

Iraq's

*The importance of
adding oil to the equation.*

Currency Solution

BY JEFFREY FRANKEL

Well-functioning monetary arrangements are as important as other aspects of the infrastructure in putting Iraq back on the road of economic development. After the unification of the two kinds of dinars that have been circulating, the next order of business will be to decide what should determine the value of the currency. What exchange rate regime is appropriate for Iraq, at this key juncture in its history?

WHAT'S WRONG WITH PROPOSALS TO PEG TO THE DOLLAR OR EURO?

Given instability in the region and the absence of credible institutions, the Iraqi dinar requires an anchor of substantial credibility. Some have proposed a rigid peg to the dollar, as via a currency board or outright dollarization (see Steve H. Hanke, "An Iraq Currency Game Plan," in the previous issue of *TIE*). But this idea has major drawbacks. That it would mean giving up the ability to set monetary policy independently is not such a big cost, as few governments have been able to use such discretionary policy well anyway. But there are other big disadvantages.

One big drawback of a fixed exchange rate is that it means giving up the automatic depreciation that a

floating currency would experience during periods when the world market for the country's exports are weak. In the case of Iraq, the major export is of course oil. Large fluctuations in the world price of oil have wrought havoc on the economies of other major oil-producing debtors such as Indonesia, Nigeria, and Venezuela, often entailing a serious currency crisis before a change in the terms of trade is accommodated. A second major drawback of fixing the dinar to the dollar would be the introduction of gratuitous volatility when the dollar fluctuates against other major currencies. Argentina's version of the currency board notoriously collapsed two years ago, not just because the straitjacket was so rigid, but because the rigid link was to a currency, the dollar, that had appreciated strongly against the euro and other trading partner currencies during the second half of the 1990s, imposing a huge loss in competitiveness on Argentine exports at a time when world market conditions were already weak. A third drawback is that to impose the dollar on Iraq might tend to play into widespread fears of U.S. im-

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perialism. The politics would get even worse if the arrangement came to tears as it did in Argentina, for example, as a consequence of a future increase in U.S. interest rates.

An alternative would be to peg the dinar to the euro. But this idea has major drawbacks as well. The euro has been appreciating against the dollar, and might continue to do so as a result of ever-widening U.S. trade deficits. A peg to the euro would thus risk a future loss in competitiveness against non-euro trading partners. The problem is that, as Iraq's trade returns to normal, its trading partners will be so dispersed geographically that a peg to either currency alone—the dollar or the euro—would introduce unwanted volatility *vis-à-vis* the other. Like other geographically diversified countries, Iraq may thus be headed for a basket peg, with equal weight on the dollar and euro.

THE PROPOSAL TO "PEG THE EXPORT PRICE" (PEP)

A basket peg does not solve the problem that in the event of large future declines in the world price of oil, the currency of an oil exporter must be able to depreciate in order to accommodate the adverse shift in the terms of trade and help stabilize export earnings. A new proposal designed for small-commodity exporters addresses precisely this issue: Peg the Export Price ("PEP"). The proposal is for a country to peg the currency to the export commodity. The argument for this idea in general is explained at greater length in my paper, "A Proposed Monetary Regime for Small Commodity-Exporters: Peg the Export Price" (*International Finance*, Blackwell Publishers, vol. 6, no. 1, Spring 2003, pp. 61–88).

The proposal could be implemented as follows. The central bank would set the daily price of dinars in terms of dollars in direct proportion to the daily price of a barrel of oil in terms of dollars. The result would be to stabilize the price of oil in domestic terms. The proposal carries the best advantages of both fixed and floating exchange rates. Like fixed exchange rates, it constitutes a transparent nominal anchor and also helps promote

integration into world markets. And yet, at the same time, it retains a major advantage claimed by floating exchange rates: automatic accommodation of fluctuations in world markets for the export commodity. Thus it delivers the best of both worlds, fixed and floating.

Australia was spared the worst of the East Asian crisis because its floating currency automatically depreciated along with world market conditions for its exports. It has even been proposed that countries such as Argentina should use the Australian dollar as an anchor because it is a proxy for commodity prices. (E.g., David Hale, "The Fall of a Star Pupil," *Financial Times*, January 7, 2002.) But then why not peg directly to the relevant commodity—oil, wheat, or whatever the country produces—and cut out the imperfectly correlated middleman?

ALTERNATIVE ANCHORS

To appreciate the virtues of the PEP proposal, consider the various economic magnitudes that economists have proposed as alternative candidates for nominal anchor. Each has its own characteristic sort of extraneous fluctuations that can wreck havoc on a country's monetary system.

■ A monetarist rule would specify a fixed rate of growth in the money supply. But fluctuations in the public's demand for money or in the behavior of the banking system can directly produce gratuitous fluctuations in velocity and the interest rate, and thereby in the real economy. For example, in the United States, a large upward shift in the demand for money around 1982 convinced the Federal Reserve Board that it had better abandon the money growth rule it had adopted two years earlier, or else face a prolonged recession.

■ To some, the novel idea of pegging the currency to the price of the export good may sound similar to the current fashion of targeting the inflation rate or price level. Indeed, inflation targeting is a leading proposal for Iraq (Stephen Cecchetti, "How to Establish a Credible Iraqi Central Bank," in the previous issue of *TIE*). But the fashion, in such countries as the United Kingdom, Sweden, Canada, New Zealand, Australia, Chile, and Brazil, is to target the CPI.

A key difference between the CPI and the export price is the terms of trade. When there is an adverse movement in the terms of trade, one would like the currency to depreciate, while price level targeting can have the opposite implication. If the central bank has been constrained to hit an inflation target, positive oil price shocks (as in 1973, 1979, or 2000), for example, will require an oil-importing country to tighten monetary policy. (Positive wheat-price shocks will do the same for Iraq.) The result can be sharp falls in national output. Thus under rigid inflation targeting, supply or terms-of-trade shocks can produce unnecessary and excessive fluctuations in the level of economic activity.

■ The need for robustness with respect to import price shocks argues for the superiority of nominal income targeting over inflation targeting. A practical argument against nominal income targeting is the difficulty of timely measurement. For developing countries in particular, the data are sometimes available only with a delay of one or two years.

■ Under a gold standard, the economy is hostage to the vagaries of the world gold market. For example, when much of the world was on the gold standard in the 19th century, global monetary conditions depended on the output of the world's gold mines. The California gold rush from 1849 was associated with a mid-century increase in liquidity and a resulting increase in the global price level. The absence of major discoveries of gold between 1873 and 1896 helps explain why price levels fell dramatically over this period. In the late 1890s, the gold rushes in Alaska and South Africa were each again followed by new upswings in the price level. Thus the system did not in fact guarantee stability.

■ One proposal is that monetary policy should target a basket of basic mineral and agricultural commodities. The idea is that a broad-based commodity standard of this sort would not be subject to the vicissitudes of a single commodity such as gold, because fluctuations of its components would average out somewhat. The proposal might work if the basket reflected the commodities produced and exported by the country in question. But the Achilles heel is the same as for inflation targeting: such a peg

gives precisely the wrong answer in a year when the prices of import commodities go up. Just when the domestic currency should be depreciating to accommodate an adverse movement in the terms of trade, it appreciates instead. Brazil should not peg to oil, and Iraq should not peg to wheat.

■ Under a fixed exchange rate, fluctuations in the value of the particular currency to which the home country is pegged can produce needless volatility in the country's international price competitiveness. For example, the appreciation of the dollar from 1995 and 2001 was also an appreciation for whatever currencies were linked to the dollar. There was no necessary connection between the U.S. economic situation and the fundamentals of smaller dollar-linked economies. The problem was particularly severe for some far-flung economies that had adopted currency boards over the preceding decade: Hong Kong, Argentina, and Lithuania.

Dollar-induced overvaluation was also one of the problems facing such victims of currency crisis as Mexico (1994), Thailand and Korea (1997), Russia (1998), Brazil (1999), and Turkey (2001), even though none of these countries had formal rigid links to the dollar. It is enough for the dollar to exert a large pull on the country's currency to create strains. [The loss of competitiveness in non-dollar export markets adversely impacts such measures of economic health as real overvaluation, exports, the trade balance, and growth, or such measures of financial health as the ratios of current account to GDP, debt to GDP, debt service to exports, or reserves to imports.]

SIX ALTERNATIVE CANDIDATES FOR MONETARY TARGET, AND THE ACHILLES HEEL OF EACH:

	Targeted variable	Vulnerability	Example
Monetarist rule	M1	Velocity shocks	United States, 1982
Inflation targeting	CPI	Import price shocks	Oil shocks of 1973, 1980, 2000
Nominal income targeting	Nominal GDP	Measurement problems	Less-developed countries
Gold standard	Price of gold	Vagaries of world gold market	1849 boom; 1873–96 bust
Commodity standard	Price of agricultural & mineral basket	Shocks in imported commodities	Oil shocks of 1973, 1980, 2000
Fixed exchange rate	Dollar (or euro)	Appreciation of dollar (or euro)	1995–2001

To recap, each of the most popular variables that have been proposed as candidates for nominal anchors is subject to fluctuations that will add an element of unnecessary monetary volatility to a country that has pegged its money to that variable: velocity shocks in the case of M1, supply shocks in the case of inflation targeting, measurement errors in the case of nominal GDP targeting, fluctuations in world gold markets in the case of the gold standard, and fluctuations in the anchor currency in the case of exchange rate pegs.

For those small countries that want a nominal anchor and that happen to be concentrated in the production of a particular mineral commodity, a peg to that commodity may make perfect sense. For them fluctuations in the international value of their currency that follow from fluctuations in world commod-

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ity market conditions would not be an extraneous source of volatility. Rather they would be precisely the sort of movements that are desired, to accommodate exogenous changes in the terms of trade and minimize their overall effect on the economy. In these particular circumstances, the automatic accommodation or insulation that is normally thought to be the promise held out only by floating exchange rates, is instead produced per force by the pegging option. Thus PEP simultaneously delivers the nominal anchor and adjustment to trade shocks.

A CURE FOR THE DUTCH DISEASE

Economists use the term “Dutch Disease” to describe the problem of economic dislocations arising from large fluctuations in the real price of oil, or whatever is the mineral or agricultural export commodity of the country in question. These fluctuations can result in labor and capital wastefully shifting back and forth between production in first one sector and then another. One possible objection to the PEP proposal is that the supply of oil is relatively inelastic, either because it is hard to boost capaci-

ty in the short run, or because output is limited by quotas in the case of those OPEC members who comply with them. In other words, output in the short run doesn’t shift that much in response to price signals. Perhaps then it is not so important to dampen the increase in the real price of oil in boom times, or moderate the decline in down times, as the PEP proposal is designed to do?

It is indeed important to stabilize the real price of oil. (By “real,” I mean in terms of purchasing power over the domestic consumption basket, including goods and services that are not internationally traded.) When an oil producer falls prey to the Dutch Disease, the cost doesn’t primarily take the form of shifts in investment and output in the oil sector per se. Rather, it is because oil revenues soar in boom times and crash when world market conditions are weak—even if output does not respond much to the price. Booming oil revenues are reflected in spending, especially in wasteful government spending and employment, which then is difficult to cut back when the pendulum swings the other way. For this reason, stabilizing the real price of oil domestically would help stabilize the economy, even if supply is inelastic.

The smaller Gulf states have an even stronger interest than the rest of us in the successful stabilization and development in the Iraqi economy, and its integration into the rest of the world. As the Gulf Cooperation Council discusses economic and monetary integration among its members, it may wish to tie Iraq in as well. For this purpose, it would help if the monetary anchor for Iraq were the same as the monetary anchor for the Gulf states. (When countries share a common currency, it boosts their trade with each other substantially.) But the PEP proposal applies to the other Gulf states as much as to Iraq. They have already had historical experience with the Dutch Disease, and know all about government workers who have little to do, but cannot be moved off the payroll when oil money is no longer as plentiful as it was. Thus it might make sense for all of the region’s oil producers to adopt the oil peg in tandem.

INCLUDE OIL IN A BASKET

To fix the dinar (or other countries’ currencies) simply to oil alone may be too radical a proposal. While it would facilitate the recovery and expansion of the oil sector in Iraq, it might at the same time discourage production of other internationally tradable goods by shifting the entire burden of price uncertainty onto them. My proposal for Iraq, therefore, is to add oil to the basket of currencies to which the dinar is to be pegged. For simplicity, give equal value weights to all three units. Or, what is almost equivalent, define the value of the dinar as one-third of a U.S. dollar plus one-third of a euro, plus one-hundredth of a barrel of oil. Unlike other proposals for nominal anchors, this is one that an oil producer like Iraq could live with even if there are big swings in international exchange rates or world oil prices in the future. ◆