Rebuilding Iraq involves many difficult problems. It may seem that the question of the exchange rate should be one of the easier ones to solve. The choice of a currency regime – particularly what to anchor the currency to – is perhaps the most widely studied topic in international monetary economics. Yet this question too turns out to be difficult; none of the traditional solutions will quite fit.

Given instability in the region and the absence of credible institutions, the Iraqi dinar requires an anchor of considerable credibility. Some have proposed a rigid peg to the dollar, as through a currency board. But this idea has significant drawbacks. That it would mean giving up the automatic 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 serious disadvantages.

One big drawback of a fixed exchange rate is that it means giving up the automatic depreciation that a floating currency would experience at times when the world market for the country's exports were weak. In the case of Iraq, the most important export is of course oil. Large fluctuations in the world price of oil have wrought havoc on the economies of other big oil-producing debtor nations such as Indonesia and Venezuela, often entailing a serious currency crisis before a change in the terms of trade is accommodated.

A second big drawback of fixing the dinar to the dollar would be the introduction of gratuitous volatility when the dollar fluctuates against other leading currencies. Argentina's currency board collapsed two years ago, not just because the straitjacket was so rigid but also 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. That meant Argentine exports suffered a huge loss in competitiveness at a time when world market conditions were already weak.

Finally, imposing the dollar on Iraq could also feed widespread fears of US imperialism. The politics would get even trickier if, as in Argentina, the arrangement hit a crisis – for example, as a consequence of an increase in US interest rates.

An alternative would be to peg the dinar to the euro. But this idea has big drawbacks as well. The euro has been appreciating against the dollar and might continue to do so as a result of ever-widening US trade deficits. A peg to the euro would thus risk a future loss of 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 with respect to the other. Like other countries with geographically diverse trading partners, Iraq may thus be headed for a basket peg, with equal weight given to the dollar and euro.

But 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 stabilise export earnings. Fortunately a proposal designed for small commodity-exporters, which I have called "peg the export price", addresses precisely this issue.

The proposal is for a country to peg its currency to the export commodity. It 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 stabilise the price of oil in domestic terms. This approach combines the best features 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 crucial advantage claimed by floating exchange rates: automatic accommodation of fluctuations in world markets for the export commodity. In short, it offers the best of both worlds.

To fix the dinar simply to oil alone may be too radical a proposal. While it would facilitate the recovery and expansion of the oil sector, it might at the same time discourage production of other internationally tradeable goods by shifting the entire burden of price uncertainty on to them. My proposal for Iraq, therefore, is to add oil to the basket of currencies to which the dinar is pegged. For simplicity, give equal weight to all three units. Or, what is almost equivalent, define the value of the dinar as one-third of a 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 Iraq could live with even if there were big swings in world exchange rates or oil prices in the future. The country faces enough challenges without worrying about the risks of a future currency crash.