Two Cheers for Iraq: Exchange Rate Challenges **28 May 2024**

Executive Summary

The beginning of 2024 reveals good news for Iraq in two important areas. The GoI is engaged in a serious anti-corruption effort that should reduce the "corruption tax" that burdens the country's people. As discussed in the 2021 IBBC Report "Corruption Worse Than ISIS: Causes and Cures for Iraqi Corruption"[1], the war against corruption will take years if not decades and will require substantial political will. But if corruption can be substantially reduced, the benefits to the Iraqi people will great.

Another piece of good news is that there is an attempt to resurrect the hitherto moribund banking system in Iraq through the planned recapitalization of the state-owned banks, new banking regulations, and establishing a framework for electronic banking. It is an aggressive plan that, if successfully executed, should lead to a gradual expansion of the private sector. An expanding private sector will not only provide employment opportunities but also reduce the excessive dependency of the Iraq economy on crude oil exports.

However, the political economy of Iraq only rates two out of three cheers. The strong recovery of oil prices after the 2020 collapse led to a generous three-year budget with substantial increases in both current expenditures – primarily salaries and pensions – and infrastructure investment. The budget not only reenforces the country's oil dependency but, as will be discussed below, the spending commitments assume unrealistic oil prices and export volumes.

[1] Iraq Britain Business Council (2021) "Corruption Worse Than ISIS: Causes and Cures for Iraqi Corruption" Published in English and Arabic. April.

All three of these forces – the anti-corruption effort, the banking liberalization, and the lavish 2023-2025 budget – will create challenges for the management of the dinar exchange rate. One could argue that over the last two decades the Government of Iraq (GoI) had little control over its exchange rate; that exchange rate policy was determined by other sectors of the political economy in Iraq. But even if this is true, the level of the exchange rate and changes in that level are believed by many Iraqis and foreigners as providing valuable insight into the quality of economic management in Iraq. This importance is exemplified by the current efforts to de-dollarize the Iraqi economy while there is excess demand for dollars. This excess demand is shown by a parallel exchange rate of roughly 1500 dinars per dollar compared to the official exchange rate of 1310 dinars per dollar.

An important cause of this exchange rate gap is that the GoI, with the strong encouragement of the U.S. Federal Reserve, is attempting to reduce the use of the U.S. dollar in both Iraq's internal economy and its external transactions. Since 2003, the U.S. dollar has facilitated economic growth in Iraq by providing a widely accepted medium of exchange for purchases as well as a reliable store of value for savings. In the long run, whether de-dollarization will have a significant adverse impact on the Iraq economy will depend on how rapidly the GoI can increase both the efficiency of alternative mediums of exchange and the perceived security of alternative stores of value.

Introduction

After a short summary of the "circular flow" of dinars and dollars in the Iraqi economy, this report will discuss the more important institutional factors that have resulted in an excessive demand for US dollars in Iraq. This excess demand results in a wide gap between the official and market rates increasing exchange rate instability, facilitating corruption, and slowing economic growth. This will be followed by a discussion of policy options to reduce the excess demand for dollars. The report will end with the medium-term difficulties for exchange rate management caused by the excessive 2023-2025 budget.

Circular Flow of Dinars and Dollars in Iraq: Relationships Between Monetary, Exchange Rate, and Fiscal Policies

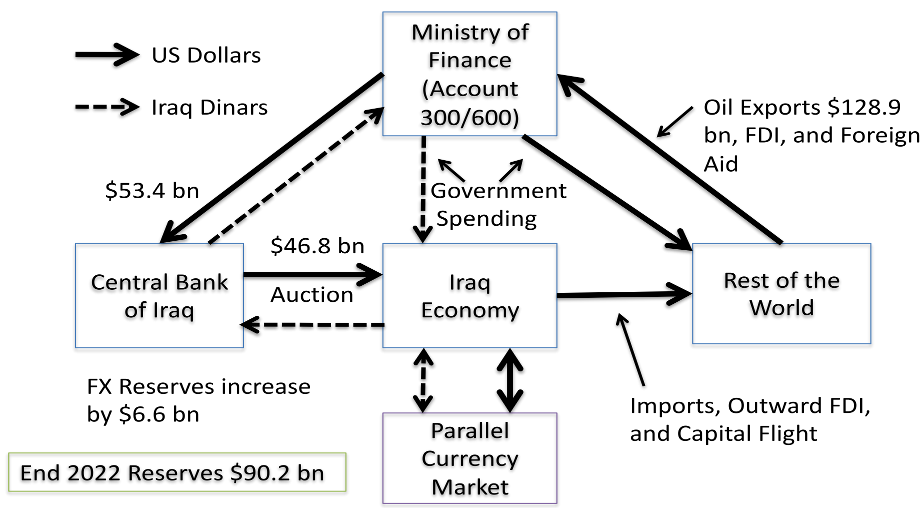
The complex relationship between Iraq's monetary, exchange rate, and fiscal policies is illustrated using 2022 data in Figure 1.[2] Oil export revenues in dollars - $128.9 billion in 2022 – plus foreign direct and portfolio investments, and a small amount of foreign aid were received either directly by the Iraq Ministry of Finance (MoF) or by one of the two MoF accounts at the New York Federal Reserve (NY Fed).

Upon request by the MoF, the NY Fed released funds to the MoF. Some of these dollars were used for Iraqi government spending for imports, debt service, and some other foreign

[2] The figure is from Frank R. Gunter (2021) *The Political Economy of Iraq*, pp. 285-286 while the 2022 data is from Ahmed Tabaqchali (2024) *A Fistful of Dinars: Demystifying Iraq's Dollar Auction,* LSE Middle East Centre Paper Series 85, April, Table 1, p. 12.

transactions. However, to obtain the dinars needed by the GoI for domestic expenditures, the MoF sold dollars - $53.4 billion in 2022 – to the Central Bank of Iraq (CBI) for dinars at the then official exchange rate of 1450 Iraqi dinars per dollar (ID/$). These sales increased the CBI's net foreign assets, its dollar holdings.

Figure 1: Flow of Dinars and Dollars



To provide dollars to the private sector, the CBI holds a daily currency auction where it invites a limited group of banks and other financial institutions to buy or sell US dollars at the official exchange rate.[3] It is a very rare event when these institutions seek to sell dollars to the CBI. In 2022, these institutions purchased $46.8 billion from the CBI. The difference between the US dollar sales to the CBI by the MoF and the dollar sales by the CBI to financial institutions

[3] For detailed analysis of the Central Bank of Iraq's currency auction, see Ahmed Tabaqchali (2024) *A Fistful of Dinars: Demystifying Iraq's Dollar Auction,* LSE Middle East Centre Paper Series 85, April; and Kapita (2023) "The Dilemma of the Iraqi Dinar: A Brief on the Currency Workflow and Current Systems Consequences" April, pp. 15-18.

increases or decreases the CBI reserves. In 2022, these transactions increased foreign reserves by $6.6 billion: the difference between the $53.4 billion the CBI received from the MoF and the $46.8 billion sold at the CBI currency auction. Note that this is not the only determinate of changes in Iraq international reserves which increased by almost $26 billion in 2022.

Financial and non-financial firms that are not allowed to buy dollars at the CBI auction purchase them in the market or parallel currency market. While the parallel rate is mostly determined by the demand and supply of dollars in Iraq, there have been accusations that some large currency exchange houses, possibly with the assistance of some government agencies, have been able to manipulate the parallel exchange rate – at least in the short run – to increase their profits.

The difference between the official exchange rate and the exchange rate in the parallel market provides critical information on the true value of the dinar. A difference of less than 2% between the two rates is expected. This provides a riskless profit for those financial institutions that have access to the currency auction to buy dollars there and resell them in the parallel market. However, since the 10.3% revaluation[4] of the dinar in February 2023, the gap between the official rate and that in the parallel market has increased substantially. In November 2023, the parallel rate reached 1,650 ID/$ - a gap of almost 26%. More recently, the parallel rate has stabilized. By mid-March 2024, the parallel rate was approximately 1,520-1,530 ID/$ – a gap of almost 16%.

[4] An increase in the value of the dinar is called a revaluation if the strengthening is the result of a policy decision but is called an appreciation if the strengthening is the result of a change in the market demand and supply of the dinar. Similarly, a devaluation is the result of policy while a depreciation reflects changes in the market demand or supply.

Determinates of the Excess Demand for Dollars

Price of Oil:

Although Iraq has experienced a gradual increase in the volume of oil exports, its earnings are dominated by changes in the price of oil. For example, in 2020, Iraq oil price was $38.4 per barrel (pb) resulting in crude oil export receipts of $42 billion. As a result, government revenues in 2020 were insufficient to pay salaries and pensions much less other current and investment expenditures.

However, oil prices almost tripled to $95.60 pb in 2022 resulting in export receipts of a record $116 billion before oil prices declined again to $79.20 pb in 2023 which resulted in a 16% decline in export receipts to $100 billion.[5] With current oil exports of 3.5 million barrels per day (mbpd), a one dollar increases in the price of oil results in an about a $1.3 billion (1.7 trillion dinar) rise in oil export earnings. High oil export earnings tend to be accompanied by increases in the country's international reserves which increases confidence that the international value of the dinar will remain stable or even increase in value - appreciate. Conversely, low oil export earnings leading to a loss of international reserves raise fears of a substantial dinar devaluation such as occurred in December 2020.

Much depends on the price of crude oil and the volume of Iraq oil exports over the next few years. In January 2024, the average price was $77.54 pb and the volume was 3.34 mbpd.[6] While

[5] IMF (2024) *Iraq 2024 Article IV Consultation,* May, Table 1, p. 24 and Table 5, p. 28.
[6] As of May 1, 2024, the Iraq Ministry of Oil has not published the monthly estimate of the average price of oil exported for February and March. This delay is releasing this critical piece of data is unprecedented and is probably an attempt to conceal bad news – governments do not delay the release of favorable data.

this resulted in $400 million more export earnings than budgeted, it was insufficient to prevent an increase in the budget deficit. The IMF estimates that even if oil exports rise to 3.5 mbpd in 2024, the fiscal break-even oil price will be almost $90 pb this year which is equivalent to a Brent Blend price of about $98 pb.[7] And, despite the generous increases in GoI expenditures in the three-year budget, there is currently political pressure to further increase such expenditures over the next two years. Of course, if the GoI commits to such expenditure increases, the breakeven oil price will be higher than $90 pb.

Predicting oil prices is often a fool's effort. Among the drivers of the future price of oil are OPEC+ policies, the continuing impact of sanctions on Russia, and Iran, the growth rates of China, India, Europe, and the United States, and changes in technology. Currently, the greatest source of uncertainty for oil prices are the several conflicts in the Middle East and the Ukraine. Iran and Israel traded missile and drone attacks in April 2024 which may lead to increased sanctions on Iranian oil exports – reducing world oil supply. And the continuing Russian invasion of Ukraine may lead to further international efforts to further defund Moscow by restricting its energy exports.

Despite these occurrences, Brent Crude Oil futures contracts, where speculators are risking their own funds on their predictions, point to a gradual decline of oil prices. From an expected $86 pb in mid-2024, Brent Blend prices are expected to fall to $81 pb in 2025, and $76 pb in 2026.[8] And since Iraq earns about 92% of the Brent Blend price; if these futures contracts are accurate, the

[7] IMF (2024) "Iraq: Concluding Statement of the 2024 IMF Article IV Mission" March 3.
[8] Wall Street Journal (2024) "Brent Crude Oil Continuous Contract" June contracts, April 18.

GoI can expect to earn an average of roughly $79 pb this year, $75 per year in 2025, and $70 pb in 2026. These prices are substantially below the budget break even oil price of $90.

As a result, execution of the 2023-2025 budget can be expected to lead to a reduction in the country's international reserves and renewed fiscal pressures especially if world oil prices decline. And it these fiscal pressures become serious enough, they will strengthen the expectation that the GoI will devalue the dinar as it did under similar circumstances in 2020.

U.S. Government Restrictions on Currency Shipments:

Until recently, the New York Federal Reserve would supply dollars either in the form of electronic transfer or actual physical currency. The currency shipments averaged about $10 billion a year. However, as part of an effort to sanction Iran, the US government has reduced supplying currency while still allowing electronic transfers of money. Also, in July 2023, the U.S. government banned transactions with 14 Iraqi banks for allegedly violating its rules concerning client documentation.[9] An additional eight banks were banned in February 2024.[10]

While restrictions on dollar transactions should increase the cost to Iran and Syria of obtaining dollars, it can also be expected to slow economic growth in Iraq by increasing transactions and financing costs. To avoid adverse effects on the Iraq economy, these tighter restrictions on dollar transactions involving Syria and Iran should be combined with a rationalization of Iraq's banking and equity markets to ensure that a liquidity shortage doesn't stall the Iraq economy.

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[9] *Rudaw* (2023) "Iraq Launches Visa Direct Service to Combat Corruption, Illicit Funding" November 1.
[10] Adam Lucente (2024) "Why Iraq's Dinar is Trading Below Official Dollar Rate Amid New Restrictions" February 5.

The Iraqi economy's extreme dependence on foreign exports and imports as well as the need for foreign capital to finance the country's economic development stress the importance of a stable exchange rate. Unfortunately, there have been not only substantial trade and finance disrupting exchange rate changes including a 22.7% dinar devaluation in December 2020 and then a 10.3% dinar revaluation in February 2023 but also Iraq is currently a dual exchange rate economy. The official currency auction rate is 1310 ID/$ while, when this report was written, the rate in the parallel market was about 1500 ID/$.

This gap between the official and parallel exchange rates has several adverse effects. First, it complicates business transactions since managers often must deal with calculations in two or more different exchange rates. Second, multiple exchange rates facilitate corruption. Officials will seek to have funds received denominated in dollars while having funds paid denominated in dinars. This will allow these officials to profit by the difference between the official and parallel exchange rates. Finally, a parallel rate of dinars to dollars that is greater than the official rate will be taken as a warning sign of a future dinar devaluation.

Concern about a future devaluation will have a wide impact. The increased exchange rate risk may lead potential non-oil foreign investors in Iraq to hesitate. Official and private sector planners will have a shorter planning horizon which tends to reduce efficiency. Iraqi individuals and entities will react by increasing their holdings of real assets such as precious metals and real estate as well as U.S. dollars.

The market for direct hedges against a future dinar devaluation are shallow and expensive. However, an indirect hedge is possible. A rise in oil prices tends to increase Iraq's international reserves and therefore makes a devaluation less likely. Conversely, a fall in oil prices decreases reserves and raises the probability of a devaluation. Purchasing puts on oil prices – contracts that profit by a decline in oil prices – is therefore an indirect hedge against a dinar devaluation. However, unlike a direct hedge, it is possible that the relationship between oil prices and devaluation could be looser than expected. For example, one could conceive of a expansion of Iraq non-oil exports breaking the relationship between oil prices and the value of the dinar.

Iraq Imports and Debt Service:

The MoF has substantial dollar denominated imports. And in 2022, these public sector imports increased by 66% motivated primarily by an increase in food and related products imports financed by the Emergency Law Food Security program. Iraq was also forced to pay higher prices in 2022 for necessary grain imports due to the Russia invasion of Ukraine which restricted grain exports from the extensive Ukrainian fields. The GoI accounted for 30% of all imports in 2022.[11]

In addition, private sector imports also surged by an estimated 24% because of increased construction related imports and capital goods. The combined increases in public and private imports resulted in a sharp rise in the demand for dollars contributing to the gap between the official and parallel exchange rates.

[11] World Bank (2023) *Iraq Economic Monitor,* Spring/Summer, p. 14.

Exchange Rate Changes

The exchange rate at which the MoF sells dollars to the CBI has an important fiscal impact. When the dinar was devalued in December 2020 to 1450 ID/$, each dollar of oil export earnings provided the MoF with 22.7% more dinars than previously which substantially alleviated the fiscal crisis. Conversely, when the GoI *inexplicably* revalued the dinar to 1310 ID/$ in February 2023, it was equivalent to a substantial reduction in the MoF dinar revenues.

The economic case for this revaluation was weak and an observer can only conclude that its primary motivation was political pressure from influential groups. Public and private entities involved with imports, dealing with dollar denominated foreign debt, or dollar smuggling to Iran and Syria urged the GoI to revalue the dinar to benefit themselves despite the extensive damage to the rest of the Iraq economy. However, the increase in the value of the dinar seems to have reduced inflation.

Note that the official exchange rate depends on the nature of the transaction. Currently, the MoF sells dollars to the CBI at a rate of 1,300 ID/$. However, the CBI then sells dollars to authorized financial institutions at a rate of 1,310 ID/$ while these authorized financial institutions are expected to sell these dollars to their clients at a rate of 1,320 ID/$.[12] Even assuming there is no "leakage" of dollars into the parallel market, this transaction provides banks, and other institutions that have access to the currency auction, with a riskless overnight return of 0.7%. Repeated for the roughly 270 auction days a year would provide an annual compounded return of almost 700%!

[12] For the rest of this report, the official exchange rate will be given as 1,310 ID/$.

Since Iraq has fixed the dinar to the U.S. dollar, Iraq's monetary policy is determined largely by the NY Fed. To fight inflation in the U.S., the NY Fed has raised U.S. interest rates which has resulted in a strengthening – an appreciation – of the dollar. And, since the dinar is tied to the dollar, the real value of the dinar has strengthened as well even with an unchanged official dinar/dollar exchange rate.

Among the losers from the dinar revaluation are merchants who must pay for products in dollars but sell them for dinars. Not only has the revaluation increased their costs but also the possibility of another change in the exchange rate increases uncertainty and motivates such merchants to delay purchases even at the risk of having empty shelves.[13]

This revaluation of the dinar combined with restrictions on dollar transactions has also seriously injured private sector businesses that were engaged in exporting. Previously, many contracts between international firms such as oil companies and their Iraqi employees and suppliers were denominated and often paid in dollars. Iraqi employees and firms could then convert these dollars into dinars at the parallel rate – currently about 1,500 ID/$. However, beginning is 2024, the GoI required, that regardless of the currency specified in contracts, payments will be made in dinars only and at the official rate – 1,310 ID/$. Overnight, many Iraqi employees and firms suffered about a 16% cut in compensation. Adjustment of payments to reflect the new currency realities may not occur until contracts are up for renewal which may not occur for up to five years.

[13] Amwaj Media (2023) "Deep Dive: Will Iraq's Central Bank Bring an End to the Dinar Crisis?" February 7.

More difficult to quantify is the impact of the revised rules on consumer willingness to spend. In other words, the increased uncertainty has encouraged Iraqi firms and individuals to reduce spending and, instead, hoard both dollar and dinar currency. This currency hoarding may partially offset the impact of higher oil prices on the economy.

Finally, two significant exchange rate changes in four years increases the expectation of future changes and, therefore, the risk of long-term contracts. This can act as a barrier to non-oil foreign direct investment. Foreign firms would prefer an extended period of stable exchange rates in order to be confident of their ability to recoup the initial costs of establishing themselves in Iraq.

While the substantial gap between the official and market rates exchange rates is clear evidence of excessive demand for US dollars in Iraq, there is a debate over the causes. While exchange rate issues are generally analyzed as a function of a country's monetary and exchange rate policies – its macroeconomic policies - the unique characteristics of Iraq's political economy mean that it might be more productive to consider institutional factors – Iraq's microeconomy - that lead individuals and organizations to prefer dollars to dinars in domestic transactions including domestic trade, savings, and investments.

Foreign Demand for Dollars

Iraq's fixed exchange rate is under pressure from entities and persons especially in Syria and Iran and, to a lesser extent, in Jordan, Lebanon, Turkey, and even the UAE. In these countries, obtaining dollars from Iraq is generally cheaper – requires less expenditure of real resources -

than obtaining them through exports to or investments from the USA and others. But the pressure to obtain dollars is highest for Syria and Iran.

Since 2011, the government of Syria has used military force to crush a widespread popular protest. The resulting violence, combined with international sanctions, led to a severe economic downturn and the collapse of the Syrian pound. The pound lost almost 99% of its value as it fell from a pre-crisis rate of 47 Syrian pounds/$ to 13,001 pounds/$ in April 2024.

Iran is also experiencing economic difficulties and a collapse of its currency, the Rial, due, in part, to international sanctions intended to discourage the country from pursuing its nuclear program. As a result, the Rial lost 75% of its value falling from 10,500 rials/$ in December 2011 to about 42,000 rials/$ in April 2024.

The collapse of these currencies has led to a strong demand for U.S. dollars in both countries. In addition to their governments need for hard currencies for authorized imports, debt service, and international transfers; the non-government sector also seeks dollars. This private sector demand has several causes. U.S. dollars are sought as a hedge in both countries against inflation and the accompanying depreciation. The possession of dollars also facilitates residents of these countries moving their wealth out of the country - capital flight. For lower income or less well-connected residents of Syria and Iran, dollars can be used as “domestic” capital flight. In this case, poor Syrians and Iranians will hold dollars as insurance against an uncertain future. While data on dollar smuggling is notoriously unreliable, one estimate is that between $100 and $260 million dollars are smuggled to Iran and Syria from Iraq each week.[14]

While these governments can utilize credit money – such as bank to bank transfers - for a portion of their authorized payments for imports, debt service, and transfers; a large proportion of these governments demand for dollars and almost all private sector demand is for physical U.S. currency – green pieces of paper with pictures of dead U.S. presidents. The U.S. dollar is accepted everywhere, and currency is untraceable which is a valuable characteristic if you are trying to avoid international sanctions or the attention of your own government.

Obtaining U.S. dollars from Iraq by Syrian or Iranian entitles is a three-step process.

First, one must obtain dinars. This may result from legitimate transactions such as the earnings of Iranian or Syrian businesses and individuals active in Iraq. However, it is more likely that these dinars are obtained in the informal or black market. For example, smuggling across both Iraq's western and eastern borders is widespread and, although it is possible that these smuggled goods might be sold directly for dollars, they are often sold for dinars. And since an important motivation of the smuggling is to eventually obtain dollars, the price of these goods will often be less than that of equivalent products produced in Iraq.

Second, dinars must be converted into dollars. The best conversion rate requires access to the CBI currency auction. Only a relatively few financial institutions have access to this auction, and

[14] Amwaj Media (2023) "Deep Dive: Will Iraq's Central Bank Bring an End to the Dinar Crisis?" February 7.

they are supposed to rigorously evaluate and document their clients' need for dollars. However, until the recent crackdown, many evaluations were perfunctory and based on incomplete or inaccurate documentation. It should be noted that the 10.3% revaluation of the dinar in February 2023, reduced the number of dinars that entities or individuals connected to Iran or Syria needed to obtain a dollar. This may explain why some militia groups associated with Iran supported the dinar revaluation.

Less favorable exchange rates can be obtained in the parallel market where financial institutions that have access to the CBI currency auction resell the dollars that they purchased at the auction. Since dollars in the parallel market can sell for 16% more dinars than at the CBI auction, many small banks concentrate on profiting from this almost riskless arbitrage rather than the more challenging business of making loans.

Finally, the physical currency must be moved across borders. The GoI has cracked down on the option of using pre-paid cards. Banks were allowed to issue depositors pre-paid cards valued at $10,000 at the official rate. These cards were then taken to other countries and used to withdraw dollars. In one case, an Iraqi was arrested preparing to leave the country with 300 bank pre-paid cards. Another method is to buy airplane tickets in Iraq at the official rate and then cash them for dollars in other countries.[15] While elaborate methods may involve pre-paid cards or mis-invoicing otherwise legal imports, it is believed that most of the currency is simply smuggled across Iraq's porous borders. Note that international transactions using the hawala system doesn't necessarily transfer physical dollars across borders.

[15] Wall Street Journal (2023) "Iraqis Fly to Nearby Countries to Get Dollars as U.S. Cracks Down on Money Laundering" May 8.

Domestic Demand for Dollars

The demand for U.S. dollars inside Iraq can be viewed as a function of the return, risk, transaction costs, and convenience of alternative assets. Consider the tradeoffs between an Iraqi person or entity owning dinars, dollars, or a bank account as a medium of exchange – used for transactions - and a store of value – as a form of savings.

Medium of Exchange: U.S. dollars were widely accepted in Iraq not only by private businesses but also by government agencies. Until recently, dollars were rarely refused as payment at a variety of businesses, and it was not uncommon, when one attempted to make a payment in dinars, for the business to request dollars instead. Even government agencies preferred dollars. For example, shipping firms were encouraged to pay customs and other fees in dollars.[16] And an international traveler trying to obtain a visa upon arrival at Baghdad International Airport was told that they cannot pay the visa fee with dinars - only U.S. dollars are acceptable. This dollar preference is partially a matter of convenience. The largest dinar currency is 50,000 dinars (about $39) while U.S. dollar bills of $100 are available.

However, effective on January 1, 2024, a series of regulations attempt to discourage business and individual use of U.S. dollars. According to the CBI's October 5, 2023 clarification, beginning on January 1, 2024; there will be a divergence in bank withdrawal rights. People who deposited dollars into banks before the end of 2023 may withdraw these funds in either dollars or dinars in

[16] Iraq Britain Business Council (2023) "Seaports and Airports of Iraq: Rules Versus Infrastructure". Published in English and Arabic. June.

2024. However, dollar deposits made after January 1, 2024, may only be withdrawn in dinars at the official exchange rate.

In addition, as discussed above, all dollar denominated contracts in Iraq whether involving individuals or organizations must be settled in dinars at the official exchange rate.

Almost immediately, there were methods created to avoid the requirement of dinar only transactions. "Ghost travelers" is one option. An investigation revealed that more than 150,000 Iraqis obtained an estimated $600 million dollars at the official rate supposedly for international travel but never left the country. Rather these dollars were sidetracked into the parallel currency market.[17]

Another option to avoiding transactions at the official exchange rate is through mis-invoicing international transactions.[18] By under-invoicing exports and over-invoicing imports, an Iraqi firm can move dollars out of the country at the parallel rate. As an example of over-invoicing imports, an Iraqi business could invoice a transaction at $1 million and provide this false documentation to their bank to obtain the dollars. But if the actual value of the transaction is $800,000, the remaining $200,000 could be deposited by the Iraqi business's foreign exporter partner into an account controlled by the Iraqi business or individual.

[17] Menmy, Dana Taib (2024) "Iraq's Federal Board of Supreme Audit Exposes US $600 Million Corruption Involving 'Ghost Travelers'" *The New Arab*, April 24.

[18] *Kapita* (2023) "The Dilemma of the Iraqi Dinar: A Brief on the Currency Workflow and Current Systems Consequences" April, p. 24.

Store of Value: Whether a particular asset will be used to store value depends upon its liquidity, risk, and return. Unfortunately, dollar currency currently "dominates" the liquidity/risk/return of many alternative assets in Iraq. Liquidity is the ease/expense with which an asset can be converted into currency, into paper dinars. Despite recent efforts to restrict dollar use in Iraq, the dollar currency remains a very liquid asset although not as liquid as even a few months ago.

As discussed above, uncertainty about future dinar/dollar exchange rates leads many in Iraq to prefer lower risk dollars. Finally, both dinar and dollar holdings have had extended periods when they earned negative returns as both lose value because of inflation. However, over the last decade, dinar inflation has been both higher and more variable than dollar inflation. In 2023, inflation was a high of 7.5% in January although is gradually decreased to about 4.0% at the end of the year.[19]

In many countries with a similar level of economic development as Iraq, bank deposits compete with currency as a store of value. In these countries, bank deposits are liquid, are low risk due to deposit insurance, and often earn a positive return – pay an interest rate greater than inflation. However, in Iraq, the banking industry is dominated by state owned banks and the lack of core banking at these banks and the shortage of ATMs results in low levels of perceived liquidity, there is no explicit deposit insurance, and, between fees and inflation, the return is usually negative although the recent decision to increase bank deposit interest rates may provide a positive return in the future.

[19] IMF (2024) "Iraq: Concluding Statement of the 2024 IMF Article IV Mission" March 3.

The lack of deposit insurance favors the seven state owned banks (SOB) including Rafidain (largest bank in Iraq) and Rasheed (3rd largest) since there is an implicit state guarantee. And, except for the Trade Bank of Iraq (2nd largest), the SOB are bureaucratic organizations that focus on serving the state-owned enterprises. As a result, only 26% of the population have a deposit account which is one of the lowest rates in the MENA.

While it may seem counter-intuitive, recent changes in rules governing currency conversion by banks may increase dollar currency dominance over bank deposits! Previously, as discussed above, depositors had the option of withdrawing their bank deposits in the form of either dinars or dollars regardless of currency of the original deposit. But new regulations intended to reduce the misuse of dollars established a two-tier system. Dollar deposits made into banks before the end of 2023, may continue to be withdrawn in dollars. However, beginning January 1, 2024, new dollar deposits could only be withdrawn in dinars at the official exchange rate.[20]

The restriction on withdrawing dollars can be expected to have several partially offsetting effects. It will become more difficult to convert dinars to dollars for non-financial institutions. These will make it more difficult to obtain dollars to smuggle to Syria and Iran. However, it will probably also provide increased incentives to hold physical dollar currency in a home or business safe as a store of value since additional dollar deposits in banks are trapped – cannot be withdrawn as dollars. Finally, it may reduce dinar deposits as well. The willingness of the CBI to change previous rules to restrict withdrawal currencies may stoke fears that, during some future financial crisis, the CBI may follow the example of Lebanon’s Central Bank in 2019 and arbitrarily limit access to all bank deposits regardless of the currency involved.

[20] Azhari, Timour (2023) “Iraq to End All Dollar Cash Withdrawals by January 1, 2024” *Reuters,* October 5.

Restrictions on dollar transactions will also force a major change on private banks' business plans. Until the imposition of restrictions on banks dealing in the currency auction, many private banks made few loans. Instead, they earned a steady return by purchasing dollars from the CBI in the daily auction and immediately reselling these dollars in the parallel market thus earning 2 % - 15% overnight return in an almost riskless transaction. If deposits at Iraq banks, whether SOB or private banks, are to provide reasonable returns to compete with dollars as a store of value, they must be able to lend out deposits at reasonable risk with adequate return. This will require two important institutional changes that are discussed below.

Stocks and Bonds as Stores of Value: In many countries with similar per capita income to Iraq, investing in government bonds and corporate stocks is an important store of value. However, in Iraq, such investments are rare.

The bond market is thin with most government bond issues intended to be initially purchased by banks and then resold to the CBI. The secondary market in bonds barely exists since, except for Iraqi banks, there is little domestic or international private sector interest in Iraqi government bonds. This lack of interest is not a function of concerns about excessive government debt. According to the recent correction of reported debt data for 2022, the debt to GDP ratio in Iraq is only 40.8%[21] which is a very good ratio for a country at Iraq's level of economic development.

[21] World Bank (2023) "Statement on the Iraq Economic Monitor Spring/Summer 2023" Note this is a correction, the original World Bank report incorrectly stated that the debt/GDP ratio was 53.8%.

The Iraq Stock Exchange (ISX) was founded in 2004 and has a monopoly on securities trading in Iraq. Iraq's stock market is shallow with relatively few firms listed. Iraq's ratio of market capitalization to GDP is extraordinarily low compared to that of other MENA countries. Trading volumes and value are dominated by bank and telecom stocks with some other firms not experiencing a single trade in a month. The binding constraint on stock market growth is the absence of timely audited income and balance sheet statements for member firms. This results in severe information asymmetry that strongly favors firm insiders. As a result, the stock market is not a good store of value option in Iraq.

GoI is currently using the "stick"- threat of penalties - to reduce dollar demand. However, it might lead to more rapid reduction of pressure for dinar devaluation if the GoI made greater use of the "carrot" – opportunities for private sector benefits – to encourage greater reliance on dinar. This would include improving bank operations to provide an alternative medium of exchange and closing the data gap that prevents banks, the bond market, and the stock market from providing non-dollar stores of value.

Currency Auction Regulations:

The CBI regulates both which financial institutions may access the currency auctions as well as the purposes for which dollars may be purchased. The GoI has been persuaded by the US government, as part of its efforts to sanction Iran, to both reduce the number of institutions that may access the auction as well as require more detailed documentation. This has reduced the volume of dollars auctioned and contributed to a widening gap between the official and parallel market exchange rates.

Stricter documentation requirements have affected not only the volume of currency transactions but also have often increased the time required for settlement. There are cases where firms have waited months for their documentation to be approved and then there were further delays until the dollars were received. As a result, firms engaged in international trade and finance have found themselves forced to either make dollar payments to foreign suppliers and financiers before they received dollars from their Iraqi partners or risk cancelation of contracts. In low margin industries such as reinsurance, the payment delays will often render transactions unprofitable leading foreign firms to withdraw from the Iraq market.

To provide a sense of scale for recent currency auctions, over a two-day period in March 2024, the CBI sold about $412 million to about 50 exchange and brokerage companies. Of the total, about 90% was in the form of transfers and credit transaction while the remaining 10% was for currency deals. The CBI rate was 1,305 ID/$ for documentary credits and international settlements of electronic cards and 1,310 ID/$ for foreign transfers and cash transactions.[22] While the data is difficult to obtain and analyze, it is estimated that only 30% of the dollars obtained at auction are used to purchase authorized imports.

Summary: The fundamental source of instability facing Iraq's exchange rate system is the combined foreign and domestic demand for dollars is greater than the supply.

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[22] CBI report of currency transactions on Sunday, March 10, 2024, and Monday, March 11, 2024.

What Can Be Done?

Of course, it is possible to enforce existing regulations more rigorously or write new regulations to deal with each creative method of avoiding dealing at the official rate. However, it is challenging to enforce or create a regulation that will deal with the exchange rate gap without having an unanticipated adverse impact on Iraqi businesses. Rather than the stick – sanctions including arrests for violators of currency controls – it might be more productive to use a carrot – provide incentives to use non-dollar alternatives.

At least initially, these currency regulations have been successful at discouraging dollar use in retail transactions. But if dollars are less used as a medium of exchange in Iraq, what are the alternatives?

In most countries, the banking system is a major source of a medium of exchange primarily in the form of demand deposits. These demand deposits (credit money) can be easily transferred between persons/entities by checks or electronic funds transfer. And though bank branches and ATMs, bank clients can easily convert their demand deposits into currency.

However, Iraq’s banking system is moribund. There are relatively few banks, and their services are limited. As a result, banks and other Iraq financial intermediaries fail to provide a useful medium of exchange. The primary cause is that, compared to the rest of the MENA, Iraq is severely underbanked. There are only 4 bank branches and 5 ATM per 100,000 population. This is the lowest ratio in the MENA where the averages are 14 and 37 respectively.[23] There are smaller towns that lack even a single bank branch or ATM. And, even when a bank branch is near, it is often difficult to open a bank account especially for potential depositors who lack required documentation or have limited literacy. And even when an account it successfully opened, the major banks including Rafidain and Rasheed make little effort to cater to their retail customers.

The weaknesses of the Iraqi banking system motivate Iraqis to continue to depend on currency transactions. According to the CBI, in January 2024, about 92 trillion (a million million) ID (about $61 billion at the parallel market rate) in currency was held outside banks. And this currency outside of banks has increased sharply since 2022.[24] The CBI has made some efforts to encourage a shift of these funds into the banking system including raising the interest rate paid on deposits but there has been little success.

A major difficulty in motivating greater use of the banking system is limited bank services such as the lack of core banking at the state owned banks. With core banking, a person or business can deposit funds in one branch and withdraw these funds from another branch of the same bank. Without core banking, withdrawals can only be made from the same branch as the deposit. As a result, if an Iraqi business needs to make a payment, it is probable that currency will be used. Although civil servants receive their salaries directly deposited into their bank accounts, many will immediately withdraw these funds to pay bills, etc. Memories of the high inflation of the Saddam era which ended the middle-class lifestyle of many Iraqis combined with the great

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[23] World Bank (2023) *Iraq Economic Monitor,* Spring/Summer, pp. 10-11.

[24] CBI (2024) Graph “Currency Outside of Banks” website: https://www.cbiraq.org/Serieschart.aspx?TseriesID=156

variance in inflation have resulted in many Iraqis having a strong preference for dollar currency instead of paper dinars. This preference is strengthened by the knowledge that dinars have little value beyond the borders of Iraq.

The GoI is making some efforts to improve the liquidity/risk/return situation of bank deposits. As part of its comprehensive economic reform package, the GoI is requiring that State Owned Banks adopt modern technology in all banking transactions. This should lead to core banking at least on a next day basis.[25]

In addition, Iraq has the potential to supplement or replace dependency on traditional "brick and mortar" bank offices by facilitating e-banking through cell phones. Almost 90% of the Iraqi population have access to cell phones and about half of these phones are "smart" which would allow them to be used to make purchases and transfer funds. In 2016, the CBI authorized mobile wallets such as ZainCash and AsiaPay (formerly AsiaHawala). However, connecting mobile wallets and "brick and mortar" banks is still challenging which limits e-banking use.

With the intention of bringing about a substantial improvement in Iraq's financial system, the CBI has decided to establish a "National Company for Electronic Payment Systems in Iraq". This company will be responsible for "efficiently developing, operating, and managing national electronic payment and settlement systems."[26] Whether this new company will be successful in its efforts to substantially improve financial intermediation in Iraq is questionable. For almost two decades, Rafidain and Rasheed state-owned banks have successfully resisted multiple

[25] John Lee (2023) "Iraq PM Orders Reform of Banking Sector" *Iraq Business News,* November 16.
[26] John Lee (2023) "The Central Bank of Iraq (CBI) has decided to establish the National Company for Electronic Payment Systems in Iraq" *Iraq Banking & Finance News,* December 14.

attempts to upgrade their procedures and have used their strong political connections to prevent repercussions. Overcoming their delaying tactics will require substantial political will.

In addition, the CBI has authorized Iraqi banks to establish correspondent relations with Turkish banks to facilitate trade denominated in euros as an alternative to dollar transactions.[27]

The GoI is currently encouraging the increased use of pre-paid debit cards as a substitute for currency. For example, the Ministry of Oil is moving towards requiring the use of pre-paid debit or credit cards to purchase fuel. This should lead to more accurate data on transactions as well as reducing theft since Iraqis will be carrying less currency.

However, there are some disadvantages that are slowing the adoption of such cards. There are commissions charged when pre-paid cards are used. Many fuel and other businesses lack the point-of-sale equipment needed to process card payments. Less educated Iraqis are uncomfortable with using these cards rather than physical currency. Finally, the use of pre-paid cards sometimes disrupts traditional means of compensation. In some areas, it was customary that a purchaser would tip a clerk during a currency transaction possibly by rounding up a payment to the nearest 100 or 500 dinars. But with a pre-paid card charge for the exact amount of the transaction, such tips are increasing rare.

In addition, the First Iraqi Bank and Visa Global announced the establishment in Iraq of a Visa Direct money transfer service which enables Iraqis to transfer funds to more than 160 countries. If Visa Direct is widely accepted, it should help curb money laundering by providing an

[27] RS Research (2023) “Weekly Bulletin”, November 16.

electronic trail of international transactions.[28] Also, by reducing the volume of legitimate international currency transactions outside the banking system, it should become more difficult to hide illegitimate ones.

While progress is being made, corruption is still widespread in Iraq. Since there is no market for dinars outside of Iraq, corrupt officials tend to accumulate dollars either as part of their domestic holdings or as a step in moving their ill-gotten gains to a sanctuary outside the country. In other words, a reduction in corruption should also result in a reduction in the domestic demand for dollars.

The adoption of core banking among brick-and-mortar banks, expanded use of e-banking, and a greater number of ATMs will increase the usefulness of the dinar as a medium of exchange which will reduce the harm from de-dollarization.

First, an efficient registry system for assets offered as loan collateral to prevent a borrower from offering the same collateral for loans at several banks. Gaps in the current registry system has resulted in real estate and jewelry being the most common form of acceptable loan collateral. Banks can record real estate loan transactions with the land registry while banks can secure jewelry in the bank's vault.

Second, relatively few individuals and firms in Iraq have their essential credit data documented in public or private credit agencies. This makes it difficult to obtain reliable information on the

[28] *Rudaw* (2023) "Iraq Launches Visa Direct Service to Combat Corruption, Illicit Funding" November 1.

financial situation of most individuals and firms. Unable to separate good from bad credit risks, Iraq banks tend to focus on loans to government employees and state-owned enterprises. As a result, persons and entities without a direct government connection have limited access to the financial system and are limited to a cash economy.

Medium-term (3-5 years) Concerns

Following a long delay for government formation, the GoI proposed a three-year budget that includes an unprecedented increase in expenditures.[29] Total current and investment spending is budgeted to expected to increase by almost 31%. Among the increased expenditures are a planned 26% increase in the number of public sector employees as the GoI returns to being the "employer of first resort." Even if the country can meet its 2023-2025 oil export target of 3.5 mbpd at an average price of $70 pb (equivalent to about $76 pb Brent Blend); this spending flood is expected to result in a large deficit to be financed primarily by the discounting of treasury bills by the Central Bank of Iraq. As a matter of scale, the World Bank states that the necessary breakeven oil price to cover all the planned expenditures is almost $90 pb (equivalent to about $98 pb Brent Blend)![30]

The problem with the 2023-2025 budget is not primarily on the revenue side. The three-year budget assumes an oil price of $70 pb and 3.5 mbpd of oil exports for total annual oil export earnings of $89.4 billion. In the first year of this budget, oil prices were $79.20 which combined with an oil export volume of 3.5 mbpd resulting in 2023 oil export earnings of $100.2 billion.

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[29] Ahmed Tabaqchali (2023) "Debt and the Ides of March: An Overview of Iraq's 2023 Federal Budget Proposal" May 8.
[30] IMF (2024) "Iraq: Concluding Statement of the 2024 IMF Article IV Mission" March 3.

However planned expenditures are expected to grow sharply. Compared to 2022, current expenditures are budgeted to increase almost 22% due in part to a 26% increase in the number of public sector employees to 3.4 million as well as substantial increases in salaries and pensions. Capital expenditures are budgeted to increase by 53% as a substantial increase in non-oil investment more than offsets an expected *decrease* in oil related investment. Combined with a doubling of debt service, total expenditures plus debt service in 2023 were budgeted to increase by almost 37% over 2022 levels.[31]

As expected, the actual fiscal outcome in 2023 was more favorable than the budget predicted due primarily to the difficulty the ministries had in spending the increased investment funds. However, the fiscal balance which showed a surplus equal to 10.8% of Iraq's GDP in 2022, fell to an expected 1.3% deficit in 2023.[32] And as the ministries gradually increase budgeted investments, the government's deficit is expected to widen to an about 8% of GDP in 2024.

Further exacerbating Iraq's fiscal situation, expected oil prices are substantially below the predicted break-even price of $90 pb that will allow the GoI to pay for its budgeted current and investment expenditures. While probably not as immediately serious as in 2020, the GoI can expect a steadily deteriorating fiscal situation for the foreseeable future. And, of course, any unexpected decrease in revenues or increase in expenditures would accelerate this fiscal deterioration. Eventually, the situation can be expected to deteriorate to the one described in both

[31] Ahmed Tabaqchali (2023) "Debt and the Ides of March: An Overview of Iraq's 2023 Federal Budget Proposal" LSE Blog, May 8.
[32] IMF (2024) "Iraq: Concluding Statement of the 2024 IMF Article IV Mission" March 3.

the IBBC 2020 report "Iraq 2020: Country at the crossroads"[33] and the GoI 2020 "White Paper."[34] And the options for either reducing the expected growing deficits or obtaining increasing amounts of deficit finance are limited.

The challenge of deficit financing in Iraq is complicated by the lack of a Treasury Single Account (TSA). Instead of a TSA where all treasury deposits and payments are executed by a single centralized authority, government funds are held my dozens of ministries and some sub-ministerial agencies. Not only does the lack of a TSA make it difficult to determine the true fiscal balance in real time but also the existence of many accounts without oversight facilitates waste and corruption.

For political reasons, current expenditures will not decrease even if oil prices collapse. In other words, a wage and pension freeze or even the gradual attrition of government employment by not replacing retirees are unlikely outcomes. Instead, investment is likely to continue to be the shock absorber of fiscal policy in Iraq. Since 2005, any decrease in oil export earnings resulted in a disproportionate decrease in investment sacrificing the country's future. Most infrastructure and other investment in transportation, electricity, schools, clinics, and water supply will slow or grind to a stop with all the associated waste until investment spending is restored in a future budget. If current expenditures are unchanged – about 73% of total budgeted expenditures in 2023 – even a sharp reduction in investment expenditures will be insufficient to completely close the deficit caused by declining oil prices. There exist many options for increasing non-oil

[33] Iraq Britain Business Council Report (2020) "Iraq 2020: Country at the Crossroads" Co-authors: Mohammed al Uzri, Renad Mansour, Hani Akkawi, Husseain al Uzri, Shwan Aziz Ahmed, Christophe Michaels, and Frank R. Gunter. Published in English and Arabic. May.

[34] GoI Emergency Cell for Financial Reforms (2020) "White Paper", October.

revenues and decreasing non-salary/pension expenditures, but as a few examples illustrate, all these options have complications.

Among the possibilities for increasing non-oil revenues are to begin collecting payments for electricity and water. Currently, only about 5% of the power and water tariffs charges are actually paid. This reduces government revenue and encourages waste because users treat items with a zero price as having a zero cost. Unfortunately, under Saddam, power and water were essentially free and many Iraqis expect current elected officials to continue these very expensive subsidies.

Another option is to charge the tens of millions of religious tourists for their visas. Again, this would be considered controversial both within Iraq and by Iran which is the home of most of these tourists. A related possible source of revenues would be to not only collect customs fees but also transfer the collected funds to the MoF. Currently, only a fraction of customs levies is collected and a large proportion of the levies that are collected are retained by customs officials and other government agencies.

There are also some options for decreasing non-salary/pension expenditures, but all have adverse long-term implications. For example, considering the loss in confidence and hardship that occurred in 2020 when the GoI ceased making payments on schedule to the international oil companies as well as delaying salaries for government employees, it is hoped that payment arrears can be avoided.

But even if some of these revenue-increasing or expenditure-decreasing initiatives are adopted, if oil prices decrease, it is likely that the GoI will face a widening fiscal deficit. How can the GoI finance any remaining deficit?

Unless there is a substantial increase in the willingness of Iraqi and/or foreign entities to buy GoI bonds, the CBI will once again have to encourage state-owned and private banks to purchase these bonds with the expectation that the CBI will repurchase them from the banks. As can be seen in the circular flow diagram, if the CBI engages again in such repurchase agreements, it will lead to a reduction in the country's international reserves. Such a reduction will probably decrease the confidence of both Iraqis and foreigners that Iraq will be able to avoid a devaluation – a fall in the value of the dinar.

To avoid a speculative attack and to increase the number of dinars available to the MoF for each dollar received for oil sales, the GoI might decide to devalue the dinar like it did in December 2020. In the short-term, this would relieve the fiscal pressure as well as close the gap between the official and parallel exchange rates. However, in the absence of a sharp rise the price of oil, the benefits would be temporary.

Any such devaluation would lead to an increase in inflation and, therefore, after a lag to demand for increased government spending for salaries and pensions. In addition, every time Iraq devalues the dinar strengthens the expectation that another devaluation will occur leading to riskless speculation against the dinar.[35] A succession of dinar devaluations will discourage foreign direct investment by increasing the risk of such investments.

The 2023-2025 budget will increase the country's oil dependency, lead to widening fiscal deficits and increase the likelihood of devaluation.

Conclusions

The GoI is currently engaged in much needed initiatives to reduce corruption and improve financial intermediation by Iraqi banks. These efforts have been complicated by efforts, motivated by the US government, to reduce the flow of US currency to Iran and Syria. These GoI initiatives will take time to have their full impact on the economy and, in the meantime, Iraq will have two exchange rates with a large gap between the official or auction rate and the market or parallel rate. The existence of two exchange rates raises issues of equity, hinders anti-corruption efforts, and leads to market inefficiencies that will slow economic development. To de-dollarize the Iraqi economy without causing an economic slowdown, the GoI should move aggressively to improve financial intermediation by banks and the stock exchange.

In addition, medium-term exchange rate stability is threatened by the unrealistic three year, 2023-2025, GoI budget. Based on market predictions of oil prices, the GoI can expect a wider fiscal deficit, declining international reserves, and increased pressure for a dinar devaluation. As advocated during the 2020 financial crisis, Iraq should move aggressively to reduce oil

[35] One politically unpopular option would be for Iraq to return to a currency board such as the country had in 1930-1949. See Frank R. Gunter (2021) *Political Economy of Iraq*, pp. 292-296.

dependency by allowing the expansion of the private sector and developing a realistic national budget.

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