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by Steve Hanke and Matt Sekerke
The Johns Hopkins University

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Central Banking Publications Ltd
6 Langley Street, London WC2H 9JA, UK
Tel: +44 20 7836 3607, Fax: +44 20 7836 3608
E-mail: info@centralbanking.co.uk
Website: http://www.centralbanking.co.uk

Iraq's botched currency reform

Prescriptions by official sector institutions for Iraq ignore political realities and their own findings argue Steve Hanke and Matt Sekerke.

The transitional government in Iraq is faced with enormous challenges. It inherited an economy that had been centrally directed to serve the needs of a totalitarian state. Most prices were controlled, many consumer goods and foodstuffs rationed, and the money and banking system was suited only to extract savings to finance the state apparatus. The Iraqi economy, particularly in the wake of the 1991 Gulf War, has suffered from high inflation, capital consumption and rapidly falling living standards.

To turn the economy around, the transitional government is trying to devise a strategy to restrain inflation following the liberalisation of administered prices, which still account for the bulk of Iraqi consumption baskets and production inputs. The banking system needs to be restructured to honour depositors' claims and begin intermediation. A credible fiscal regime is needed to establish confidence in the government. The list goes on, but for practitioners in the field of money and banking, these issues are key.

When the fiscal regime implies a series of large deficits, or when a straining banking sector is in need of a bail-out, there is an evident risk of money creation by the central bank, which means higher inflation. As everyone wants to avoid real losses *now*, they negotiate higher wages, raise retail prices, and so on, which ends up producing high inflation *today*. But, if the government can develop a credible fiscal policy regime and deal with the banking sector without pumping up liquidity, expectations of future inflation will be low. That means low inflation today. In other words, the preconditions that must be met *now* for low inflation *today* are *clearly articulated and credible policies* on fiscal management and bank intervention, (see Sargent 1986: ch. 3, Sargent and Wallace 1981).

In addition to these central problems, the future of money and banking matters in post-war Iraq turns on issues of technical feasibility, many of which are familiar to students of central banking in developing and transitional economies. These technical issues weigh heavily on economic

Steve H. Hanke is a professor of applied economics and Matt Sekerke is a research associate at the Johns Hopkins University.

policy decisions: unless the solution works technically, on the ground, it is no solution at all.

Measures taken by the transitional authorities

The Coalition Provisional Authority (CPA) administering Iraq has so far taken three steps to improve Iraq's money and banking system. It has replaced a worn stock of notes with crisp new dinars, removing an icon of the old regime and unifying the country's currency geography[1]. It has given the Central Bank of Iraq legal independence, stipulating that the central bank "shall have the authority to determine and implement monetary and credit policy without the approval of the Ministry of Finance.[2]" Finally, it has issued a bank law which clarifies the operating rules for domestic commercial banks and foreign entrants to the banking system. The CPA has also indirectly supported the money and banking system by presenting budgets for the second half of 2003 and 2004 that eschew inflationary financing of deficits. The central bank now conducts daily currency auctions and knows the amount of currency in circulation. The auctions are producing exchange rate data and giving the central bank an idea of the demand for the dinar.

These measures have improved confidence and have established legal foundations for the relevant institutions. But neither the CPA nor the Iraq governing council has solved the problem of stabilising expectations. No one knows how the central bank will conduct monetary policy, how the government will make ends meet, or what is going to happen with the banking sector. It all looks as if the CPA and the governing council have neglected the most substantive money and banking issues.

Some unsolicited advice

In an attempt to fill this vacuum, the IMF has rushed in. It presented its policy conclusions at the October 2003 International Conference on Reconstruction in Iraq and brought its considerable influence to bear on the Iraqis. The Fund stated that "the primary objective for monetary policy should be to maintain broad price stability" and finds it "encouraging that a consensus appears to have emerged in favour of a managed float arrangement,"(IMF 2003: 21). Just what consensus they mean is not clear, however. The United Nations and World Bank, for their part, want "a functional Central Bank of Iraq able to resume its critical functions as provider of liquidity and lender of last resort to the banking sector," (United Nations and World Bank 2003: 39). In short, the three most important international organisations have already decided that the Iraqi central bank should target inflation, manage a floating dinar, and act as lender of last resort to the banking system.

1 This accomplishment is not to be sneezed at, for several reasons. Replacing the old dinars frustrated terrorists' attempts to recruit Iraqis (terrorists have a harder time obtaining the new dinars or hard currency) and gave the monetary authorities an indication of the amount of currency in circulation – a previously unknown variable. Furthermore, extensive counterfeiting of the 10,000 dinar note had led to its being traded at a discount to face value.

2 Coalition Provisional Authority Order Number 18, "Measures to Ensure the Independence of the Central Bank of Iraq," July 7 2003. Available at http://www.cpa-iraq.org.

There are four problems with this approach. First, the central bank will only be able to conduct monetary policy with direct instruments, which are antithetical to a market economy and counterproductive to the development of a well-functioning banking system. Secondly, the dearth of quantitative data on Iraq's economy and the inadequate training of bankers will make it virtually impossible for the central bank to operate a rational monetary policy in practice. Thirdly, it is likely that the central bank's legal independence will be undermined by pressures from the budget and the banking system. Fourth, a managed float will be very difficult to manage in practice.

Instruments of monetary policy

It seems that events so far bear out these criticisms. In its needs assessment report for Iraq, the United Nations and World Bank observe that "The banking system has no credit facilities and no effective payments system." Overall, "Iraq's financial system is currently dysfunctional, with little financial intermediation, ineffective institutions, and a poorly organised regulatory framework," (*op. cit.*: 39). The Fund likewise reports "the latitude for proper monetary and exchange rate policy actions is limited by a lack of appropriate instruments," (*op. cit.*: 13) confirming that indirect instruments of monetary policy are not available to the central bank.

In addition to the absence of indirect instruments, Article 15 of the CPA's new bank law suggests that direct instruments of monetary policy will dominate in the central bank's operations: "Each branch of a foreign bank, if so directed by the CBI [Central Bank of Iraq], shall maintain in Iraq an excess of assets over its liabilities to residents of Iraq in such amount, if any, as the CBI may stipulate." In other words, the central bank may conduct credit policy by taking direct control of bank balance sheets. This is particularly worrisome because the central bank can require commercial banks to buy government debt, preserving its own formal independence but rigging the public debt market.

Even with the authority to institute direct controls, "the banking supervision regime is poor and in need of significant improvement in all areas including banking and supervision laws, organisation, technology, human resources and training, development of procedure and operational manuals, regulations, and supervisory framework," (United Nations and World Bank 2003: 39). Direct instruments of monetary policy are destructive even when applied with care, but it appears that such instruments will be employed only ham-fistedly in Iraq.

Data and knowledge problems

In most central banks staff estimate and calibrate models of the economy to gauge the sensitivity of the economy to central bank actions, and formulate appropriate responses to shocks. To make such an approach work, one needs timely and accurate data. However, in its report on Iraq's economy (*op. cit.*), the Fund notes that currency in circulation "is the only monetary variable for which information exists, and that monetary transmission channels are uncertain" (p. 18). There is an "absence of reliable basic macroeconomic data," (p. 6 fn. 1) and "no reliable balance of payments data exist" (p. 9). Furthermore, "most government records have disappeared in the pervasive looting and destruction of ministries" (p. 11). The central bank cannot even assemble a continuous time series for the exchange rate of the dinar (p.12). To sum up, the report concludes that "the dearth of reliable economic data in Iraq complicates the design and evaluation of the macroeconomic strategy" (p. 19). An understatement, surely.

Even if better information were to be had, it would not result in successful monetary control; the needed management skills are even more important. "The role of financial institutions – including the CBI [Central Bank of Iraq] – was restricted to the provision of cash to the government sector, including the SOEs [State Owned Enterprises]," (p. 8) continues the Fund, implying that staff at these institutions are not prepared to operate a central bank and commercial banks in a market economy. The United Nations and World Bank (*op. cit.*) concur: "Iraq's immediate challenge in the financial sector, therefore, is improving the banks' financial and managerial capacity," (p. 11).

Challenges to central bank independence

The central bank's much-advertised independence is hostage to present and future government budgets and future states of the banking system. It is not, as the literature on central bank independence proposes, a matter of enshrining price stability as the central bank's primary objective. If the government cannot match expected revenue and receipts from borrowing to planned expenditures and debt obligations, the difference must be made up by the printing presses. Similarly, if the distressed banking sector is not handled properly, sustained liquidity assistance will also require money creation. These two preconditions are necessary for price stability[3]. Without them, the price stability objective is empty, and the independence of the central bank becomes fraudulent.

The 2004 budget prepared by the Ministry of Finance and the Ministry of Planning does not rely on debt issuance or the CBI's printing presses[4]. But the budget is highly sensitive to the dinar exchange rate. The 2004 budget is prepared on the assumption that the dinar exchange rate will be 1500 to the dollar. (Republic of Iraq 2003: 13) This is an extremely important assumption because most of the government's revenues are in dollars, and most expenditures are in dinars. If the dinar continues to appreciate against the dollar – as it has in recent months due to returning demand for the dinar and the resulting sales of dollars for dinars – the budget balance will deteriorate. If the central bank is not to cover the deficit, how will resulting shortfalls be met? The only hedging instrument available to the government is central bank management of the exchange rate. Not only does this budget issue create a conflict for the central bank, it also makes a mockery of the reasons used to justify a floating exchange rate. The exchange rate will not be able to remedy shocks to the external balance if it is being managed to suit the needs of the finance ministry[5].

3 A full exegesis of these points may be found in Sargent (1999).

4 It is still unclear what will be done to handle Iraq's external debt, which currently amounts to some 900% of GDP – one of the most crushing debt loads outstanding in the world.

5 In addition to the government's exchange rate exposure, we identified (Hanke and Sekerke 2003: 6) several other risks to the integrity of the budget, including theft and sabotage in the oil sector, false starts on privatisation, a limited tax base combined with minimal taxation infrastructure, and extravagant social spending priorities.

Recent movements in the dinar exchange rate have demonstrated the very real nature of the government's foreign exchange risk. Driven higher by speculation in neighbouring countries[6], the dinar, which floundered at about 2,000 to the dollar when the CPA's currency exchange began in mid-October, zoomed past the budget's 1,500 per dollar estimate to 1,000 per buck shortly after the Saddam dinar ceased to be legal tender on January 15. (The dinar's excursion into the stratosphere was aided, as it were, by an intervention by the central bank *on the wrong side of the market*, doing much for the credibility of central bank governor Sinan al-Shabibi's 'managed float'.) What sort of damage does this do to the budget? Well, a dinar at 1,200:1 increases the budget deficit by roughly four trillion dinars for each of the next three years, and a 1,000:1 rate opens the annual gaps by about six trillion dinars[7]. Needless to say, these shortfalls will more than exhaust Iraq's present financing sources.

John Taylor, the US under-secretary of the treasury for international affairs, paints a dismal picture of the Iraqi banking system, suggesting that the sector will put inflationary demands on the central bank. The portfolios of the fledgling banking system – which has a mere $2 billion in assets – are dedicated almost entirely to financing the government and state-owned enterprises (Taylor 2003). These loans and the treasury bills used to securitise them are not producing cash flows. The new budget makes it a priority to resume payments on these treasury bills, but the 6% coupon implies a sharply negative real return in what is likely to become a highly inflationary environment upon removing price controls. Furthermore, should the central bank be able to extend liquidity to these institutions, it is unlikely that there will be much improvement to their portfolios. Indeed, banks are not even prepared to make basic loan assessments, and micro-finance operations will probably prove more competitive[8].

Assessment

Ignoring the technical challenges we have pointed out results in disastrous economic outcomes. It is worth considering an example from history. An advisor to the Bank of England, J.L. Fisher, travelled to Nigeria in 1952 to make recommendations to the soon-to-be-independent colony on the feasibility and desirability of a central bank (Fisher 1953). Nigeria resembled Iraq today in the broad assessment: it had a minimal local banking system, a lack of securities markets, and a government with ambitious development and social expenditure priorities exceeding its potential revenues.

Fisher was not primarily concerned with the interplay between the government finances and a prospective central bank, as Keynes (1923: 51), in contrast, was in "A Tract on Monetary Reform". ("The [German]

6 Our diagnosis of this phenomenon is that people in nearby countries are buying dinars to purchase imports in Iraq, where tariff levels are minuscule relative to those in their own countries. The goods purchased are then smuggled out of Iraq.

7 In making this calculation we assumed that oil revenues and capital expenditures would be denominated in dollars, whereas operating expenditures and various taxes would be denominated in dinars. Budget calculations are sensitive to several other factors, which we do not consider here for lack of space and precision.

8 In light of these considerations, it would probably be least costly to just liquidate the banking sector and leave the industry open to new entrants. Liabilities to surviving depositors – an amount much less than $2 billion – could be retired using foreign aid money.

government cannot introduce a sound money, because, in the absence of other revenue, the printing of an unsound money is the only way by which it can live.") But Fisher *was* worried by the lack of instruments with which the central bank could operate, and the problems of dealing with a flimsy banking sector. He wrote: "It would be wrong if the public would be led to think that a central bank was responsible for the management of the Nigerian banks. To saddle a central bank with such a responsibility would mean, in effect, that the central bank would have actively to *control* the operations of the banks. [ie, employ direct instruments] In effect the banks would become branches of the central bank. This could hardly lead to a strong and stable banking system," (p. 13-14).

Fisher also worried about whether expertise could be found to manage a central bank. "A central bank requires highly trained staff and it is not easy to see from whence it would be drawn," (p. 14). Given these concerns about knowledge and a lack of instrumentation, Fisher concluded that Nigeria should retain its membership in the West African Currency Board:

> *The financial environment hardly exists at present for a central bank to function in Nigeria other than semi-automatically as a bank of issue: and it is highly doubtful if a central bank could be adequately staffed at the moment even if the existing banks could afford to release some of their more senior African staffs, which is unlikely. A central bank would also be expensive. … I conclude that it would be inadvisable to contemplate the establishment of a central bank at the moment, (p. 18).*

Nigeria was, however, unable to resist the rush to central banking that resulted in the proliferation of central banks as former British and French colonies became independent after the second world war. The Central Bank of Nigeria opened in 1959 and subsequently became one of the world's worst: hyperinflation and currency depreciation have been common and the naira is a junk currency. Worse, the Nigerian standard of living has not changed by much over the last 40 years. While an exhaustive treatment of the history of Nigeria's central bank is not possible here, the lesson from theory and history is plain: when a central bank cannot operate through markets and is not supported by a robust banking system, low inflation and economic growth cannot be expected.

It is therefore bewildering that the reports issued by the United Nations, World Bank, and the Fund take note of the phenomena discussed above, but recommend a central banking regime for Iraq[9]. The policy conclusion is stubbornly at odds with the institutions' own observations. It will take years for the necessary markets and institutions to be established in Iraq for a central banking regime to operate properly, and the challenges presented

9 We think that this apparent disconnect is a consequence of the way in which most economists use models. Economists who consider questions of monetary policy have become more accustomed to thinking of central banks as agents with response functions, rather than institutions within the financial system which operate by transacting in markets. While it is convenient for purposes of abstraction to conceive of a central bank as an agent that converts a vector of inputs and outputs into an inflation rate or short-term interest rate, the means by which this is accomplished cannot be neglected by economic and policy analysis. We are not dealing with black boxes. The means by which central banks operate are well known, and have been for some time.

by the government budget and the banking system will destroy the credibility of any economic policy regime centred on a central bank. The proposal endorsed by the United Nations, World Bank and IMF is not credible and will not solve Iraq's problems[10].

Fortunately for Iraq the choice of monetary regime is still an open question. Indeed, as Peter McPherson, the CPA's former director of economic policy, writes: "Floating the new currency was not a rejection of a currency board, an idea that was considered. Rather, it reflects a desire to defer that decision to the new Iraqi government," (McPherson 2004). The Iraqis should tell the Fund, World Bank and United Nations that they would like to pursue a fixed exchange-rate-based currency reform with a currency board or dollarisation, as we recommend in "Monetary Options for Postwar Iraq"[11]. With a fixed exchange rate regime established in international law (as is working so well in Bosnia and Herzegovina) and headquartered abroad, the Iraqis can establish a credible monetary regime at arm's length from banking sector woes and budget uncertainties. Such a regime would produce low inflation while hedging the government budget's foreign exchange exposure. It would become the cornerstone of a stable monetary system and lay an indispensable foundation for a market economy. □

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10 This goes also for the proposals made by Cecchetti (2003) and Spiegel (2003), which are broadly similar. Frankel (2003) has suggested that Iraq peg its exchange rate to the oil price. We do not discuss this proposal directly here, but it should be clear why we also consider that proposal to be flawed.

11 Available at http://www.cato.org/pubs/fpbriefs/fpb-080es.html.