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MONETARY POLICY STRATEGIES AND THEIR APPLICABILITY IN AFGHANISTAN

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Abstract

Various strategies are used to conduct monetary policy in developed and developing countries; exchange rate targeting, monetary aggregate, and inflation targeting. Each of them has its own advantages and disadvantages. The central bank of Afghanistan target monetary base to conduct monetary policy which is not appropriate to achieve price stability as a goal of monetary policy with the primary instrument foreign exchange action. The use of other indirect instruments and strategies such as exchange rate and particularly inflation targeting is not possible now due to the weak financial system and other preconditions.

Keyword: monetary policy strategies, inflation targeting, exchange rate targeting, monetary targeting, and foreign exchange auction.

1.INTRODUCTION

The central bank of Afghanistan (DAB)1 has been responsible for conducting monetary policy since its establishment in 1939. From 1939 to 1978, the central bank of Afghanistan conducted its monetary policy taking into consideration the economic condition of the country. However, during more than two decades of war Afghanistan was governed by different regimes (1978-2001). The devastating war damaged many social and economic relations of the country. The government lost most of its sources of revenue in the country so it had to finance its expenditures by printing money. This caused hyper-inflation in the country especially in the period 1991 to 2001. The central bank of Afghanistan which is responsible for the stability of prices was not able to fulfill its function properly to fight inflation; actually, there have not been any strategy or instruments *a all. DAB was just* printing *money to finance* the government's military and other expenditure

After the establishment of a new government in Afghanistan in 2001, the authorities of the central bank adopted a new monetary policy frame work and strategies to conduct monetary policy. The main and primary instruments that have been used were foreign exchange auctions and, recently, open market policy by Capital Notes to control liquidity in the country. Despite the efforts made by the central bank of Afghanistan, inflation is still a problem for people because there are some internal and external factors which are beyond the control of the central bank of Afghanistan. External shocks like an increase in world food and fuel prices cause inflation in the country because Afghanistan is a net importing country. Internal shocks are, for example, a weak financial system, insecurity and infrastructures that have been damaged during the war. Furthermore, many strategies are used by central banks in the world to conduct monetary policy such as inflation targeting, exchange rate targeting and monetary targeting. Taking into account these strategies and on the above-mentioned problems, this paper reviews the monetary policy strategies and discusses their applicability in Afghanistan

2.MONETARY POLICY STRATEGIES

Monetarists and classical macroeconomists are supporters of rules in monetary policy. They believe that the central bank should follow a set of simple rules that are agreed on before. For example, the central bank might be instructed to increase the monetary base by one percent. Furthermore, the rules should be stated in

[1] DAB is the Abbreviation form of Da Afghanistan bank or central bank of Afghanistan

terms of variables that the central banks can control directly or nearly directly (Mcconnell and Brue, 1998). The opposite of the rules approach is called discretion. Keynesians, by definition supporters of discretion, believe that central banks should be free to conduct their monetary policy in any way they believe will achieve the ultimate objectives of low and stable inflation. In particular, the central bank should continuously monitor the economy and also should change the money supply using the advice of economic experts, as needed to achieve its goals in the best way possible. For example, if inflation is currently low and economic indicators suggest that the economy is moving toward recession; by a strategy of discretion the central bank should be free to increase the money supply to try to stimulate the economy. In contrast, by strategy or rules the central bank would have to follow its rule which has been imposed before and would not be free to apply such stimulus.(Abel and Bernanke, 2005).

There are three main strategies (rules) that central banks have used to control inflation:

1- exchange rate targeting
2- monetary targeting
3- inflation targeting and inflation reduction without an explicit anchor(Mishkin,1997)

Each one has its own characteristics, advantages, and disadvantages which are discussed in brief.

2.1. Exchange rate targeting

One strategy to keep inflation low for a country is to fix the value of its currency to the currency of large low-inflation countries. This strategy requires fixing the exchange rate at a fixed rate to that of other countries. But there are other cases too for example in case of crawling peg the country can allow its currency to depreciate at some steady rate. It should be mentioned that exchange rate targeting was widely used in the past (Mishkin, 2001). Because it has various advantages and disadvantages that will now be discussed in brief.

2.1.1. Advantages of exchange rate targeting

A key advantage of exchange rate targeting is that it can prevent the time-inconsistency problem. This problem occurs because there is an incentive for policymakers to pursue an expansionary policy to increase the economic output and create jobs in the short run. If there is a rule for a fixed exchange rate, it can restrict policymakers from playing this game and thus the problem of time-inconsistency policy will be eliminated. By pursuing exchange rate targeting the central bank no longer has the discretion to conduct expansionary policy to obtain output gains which causes time inconsistency (Mishkin, 1997).

Another advantage of an exchange rate targeting is that it is simple and clear and thus can be understood by the public. In addition, this strategy helps the pegging country to achieve the credibility of a low-inflation country. This can only happen if the exchange rate peg is credible. As a result, the exchange rate can help to lower the inflation expectations of the targeted country. This will help to decrease inflation to the level of that of low-inflation countries. (Mishkin and Savastano, 2000).

Furthermore, inflation can be controlled effectively by exchange rate targeting if the commitment to the exchange rate peg is strong. The currency board is a strong form of commitment mechanism to a pegged exchange rate which increases the credibility and transparency of the central banks. A currency board requires that a country, when it announces a fixed exchange rate for a particular foreign currency, then it should be willing to exchange the domestic currency for the foreign currency at that rate when people request it. The advantages of exchange rate targeting can be summarized as follows: it fixes the inflation rate for internationally traded goods and contributes to keeping the inflation under control, it anchors inflation expectation and, moreover, by providing a rule for the conduct of monetary policy, it prevents the time inconsistency problem (Mishkin, 2007).

2.1.2. Disadvantages of exchange rate targeting

Although exchange rate targeting can principally control inflation, it also holds some problems. First, by choosing exchange rate targeting the central bank loses its independency and cannot conduct its own monetary policy. By following this strategy shocks cannot be controlled by the central bank. The central bank could control and ease these shocks by adopting a monetary policy in the absence of exchange rate targeting. Moreover, the exchange rate targeting country can be affected badly by shocks in the anchor country which can be transmitted to the targeting country. However, it should be mentioned that successfully conducting discretionary monetary policy is very difficult in many developing countries because of a lack of independence of and political pressures on central banks. (Kadioglu et al, 2000).

Second, by adopting exchange rate targeting, a financial system is likely to be promoted in emerging and developing countries. For example, if the domestic currency surprisingly has to be depreciated it can damage the balance sheet of banks and firms very badly. Since in most developing countries foreign currency denominated debt is higher than the foreign currency denominated assets on their balance sheets this increases their debt burdens. (Kadioglu et al, 2000).

The third disadvantage of exchange rate targeting in emerging markets and developing countries is that although inflation can be brought down by this strategy, a surge in inflation can be triggered by successful speculative attacks. Because many central banks lack credibility in many developing countries actual and expected inflation can be increased by depreciation of the currency after speculation. This, in turn, results to a rise in interest rates which promotes some other problems and deepens the financial crisis (Mishkin, 2006).

2.2. Monetary targeting

As has been discussed, there are some problems using exchange rate targeting to control inflation. Furthermore, in many countries, it cannot serve as an option because the country (or a block of countries) is too large or because there is no country whose currency is a clear choice to serve as the nominal anchor. Monetary targeting is another strategy that can be used to control inflation. For example, after the collapse of the fixed exchange rate of the Bretton Woods regime, many countries were encouraged to choose monetary targeting, especially Germany, commencing in the mid-1970s (Mishkin, 1997). The use of monetary targeting is based on the assumption that the demand for money is related to a small number of macroeconomic variables, including the price level. Inflation can be kept low if the money supply growth is controlled properly and if the monetary target is based on the quantity theory of money: MV = PQ, with M = money supply, V = velocity, P = prices and Q = quantity. If V remains stable in this equation the nominal GDP (PQ) can be affected by changes in M. This implies that if the growth rate of money is controlled, then there will be an impact on the nominal GDP. To control inflation a target for the growth of monetary aggregate is announced by the central bank every year. Monetary targets are currently much less in use than in the 1970s and 1980s.

2.2.1. Advantages of monetary targeting

The first advantage of monetary targeting is that by using this strategy the central banks can adjust their monetary policy to deal with domestic economic developments. Moreover, it can help central bank to choose goals for inflation which is different from other countries and gives the central bank the possibility to show responses to output fluctuations. Furthermore, as with the exchange rate targeting information on targets of central banks can be understood by the public. Figures about monetary aggregates are reported within a couple of weeks so immediate signals can be sent to the public and markets about the stance of monetary policy. In addition, accountability is given to the central bank to keep inflation low.

Another advantage of monetary targeting is that it provides data about money supply growth without any major time lag, which in turn gives information on the outlook for inflation. Yet another advantage is that the nominal supply of money can be controlled by central bank more directly than inflation. (Mishkin, 2006).

2.2.2. Disadvantages of monetary targeting

The main disadvantage of monetary targeting is that there is not always a strong and reliable relationship between the monetary aggregate used for targeting purposes in either the short or the long run. There has to be a strong relationship between the goal variable (inflation and nominal income) and the targeted aggregates. If the relationship between the monetary aggregate and the goal variable (such as inflation) is not strong enough then monetary targeting will not be effective. In this case, hitting the target will not bring about the desired result on the goal and therefore the monetary aggregate will not give enough signals about the stance of monetary policy. The second disadvantage is that the central bank must control the targeted monetary aggregates, otherwise a clear signal about the intention of the policy makers cannot be provided. (Mishkin, 2006).

2.3. Inflation targeting

It is perfectly clear that the main goal of monetary policy in any country should be to keep a low inflation low. Inflation targeting is a monetary policy framework which aims at the achievement of price stability. In contrast to other strategies, money or exchange rate targeting, which try to achieve low inflation by targeting intermediate variables, such as the growth rate of money aggregates or the level of the exchange rate, inflation targeting aims at directly targeting inflation (Laxton et al, 2006).
Mishkin (2000) has identified some common features of inflation targeting strategies: "(1) announcement of medium-term numerical targets for inflation; (2) an institutional commitment to the price stability as the primary, long-run goal of monetary policy and commitment to achieve the inflation goal; (3) an information-inclusive strategy in which many variables (and not just monetary aggregates) are used in making decisions about monetary policy; (4) increased transparency of the monetary policy strategy through communication with the public and markets about the plans and objectives of monetary policymakers and (5) increased accountability of the central bank for attaining its inflation objectives." (Mishkin, 2001, pp. 521-522)
Regarding numerical target, it is common among countries that have adopted the inflation targeting strategy to determine the target above zero percentages, for example, 2 or 3 percent for developed countries because zero price stability is not considered preferable due to upward bias included in the measurement of the CPI (quality and substitution bias,etc.). However, in most developing countries the numerical target is somewhat higher, for example between 4 and 8 percent.2
It is worth mentioning that by the inflation target strategy the inflation forecasts have a special role. Central banks use inflation forecasts in policy making processes. When it comes to a difference between expected and targeted inflation, monetary authorities adopt actions to clear these differences. Accordingly, it is essential for central banks to develop models to describe the dynamics of the economy and use all relevant information for forecasting inflation. (Kadioglu et al, 2000)

2.3.1. Conditions for establishing inflation targeting

The main requirements of inflation targeting are that central banks should not be dominated by fiscal and political pressure and have full legal independence to adjust their instruments toward the achievement of a low level of inflation. This independence requires at least instrument independence which provides the way for the central bank to follow its monetary policy in an effective way. Moreover, the central bank should not target any other nominal variable such as wages and or nominal exchange rate. That is, other objectives such as wage rates, the level of unemployment and the exchange rate must be subordinated to the inflation objective. (Carare, et al, 2002).
Accountability and transparency are additional preconditions for adopting the inflation targeting strategy. Accountability is important because the transmission lag makes it difficult for people to monitor monetary policy. The following cases should be considered in order to ensure people that they have sufficient information to hold the central bank responsible. (Carare, et al, 2002).
A clear understanding of the principle of monetary policy operation is essential for people and the indicators that reflect the stance of monetary policy should be fully understood by them. In addition, whenever there is an announcement about the stance of monetary policy the factors that motivated the changes should be explained, which helps the public monitor the commitment of the central bank. (Carare, et al, 2002).
Furthermore, the absence of fiscal dominance is another precondition for adopting inflation targeting; in other words, fiscal considerations should not dominate or restrict the conduct of monetary policy. This indicates that the government should not borrow from the central bank at all or at least the government should have to rely less on borrowing from the central bank or banking system. By meeting this precondition, the credibility of the central bank will be strengthened by strong fiscal

[2] http://sedlabanki.is/uploads/files/mb001_6.pdf accessed on 10/4/2019

disciplines. There are two cases that should be considered: first, countries with a history of high inflation. The reason for this high inflation is a direct and indirect financing budget deficit by central banks. Now, in order to gain credibility for such countries with an inflation targeting strategy a firm fiscal discipline is required. In these countries, if there are no firm fiscal disciplines, the public will lose confidence in the viability of the inflation targeting framework because of a high inflation record in these countries and limited access for the respective government to the markets to fund its deficit. Second, there are countries that have experienced low inflation and in these countries governments have easy access to financial markets to finance their budget deficit(Carare et al, 2002). This way the credibility of monetary policy strategy can be kept safe and there is no fear of fiscal dominance. Financial stability is another precondition for choosing inflation targeting. With a stable financial market, there is no concern regarding the health of the financial system and the central bank can follow its inflation target. Therefore, before adopting an inflation targeting strategy, developing countries should work toward improvements of their financial system. For an increase in the effectiveness of monetary policy, deep and liquid government securities are essential. Finally, the choice of the right monetary policy instruments is another precondition for the inflation targeting strategy and the central bank should be able to control these instruments. In this manner, before following an inflation targeting strategy, central banks should use indirect instruments of monetary policy (open market operations). Indirect instruments are better in order to manage liquidity on a day-to-day basis. (Carare, et al,2002).

Furthermore, a well-developed technical infrastructure and economic structures are other preconditions for adopting an inflation targeting strategy. A well-developed technical infrastructure means that the central banks should have inflation forecasting and modeling capabilities. Among economic structures, dollarization should be kept minimal. Countries should not be sensitive to fluctuations in exchange rates and commodity prices and the government has to deregulate the prices. (Laxton, 2002).

At last, it should be mentioned that establishing preconditions in order to choose a monetary policy strategy in an inflation targeting framework would lead to a very long discussion. It is not necessary to mention them in detail in this paper.

2.3.2. Advantages of inflation targeting

Supporters of inflation targeting strategies cite the advantages of inflation targeting, namely that by adopting an inflation targeting strategy low and stable inflation could be achieved. Furthermore, the accountability and transparency of central banks can be enhanced so the uncertainty among wage and price setters regarding the inflation will be decreased in the future. Moreover, inflation targeting helps central banks to achieve credibility, anchor inflation and makes clear that low inflation is the primary objective of central banks and the commitment of central banks to low inflation is confirmed to the public. (Tutar, 2002).

Inflation targeting also holds the key advantage that it is understood by the public and therefore it is very transparent. Moreover, inflation targeting enables the central bank to focus on domestic consideration and, whenever there is a shock to domestic economy, respond to it quickly. For a successful implementation of this strategy, a stable relation between money and inflation is not essential. With this strategy, central banks can use all available information while not being restricted to just one variable in conducting monetary policy. (Mishkin, 2001).

Inflation targeting strategy reduces the possibilities of falling into the inconsistency trap by avoiding pressure from politicians in order to expand the economic activities because inflation targeting strategy concentrates on what the central bank is able to do in the long run (e.g. keeping the inflation low). It does not focus on what the central bank is not able to do (e.g. promoting economic growth and increasing employment). With the inflation targeting strategy, the central banks are provided with transparent and regular communication, so the central bank can explain the goals and limitation of monetary policy. For example, the central bank can explain numerical values of the inflation target, how they were determined and how the inflation target will be achieved. (Mishkin, 2001).

In addition, more flexibility is provided by inflation targeting because the central banks cannot control inflation instantaneously and the central banks interpret inflation as a medium-term objective. This indicates that central banks follow the inflation target over a certain horizon, by focusing on keeping inflation expectations at the target. Short-term deviations are possible and are generally accepted, so it does not mean a loss in credibility. (Laxton, 2006)

2.3.3. Disadvantages of inflation targeting

Despite the advantages of inflation targeting above mentioned, there are many critical factors that can be explained in the following.

The first problem with inflation targeting is that inflation is more emphasized by this strategy. Furthermore, it prevents monetary policy authorities from responding to the shocks which have a negative impact on the economic growth because the structure of inflation targeting is rigid. The second problem is that controlling inflation is difficult with this strategy. Moreover, policy instruments have their effect on inflation with long and variable lags. As a result, an inflation target cannot give immediate signals to public and markets about the stance of monetary policy. (Mishkin, 2001). Developing countries have this problem when monetary authorities are trying to bring down inflation from high levels. In this case, forecast errors and target misses are likely to occur. As a result, the central banks will have problems describing the reasons for the deviations from the targets and keeping their credibility, which is important for an inflation targeting country. Furthermore, fiscal dominance cannot be prevented in the long run with this strategy, large fiscal deficits will cause either monetization of the deficit or devaluation and in this way they will bring in high inflation (Kadioglu, 2000).

In addition, simple rules about the conduct of monetary policy are not imposed under inflation targeting. Contrary to simple rules, more information should be available and the central bank should use all available data to attain the target (Mishkin, 2001). In addition to the problems regarding inflation targeting mentioned above, there are some other disadvantages that are not necessary to be mentioned in this paper.

3.MONETARY POLICY FRAMEWORK AND INSTRUMENTS IN AFGHANISTAN

The current monetary policy framework of the central bank of Afghanistan is based on targeting monetary base. It consists of an ultimate objective (controlling inflation), an intermediate target (currency in circulation), and an operating target (weekly foreign currency auction) (DAB, Annual Bulletin, 2017).

The central bank of Afghanistan has designed a monetary program in cooperation with the IMF under this program, DAB targets money supply as liquidity index taking the economic situation of the country into consideration. The monetary policy strategy under this program is based on the principle that the money supply should grow at or less then the growth rate of the nominal GDP. (Weekly report of DAB, 2008).

The current monetary policy instruments of DAB are as follows:

Foreign exchange auction. In the absence of a developed financial system in the country, the main instrument of DAB is the sale of foreign exchange by foreign exchange auctions. Foreign exchange auctions are used to prevent heavy fluctuations of the exchange rate and to control the growth of money supply. If DAB sells dollars for Afghani the money supply will decrease. If, on the other hand, it buys dollars in exchange for Afghani the money supply will increase. Selling and buying of dollars in exchange for Afghani influence the exchange rate.

The government of Afghanistan deposits a foreign assistance fund at DAB which increases the foreign assets of DAB. If the foreign exchange inflow and the foreign peace keeping forces' spending would be converted at once into Afghani it would double the domestic supply of money and result in an erosion of the value of the Afghani. In order to prevent this, DAB conducts auction sales of foreign exchange twice a week to decrease extra liquidity. (DAB Quarterly Bulletin third quarter 2008).

It is important to note that DAB does not directly target the exchange rate as exchange rate targeting is not the monetary strategy of the central bank. It just flattens short term market volatility by intervening in the foreign exchange market to keep the exchange rate at a reasonable level. It cannot influence long-term trends. However, it should be noted that a depreciation of the exchange rate of the Afghani will let the prices of imported goods increase and make private investment projects in Afghanistan more expensive. On the other hand, a real depreciation of the exchange rate may increase the foreign demand for Afghan goods. (Achievement of DAB, 2007-2008).

Open market policy by capital notes auctions. Capital Notes (CNs), i.e. short term financial instruments, were introduced by DAB in September 2004. DAB defines CNs in the following way: "Capital Notes are short-term Afghani denominated securities sold by the central bank at weekly auctions. An investor buys the notes at a discount rate and receives payment of face value on the maturity date. Capital Notes are discount securities, which mean that they are issued and traded at a discount rate to face value. Discount securities make only one payment, namely the face value on the maturity date. The difference between what is paid for the capital notes at purchase date and the face value is the interest earned." (DAB Third Quarterly Bulletin, 2008, p. 44).This is the same as the selling and buying of government securities in developed countries, while the effect on the central bank's own balance sheet is different. When DAB sells capital notes to a bank it debits the current account of that bank at DAB and credits Capital Notes (a liability of DAB), the monetary base decreases. When a central bank sells a government security to a bank, it debits the bank's current account at DAB and credits its holdings of government security (an asset of that central bank), the monetary base also decreases. As a result, these declines in the monetary base promote declines in the broader monetary aggregates, and in the supply of credit in the economy (DAB Quarterly second Bulletin 2008).

DAB issues capital notes to manage liquidity in order to maintain price stability. In other words, if there is much liquidity or money supply, DAB will sell Capital Notes and vice versa. For the effective use of Capital Notes for monetary policy DAB has regulated secondary markets, because the establishment of the secondary markets will bring together the buyers and sellers of Capital Notes and helps DAB to manage liquidity in the economy by its open market operations.(Regulation of secondary market for Capital Notes, 2008).

Reserve requirement is another instrument of the monetary policy of DAB. According to Article 62.1, DAB is allowed to demand that required reserves of banks be deposited in DAB. The rate of required reserves is determined by regulation (Law of DAB, 2003).The current rate of reserve requirements is 8 percent. (DAB Quarterly Bulletin, Sep 2007).

Overnight Standing Credit Facility (ONSCF) and Overnight Standing Deposit (ONSDF). ONSCF is available for banks when they are faced with shortage of cash. This facility is used for short-term cash needs of banks. ONSDF is available for all commercial banks to deposit these excess balances, or, by other words, a bank may place funds overnight with DAB at rates below market rates at currently 1.5 percent (DAB, Quarterly Bulletin (2007).

3.1. Challenges

A weak financial system. The financial system of Afghanistan is comprised of banks, foreign exchange dealers, micro finance institutions and money service providers. There are 17 licensed banks (compared to six banks in 2001), including three state-owned banks and four branches of foreign banks. There are more than 171 branches of banks in more than 20 provinces. Furthermore, there are more than 311 foreign exchange dealers throughout the country. Additionally, there are 89 licensed money service providers. There are more than 14 microfinance institutions providing loans to businesses. The insurance sector is week. A bond and money market does not exist and the capital market is limited to primary issuance of short-term Capital Notes (security of the central bank). (IMF Country Report No.08/71, 2008).

Despite the rapid growth of the banking sector, the financial system is not deep enough. Indicators of financial depth, including bank credit to the private sector and deposits as a percentage of GDP, remain well below those of neighboring countries. Most of the activities of the banking sector focus on foreign currencies, reflecting a historically high inflation and exchange rate volatility. The share of foreign exchange deposits to total deposits in the banking system is 80 percent. In addition, borrowers take on dollar-dominated loans, because of cheap dollar financing. Interest rate spreads are wide, which shows much overhead costs. The average Afghani lending rate is about 20 percent, while that on Afghani deposit is about 7 percent. Only a small part of the population has access to formal financial services. A core set of basic commercial law does not exist, including mortgage and commercial arbitration laws, which prevents banks from providing credit to small-and medium-sized enterprises. As a result, banks are highly liquid. (IMF Country Report No.08/71, 2008).

DAB needs to work towards the development of am money market. By the development of a money market, the transfer of excess liquidity among banks will be facilitated. In this regard there are many issues which should be considered: first, the lack of instruments as collateral to back the lending operation. Second, the management of state-owned banks is very poor. Third, the legal framework for market operations should be strengthened. The development of a money market would also help DAB to have control of broad money and hence enhance the efficiency of monetary policy using current monetary policy strategy. When relying primarily only on foreign currency auction, monetary policy has a limited effect on the overall liquidity. The development of a money market would allow DAB to conduct money market operation and control the overall liquidity of the banking sector. (DAB, Annual Bulletin, 2017)

Currency substitutions. Dollarization, use of other currencies and large inflow of foreign aid have been obstacles towards the implementation of an appropriate monetary policy strategy. After the introduction of the new currency in 2002, it was assumed that DAB would maintain price stability by stabilizing the nominal exchange rate which strengthens the demand for Afghani and, as a result, reduces dollarization. However, inflation is still a problem mainly caused by large inflows of foreign aids and opium exports. Dollarization which was brought about by the increased demand for foreign currency as a hedge against exchange rate risk is being supported by large inflows of foreign aid which promotes currency substitution. So the quantity of money for transactions includes foreign currencies that are close substitutes to the Afghani. Consequently, the interventions of DAB through foreign exchange auctions as a key instrument of monetary policy change the compositions of the money stock but not its overall size. In this way, currency substitution undermines the effectiveness of foreign exchange auctions as well as that of monetary policy strategy. In order to impact overall liquidity a more effective instrument of monetary policy is needed to be developed by DAB in order to use more advance monetary policy strategy. (IMF Country Report No.08/71, 2008).

Liquidity forecasting. The main objective of liquidity forecasting is to achieve accurate quantitative guidelines for the appropriate level and directions of monetary operation when indirect instruments of monetary policy are used. Liquidity forecasting follows day-to-day changes in the central bank's balance sheet and currency in circulation. In addition, it forecasts the changes in demand for bank reserves, excess reserves and required reserves. (Strategic Plan of DAB, 2009)

Despite some improvements in the implementation of monetary policy from liquidity forecasting by DAB, further progress has to be initiated. In the Afghanistan government, NGOs and the US army depend on the transfer of funds from broad for funding. So the forecasting of all expenditures by the government, the US army, and other donors is important for liquidity forecasting. So far, DAB has been successful in taking into account the projected liquidity injections by the MOF and the US military in liquidity forecasting; however, DAB has not been able to take into account the government expenditures in the development budget. Furthermore, the coverage of expenditure of NGOs and donors is weak in liquidity forecasts. (IMF Country Report No.08/71, 2008).

4.CONCLUSION

Different possible strategies can be adopted by central banks to fight inflation: exchange rate targeting, monetary targeting and inflation targeting.

By exchange rate targeting a country connects the value of its currency to that of an economically powerful country to keep its inflation low. Given its advantages, it has been used in both developed and developing countries. However, the main disadvantage of exchange rate targeting strategies is the loss of independent monetary policy. The central bank of Afghanistan cannot use this strategy due to current economic condition in the country. However, the monetary authorities should evaluate the advantages and disadvantages of this strategy while taking into consideration the economic situation and financial system of their countries before choosing this strategy.

After the demise of the Bretton Woods system many developed and developing countries adopted monetary targeting because of its advantages. However, for monetary policy to be successful under this strategy there should exist

a strong relationship between any monetary aggregates used for targeting purposes and the nominal GDP. This is the only strategy than can be used by central bank of Afghanistan

Inflation targeting, which is a new monetary policy, also comes to use in some developed countries as it requires some specific preconditions before adopting it. These preconditions, as said before, are full independency of central banks, the use of indirect instruments of monetary policy, no sign of fiscal dominance, a developed financial system, the ability of central bank to forecast inflation etc. in sum, The current monetary policy frame work of DAB is based on monetary anchor aims targeting the currency in circulation, which is maintaining the growth of the money supply below the nominal growth of GDP. DAB uses foreign exchange auctions as the main instrument of monetary policy and another new instrument, namely open market policy by capital note auctions to control liquidity and keep the prices stable. Exchange rate targeting is not an appropriate strategy to be adopted by central bank of Afghanistan.

Furthermore, Afghanistan like other developing countries, cannot meet most of these preconditions at present in order to adopting inflation targeting strategy. For many developing countries it is too early to fulfill these preconditions needed to implement this strategy. To conclude, the monetary targeting s strategy of DAB is not appropriate. With the development of the financial sector and the availability of data from the banking sector, DAB should base its monetary policy on broader monetary aggregates and expand their monetary policy instruments and use other strategies. Furthermore DAB should develop the secondary market for Capital Notes and raise their volume to strengthen the effectiveness of monetary policy. In addition, DAB should try to strengthen its capacity in liquidity forecasting so that it can control on overall liquidity in the country

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