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What Monetary Regime for Post-War Iraq?

Among the many challenges the new Iraqi government will face is the choice of a monetary regime that will promote price stability, an essential element in any well-functioning market economy. In forming its new government, Iraq has a rare opportunity to choose the monetary regime that will best suit its unique characteristics. In this *Economic Letter,* I examine the distinct features of the Iraqi economy and discuss their implications for the relative desirability of a number of monetary regimes.

History

In determining the optimal post-war monetary policy for Iraq, the first question one might ask is what type of monetary regime was maintained before the war. The answer is, perhaps, a little surprising. From 1982 to 1998—that is, even *during* the post-Gulf War period in the 1990s, when Iraq faced United Nations sanctions that limited its oil exports—Iraq officially maintained either a peg to the dollar or a managed float against the dollar (Reinhart and Rogoff 2002). In practice, however, foreign currency was not widely available at these rates to the general public. There was a functioning black market, under which dollars were widely available only at high premia relative to the official posted rates.

The maintenance of an official peg to the dollar indicates not Iraq's desire to price exports competitively for the U.S. market—in 1990, Iraqi exports to the U.S. comprised only 13.6% of its total exports—but rather Iraq's prominence as an oil exporter, because oil prices are usually quoted in dollars per barrel. Before the Gulf War, oil was everything in terms of Iraqi exports; in 1990, petroleum and petroleum products made up 93% of total Iraqi exports. With the lifting of sanctions by the United Nations, it is almost certain that oil again will dominate Iraqi exports for the foreseeable future.

Iraq is not alone among oil-exporting nations in choosing some sort of peg against a hard currency as its exchange rate regime. For example, Reinhart and Rogoff (2002) report that among the OPEC member countries, Iran, Libya, Nigeria, and Venezuela all pursue an exchange rate regime with some sort of tie to the value of the dollar; furthermore, Kuwait and Saudi Arabia—which, like Iraq, obtain almost all their export income from oil—both maintain a de facto peg against the dollar. Algeria, which has special ties to Europe, pursues a managed peg against the euro. The exception is Indonesia, which has pursued a freely floating monetary regime since the Asian Crisis (information on Qatar and the United Arab Emirates is not available).

Therefore, it would not be surprising if, in anticipation of regaining its position as a major oil exporter, Iraq were to choose a monetary regime that maintains at least a managed peg against a hard currency, such as the dollar or the euro, or some combination of the two. Oil-exporting countries can enjoy the credibility-enhancing advantages of hard currency pegged regimes without suffering the terms of trade issues associated with currency pegs faced by exporters of more diversified economies.

Current events

Although Iraq is similar to Kuwait and Saudi Arabia in terms of being an oil exporter, its current situation is quite different from that in those countries. This suggests that its most desirable monetary regime may differ from that pursued by those countries. In particular, post-war Iraq faces a daunting debt burden. Economists have estimated that Iraq's current debt obligations stemming from both claims for Gulf War reparations and foreign debt are well over $300 billion (Barton and Crocker 2003). Krueger (2003) estimates that even if 50% of Iraq's future export income were diverted to servicing these obligations (three times the amount extracted from Germany after World War I), it still would take more than 35 years for Iraq to pay them off. While there has been discussion of possibly reducing this debt burden through moratoria and outright forgiveness, servicing its outstanding debt burden is likely to be a major feature of Iraqi public finance going forward.

Thus, the post-war Iraqi situation appears to be one of a heavily indebted oil-exporting country, more similar to Venezuela than to Saudi Arabia or Kuwait (although it should be noted that recent figures place Venezuela's external debt at around a relatively manageable 27% of GDP). Moreover, the cost of rebuilding Iraq after the war is likely to place further burdens on its public finance.

This heavy debt burden is likely to pose challenges for Iraqi monetary policy. While the empirical evidence on the relationship between government deficits and inflation is mixed, recent studies have again supported the notion that in emerging market economies, fiscal deficits tend to be accompanied by inflation in the long run (Catão and Terrones 2001). The conventional explanation of this relationship is that when a government finds its fiscal situation under pressure, either due to a high outstanding debt burden or to an imbalance between revenues and expenditures in the current budget, the independence of the central bank is likely to be threatened as the government comes to view the central bank as a tempting potential source of seigniorage revenues—that is, a tool for monetizing the debt.

The fear that a nation's central bank will give in to pressure and devalue its currency can lead to a loss of confidence in a fixed or managed peg regime and an increase in a nation's cost of borrowing. This can further exacerbate the government's budgetary problems and lead to an inflationary spiral ending in a collapse of the exchange rate peg.

Mechanisms to enhance exchange rate credibility in post-war Iraq

Since speculative attacks on exchange rate regimes are not uncommon, the public finance issues that the new Iraqi regime will face make it imperative that steps are taken to ensure the credibility of the chosen exchange rate regime.

One possibility is that the Iraqi government might initially maintain its peg under the control of a currency board. Formally, a currency board is a monetary regime that is commissioned to maintain a fixed exchange rate peg to a hard currency, which in this case would likely be the dollar, but which also could be a basket of hard currencies, such as SDRs (special drawing rights from the International Monetary Fund). Unlike simple fixed rate regimes, a standard currency board is obligated to hold reserves that exceed outstanding domestic currency so as to have the capacity to redeem all outstanding currency at the announced peg. With a fully backed currency board in place, holders of Iraqi currency would know that as long as the government was committed to the maintenance of the exchange rate peg they would be able to convert their claims at the announced peg. *The Economist* (April 19, 2003) notes that a currency board has led to general acceptance of the convertible mark in post-war Bosnia.

Of course, the world recently witnessed the dramatic collapse of a currency board regime in Argentina. This indicates that currency boards are by no means foolproof. If the post-war Iraqi government faced an unsustainable fiscal situation analogous to that in Argentina, would it not also be tempted to abandon its currency board and devalue, just as Argentina did?

The answer to this question appears to be that the Argentine currency board was unique in a number of dimensions. First, the Argentine currency board was less than fully backed. In 2001, the foreign reserve backing for the Argentine currency board fell to 82% (Spiegel 2002). Second, the currency board acted as a lender of last resort, extending funds to Argentine commercial banks during the Mexican peso crisis of 1995. Third, the Argentine government had issued a large amount of domestic debt, giving it the opportunity to decrease its debt burden dramatically through devaluation. Finally, the Argentine peg to the dollar left its exports increasingly uncompetitive with its main trading partner, Brazil, after the large dollar appreciation in the 1990s. None of these conditions necessarily apply to the Iraqi case.

Nevertheless, there are perceived costs to maintaining a currency board. First, maintenance of the currency board requires the holding of adequate foreign exchange reserves. This could put a further burden on Iraqi public finance conditions if superior returns are available domestically. Second, a standard currency board would preclude any flexibility, so that the Iraqi central bank would be unable to engage in lender of last resort activity or moderate countercyclical policy.

Instead of launching a formal currency board and incurring these costs, the nation could just pursue a managed peg. However, the credibility of such a peg would be hindered by the pressured fiscal situation that the Iraqi government will inevitably face. At a minimum, an announced peg is likely to be tested by speculation, leading to increases in risk premia on Iraqi borrowing. At worst, the peg could collapse dramatically, leading to financial turmoil. Because of the exposure to these difficulties, it would be imperative that a managed exchange rate peg regime be tailored to limit concerns about Iraqi monetary policy. Some concrete steps that could be taken to ensure credibility of the peg include giving the Iraqi central bank a strong mandate to maintain price stability and retaining its independence from the Iraqi treasury.

Instead of a pegged exchange rate, the Iraqi government also might consider an explicit inflation-targeting regime. A typical inflation-targeting regime would include central bank independence with an explicit inflation target as the goal of monetary policy. A number of emerging market nations currently appear to be successfully pursuing inflation-targeting, including Chile, which is a developing nation with extensive primary product exports (copper). However, as in the case of a managed peg regime, the credibility of an inflation-targeting regime is only as strong as the government's willingness to maintain it. Again, the fiscal burdens faced by the new Iraqi government could put pressure on the Iraqi central bank to pursue policies, such as purchases of government securities, that could undermine the achievement of the inflation target.

Conclusion

The post-war Iraqi government faces a significant number of economic challenges. A critical issue is the determination and management of the country's outstanding liabilities and the costs of financing the rebuilding of the nation. No less important, however, is the need to institute a monetary regime that promotes price stability, the most positive environment in which to meet these other challenges. With its likelihood of returning to its role as a prominent oil exporter, Iraq could benefit from some form of exchange rate peg.

Its pegged regime could range from the formal launch of a currency board to a managed peg. A currency board would greatly limit monetary flexibility, but it also would at least partially address the credibility issues that will arise due to Iraq's fiscal pressures; such a regime appears to have worked well in the case of post-war Bosnia. A managed peg regime would allow for limited countercyclical policy and lender of last resort activity, but it could expose the monetary regime to speculative attacks. If a managed regime were chosen, it would be important to introduce concrete institutional features, such as central bank independence and a mandate of price stability, to ensure its credibility. Finally, an inflation-targeting regime is another alternative. While oil-exporting regimes usually choose some form of a hard currency peg, other primary-product exporting countries have used an inflation-targeting regime with apparent success.

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