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Iraq's central bank: in search of a *raison d'être*

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Iraq's central bank: in search of a *raison d'être*

Iraq's underdeveloped financial markets make it impossible for the central bank to fulfil its mandate
argue Matt Sekerke and Steve H. Hanke.

In September of 2003 we published a largely speculative assessment of Iraq's money and banking system¹. We concluded that central banking in Iraq would be inadvisable, if not infeasible, should our expectations prove correct. We anticipated that there would be fundamental problems with human capital and knowledge: official and private sector personnel would have to adapt to business in a market economy, and economic data would be scarce, if not irrelevant. There were reasons to worry about the integrity of future government budgets, jeopardising the independence of a prospective central bank. Furthermore, there would likely be no markets in which a central bank could operate. Securities markets were probably underdeveloped; the banking system, insolvent and illiquid. Hence, we recommended that Iraq opt for a currency board arrangement, or simply adopt the euro or dollar as legal tender.

Soon, better information became available on Iraq's money and banking system (we had been in no position to go there ourselves for field research). Reporting on developments in these pages, we concluded again that Iraq should operate a fixed exchange rate regime, many of our original conjectures now having acquired the status of historical fact². And lest readers be unimpressed by our a priori policy arguments, we presented evidence regarding Nigeria's actions under eerily similar circumstances in the 1950s. In a rush to acquire a symbol of national sovereignty, Nigerian policymakers politely ignored the Bank of England's advice to maintain a

¹ Hanke, Steve H. and Sekerke, Matt "Monetary Options for Postwar Iraq". Cato Institute Foreign Policy Briefing No. 80, September 22 2003. Available at <http://www.cato.org/pubs/fpbriefs/fpb-080es.html>.

² Hanke, Steve H. and Sekerke, Matt "Iraq's Botched Currency Reform". *Central Banking* 14.3, 39-45, February 2004.

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currency board arrangement. Two decades of decline followed. Even now, living standards are roughly at 1960s levels.

Regrettably, sticking to our policy conclusions seems to suggest that we would derive some perverse satisfaction from policy failures in Iraq, as our advice has been not so politely ignored³. This is not the case. One can hardly argue with Iraqis' resolve to assert their newfound self-determination, just as one would have been obtuse, even callous – or at least curiously immune to the *Zeitgeist* – to have denied the Nigerians some expression of their liberation from colonialism. Our job is to make explicit the trade-offs inherent in policy decisions. If the government believes its voters will bear the cost of choosing a monetary regime solely on the criterion of sovereign symbolism, then we are hardly in a position to stop them from pursuing that end. Still, our analysis is as objective as we can make it, so the costs of that decision are unlikely to disappear.

In contrast, consensus opinion on Iraq finds no need for trade-offs. One needs only to organise a central bank according to the tenets of “international best practice”. A modern banking system and liquid securities markets will “rise from the ashes”. Price stability will follow the liberalisation of controlled prices, spendthrift budget proposals will be beaten back, and the balance of payments will sing the music of the spheres. Although their optimism is admittedly more guarded than most, Robert Pringle and Nick Carver paint just such a picture in their August 2004 article⁴. The development process will take time, they say, but no one has any idea how much time, nor is time viewed as a cost. Therefore, how will anyone know when the process is taking too long?

Furthermore, no one has seriously considered what should be done if some recalcitrant feature of the grand policy design fails. What if Iraqi banks are lousy at making profitable loans and monitoring for defaults? What if it takes 25 years for any sort of stable yield curve to emerge in Iraq's brand-new securities market, and another 25 years for other rates of interest in the economy to react in some predictable way to it? What if a new government is elected that does not share the current government's commitment to fiscal restraint? Economists who advocate inflation targetting in Iraq are all too eager to sweep such questions under the rug. Thus, they misrepresent the costs and benefits of their policy position.

Have we understated the potential costs of a currency board arrangement, or adopting another state's legal tender? Advocates of central banking like Pringle and Carver would undoubtedly say yes. This list of costs includes the inability of a fixed exchange rate regime to play lender of last resort, uncertainty about selecting the correct rate and painful domestic adjustment to external conditions⁵. It is worth returning once

³ Article 16 of the Central Bank of Iraq law prohibits the central bank's board from entering a currency board arrangement or a monetary union.

⁴ “Rising from the ashes: the Central Bank of Iraq”. *Central Banking* 15.1, 57-68, August 2004.

⁵ The fear of not enough foreign reserves is a chimera. A currency board arrangement is a flow mechanism rather than a stock mechanism. If policymakers are concerned about credibility when reserves are low, they might consider modifications to the orthodox currency board – for example, controls on capital outflows which would be rescinded as soon as sufficient reserve coverage (say, 80% or 90%) is achieved – rather than discard the idea entirely. Because such alternatives have not been entertained, we fear that the objections raised against a fixed exchange rate regime in Iraq are merely convenient excuses for ideological opposition.

again to these concerns in light of newly available information and, importantly, to put them in perspective with the costs of alternative proposals. Concentrating in particular on the lender-of-last-resort issue, we find that the “cost” of abandoning such facilities may well be a benefit.

Non-performing banks If a bank of issue does not lend to the government and aspires to be something more like a central bank, its *raison d'être* is, ultimately, the banking system. Historical statistics on Iraq's economy, recently issued by the Central Bank of Iraq, show that commercial bank deposit and lending rates were essentially fixed for the entire 1995 to 2001 period; we can presume that this was the state of affairs prior to 1995 and from 2001 to 2003 as well. As we had originally anticipated, it seems banks have made no effort in recent memory to bid for loanable funds or to compete for profitable lending business. After an interval such as this, who among current Iraqi bank personnel can anyone reasonably expect to manage a modern, competitive bank competently?

Newly released statistics for the first six months of 2004 lend credence to this sinking suspicion. As of June 2004, a mere 1% of commercial bank assets were actually lent in Iraq⁶. Lending to the private sector stands at about 0.5% of commercial banks' total portfolios, up slightly from earlier in the year. Instead of financing private sector growth, the banks have been loading up on foreign exchange, increasing their holdings by about \$1.9 billion in the first half of 2004. This near-tripling of banks' foreign asset holdings is not the fruit of a private-sector trade surplus; almost all foreign exchange is earned by the state-owned oil companies, which is transferred to the Ministry of Finance and eventually sold to the central bank for its foreign exchange auctions. The banks then buy foreign exchange from the central bank with what dinar liquidity they may have.

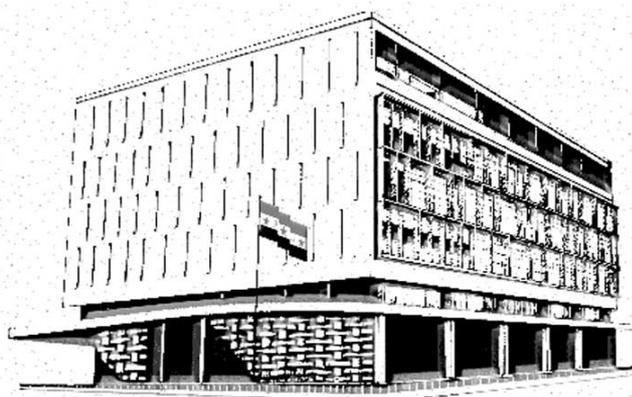
The dearth of lending, combined with a still-underdeveloped payments system, has forestalled the growth of higher-order monetary aggregates; banknotes and coins still make up over 80% of the money supply. Iraq's September 2004 Letter of Intent to the IMF adds yet more detail to this bleak picture; in fact, it is so bleak that there is still no plan on the table for its resolution. “Problems in lending and payments mean that banks are unable to contribute to recovery and may impose fiscal costs. ... The institutional capacity for bank resolution needs to be developed and a bank resolution strategy formulated,” (see paragraph 49). Straightening out the banking system will be extremely costly and, in all probability, inflationary. But, as we have shown, banks are not financing private sector growth. If existing Iraqi banks fail, will it make a difference?

How can monetary policy work? It is also worth asking how monetary policy will work with a banking system in this condition. To posit a stable, predictable relationship between marginal liquidity made available to banks and credit growth would be brave indeed. In that case, changes in the reserve requirement or discount rates would have no efficacy – and that is even assuming that an interbank market develops in a reasonably short time!

⁶ Non-loan assets are taken to be reserves, foreign assets, bank premises, and “other assets”, the opaque category which contains most commercial bank assets. We conjecture that this category includes mostly non-performing credits left over from Saddam Hussein's heyday.

In sum, the new evidence supports our early conjecture that the banking system is an *ersatz* banking system. Indeed, the system does not do what normal banks do: accept deposits and make loans which facilitate investment and growth. Consequently, Iraq's central bank cannot conduct monetary policy through bank channels because there is no obvious connection between Iraqi banking and real economic activity. It follows that the banking system cannot be a *raison d'être* for the central bank. For these reasons, we continue to stand by our recommendation to liquidate the banking system, making an effort to honour depositors' claims to the fullest extent possible. This course of action would, among other things, avoid the problems created by *ersatz* banks in Russia, namely a substantial fiscal drain and an obstacle to monetary policy.⁷ If and when the situation allows it, new banks can open under the terms of Iraq's exemplary banking law and a modern banking system can be allowed to develop of its own volition. Banks will then only be in business if they can expect to earn profits, not merely because they exist as legacies of a directed economy. Also for these reasons, some commonplace objections to fixed exchange rate regimes – no lender of last resort and no banking supervision – fail to have any relevance to Iraq's situation.

If the banking system were liquidated and therefore taken off the Central Bank of Iraq's agenda for the near future, the central bank might still be called on to keep inflation at a manageable level and achieve a stable exchange rate. Because the money supply is almost all currency, pursuit of these goals turns on the central bank's ability to manage its balance sheet. And because there will be no other domestic assets or liabilities for Iraq's central bank to hold without a banking system, its ability to manage its balance sheet turns on the integrity of its independence from the government.



The Central Bank of Iraq

How well did the Central Bank of Iraq assert its independence in the first half of 2004? The central bank's independence depends on the extent to which government needs are kept from influencing monetary conditions; therefore it depends on how much government accounts affect the central bank's balance sheet. From this perspective, its balance sheet does not lend much credibility to the Central Bank of Iraq's independence. On the asset side, loans and advances to the government increased by more than 500 billion dinars (NID) from January to June 2004. This increase was offset partially by a NID200 billion reduction in government security holdings. On the liabilities side, government deposits increased slowly at first, but jumped by NID2 trillion from May to June 2004⁸. As a result, in every one of the first six months of 2004, changes in government accounts at the

Failing independence tests

⁷ Bernstam, M. and Rabushka, Alvin "Fixing Russia's Banks: A Proposal for Growth". Stanford, Hoover Institution Press, 1998.

⁸ We present this figure with some trepidation, as the Central Bank of Iraq's balance sheet does not balance in June 2004.

central bank were material in determining changes in base money, and hence the money supply:

These statistics deserve explanation, because they throw serious doubt on the Central Bank of Iraq’s independence from the government. Unless a good explanation is forthcoming, one can’t be very confident that the central bank has control over its balance sheet, and therefore one must doubt its capacity to pursue stable prices and orderly changes in the exchange rate.

Table 1: Changes in the central bank’s net claims on the government in 2004

Change as a % of the money supply	
January	37.3
February	89.5
March	-25.0
April	93.8
May	-463.5
June	-138.3

Source: Central Bank of Iraq

But take away the transactions with the government – as the Iraqis propose to do in their Letter of Intent by placing a ceiling on lending to the government – and what will be left? Without a viable banking system, the country’s central bank activities are reduced to foreign exchange operations⁹. State enterprises sell their foreign exchange earnings to the central bank vis-a-vis the Ministry of Finance. The ministry is then able to pay wages and make other distributions. The central bank then sells the foreign exchange to the public through an auction.

In its foreign exchange auctions, the central bank essentially allows the public to repurchase as much of the foreign exchange as it wants at the rate it offers – there do not appear to be any other sellers of foreign exchange in the market¹⁰. If the central bank were only to fix this exchange rate, then it would be operating, essentially, as a currency board. This seems to be the case for the latter half of 2004, as the exchange rate has remained steady at about NID1450 to the dollar. It is really too bad that such activity is illegal in Iraq. However, it is hard to tell from how the law is written whether the choice of monetary regime will again be open to debate following the elections scheduled for the end of January.

We are left with little to justify the existence of the Central Bank of Iraq as a central bank *per se*.

⁹ We do not consider open market operations by the CBI to be a serious possibility anytime soon.

¹⁰ It may even be misleading to call this process an auction, as buyers bid with quantities rather than prices.

It is tempting to reflect on lessons learned from the debate on monetary regimes for Iraq. It is not possible to develop these lessons fully at this time, but it is worth sketching some points here. **Lessons from the Iraqi reform**

First, both sides of the debate agree that policy recommendations should be founded in theory, which is a sign of sound practice. However, current theories of monetary policy based on reaction functions (of which the theory of inflation targetting is an example) have limited claims to generality – and therefore to applicability in developing countries – because they depend on the existence of particular central bank instruments and developed financial markets. What is good for the Bank of England, the ECB, Sweden’s Riksbank, and the Federal Reserve, among others, is therefore unlikely to be good for Iraq or other developing countries where markets are not well developed and instruments are limited. Turkey, for instance, is only now achieving its inflation targets after *six years* on the most heavily-financed IMF adjustment programme in history, during which it has endured a series of devaluations, rapid currency depreciation under a floating regime, spectacular bank failures, and continued high inflation. Brazil pursued a similar programme and came within an eyelash of a downward debt/default/depreciation spiral during its last elections. It has avoided wide misses of its inflation targets only by maintaining real interest rates at high levels which all but disqualify bank lending as a viable source of finance. Consequently, it seems worthwhile to evaluate the generality of a theory before allowing it to become the motivation for policy recommendations.

Second, the theory of inflation targetting does not translate unambiguously into policy. Admittedly, the translation from theory to policy is never easy, but there are reasons to favour an impossibility result – such as the impossibility of pursuing both internal and external balance – to theoretical results based on existence. When some combination of objectives is known to be impossible, one can simply stop trying to achieve the objectives simultaneously. But when one strives for a state of affairs that is only conjectured to exist, any number of alternative techniques may be tried, perhaps over long periods of time at a substantial cost. **Challenging the consensus**

That said, the third lesson learned from this debate is that the consensus in favour of inflation targetting for developing countries is almost universal. Once again, the IMF seems to have spearheaded the effort, having replaced its traditional ceilings on net domestic assets with inflation targets in a number of recent adjustment programmes¹¹. Such levels of consensus are exceedingly rare in economics, and therefore arouse a contrarian’s suspicions. It is worth inquiring further into the causes of this consensus.

We are left with a number of interesting questions for the theory of central banking in open economies, all of which deserve better answers before economists are called upon to lend their expertise to the next country in need of assistance. And at this moment, with no good answers forthcoming on *how* to operate a bona fide inflation targetting regime in Iraq, we implore the Iraqis once again to reconsider their choice of monetary regime. □

¹¹ See Blejer, M. et al, “Inflation Targetting in the Context of IMF-Supported Adjustment Programs”. IMF Staff Papers, 49(3), 313-338, 2002, (published in working paper form March 2001).