An Iraq Currency Game Plan

Either adopt the classic British currency board model or simply "dollarize" Iraq.

BY STEVE H. HANKE

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

In war or at peace, every successful action requires a game plan. The allied forces proved as much by executing their regime change objective in Iraq with precision. But even though the victors have grand ideas about remaking the Iraqi economy and society within a year, those ideas remain mere tacit musings. The victors have found themselves without a game plan, and the Iraqi economy remains in chaos.

Generals once knew that after a war, the vanquished must get their economy up and running again, and to accomplish that, the first order of business must be the establishment of a sound currency. Before the landings in Normandy and North Africa, the top brass at the Pentagon were busy developing a currency game plan. And to assist, they called in none other than Dr. Felix Somary, a Vienna-trained Swiss banker and one of the world's greatest currency experts, who was residing in Washington, D.C. Somary received an urgent early-morning call and was asked to meet immediately with top generals at the Pentagon. When he arrived for the meeting, Somary was asked by the assembled what the parity between the French franc and the U.S. dollar should be. He responded with another question: Which franc? The one in France or the one circulating in North Africa?

This surprised and puzzled the chairman of the meeting. He wondered why Somary had made a distinction between the mainland and the African French franc. Dr. Somary replied that the two francs had dis-

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University, a Senior Fellow at the Cato Institute, and a TIE *contributing editor.*

Representative **Paul Ryan** (R-Wisconsin) has devised a creative approach for promoting monetary stability in Iraq. Ryan's bill provides that if Iraq becomes officially dollarized, the United States could rebate to Iraq most of the seigniorage (profit) from the dollar paper money and coins used to replace Iraqi dinars in circulation. Iraq would be free to start or stop using the dollar officially at any time, although if it stopped, the rebates would cease.

tinct exchange rates. Realizing that the assembled generals didn't know what they were talking about, and to avoid public embarrassment, the chairman said, "You must swear not to tell anybody the questions we asked you." Never mind. The Pentagon brass were at least smart enough to accept Somary's recommendations in a memorandum and formulate a game plan.

To be successful, a currency reform plan must be informed by Iraq's history and well-crafted. Speedy implementation is of the essence because victors often find that the time within which they enjoy the good will of the vanquished is short. That's why a game plan for Iraq's currency is long overdue.

Iraq established a central bank on November 16, 1947. Like central banks in most developing countries, the Central Bank of Iraq's history has been replete with mismanagement, coercive stop-gap measures and, yes, the production of an unstable, unreliable currency which has not been tradable on international markets for years. Consequently, international transactions can only take place with foreign currencies. Under Saddam Hussein's regime, attempts to compete with his foreign exchange trading monopoly were—to put it mildly—credibly deterred, and the Iraqi dinar functioned as a powerful instrument of repression.

Since Saddam Hussein came to power in 1979, the Iraqi dinar has collapsed. In 1979, 1 dinar was equal to US $3.39. Today, the official rate available only to Saddam Hussein and his cronies is 1 dinar = $3.22, a rate that has remained the same since 1982. For the Iraqis outside of Saddam's inner circle, the only way to obtain foreign currency is through the black market. But the black market rate has been reported to be as low as 4,000 dinars = $1, nearly 13,000 times below the official rate and 600 times lower than at the end of the first Gulf War.

Central banking and unstable money were not always the norm in Iraq. A century ago, what is now Iraq was part of the Ottoman Empire and the official currency of the empire was the Ottoman pound. However, the most widely used currency in Iraq was the Indian rupee, which was linked to the pound sterling. After the territory was captured by British forces in 1916 and removed from the Ottoman Empire, the British made the Indian rupee the official currency and retired the Ottoman pound. Iraq was, therefore, officially "dollarized."

After prolonged agitation by Iraqis, Britain granted independence to Iraq in October 1932. As part of the preparations for independence, the Iraq Currency Board opened in April 1932. It issued the Iraqi dinar at par with the British pound, backing the dinar fully with British pound reserves. Until it was replaced with a central bank in 1947, the currency board operated without problems.

A currency reform for Iraq must not include a central bank. Iraq's history suggests two superior alternatives to central banking. The first option would require a return to an orthodox currency board system. Designing an orthodox currency board for Iraq will require discarding the model used by the International Monetary Fund in Argentina, Estonia, Lithuania, and Bulgaria. All of these systems graft central banking features onto the orthodox currency board model, and as Argentina demonstrated, the mix of these disparate elements can be explosive.

And speaking of Argentina, a few words are in order. The Economics Establishment Creed has it that Argentina employed a currency board that put the central bank in a straitjacket, resulting in an overvalued peso and an uncompetitive Argentine export industry.

The term "currency board," applied to Argentina's convertibility system, is a misnomer. A currency board cannot neutralize changes in international reserves by expanding or contracting domestic credit. But Argentina's central bank did just that in virtually every month of convertibility's existence (April 1991–December 2001). During convertibility's life span, 59 percent of changes in net international reserves were neutralized by contrary adjustments to domestic credit. These adjustments were especially pronounced in 2001: the central bank outdid itself by responding to a $12 billion loss of international reserves by compensating with a 122 percent offset in domestic credit. Indeed, the Argentine central bank intervened in this manner with such aplomb that from 1994 to 2001 its

A game plan for Iraq's currency

is long overdue.

Like central banks in most developing countries, the Central Bank of Iraq's history has been replete with mismanagement, coercive stop-gap measures and, yes, the production of an unstable, unreliable currency which has not been tradable on international markets for years.

domestic credit position was over six times more volatile than that of Chile's central bank, which plainly has an independent monetary policy and has had a floating exchange rate since 1999. Argentina's central bankers were not sitting bound in a straitjacket, but rather bouncing off the walls of a large padded cell.

The establishment's assertions about Argentina's uncompetitiveness fail to pass the smell test, too. Argentine exports increased in every full year during convertibility except 1999, when Brazil, Argentina's largest trading partner, suffered a currency crisis. Even during the first eleven months of 2001, when Argentina was in the grip of a full-blown crisis, exports were 3.2 percent ahead of exports during the same period in 2000, outpacing a comparable real growth rate for world trade of only 0.9 percent.

Under Saddam Hussein's regime, attempts to compete with his foreign exchange trading monopoly were—to put it mildly—credibly deterred, and the Iraqi dinar functioned as a powerful instrument of repression.

It's time for the economics establishment to trade stylized facts for facts and stop maligning currency boards by pointing an accusatory finger at Argentina's convertibility system. A misrepresentation of Argentina's system and unfounded assertions about straitjackets and uncompetitive exports might be politically correct, but they are not factually correct.

Ideally, legislation for an Iraqi currency board would follow the model of the classic British currency boards. Bosnia and Herzegovina's currency board, which was mandated by the Dayton/Paris Treaty of 1995, is a close approximation of such an orthodox system.

The other possibility would be to "dollarize" Iraq. Postwar Iraq could use the euro just as it once used the Indian rupee. The euro has international acceptance, and neither the United States nor Britain uses it, which may be something of a political advantage in the current context. Several other countries have replaced their local currency with a foreign currency in the last few years, including Ecuador, El Salvador, and East Timor (which use the dollar), and Montenegro and Kosovo (which use the euro). Even for countries in difficult economic circumstances, no significant technical obstacles stand in the way of abandoning a domestic currency and replacing it with a foreign one.

To give the Iraqis some measure of confidence, a reliable, internationally convertible currency is an urgent priority. At least one Washington politician realizes this fact and has developed a currency game plan. Indeed, Representative Paul Ryan (R-Wisconsin) has devised a creative approach for promoting monetary stability in Iraq. Ryan's bill provides that if Iraq becomes officially dollarized, the United States could rebate to Iraq most of the seigniorage (profit) from the dollar paper money and coins used to replace Iraqi dinars in circulation. Iraq would be free to start or stop using the dollar officially at any time, although if it stopped, the rebates would cease. ◆