

How To Establish a Credible Iraqi Central Bank

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The vaults of the Central Bank of Iraq have played a role in some colorful news stories that have appeared in recent months. First, there is the claim that on the night of March 18, 2003, one of Saddam's sons made what has been euphemistically described as the "illicit withdraw" of \$900 million in \$100 bills, €100 million in euro notes, and an indeterminate amount of gold bullion. If this actually happened, it was surely quite a job to load this into the three tractor-trailer trucks that it took to cart the money away. And then there is the story of the jewels and gold of the 2800-year-old Assyrian Treasure of Nimrud that has rescued after workers pumped nearly 700,000 gallons of water out of the flooded main central bank vault in Baghdad.

If the Iraqi financial system is to develop smoothly, and the Iraqi economy is to rejoin the modern industrialized world, the new Central Bank of Iraq will have to be much more than a storage facility for currency and priceless objects. Together with the post-war occupation government, the central bank will have to manage a transition, crafting the necessary market-based institutions, and then it will have to set in place a framework capable of delivery stable long-term growth.

Before getting to the substance of what the new Central Bank of Iraq needs to do and how it will have to do it, there is an important precondition for success. Every successful financial and economic system is predicated on the idea that investors can keep the fruits of their investments. For this to happen, there has to be a government making and enforcing laws to protect property rights. The Babylonia ancestors of modern day Iraqi's were the first westerners to figure this out when, around 1750 B.C., King Hammurabi created the first recorded rules governing financial operations. What was true 4000 years ago is still true today.

With the legal foundations in place, the central bank will need to focus on meeting two principle objectives. First, it must create an environment in which financial institutions can flourish, insuring stability of the entire system. A banking system that is constantly in crisis is worse than useless. Second, the new Central Bank of Iraq must operate a monetary policy that keeps domestic Iraqi inflation check. Inflation makes doing business difficult by increasing risk to both borrowers and lenders, and making prices unreliable signals. Low inflation is an indispensable foundation for real growth.

To achieve financial stability, the new Central Bank of Iraq needs to encourage the development of a sound banking system based on arms-length relationships and market incentives. This means chartering banks to keep unsavory characters from running them, and setting up a system of supervision that penalizes bad business decisions. Then there are day-to-day services that the central bank will have to provide. These include both the more mundane job of exchanging old, worn currency for new, crisp notes, and the technologically complex task of providing a payments

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network that allows funds to move among banks. The existence of an electronic payments system is essential to the process of intermediation. It will persuade individuals to deposit funds into banks and, in turn, encourage banks to make loans. To ensure that the payments system develops, the new Central Bank of Iraq should subsidize the interbank payments system at least initially, making it cheaper and easier for commercial banks to serve their retail customers.

Success in policymaking is as much an issue of institutional environment as of the people who are put in charge. Over the past several decades, we have come to a consensus about the best way to design a central bank so that the people in running it can be successful. A central bank must be (1) independent of political pressures, (2) accountable to the public, (3) transparent in its policy actions, and (4) a clear communicator with financial markets and the public. There is also agreement that it is prudent to have policy decisions made by committee rather than by a single individual.

Of these requirements, independence is by far the most important. In fact, virtually every high inflation episode in the world, including the Iraqi inflation that averaged somewhere between 50% and 100% per year since the end of the first Gulf War in 1991, is a direct consequence of the political subjugation of the central bank. Without alternative sources of revenue, governments turn to the central bank for financing, forcing them to print more and more money. The result, not surprisingly, is inflation. So the first step in achieving economic stability is to take the printing presses away from the politicians.

As for accountability, transparency and communications, these become crucial once the bank has been made independent. While the manner in which they are implemented depends critically on local culture and so it differs across countries, a few things are universal. First, the public announcement of targets for the central bank is the only way to generate credibility. And second, the central bank has to publish certain statistics regularly. Many central banks publish their balance sheets weekly, and the new Central Bank of Iraq would be well advised to do the same thing. But in the end, exactly what they say and how they say it should depend on what works best with the Iraqi people.

All of this is well and good, but what about the transition? How can Iraq get from where it is today to where it needs to be? Conditions on the ground in Iraq are surely changing by the hour in ways that only people who are there can appreciate. So my recommendations need to be read in that light. First, the 1990s experience in Eastern Europe and the former Soviet Union leads us to expect that Iraq will encounter high inflation in the near term. When a previously centrally planned economy abolishes price controls, that's what happens.

The important thing is to expect a bout of high inflation and make certain that it is brought under control as quickly as possible. Looking at the history, there are two paths that the new Central Bank of Iraq might take to stabilize prices. It could set up a currency board, or it could adopt an inflation target. I favor the inflation targeting approach mainly because of my strong opposition to a currency board. The problem with the currency board is two fold. First, since the central bank can no longer simply print money it cannot operate as a lender to sound banks that come under unjustified attack. The inability to act as a "lender of last resort" severely limits the central banks ability to avert financial crises. Second, a currency board creates the false impression of monetary policy austerity. As the Argentines learned the hard way, a currency board provides no protection from fiscal excesses. Without fiscal discipline, monetary policy is impotent to control inflation. It

doesn't take much imagination to envision an Iraqi region government following in the footsteps of Argentinean regional governments, and printing up its own currency in defiance of the central bank.

Without fiscal discipline, monetary policy is helpless. Looking at Iraq today, we see immediately that this creates a serious risk. Rebuilding the country's physical infrastructure and transforming its economy into a market-based system is going to be very expensive. During the transition, the central bank is going to be pressured to print money to finance the widening fiscal deficits. It is absolutely essential to find a way to avoid this. My suggestion is that the occupation government should take charge of fiscal policy during the transition, giving the central bank some breathing room to confront the inflation problems they will inevitably face. The hope is that the new Central Bank of Iraq will be able to control inflation in the short-term, thereby building the credibility that will be essential to a successful long-term inflation-targeting regime.

Cultural legitimacy is the final and most important issue to confront in designing the new Central Bank of Iraq. What any of foreigners write or say is irrelevant unless the people of Iraq are involved. Most importantly, we cannot go into Iraq and build a set of institutions that reflect American and Western European values. This will not work. The new Central Bank of Iraq will belong to the Iraqis and so they have to set it up. While I might think it would be fitting to start printing new Iraqi currency with an image of King Hammurabi on it, I'm not going to use the currency. And while I might think that publication of a quarterly report inflation conditions is a good way for central bankers to communicate with the public and ensure accountability, if the people of Iraq want to do it differently, that's their business. We can set out framework of principles that appear to be universal, but the details are up to the people who live there, not us.