



The Strategic and political dimensions of the dollar exchange rate crisis

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In the aftermath of Iraq's invasion of Kuwait on August 2, 1990, the United Nations Security Council, on August 6, 1990, passed Resolution 661¹, imposing severe economic sanctions on Iraq. In this resolution, the Security Council demanded that all States refrain from undertaking any form of trade with Iraq, in respect of both imports from and exports to Iraq, except for medical and food supplies to Iraq, as well placing restrictions on Iraqi assets and funds abroad². As for the Central Bank of Iraq, restrictions were applied to all its accounts and financial activities abroad. The Central Bank of Iraq needed approval from a special committee within the Iraqi Asset Management to carry out any major financial operations or transfer of funds.

Following the military intervention in March 2003, followed by the occupation of its territory, the legitimacy of the authorities heading Iraq was not recognized, especially since they did not exercise any real sovereignty under the role played by Paul Bremer and the occupation authorities³. Security Council Resolution 1483 was implemented on 22/5/2003,

¹ <http://unscr.com/en/resolutions/doc/661>

² Ibid.

³ Toussaint Eric. 2005. Your Money or Your Life, The Tyranny of Global Finance, Haymarket Books, Chicago, chapter 16, p. 327-338.

which lifted the economic sanctions imposed on Iraq and reinstated its affairs to its pre-1990 status. However, among the provisions of the resolution was the establishment of the Development Fund for Iraq into which all funds derived from the export of oil and gas are deposited and to meet other needs⁴. The funds of the Development Fund were deposited in the US Federal Bank in New York. Furthermore, the Governor of the Central Bank of Iraq was appointed in cooperation with the US Federal Bank to manage these funds⁵.

In due course, the Strategic Framework Agreement was signed in 2008 to underscore the friendship and cooperation between Iraq and the United States of America, which was also the preamble to the eventual withdrawal of American forces from Iraq and the end of formal occupation⁶. In response to a letter from Iraq's then prime minister, Nouri al-Maliki, to the President of the Security Council, UN Security Council Resolution 1956 of December 15, 2010 was passed which effectively terminated the Development Fund for Iraq and also ended the monitoring, immunity and supervision of the Central Bank of Iraq⁷.

Regarding the Iraqi funds held by the US Federal Reserve, the agreement between the Central Bank of Iraq and the Federal Bank to hold those funds was renewed, subject to the terms and conditions of transparency set by the US Federal Reserve. However, control over and the management of the funds remained with the Central Bank of Iraq⁸.

In relation to Iraq's outstanding debts to Kuwait, the task of the Compensation Fund, established by the Security Council in its resolution 687 under Chapter VII of the Charter of the United Nations in 1991, has been achieved. Meanwhile, the last remaining payment of compensation due to Kuwait was paid on February 22, 2022, amounting to \$ 44 million, out of a total of \$ 52.4 billion. With this, Iraq had finally fully paid off the compensation imposed on it under the supervision of the UN, more than 31 years after the invasion of

⁴ Resolution 1483 (2003) / adopted by the Security Council at its 4761st meeting, on 22 May 2003 UN. Security Council (58th year : 2003). <https://digitallibrary.un.org/record/495555?ln=en>

⁵ IRAQI FUNDS Obligated for Reconstruction Activity by CPA. https://www.globalsecurity.org/military/library/report/2006/sigir-jul06_appdx-e.pdf

⁶ President Bush and Iraq Prime Minister Maliki Sign the Strategic Framework Agreement and Security Agreement. <https://georgewbush-whitehouse.archives.gov/news/releases/2008/12/20081214-2.html>

⁷ Resolution 1956 (2010) / adopted by the Security Council at its 6450th meeting, on 15 December 2010. <https://digitallibrary.un.org/record/694961?ln=en>

⁸ Ibid

Kuwait⁹. Despite the fact that Iraq was removed from Chapter VII and placed under Chapter VI of the UN Charter, nevertheless, Iraq has not been permitted to have access to its frozen funds abroad. Furthermore, the United States continues to have stewardship over those funds held in the US Federal Bank.

Where do Iraq's oil revenues go?

Since 2003, Iraq has deposited its foreign currency reserves in the U.S. Federal Reserve, giving the United States significant control over Iraq's dollar supplies, including Iraq's \$120 billion in reserves from oil revenues¹⁰.

Previously, the Central Bank of Iraq sold dollars from the Federal Reserve to commercial banks and foreign exchange bureaus through a mechanism known as the "dollar auction." Over the years, large amounts of dollars have been transferred out of Iraq to Turkey, the United Arab Emirates, Jordan, Lebanon, Iran and Syria through "grey market trading," using fraudulent invoices for high-value goods. According to Iraqi banking officials and politicians, the previous system of remittances allowed this to be porous and easily exploited¹¹.

At the end of last year, the Fed began imposing more drastic measures. Amongst these measures, the United States demanded from the Central Bank of Iraq the use of an electronic system for transfers that requires detailed information on the final recipient of the dollar¹².

⁹ Security Council Unanimously Adopts Resolution Confirming United Nations Compensation Commission Has Fulfilled Its Iraq-Kuwait Mandate. <https://press.un.org/en/2022/sc14801.doc.htm>

¹⁰ Exclusive: Iraq to end all dollar cash withdrawals by Jan. 1 2024, central-bank official says. <https://www.reuters.com/markets/currencies/iraq-end-all-dollar-cash-withdrawals-by-jan-1-2024-cbank-official-2023-10-05/>

¹¹ Targeting Iran, US tightens Iraq's dollar flow, causing pain. <https://apnews.com/article/united-states-government-iraq-business-0628bad5e4d46315951c90681baba202>

¹² Ibid

What does it mean for Iraq to maintain US immunity on its funds?

It was expected that if Kuwait's compensation was paid in full¹³, the UN protection in place would be withdrawn from the Iraqi government's assets abroad. At the same time, there have been many demands from historical creditors, whether governments or the private sector, who have been waiting for this protection to be lifted to enable them to seize these funds and to obtain compensation.

Some economists consider the continuation of U.S. and UN protection over government funds is of great benefit to Iraq. It is estimated that Iraq owes some eight billion dollars to international companies. These companies have been waiting for the immunity to be lifted in order to be able to seize Iraqi money, not necessarily in cash, but could also be in the form of real estate or land¹⁴.

During former Prime Minister Mustafa al-Kadhimi's visit to Washington, he received an assurance from US President Joe Biden to continue protecting Iraqi funds abroad. The United States is expected to ask other countries on the U.N. Security Council to adopt the same stance of not lifting the immunity for those funds, fearing it could become the subject of disputes between creditors¹⁵.

According to economists, it is not possible for Iraqi investments in US bonds to be withdrawn all at once, but must be done in stages. The existence of these bonds is considered a safe investment for the country, as it is held in the Treasury Department and the US Federal Reserve.

Clarification on the Monetary Cycle in Iraq

In Iraq, the cash cycle follows a system called the "flexible currency exchange rate system", which may be explained as follows:

¹³ Ibid

¹⁴ ?What does it mean to maintain US immunity over Iraq's funds<https://shorturl.at/swAZO>

¹⁵ Ibid

- 1- Oil revenues: Oil is a major source of revenue in Iraq. When oil is sold, the money goes to the Iraqi government's account in the U.S. Federal Reserve.
- 2- Money transfer: After the money reaches the US Federal Reserve, it is transferred to the Central Bank of Iraq. The Central Bank assumes the role of treasurer and custodian of the country's foreign currency reserves.
- 3- Currency auction: The US dollar is sold in Iraq through currency auctions managed by the Central Bank. The bank determines the exchange rate of the Iraqi dinar against the dollar based on the supply and demand in the market.
- 4- Buying dollars: Dollars are bought by Iraqi businessmen and state institutions, such as banks, companies, and other government institutions for the purchase of goods and services from abroad.

It should be noted that this course depends on the use of the US dollar as a currency for foreign trade in Iraq, as it is deemed to be the main currency traded globally.

Notwithstanding, the Iraqi dinar is traded in the local economy for internal transactions.

The financial crisis in early 2023

Central Bank of Iraq officials began to express concern when 80% of transactions and invoices approved by the Central Bank of Iraq were rejected by the US Fedd Reserve due to the implementation of the new system. As a result, the amount of dollars sold daily at auction dropped dramatically, from \$257.8 million in a previous period to \$69.6 million on January 31 this year. Consequently, the proportion of transactions in dollars used to buy imported goods fell from about 90 percent to about 34 percent¹⁶.

These restrictions prolonged the period of time needed to clear funds from its previous two- to three-days to 15 days. Due to the inability to purchase dollars at the official rate through

¹⁶ Ibid

banks, traders resorted to the black market to buy dollars, which led to a rise in the exchange rate¹⁷.

To address this problem, a meeting was held between a delegation from the Central Bank of Iraq and a delegation from the US Federal Reserve and the US Treasury Department in Washington, D.C., on February 10, 2023. The meeting lasted several hours. Both sides expressed their desire to jointly address the challenges of working on the electronic platform for money and cash transfers. A number of support mechanisms that could contribute to strengthening the capabilities of the Central Bank of Iraq to deal flexibly with the crisis during this stage were discussed, and the US Federal Reserve and the US Treasury Department explained that they consider the Central Bank of Iraq's measures were a step in the right direction towards building a more robust and stable banking sector¹⁸.

However, this did not solve the immediate problem of the business sector's reluctance to deal with the central bank and instead to resort to the foreign exchange bureaus and money transfer companies operating on the black market.

Reasons for the emergence of the crisis

These new US restrictions come amid rising corruption indicators in Iraq, where accusations emerged in October of last year that more than \$2.5 billion had been embezzled from the General Commission for Taxes by a network of companies and officials in Iraq's Tax Authority¹⁹. This issue attracted considerable attention in the United States, as it underscored fears that corruption in Iraq was spiralling out of control and how some neighbouring countries could benefit from this state of affairs.

Some believe that Iraq's new prime minister, Mohammed Shia al-Sudani, who took power through a coalition of parties close aligned to Iran, does not have a sufficiently strong relationship with the US Administration to persuade them to ease the implementation of

¹⁷ Ibid

¹⁸ The CBI meets the US Federal Reserve and the US Treasury same time. <https://cbi.iq/news/view/2236>

¹⁹ 'Heist of the century': how \$2.5bn was plundered from Iraqi state funds. <https://www.theguardian.com/world/2022/nov/20/heist-century-iraq-state-funds-tax-embezzlement>

the new fiscal measures. Earlier, al-Sudani had downplayed the importance of the rise in the dollar exchange and expected a continuous rise in the exchange rate of the Iraqi dinar. He also indicated that he expected the exchange rate to stabilize at the official rate set at around 1,320 dinars to the dollar. He further added that he considered the Iraqi dinar to be sufficiently robust to withstand the ongoing crisis and that the financial situation in Iraq was at its best, and expressed his confidence in the national currency²⁰.

However, the measures taken by the Iraqi government have not been effective in stopping the financial markets from bleeding, and if the situation continues unabated, it is very likely that most banks will declare bankruptcy within one year. This will in all likelihood be followed by popular unrest and mass civil disobedience. Some experts also believe that the U.S. measures have been deployed to put pressure on al-Sudani's government and to fuel protests in Iraq²¹.

Some solutions to the crisis engulfing the Central Bank of Iraq

In the view of a number of interested economic observers, the management of reserve funds is usually limited to financial investments, including bank deposits and government debt instruments of various kinds. Although the return on stocks and shares may be high in the long term, the risks associated with investing in stocks are also high, hence the general rule in the management of reserves is to avoid these risks. The investor in stocks and shares is exposed to significant losses when liquidity is needed, especially when the price of stocks and shares continue to drop over a prolonged period of time. In addition, investment in real estate is generally excluded from the list of reserve investment instruments²².

Some interested observers who are not familiar with the controls adopted in the management of financial reserves may wonder why does Iraq invest such large amounts in

²⁰ Iraqi Prime Minister expects dinar to recover. <https://shorturl.at/lpuwV>

²¹ Targeting Iran, US tightens Iraq's dollar flow, causing pain. <https://apnews.com/article/united-states-government-iraq-business-0628bad5e4d46315951c90681baba202>

²² International Financial Economics and Monetary Policy: Reviews and Research, Dr. Ahmed Ibrihi Ali, July 2011 <https://cbi.iq/static/uploads/up/file-15141084216157.pdf>

US government debt securities? The reason for this is the large and growing return from investing in these instruments. The creditworthiness of the U.S. government is also beyond doubt. Notwithstanding, it is a question of diversifying reserves rather than choosing between the United States and other countries. It is true to say that the dollar is the primary currency in international trade and investment instruments, and that the United States is considered as the world's preferred financial centre should be given due consideration. Nevertheless, it would be prudent, in order to minimise the risks, that other international reserve currencies besides the dollar should be added to the investment portfolio²³.

In fact, the Iraqi government is more than capable of depositing its receipts from oil revenues in the central banks of other countries around the world and not just in the US Federal Reserve. There is no doubt that the government's decision on where to deposit its oil revenues depends on many factors, including economic, political, and trade relations, as well as on the level of trust in the banking system of a particular country and the currencies being offered. In relation to the management of the reserves, the central bank is at liberty to manage its accounts in the manner it prefers and to carry out transfers in different foreign currencies. Countries are permitted to diversify their reserves including the possibility of selling and converting into other currencies other than the dollar. In the case of Iraq, there is nothing to prevent it from selling and transferring other currencies alongside the dollar²⁴.

The reorganization of private banks and embracing best practices in its international banking relations are important steps in the drive to strengthen the economy and trade in Iraq. By developing the private banking sector and enhancing its capabilities, Iraq can conduct business with reputable correspondent banks around the world and build strong relationships with them. In addition, the government can adopt programmes to develop the skills of its business sector and improve their understanding of international relations. The

²³ Ibid

²⁴ Ibid

government can provide businessmen with the appropriate education and training to enable them to interact more effectively with the countries of origin for their imported products and with distant markets. This will considerably enhance their ability to better manage business deals and to develop companies directly without the need for intermediaries²⁵.

In conclusion, achieving these goals requires time and a sustained effort, and may also need legal and regulatory amendments. The Iraqi government must adopt these goals to strengthen the economy and to develop a more effective banking sector if it is to achieve a strong and sustainable presence on the world stage. This will also require an integrated effort from both the government and the private sector. The government must adopt policies and procedures that encourage investment and provide a favourable environment in which businesses and banks can thrive. Cooperation between the public and private sectors must also be encouraged in order to enhance capacities and develop strategies that enhance Iraq's standing in the international arena.

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