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Reform of Afghanistan's Financial Sector: Challenges and Transformations

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ABSTRACT

This paper seeks to examine the transformation of the financial sector following the overthrow of the initial Taliban regime in 2001. The primary focus is on assessing the current status of the Central Bank and scrutinizing the reforms set in motion during the years 2002/2003, which have had a lasting impact on the financial landscape. Furthermore, the paper will delve into the prospective trajectory of the Central Bank and the broader financial sector within this evolving context.

1.0 BACKGROUND

The financial sector in Afghanistan operated entirely on a cash basis, with the formal financial sector being paralyzed and non-functional. The surviving financial infrastructure was in a dilapidated and outdated condition. Despite this, the Hawala system remained active, providing a means for people to transfer and exchange money.

Confidence in the national currency, the Afghani, was low due to its significant loss in value caused by high inflation and subsequent devaluation. The issuance of currency lacked control, resulting in three different versions circulating concurrently. Additionally, counterfeit versions of the official currency were introduced by two warlords, and a landlord established a bank, further complicating the monetary landscape. Foreign currencies, particularly the U.S. Dollar and those of neighboring countries, were extensively used.

Facing the challenge of achieving financial stability, the new government had to decide between introducing a new currency or adopting a foreign currency. The absence of a central banking structure raised questions about constructing a framework for conducting monetary policy, defining objectives, and selecting instruments. The choice between a fixed or floating exchange rate regime also needed consideration.

To establish financial stability, the government opted to introduce a new currency. The plan was announced in September 2002, and the conversion process began in October, concluding in January 2003. The swift and incident-free conversion reflected people's confidence in the new currency and the government's financial policies.

The existing conditions at the DAB necessitated building adequate capacity to conduct monetary policy. With limited personnel possessing modern monetary policy and banking knowledge, and a lack of technological resources for financial reforms, international donors played a crucial role. A new central banking law was passed to empower DAB with the primary objective of achieving and maintaining price stability, reducing exchange rate volatility, and restoring confidence in the new national currency. This law ensured central bank autonomy.

Debates arose about the appropriate exchange rate regime, with arguments for both stability and flexibility. Despite the advantages of a fixed rate regime, Afghanistan adopted a floating exchange rate regime. Discussions also delved into whether to peg the currency to the U.S. Dollar or the currencies of neighboring countries.

Reforming the central bank involved launching an indicative quantified monetary program with the assistance of the IMF. Domestic money supply, limited to the stock of domestic currency in circulation, was chosen as an intermediate target. DAB used a market-based instrument, selling foreign exchange through auctions, to prevent a negative impact on the value of the Afghani due to massive foreign exchange inflows.

Recognizing the impact of international prices and imports on inflation, DAB monitored exchange rate movements as an early indicator of changes in the domestic currency. The absence of reliable domestic data led to the estimation of the stock of Afghanis in circulation based on information from the banknote printer. Despite these challenges, a crude balance sheet estimate was constructed and used as a basis for the monetary program.

2.0 Indicative Monetary Programs for the year 2002/2003

In April 2002, the initial indicative monetary program for the year 2002/2003 was established with a target of achieving a 12-month inflation rate of 20% by March 2003. The assumption was an economic growth rate of approximately 10%, coupled with a modest increase in money demand. Consequently, the monetary program for 2002/2003 aimed for restrained money supply growth, capping it at 30%.

The Staff Monitored Program (SMP) for the years 2004-2005 featured an indicative monetary program, aiming for a 12-month inflation rate of less than 15% by March 2004, and setting a goal to limit money supply growth to 30%.

Upon analyzing monetary developments in the early years of 2002 and 2003, it became evident that a close relationship existed between domestic money growth, inflation, and the exchange rate. Specifically, in the 2002/2003 period, the currency in circulation grew

by 20%, deviating from the IMF's projected 30%. Consequently, the target had to be revised to 24%. The rate of monetary expansion varied from quarter to quarter, influenced by the volatility of money demand and the availability of the old banknotes before the introduction of the new notes.

The surge in money demand was met by the accumulation of foreign reserves at DAB. Adhering to a no-overdraft rule, the government concluded the year with a surplus. DAB's reserves increased by an estimated $100 million in 2002-03, with the stock of foreign exchange reserves reaching $426 million, including $196 million in gold valued at $279 per ounce. These reserves covered approximately 3 months of imports, serving as a sufficient cushion against negative shocks and supporting the national currency.

Except for the year 2002, marked by high volatility, the exchange rate of Afghanis remained stable in 2003. The introduction of the new currency and logistical issues in late summer and fall of 2002 had caused uncertainty, leading to a fall in the exchange rate to over 70,000 Afs per U.S. dollar in November. To address this, DAB resumed foreign exchange auctions in mid-November 2002, resulting in the Afghani strengthening to 46 per US dollar in January 2003, consequently lowering consumer prices.

Upon the completion of currency conversion, DAB could accurately determine the amount of currency in circulation. Currency in circulation experienced a significant 41% growth in 2003-2004, surpassing the 30% increase projected in the indicative monetary programs. The demand for money was entirely met by the accumulation of DAB's foreign exchange reserves, reaching $700 million in March 2004.

Underpinned by a sound monetary policy, inflation remained low at less than 1%, and the exchange rate fluctuated around 49 Afghani per USD.

3.0 Implementation of Monetary policy by Da Afghanistan Bank (Central Bank of Afghanistan)

Since 2004, Da Afghanistan Bank (DAB) has been steadfast in its pursuit of the primary objective of ensuring price stability. Its monetary framework is characterized by Monetary Aggregates targeting, and it adheres to a Managed Floating Exchange Rate Regime. DAB employs various monetary policy tools to effectively manage liquidity, mitigate exchange rate fluctuations, and sustain price stability. Over the past two

decades, data reveals that DAB has successfully maintained inflation at single-digit levels, earning commendation from neighboring countries.
In the early 2000s, DAB predominantly utilized foreign exchange (FX) auctions, later incorporating capital notes in 2006 and introducing Wadia as a monetary policy tool in

2020. However, since 2021, DAB has exclusively relied on FX auctions, with decisions regarding the use of additional tools resting with the Supreme Council.

Despite the Afghani experiencing depreciation against major currencies such as USD, GBP, and Euro, strategic employment of monetary tools has effectively slowed down this depreciation. In the years spanning from 2002 to 2020, international donations played a pivotal role in stabilizing and fortifying the Afghani. Nevertheless, challenges such as security issues, trade deficits, and political turmoil have adversely affected the currency.

DAB's proactive measures include auctioning approximately $34.95 billion and 218 million Euros since 2003, along with withdrawing 2.11 trillion Afghanis from the market during the same period. This strategic withdrawal has significantly contributed to maintaining foreign exchange and price stability. Without this withdrawal through foreign exchange auctions, there could have been increased pressure on the exchange rate, potentially resulting in higher overall prices.

Capital notes have been instrumental in promoting the use of Afghani as a crucial monetary tool for stabilizing prices. DAB has actively encouraged banks to increase Afghani deposits, maintain liquidity, and refrain from excessive issuance of new currency. Consequently, the depreciation of the Afghani against foreign currencies has been gradual, preventing more significant depreciation and inflation that could have reached double digits.

DAB has demonstrated effective utilization of monetary tools, aligning with IMF programs focusing on foreign exchange inflows, Net International Reserves (NIR), and Reserve Money targets.

Turning to the broader context of financial development and its impact on economic growth, Afghanistan, scarred by over 25 years of wars, faced crippled financial institutions. The country's reconstruction and economic growth hinged on a rapid and comprehensive redevelopment of its financial sector. Research by Holden and Pokopenko (2001) and other empirical studies underscored the significant linkages between financial sector growth, economic growth, and poverty reduction.

Recognizing the imperative of building a robust financial sector, the government initiated critical reforms to transition away from a cash-centric economy and establish an efficient commercial banking system. This involved the reconstruction of a modern central bank and addressing challenges such as building supervisory capacities and training DAB personnel.

DAB encountered challenges, including a lack of capacity in international and domestic payment systems, absence of SWIFT connections, and the absence of interbank connectivity. Central banking reforms in 2003 replaced outdated laws with new Central Bank and Banking Laws, fostering the development of a sound private banking sector. DAB issued banking licenses to international entities, fostering transparency and providing the tools for effective banking system regulation.

DAB's progress post-Taliban (since 2001) includes the establishment of a supervision department in June 2003, formulation of specific policies and procedures, and training in licensing, regulation, and supervision of banks and non-banks.

Addressing financial accounts, DAB acquired general ledger software to produce regular balance sheets, drafted accounting regulations, and trained staff to enhance financial reporting and data collection.

Despite being a central bank, DAB's commercial branch played a pivotal role in conducting various banking activities for international organizations and NGOs during 2002 and 2003. The efficiency of payment services notably improved with the introduction of SWIFT.

Looking ahead to 2023, DAB's monetary policy aims to curb inflation and stabilize the exchange rate (AFN). While significant progress was made in reducing inflation from a peak of 50% in 2003 to less than 1% in 2020, persistent inflation challenges have emerged since 2021. High inflation has eroded purchasing power, leading to economic instability and reduced investment. To address this, DAB advocates for access to its foreign exchange reserves, critical for managing money supply, stabilizing the Afghan currency, and facilitating imports.

Proposed access to foreign reserves includes an initial allowance of $150 million per month, later reduced to around $80 million, with stringent monitoring. Deviation from using these reserves for auctions could result in termination.

Highlighting the importance of a functioning central bank, funds derived from foreign reserves are deemed crucial for DAB's role in monetary stabilization and long-term economic reconstruction. DAB's interventions in the foreign exchange market have been constrained by the availability of foreign exchange reserves.

In evaluating the overall effectiveness of Afghanistan's monetary policy, progress has been made in reducing inflation and stabilizing the exchange rate. However, challenges such as limited access to reserves, insufficient resources, and capacity constraints have constrained these efforts. The country's reliance on foreign aid has added complexity to maintaining macroeconomic stability.

4.0 Outlook for 2023:

Looking ahead to 2023, DAB needs to persist in implementing effective monetary policy to curb inflation, stabilize the exchange rate, and enhance the banking system. Priorities include strengthening the capacity to monitor and regulate the financial sector, implementing AML/CFT controls, and aligning with IMF procedures. The Monetary Policy Department has continued its activities after the country's takeover by the ITA, following established procedures and manuals.

5.0 Conclusion:

In conclusion, DAB's commitment to monetary stability and financial sector development has been evident since the fall of the Taliban. Achievements include legal reforms, the establishment of a supervision department, and the implementation of policies and procedures. Challenges persist, necessitating ongoing efforts to enhance DAB's capacity and navigate economic complexities. Access to foreign reserves remains pivotal for sustaining economic stability and facilitating the central bank's critical functions.

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