims on non-bank public institutions	0.00	0.00	0.00	0.00	0.00	
Claims on deposit money banks	0.00	0.00	0.00	0.00	0.00	
Other items net of which: Non-bank non-government resident deposits	-51425.60	-51339.62	-60362.35	-66877.31	-64282.77	25.00
	0.00	0.00	0.00	0.00	0.00	
Reserve money	49291.97	51599.51	55968.05	59677.87	60419.70	22.58
Currency in circulation	47572.90	49754.57	53513.36	56488.58	55896.73	17.50
Banknotes and coins issued	54986.71	57246.95	58596.95	63116.65	64086.00	16.55
less cash holdings	7413.81	7492.38	5083.59	6628.07	8189.27	10.46
Bank deposits with DAB and capital notes	1719.07	1844.94	2454.69	3189.29	4522.97	163.11
Memorandum items:						
Gross international reserves (millions of U.S. dollars)	1915.86	2011.41	2214.45	2409.45	2352.27	22.78
Program exchange rate (Afghanis per dollar)	49.94	50.08	50.08	50.08	50.08	

Source:

ⁱ Revenue pertaining to Hoot 1386 for four provinces, Dikondy, Parwan, Khost and Badakhshan have not been classified in AFMIS due to non receipt on revenue report.
The data information for fourth quarter captured in AFMIS as at 18th April 2008 and are provisional subject to year end reconciliation.

ⁱⁱ These data for the fourth quarter 1386 have been prepared based on the information captured in AFMIS as at 18th April 2008 and are provisional subject to year end reconciliation