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A FISTFUL OF DINARS

DEMYSTIFYING IRAQ'S DOLLAR AUCTION

Ahmed Tabaqchali

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A Fistful of Dinars: Demystifying Iraq's Dollar Auction

Ahmed Tabaqchali

About the Author

Ahmed Tabaqchali is a capital markets professional with over 25 years' experience in US and MENA markets. He is the Chief Strategist of the AFC Iraq Fund. Ahmed is a Senior Fellow at the Institute of Regional and International Studies (IRIS), and non-resident Senior Fellow with the Atlantic Council - Iraq Initiative. He is a board member of the Iraq Fund for Higher Education (IFHE)/Baghdad Business School (BBS). Previously, he was former Executive Director of NBK Capital, the investment banking arm of the National Bank of Kuwait, Managing Director and Head of International Institutional Sales at WR Hambrecht + Co., Managing Director at KeyBanc in London and Director & Head of Capital Markets & Institutional Sales at Jefferies International in London. He started his career at Dean Witter International in London.

At the LSE Middle East Centre, Ahmed researches Iraq's economy and political economy, and the economic aspects of the relationship between the GoI (Government of Iraq) and the KRG (Kurdistan Regional Government), which is mostly expressed as the conflict over the KRG's share of the federal budget.

Abstract

The Central Bank of Iraq's (CBI) dollar auction has been a continuous source of controversies and conspiracy theories. The main accusations facing it include: the siphoning of dollars to Iran, money laundering, and currency smuggling. Missing from this melee is an understanding of the economy's key structural imbalances: mainly that the Iraqi economy is wholly dependent on oil export revenues, and demand for goods and services is met through imports handled by a largely informal private sector. Consequently, the government's oil revenues are the economy's major source of dollars, and the private sector depends on the auction as a significant source of dollars to pay for these imports. As such, it is the inherent imbalances in the economy's structure that led to contradictory and unsustainable compromises within the functioning of the auction, and not unsubstantiated conspiracies.

This piece aims to demystify the role and the functioning of the auction. It does so through reviewing (1) the oil and dollar lifecycle within Iraqi economy, (2) the private sector's dollar supply-demand dynamics, and (3) the causes of the currency's upheavals in November 2022, and their aftermath. It concludes that the measures undertaken in response to the upheavals have helped resolve most of the compromises that bedeviled the dollar auction in the past. However, lasting change requires addressing the economy's structural imbalances head-on through implementing fundamental economic reforms centred around redefining the oversized role of the government in the economy and society.

Acknowledgments

The information in this piece is based on publicly available data on web sites, publications, presentations, and research reports as will be seen from the footnote references. In particular a number of sources were critical; these include the IMF's Article IV Consultation Reports with Iraq 2004-23, the Central Bank of Iraq's (CBI) statistical data and reports, the writings ex-governor of the CBI Dr Ahmed Ibraihi Ali, annual audits of the Development Fund for Iraq (DFI) and its successor accounts held at Federal Reserve Bank of New York (FRBNY) 2003-19, as well discussions with colleagues in the banking system and sector who wished to remain anonymous. The analysis, however, is the author's own and reflects his views and outlook.

Furthermore, the author would like to express his gratitude to colleagues and friends at the London School of Economics' (LSE) Middle East Centre, in particular Professor Toby Dodge, Robert Lowe, Professor Michael Mason, Jack McGinn, Salma Moustafa Khalil, and the layout and typesetting team. Finally, the author would like to express his gratitude to Sarah Mustafa of Baghdad Business School for working on the diagrams within the piece that helps in simplifying some of the complex aspects of the piece, and to the anonymous peer reviewers who have enhanced the piece.

All errors, omissions and mistakes are the author's own.

Executive Summary

The state's oversized role in the economy and society has been persistently enlarged though successive budgets since 2003. This enlargement came at the expense of much needed spending on public infrastructure, destroyed by over four decades of conflict. This misspending and the state's continued direct and indirect control of major economic activities contributed to the erosion of the country's traded goods and services sectors. The result is an economy largely dependent on government spending, either directly through the state's provision of goods and services or indirectly through the public sector payroll. While, domestic needs of goods and services are mostly met through imports, managed by a largely informal private sector.¹

The most significant dollar inflows to the economy come from the state's oil export revenues, which determine the government's expenditure decisions, which effectively power domestic consumption of goods and services. The dollar auction serves to channel government sourced dollars to meet the private sector's demands to pay for imports. Although the evolution of the economy increased the sources of dollars for the private sector, the auction's volumes are still the most significant and have a meaningful bearing on the relationship between the official and parallel market exchange rates. However, the crucial role of the auction has been complicated by the inherent contradictions resultant from the informal sector utilisation of the auction, both directly and indirectly, to formally access dollars.

The implementation of the November 2022 procedures and the subsequent measures introduced by the government and the CBI, have led to a significant evolution of the auction, and ultimately to its end, in the present form, sometime in 2024. However, these measures do not alter the reality that oil exports continue to be the most significant source of dollars for the economy or that domestic consumption is dependent on the imports of goods and services, mostly provided by the private sector. The auction's significance can only be changed by gradually shrinking the state's footprint in the economy, while laying the foundations for a private sector led traded goods and services sectors and a diversified economy.

¹ The author has written extensively on the role of the Iraqi state in the economy and society, and on the economy's structural imbalances. See Ahmed Tabaqchali, 'How Demographics Erode the Patronage Buying Power of Iraq's Muhasasa Ta'ifia', *Arab Reform Initiative*, 30 July 2020. Available at: <https://www.arab-reform.net/publication/how-demographics-erode-the-patronage-buying-power-of-iraqs-muhasasa-taifia/> (accessed 25 October 2023); Ahmed Tabaqchali, 'The Accounts that Didn't Bark: Iraq's Hidden State Balances', *LSE Middle East Centre Blog*, 16 July 2020. Available at: <https://blogs.lse.ac.uk/mec/2020/07/16/the-accounts-that-didn-t-bark-iraqs-hidden-state-balances/> (accessed 25 October 2023); Ahmed Tabaqchali, 'Will COVID-19 Mark the Endgame for Iraq's Muhasasa Ta'ifia?', *Arab Reform Initiative*, 24 April 2020. Available at: <https://www.arab-reform.net/publication/will-covid-19-mark-the-endgame-for-iraqs-muhasasa-taifia/> (accessed 25 October 2023); Ahmed Tabaqchali, 'Iraq's Investment Spending Deficit: An Analysis of Chronic Failures', *Institute of Regional and International Studies (IRIS)*, December 2018. Available at: https://auis.edu.krd/iris/sites/default/files/Investment_Spending_Deficit_Final_for_Publication.pdf (accessed 25 October 2023).

The Oil, Dollar, and Dinar Cycle

The oil, dollar and dinar cycle starts with oil exports. The State Oil Marketing Organisation (SOMO) arranges and invoices for the sales of oil and oil related products in US dollars.² The revenues from these sales are deposited by buyers into the Oil Proceeds Receipts Account (OPRA) at the Federal Reserve Bank of New York (FRBNY) – which is an account held, and managed, by the Central Bank of Iraq (CBI) on behalf of the federal Ministry of Finance (MoF).³ These funds are transferred to the MoF's foreign currency account held at the CBI, which it uses to carry out the government's expenditures as set in the budget: either externally in dollars or other currencies, or domestically in Iraqi dinars (IQD) (‘I’ in Diagram 1).⁴ The MoF's fulfilment of the government domestic expenditures in dinars follows the conversion of dollars to dinars, which takes place in the form of sales of these dollars to the CBI,⁵ in return for dinars purchased from the CBI at the official

² SOMO is the marketing arm of the federal Ministry of Oil (MoO) and is the entity solely responsible for the exports and invoices of federal oil and oil products, but will likely have its remit extended to include the KRG's oil exports and invoices. This follows a ruling of the Federal Supreme Court (FSC) in February 2022, the International Chamber of Commerce (ICC)'s ruling on Iraq's arbitration case against Turkey over the Iraq-Turkey Pipeline (ITP) Agreements in March 2023, and the federal budget law for 2023–5 in June 2023. Ben Van Heuvelen et al, ‘Budget stalemate threatens Kurdistan's solvency and stability’, *Iraq Oil Report*, 12 September 2023. Available at: <https://www.iraqoilreport.com/news/budget-stalemate-threatens-kurdistan-solvency-and-stability-46039/> (accessed 29 January 2024). Ahmed Tabaqchali, ‘The KRG's Financial Conundrum: Bad Things Come in Threes’, *The Institute of Regional and International Studies (IRIS)*, October 2022. Available at: <https://auis.edu.krd/iris/sites/default/files/IER6-Formatted%20report%20-%20Oct%2019.2022.pdf> (accessed 16 July 2023).

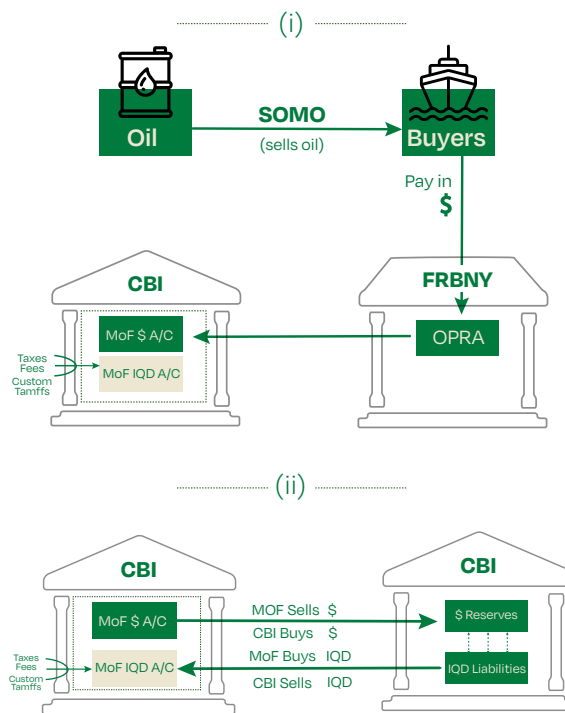
³ Crude oil sales include those sold on behalf International Oil Companies (IOCs) to cover their production fees according to the terms of their service level agreements signed with the federal Ministry of Oil (MoO), and as such the revenues from these exports go directly to the IOCs. Data on the revenues flows of federal oil exports are based on audited reports of the Development Fund for Iraq (DFI) and its successor accounts held at FRBNY. Audited reports for 2003–9 are published by the International Advisory and Monitoring Board (IAMB), available at: <http://www.iamb.info/> (accessed 16 July 2023), and for 2010–present by the Republic of Iraq's Committee of Financial Experts (COFE) website at: <https://www.cofe-iraq.iq/new/en/> (accessed 30 March 2022). However, COFE's website licence expired on 9 April 2023 and the site is unavailable, but audited reports for 2009–18 are available at the Iraq section of the Extractive Industries Transparency Initiative (EITI)'s web site, available at: <https://eiti.org/documents/financial-statements-development-fund-iraq-dfi-and-successor-accounts> (accessed 16 July 2023).

⁴ Notes: (1) Not all oil revenues in dollars are converted to dinars, some stay in MoF's dollar account with the CBI to fulfil the government foreign obligation such as the payment of debt, or to pay for the government's imports. (2) Until 2022, 95% of these funds stayed in the account, while 5% were transferred to the Kuwait Compensation Fund – which was established in accordance with UN Security Council Resolution 687 and subsequent relevant resolutions, as reparation for the Iraqi invasion of Kuwait. Payments were suspended between October 2014 and April 2018, given Iraq's budgetary constraints following the ISIS conflict and the crash in oil prices. The last payment was made in mid-January 2022, and after which 100% of the revenues from oil sales stayed in the fund.

⁵ The dollars purchased by the CBI are held in its account with the FRBNY and become part of its foreign reserve. These are either kept there or transferred, wholly or partly, into accounts held with other foreign central banks, foreign banks or used to buy foreign sovereign bonds or gold. As of the end of 2021, the composition of the CBI's foreign reserves was 48% in foreign sovereign bonds, 26% in accounts held with foreign banks, 12% in accounts with foreign central banks, 9% in gold, 3% in IMF's Special Drawing Rights (SDRs), and 3% in foreign currencies in cash (mostly dollars) held in the CBI's vaults. See Central Bank of Iraq, ‘Central Bank of Iraq, Financial Statements, 31 December 2021’, *Central Bank of Iraq*, 31 December

exchange rate.⁶ As such there are no changes in the total value of MoF bank accounts, but their composition changes. Simultaneously, the CBI's foreign reserves increase by the value of dollars purchased. This value is balanced by the liabilities incurred by the dinars it issued and sold to MoF ('ii' in Diagram 1).⁷

Diagram 1: Oil, Dollar, and Dinar Cycle



Note: The diagram is a simplistic illustration, and not a full explanation of a complex process

The government's oil revenues are supplemented by other sources of revenue, such as taxes and custom tariffs, which are collected and deposited in dinars. During periods of revenue deficits, either due to drops in oil prices or in case of expansionary budgets,⁸ the government resorts to domestic and international borrowing to sustain its expenditures.⁹

2021. Available at: <https://cbi.iq/static/uploads/up/file-165459076478337.pdf> (accessed 16 July 2023).

⁶ The official exchange rate at the time of writing is \$1 = IQD 1,300.

⁷ Crucially, unlike current misconceptions, the CBI's foreign reserves are not the proceeds of the country's oil sales but are created when MoF converts oil sales in dollars into dinars. The proceeds of the country's oil sales are the funds that are deposited into MoF's dollar account by the buyers of the oil, and then are held either in MoF's dollar and dinar accounts at the CBI.

⁸ See footnote 15 for more information and links.

⁹ In 2015–7 crises associated with the conflict with the Islamic State (ISIS) and the crash in oil prices led to the government borrowing IQD 50.9 trillion, of which IQD 38.2 trillion was domestic and IQD 13.7 trillion was international. In 2020, the government borrowed IQD 25.9 trillion domestically. See Central Bank of Iraq's Economic and Statistical Data web site, available at: <https://cbiraq.org/Default.aspx> (accessed 16 July 2023); International Monetary Fund (IMF) Iraq 2004–22 Article IV Consultation Staff Reports, available at: <https://www.imf.org/en/Countries/IRQ> (accessed 25 October 2023). The effects of domestic borrowing on the dinar money supply and domestic economic activities were discussed in: Ahmed Tabaqchali, 'Economic Roundup: What the Pandemic Tells Us About Future Growth & Volatility, Institute of Regional

Foreign debt, once received, is converted into dinars, in the same manner as oil revenues. Meanwhile, domestic borrowing involves the deposits of dinars into MoF's dinar account, which almost invariably are newly created dinars.¹⁰

The MoF transfers funds from its dinar account into the accounts of other government ministries and budget entities according to federal budget allocations.¹¹ These payments are used to pay public sector salaries and pensions, social welfare, the country's extensive subsidies, domestic investment projects, and domestic debt servicing. Subsequently, these dinars add to the money supply, i.e., money circulating in the economy, supplemented by newly created dinars from the issuance of credit by banks to both the private and the public sectors.¹²

The dinars circulating in the economy are used in domestic economic transactions for the consumption of goods and services, including retail, services, transportation, and hospitality sectors. As a consequence of the country's small traded-goods sector, the demand for consumable goods is largely met by imports, which are mostly invoiced and traded in dollars, requiring the conversion of dinars back to dollars, increasing the dollar demand.¹³

and International Studies, February 2022. Available at: <https://auis.edu.krd/iris/sites/default/files/The%20Iraq%20Economic%20Review%20Feb.%202022.pdf> (accessed 16 July 2023).

¹⁰ The government's domestic borrowing is mostly either (1) in the form of loans directly from the three largest state-owned banks (SOBs) Rafidain, Rasheed and the Trade Bank of Iraq (TBI); or (2) in the form of issuing Treasury Bills (T-Bills). The government's borrowing from SOBs is effectively the creation of new dinars by the SOB's who would then credit the MoF's dinar account in the same manner as any borrowing from banks involves the creation of new money. T-Bills are mostly bought by SOB's, with some bought by state pension funds and small amounts by private sector banks, and are paid for using the funds available to these institutions, and as such do not involve the creation of new dinars. Nevertheless, the process of indirect monetary financing by the CBI in discounting these bills from SOBs is a creation of new dinars that become part of the money supply. As of mid-December 2023, the government had IQD 47.7 trillion in T-Bills of which 89.3 percent were held by the CBI.

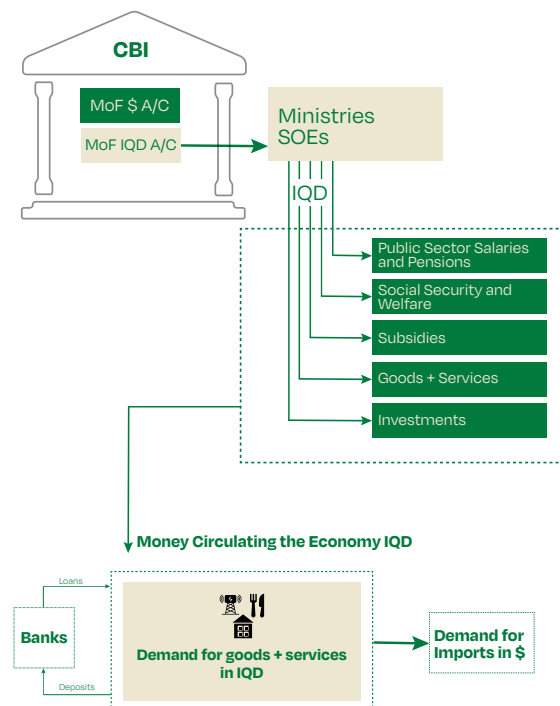
¹¹ For more information about Iraq's state budgets see: Ahmed Tabaqchali, 'Gone with the Muhasasa: Iraq's static budget process, and the loss of financial control', *Atlantic Council*, 6 January 2021. Available at: <https://www.atlanticcouncil.org/in-depth-research-reports/report/gone-with-the-muhasasa-iraqs-static-budget-process-and-the-loss-of-financial-control/> (accessed 16 July 2023).

¹² See: The Emergency Cell for Financial Reform, 'The White Paper for Economic Reform: Vision and Key Objectives', Emergency Cell for Financial Reform, *Government of Iraq*, 22 October 2020. Available at: <https://gds.gov.iq/ar/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/> (accessed 31 December 2022); Unofficial translation in English is published by Iraqi Economists Network on their web site. Available at: <http://iraqieconomists.net/en/2020/10/19/iraq-white-paper-complete-english-translation/> (accessed 16 July 2023).

¹³ The economy's high levels of dollarisation means that in addition to dinars, (existing) dollars are used as medium of exchange for the domestic consumption of both goods and services, i.e., existing dollars circulating in the economy in the form of physical dollars in safes and dollar denominated bank accounts. Foreign currency deposits as of 30 October 2023 were IQD 28.3 trillion (or \$21.8 billion), constituting 34.0 percent of all deposits held by the private sector and self-financing public sector entities including State-Owned Enterprises (SOEs). While there are no figures available on the amounts of physical dollars held in the economy, given that the physical dinar notes held by the public (outside the banking system) are IQD 93.1 trillion (\$71.6 billion), then a similar percentage to that of foreign currency deposits would imply that there is the equivalent of IQD 31.6 trillion (\$24.3 billion) in physical dollar notes in the economy. However, given the low levels of banking penetration, and the widespread informality, the actual figure is likely to be meaningfully larger. Data as of the end of October 2023. Source:

Furthermore, while some service provisions are satisfied locally, such as health services, education, transportation, auto repairs and so on, other services are consumed internationally such as tourism, university education, medical care, and so on. These services are conducted in local currencies requiring the conversion of dinars to dollars then to local currencies where the service is being provided. Similarly, private sector funding for international investments requires the conversion of dinars to dollars.

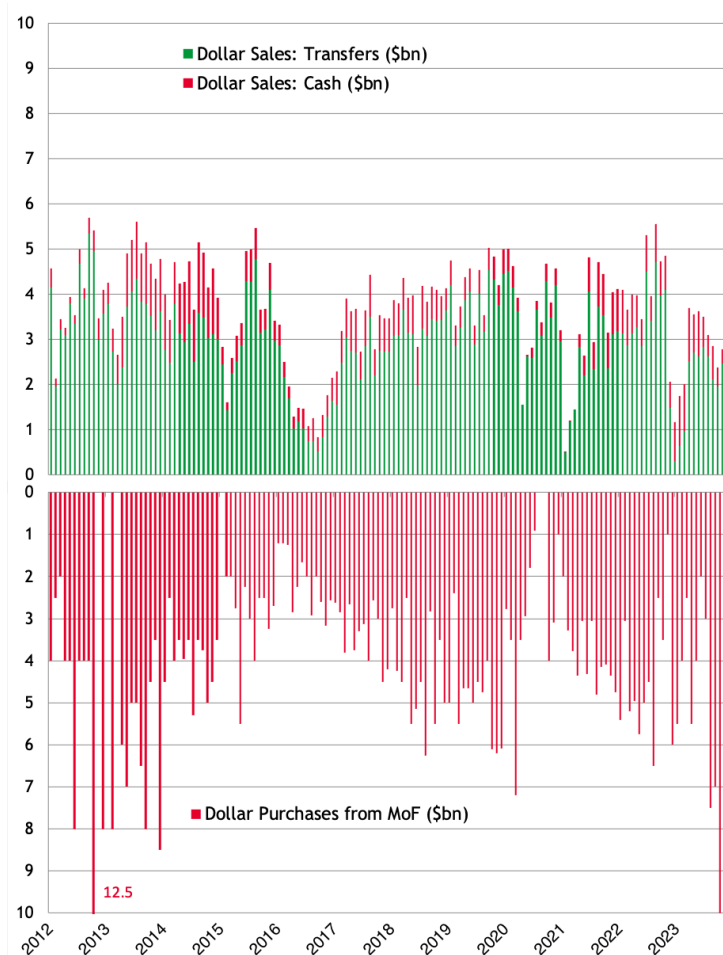
Diagram 2: Money Circulating in the Economy and Demand for Dollars



Note: The diagram is a simplistic illustration, and not a full explanation of a complex process

The CBI's 'Foreign Currency Selling Window', better known as the 'Dollar Auction' (auction henceforth), facilitates the conversion of dinars into dollars. The private sector, applying through the banks, sells dinars to the CBI in exchange for dollars from its foreign reserves at the official exchange rate. This is the reverse of the exchange that takes place between CBI and MoF; and so, it too is neutral for the CBI where the reduction of its foreign reserves through the sale of dollars is matched by equal decline in its dinar liabilities through the dinars it purchased, thus they cancel each other out. However, the essential difference between the two processes is that the CBI's purchases of dollars is initiated by MoF, while the CBI's sales of dollars are initiated by the private sector. As such, time lags and the different decision dynamics of each means that the two are not balanced on a month to month basis, but have been consistent over the 2012–23 period (Figure 1). The CBI's dollar transactions (Figure 1) affects the foreign reserves, where reserves increase if its purchases of dollars from MoF are higher than its sales of dollars at the auction, while the reverse leads to a decline in its reserves.

Figure 1: CBI's Monthly Purchases and Sales of Dollars



Source: CBI, data as of 4 January 2024.¹⁴

These monthly variations mean that in any one year the change in CBI reserves is neither equal to, nor in the same direction of, the net dollar flows. Indeed, over 2012–23 the dollar supply exceeded dollar demand leading to increases in reserves in 2012–13, 2017–19, and in 2021–22. Meanwhile, the reverse happened in 2014–16, and in 2020 when the government resorted to domestic borrowing to sustain its expenditures (Table 1).¹⁵

¹⁴ CBI Economic and Statistical Data. Available at: <https://cbiraq.org/> (accessed 31 January 2024).

¹⁵ The need for borrowing in these years was a consequence of sharp falls in oil revenues. A similar need for borrowing is likely to take place in 2024–5, but that would be driven by the government expansionist's policies as expressed in the three-year federal budget for 2023–5, and not by declines in oil revenues. Ahmed Tabaqchali, 'Debt and the Ides of March: An Overview of Iraq's 2023 Federal Budget Proposal', *LSE Middle East Centre Blog*, 8 May 2023. Available at: <https://blogs.lse.ac.uk/mec/2023/05/08/debt-and-taxes-of-what-can-we-be-certain-in-iraqs-2023-federal-budget/> (accessed 16 July 2023).

Table 1: Yearly Dollar Purchases, Sales, and Foreign Reserve Changes 2012–23

Year	CBI Auction Dollar Sales: Cash (\$bn)	CBI Auction Dollar Sales: Transfers (\$bn)	Total CBI Auction Dollar Sales: (\$bn)	CBI Dollar Purchases from MoF (\$bn)	Dollar Purchases less Sales (\$bn)	CBI Reserves Change (\$bn)
2012	3.7	45.0	48.6	57.0	8.4	8.0
2013	12.2	41.0	53.2	62.0	8.8	8.8
2014	14.6	37.2	51.7	47.5	-4.2	-11.3
2015	6.0	38.3	44.3	32.5	-11.9	-13.2
2016	4.7	15.7	33.5	25.7	-7.9	-8.6
2017	9.4	31.4	42.2	40.4	-1.8	3.9
2018	8.8	38.3	47.1	52.2	5.1	15.4
2019	5.8	45.4	51.1	58.9	7.7	3.8
2020	3.4	40.7	39.7	30.7	-9.0	-13.6
2021	6.6	30.5	36.9	46.0	9.1	9.8
2022	9.1	37.7	46.8	53.4	6.5	32.8
2023	8.4	24.9	35.4	64.0	28.6	14.9
Total	92.5	426.1	530.8	570.1	39.4	50.8

Source: CBI, data as of 31 December 2023.¹⁶

Throughout 2012–3 the total supply of dollars was \$570.1 billion, higher by \$39.4 billion than demand at \$530.8 billion, while CBI reserves increased by \$50.8 billion. This is because the auction is just one of the avenues of interaction between Iraqis and the rest of the world. Other avenues include trade, income flows, investment flows, capital and financial transactions – all of which are captured in the country’s balance of payments (BoP) statement. The dinar’s peg to the dollar, means that ultimately interactions with the rest of the world, including the auction, are balanced out through changes in reserves – with reserves increasing if its interactions lead to a surplus for Iraq, and decreasing in the case of a deficit.

The Auction, Access to Dollars, and Exchange Rates

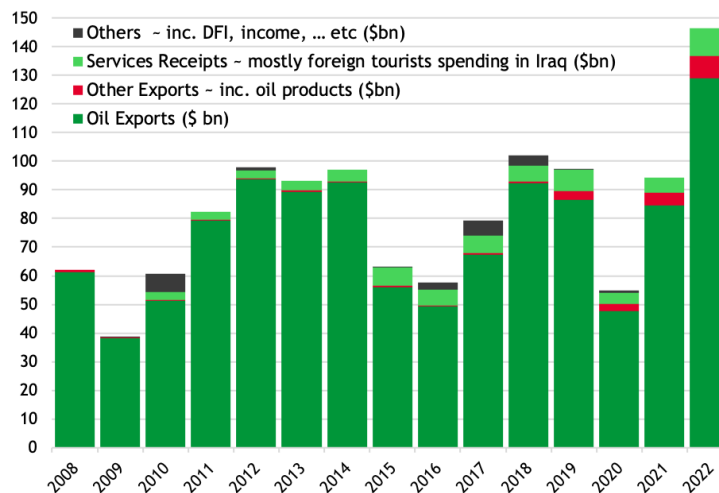
The CBI introduced the auction in late 2003 to stabilise the exchange rate of the dinar versus the dollar, and as a means of supplying the private sector with dollars. By early 2004, the arrangement evolved into a de facto peg of the dinar to the dollar and the establishment of an official exchange rate.¹⁷ The auction was, and remains, the most significant source of dollars for the private sector given that most of the dollars flowing to the country are those from the government’s oil exports (Figure 2). Consequently, the auction is essentially a means for Iraq’s compliance with its obligations under Article VIII of the ‘Articles of Agreement’ signed with the IMF, which essentially translates to ensuring

¹⁶ CBI Economic and Statistical Data. Available at: <https://cbiraq.org/> (accessed 31 December 2023).

¹⁷ The CBI started conducting dollar auctions on a daily basis on 4 October 2003 with the exchange rate of the dinar largely set by bids in the auction, but by early 2004 the CBI began to announce the exchange rate of the dinar in advance. As such the auction ceased to be an auction. The CBI renamed the ‘auction’ as the ‘Window for Selling Foreign Currency’, but the designation ‘auction’ stuck. By buying dinars in exchange for dollars, the auction has the added benefit of absorbing excess liquidity in the economy and thus automatically tightening the dinar money supply and controlling inflationary pressures. For more information, see: Malath Faeq Majeed, ‘The Role of the Currency Sale Window in Stabilizing the Exchange Rate of the Iraqi Dinar’, *International Journal of Research in Social Sciences and Humanities* 9/IV, 2019. Available at: https://www.ijrssh.com/admin/upload/18_Malath_Faeq_Majeed.pdf (accessed 28 October 2023); ‘Iraq: Article IV Consultation Reports 2004-23’, *International Monetary Fund (IMF)*. Available at: <https://www.elibrary.imf.org/search?pageSize=10&q2=Iraq+Article+IV&sort=relevance> (accessed 16 July 2023).

an unrestricted access to dollars for cross-border transfers for all at the same rate.¹⁸ Specifically, the article includes an undertaking not to impose restrictions on cross-border transfers, and not to engage in discriminatory currency arrangements or multi-currency practices, without the IMF's approval.¹⁹ Article VIII's purpose is to avoid the economic distortions resulting from varying import costs for goods and services due to different exchange rates, which in turn gives a competitive advantage, and rent-seeking practises, for those who have access to the preferential exchange rate at the expense to those don't. Moreover, a restricted access to the preferential rate is equivalent to a subsidy or a preferential treatment for those who have such an access.²⁰

Figure 2: Yearly Dollar Inflows to Iraq



Source: IMF, data as of end of 2022.²¹

Consequently, the auction provides dollars in exchange for dinars at the official exchange rate to meet all private sector demands as long as they satisfy the CBI's requirements to ensure compliance with the provisions for countering financial crime, anti-money laundering and those for countering the financing of terrorism (AML/CFT), sanctions compliance (SC), and financial crime (FC) (collectively henceforth 'AML/CFT/SC/FC provisions'), in addition to complying with Iraqi regulations. Private sector demand

¹⁸ Iraq was a founding member of the IMF and is one of 27 original members of the Fund represented at the United Nations Monetary and Financial Conference whose governments accepted membership before 31 December 1945. However, it had little official contact with the fund between 1983 and 2003, but resumed contact following the US invasion in 2003. Articles of Agreement of the International Monetary Fund are available at: <https://www.imf.org/external/pubs/ft/aa/index.htm> (accessed 16 July 2023). IMF list of members is available at: <https://www.imf.org/external/np/sec/memdir/memdate.htm> (accessed 16 July 2023).

¹⁹ Article VIII's general obligations of members include 6 obligations, which aim to promote the free convertibility of the currencies of the IMF's member states for the payments and transfers for current international transactions. The relevant parts of the two items cited in the main text above are: '... no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions' and '... No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorised under this Agreement or approved by the Fund.'

²⁰ For more information on rent-seeking behaviours see: Sebastián L. Mazzuca, 'Rent Seeking', *Britannica Money*. Available at: <https://www.britannica.com/money/rent-seeking> (accessed 25 October 2023).

²¹ BoP statements. IMF, 'Iraq: Article IV Consultation Reports 2004-23'.

for dollars comes from the need for physical dollars by Iraqis travelling abroad; and for cross-border transfers/payments to effect payments for the imports of goods and services, and other transfers.²² As such the auction consists of two sections: the first is for the provision of physical dollars (red bars in upper half of Figure 3); and the second for cross-border transfers (green bars in upper half of chart 4). The cross-border transfers section processes two types of transfers, the first are Letters of Credit (LCs), while the second are wire-transfers.²³ The essential difference between the two is that LCs generally involve four parties in the exchange of goods – the importer, exporter, and their respective banks – while wire transfers involve the importer and exporter. The involvement of banks in LCs makes them more secure and less prone to fraud and corruption than wire transfers, because banks – generally and depending on their domicile and international footprint – are subject to extensive local, and international, regulatory oversight covering AML/CFT/SC/FC provisions.²⁴

However, not all private sector demand for dollars satisfies the CBIs requirements, while others choose not to go through the auction. This demand is met at parallel market exchange rates, which are at a premium to the official exchange rate,²⁵ from sources other than the auction.²⁶ In such cases, physical dollar transactions take place through counters of domestic commercial banks, and money exchange bureaus (MEBs), while cross-border transfer transactions go through commercial banks and money transfer companies (MTCs). Cross-border transfers through commercial banks are conducted using the banks' own resources through their correspondent banking relationships with international banks.²⁷ Similarly, cross-border transfers through MTCs are conducted using the MTCs' relationships and resources with MTCs outside Iraq. The key difference between the two is that transactions through banks involve the formal banking system which are subject to global AML/CFT/SC/FC provisions, while those going through MTCs are conducted through the informal and lightly regulated Hawala system as will be explained in a later section. One of the main reasons that some private sector demand do not to go

²² These include transfers to purchase assets abroad, family support payments including those for students or medical treatments, transfers of proceeds property sales or rents, proceeds of asset sales, as well the proceeds (capital, profits, dividend income) of foreign investment in Iraq (foreigners or Iraqis living abroad).

²³ Julia Kagan, 'Letter of Credit: What It Is, Examples, and How One Is Used', *Investopedia*, 2 May 2023. Available at: <https://www.investopedia.com/terms/l/letterofcredit.asp> (accessed 16 October 2023).

²⁴ Wire transfers and the misconceptions over fraud and corruption in their operations are reviewed in a later section.

²⁵ The exception was the period following the devaluation of the dinar versus the dollar in late December 2020 when the parallel market exchange rate traded at a discount to the official exchange rate as the market believed that the devaluation would be reversed. However, after the passage of the 2021 budget into law in late March, which was based on the devalued exchange rate, the parallel market exchange rate traded at a premium once again.

²⁶ Some of the dollar demand that are met through sources other than the auction, ultimately go through the auction using opaque routes, such as the *hawaladar* route, described later.

²⁷ For information about correspondent banking see: Will Kenton, 'Correspondent Bank: Definition and How It Works', *Investopedia*, 2 May 2023. Available at: <https://www.investopedia.com/terms/c/correspondent-bank.asp> (accessed 16 July 2023).

through the auction, and acquire dollars at the more expensive parallel market exchange rate, is the onerous documentations for compliance with Iraqi regulations. For example, in the case of importers, compliance with Iraqi regulations include those that require banks to submit each auction transfers' data to the customs and tax authorities, which until recently also required upfront tax down-payments on the value of imports associated with each cross-border transfer.²⁸

The parallel market rates disseminated through media coverage, official sources, as well as international reports, are those of the exchange rate of physical dollars, which differ from those for two cases of cross-border transfers (i.e. those through banks and MTCs). The disparity between the parallel market exchange rates are due to the particular dynamics specific to each, as well the supply-demand dynamics for dollars. Preliminary research suggests that the rate for physical dollars and for cross-border transfers through banks were almost the same between 2012–5, but were in range of +/- three percent until early 2023.²⁹ This paper uses the physical dollar exchange rate as a proxy for all parallel exchange

²⁸ The Iraqi company tax income rate is 15% for all companies with the exception of oil related companies which are taxed at 25%. However, one of the peculiarities of the tax system relates to how the tax authorities consider net income, in that authorities publish a yearly list which assigns a certain net income percentage figure (i.e. an assigned net income as a percentage of revenues) for each business category; however these percentages can be, and in fact are, different from the actual net income as a percentage of revenues for each company in any business category. Nevertheless, the tax authorities apply the 15% company income tax on the maximum of the real net income or the assigned net income. Companies can appeal the General Commission of Taxes (GCT)'s assessment; however, the process is extremely onerous, time consuming and crucially the Iraqi generally accepted accounting standards are subject to varying interpretations. Consequently, many companies choose not to appeal, or falsify their records in order to pay lower taxes or choose to operate informally. The GCT imposes a 3% flat rate on the value of imports as part of the pre-assessment mechanism, which can be offset against income or corporate tax. While customs duties are levied by the Customs Directorate/Commission and paid at source. The auction's requirement was that banks conducting cross-border transfers through the auction should report each transfer to both commissions, with the GCT imposing its fees based on the value of the transfer; while the value of imports would be recorded in the company's record at the GCT. This last requirement, and the CGT's procedures described above have acted as a major barrier for many in the private sector who would legitimately access the auction at the official exchange rate but find it more cost effective and convenient to access dollars through the banking system at the parallel exchange rate (obviously, this was when the delta was around 1–2%, but the higher delta meant that the cost of complying with the GCT's requirements described above is cheaper than paying the higher delta). Other companies have opted to operate informally and transfer funds through MTCs. Sources: Discussions with Iraqi tax and customs experts and accountants, who asked to remain anonymous; PEFA Secretariat, 'Public Expenditure and Financial Accountability (PEFA)', PEFA Secretariat, October 2017. Available at: <https://www.pefa.org/node/466> (accessed 16 July 2023). Sources: Discussions with Iraqi tax and customs experts and accountants, who asked to remain anonymous; PEFA Secretariat, 'Public Expenditure and Financial Accountability (PEFA)', PEFA Secretariat, October 2017. Available at: <https://www.pefa.org/node/466> (accessed 16 July 2023).

²⁹ The data for the parallel market rate used in this piece is that of cash dollars, which are ultimately sourced from multiple exchange houses in Baghdad. These rates were published by the CBI before it stopped publishing parallel market rates in early February 2023, and subsequently data published by the Central Statistical Centre (CSO) until the end of 2023, and in January 2024 from the 'Biesh El Dollar' app. Available at: <https://cbi.iq/news/view/1270> (accessed 8 February 2023) and https://cosit.بيش_الدولار

rates to be consistent with the publicly disseminated exchange rates and crucially the consistently available parallel exchange rates for physical dollars.

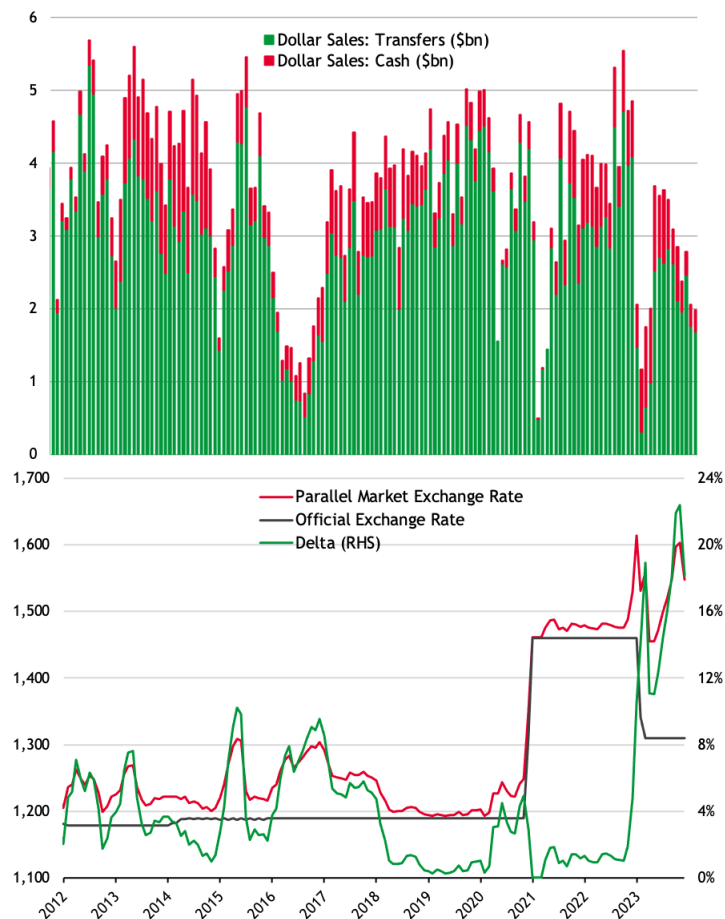
The parallel and official exchange rates are effectively a single unified exchange rate when the premium, or delta (henceforth delta), of the parallel market exchange rate over the official exchange rate, is under 2% (green line in lower half of Figure 3).³⁰ The IMF notes that there is no mechanism to ensure that the delta is under 2%, and so the CBI can only aim for a single unified exchange indirectly.³¹ The CBI does this through controlling the amounts of dollars it makes available at the auction, which increases or reduces the dollars available at the official exchange rate relative to dollars available at parallel market rates (from sources outside the auction) (later section and Figure 4); and thus influences the delta. However, the delta is also significantly affected by factors outside the control of the CBI that influence the dollar-supply dynamics, such as the amounts of the government's oil revenues and its expenditures, the performance of the economy, as well the country's political and security situation. Between 2012–23 the average monthly delta was under 2% during periods with balanced supply-demand dynamics, and between 2–23% during periods marked by supply-demand imbalances (Figure 3).

gov.iq/ar/stat-index/index-number/2018-02-28-10-04-53 (accessed 30 January 2024). There are no published data on cross-border transfer parallel rates either through banks or MTCs, however discussions with a number of specialists across the sector has provided enough data to arrive at a useful proxy for cross-border transfer parallel rates for banks. The CBI in February 2023 mandated banks to conduct cross-border transfers through intermediary banks at the same rate as that at the auction, which ended the parallel market exchange rates for cross-border transfers through banks.

³⁰ The official exchange rate from late December 2020 was \$1 = IQD 1,450 but changed on 8 February 2023 to become \$1 = IQD 1,300. The CBI converts MoF's dollars into dinars at this exchange rate, but it charges a fee of IQD 10 per \$ when it sells dollars to the banks at the auction, and thus the effective official exchange rate is \$1 = IQD 1,310 (1,460 pre-February). The banks are allowed to charge their customers up to IQD 10 per \$ for access to dollars at the auction, and thus the rate for clients in the auction (whether cross-border transfers or cash) is \$1 = IQD 1,320 (1,470 pre-February). The calculations here, including figures and tables, use the effective official exchange rate, and thus the premium or delta is the difference between this rate and the parallel market rate.

³¹ The widespread informality, the country's dysfunctional bureaucracy, and outdated procedures and regulations for compliance with Iraqi regulations, act as de facto restrictions to foreign exchange access at the official rate through the auction, and as such there is demand for dollars that is unmet. Thus, this demand is met at sources outside the auction at parallel market exchange rates leading to ultimately multiple exchange rates. The IMF throughout its engagements with Iraq since 2003, consistently advised Iraqi authorities to reduce all restrictions to foreign exchange access at the official rate that would lead to multiple exchange rates. IMF, 'Iraq: Article IV Consultation Reports 2004-23'.

Figure 3: Monthly Auction Volumes versus Monthly Exchange Rates



Source: CBI, data as of 31 December 2023.³²

Private Sector Imports and Access to Dollars

Most of the misconceptions surrounding the auction arise from simplistic assumed connections between private sector imports and dollar sales at the auction, frequently using Iraqi customs data. However, Iraqi customs data in regards to the country's imports of goods lacks reliability, and does not capture imports through the Kurdistan Region of Iraq (KRI).³³ Even when accurate sources of data are used, the value of imports is often used

³² It should be noted that data points are averages of the daily closing prices of the exchange rates for a given month, and as such should not be confused with the daily closing prices used in other figures. CBI Economic and Statistical Data is available at: <https://cbiraq.org/> (accessed 31 December 2023).

³³ In IMF reports, the 'Statistical Issues' section notes that 'External trade data has serious timeliness and quality shortcomings, due to the absence of reliable customs data. A new customs form for imports is available but is not being used at the customs border due to the security situation and the lack of resources at the border outlets. The Automated System for Customs Data (AYSCUDA) is being implemented, but the pace remains slow. The compilation of external trade statistics has been hampered by a lack of inter-institutional coordination among key data providers.' It also notes 'The coverage of the external trade statistics excludes Kurdistan, and no estimates for smuggling are made'. IMF, 'Iraq: Article

without considering whether these include or exclude costs of insurance and freight.³⁴ However, irrespective of the quality of trade data, solely focusing on the imports of goods – even including added costs – provides only a partial picture of the dollar transfers through the auction, as it ignores dollar transfers that go through the auction that are for purposes other than trade. Many legitimate transfers include proceeds of real estate sales or rental income, personal transfers such as those for education, medical treatment or family support, proceeds of investments in Iraq (capital, profits, dividends), and finally Iraqis’ foreign travel expenses.³⁵ As such a fuller understanding of the auction needs to consider all of the private sector’s demand for dollars and the sources of dollars that are available to the private sector in addition to those through the auction.

It is possible to arrive at an overall picture, albeit incomplete given data limitations and gaps, of the private sector’s demand for dollars to pay for the imports of goods and services, and then comparing this demand to dollar sources that are available for the private sector both through and outside the auction.³⁶ Dollar sources available to the private sector other than those through the auction include: foreign visitor spending, transfers by foreign companies to meet their dinar operating expenses including salaries, or investments, and Iraqi remittances, among others.³⁷ This comparison between the private sector’s dollar supply and demand can be used to gauge the indirect effects of the auction’s dollar supply on the delta (Figures 4 and 5).³⁸

IV Consultation Reports 2004–23’. The exclusion of imports through the KRI means that Iraqi trade statistics data excludes the bulk of Turkish imports and high percentage of Iranian imports, both of which are among the top three of exports to Iraq in 2012–22.

³⁴ The two classifications of export data (value of exports) that are relevant here, are ‘Cost, Insurance, and Freight (CIF)’ and ‘Free on Board (FOB)’, in which the essential difference is that CIF adds the costs of insurance and freight. Christina Majaski, ‘CIF vs. FOB: What’s the Difference?’, *Investopedia*, 22 October 2022. Available at: <https://www.investopedia.com/ask/answers/020215/what-difference-between-cif-and-fob.asp> (accessed 16 July 2023).

³⁵ Although many of these transfers are for legitimate purposes, many go through the Hawaladar route which ultimately go through the auction as the *Hawaladar* settles these transactions through the auction (described later).

³⁶ The data used here is based on the BoP section of the IMF’s ‘Iraq: Article IV Consultation Reports 2004–23. The IMF under statistical issues section of the report notes major issues with the data, and notes that it continues to provide technical assistance to CBI to assess with data reliability. Complicating matters somewhat, a number of items in BoP’s current account data are reported as net (i.e., inflows minus outflow). Moreover, there are no numbers for informal trade or for smuggling. However, comparing the IMF’s data on total imports, private sector’s imports throughout 2012–22 versus the data in UN’s Comtrade data base (using mirror data, i.e., data as reported by countries exporting to Iraq) suggests that the IMF is adjusting for most of this gap in data.

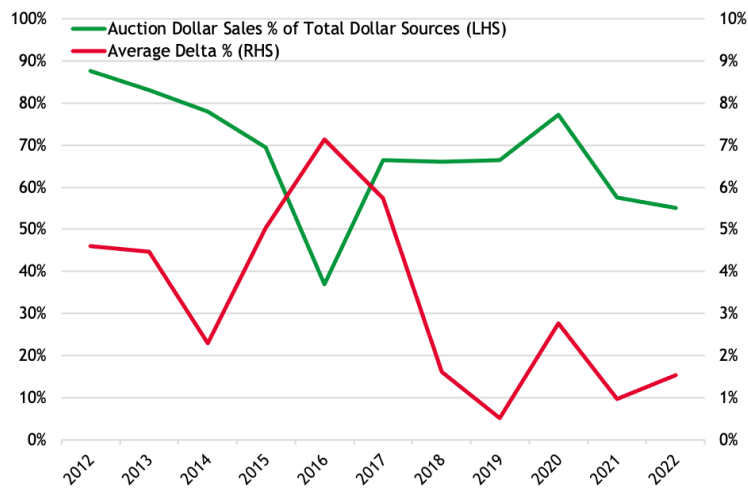
³⁷ Others (purple bars in second half chart of Figure 4) are calculated as the difference between all private sector demand; and supply for dollars as taken from the IMF’s BoP statements is used as a balancing item which can include using the dollar stock in the economy (see footnote 13 for more information on dollarisation of the economy). However, more research is needed on this, and will be covered in a future piece that will also look at the cash market, and the dollar stock in the economy.

³⁸ Data is based mostly on the BoP statements sections of the IMF’s ‘Iraq: Article IV Consultation Reports 2004–23, while auction sales are based on CBI data. An assumption is made that freight and insurance costs of imports are 15 percent as used by the CBI, and as such the services twin parts in the current account (i.e. receipts and payments) are adjusted accordingly. For others (purple bars in second half chart of Figure 4) see above footnote. Iraq’s BoP statements as provided in the IMF’s ‘Iraq: Article

Figure 4: Yearly Dollar Supply and Demand for the Private Sector



Figure 5: Yearly Auction Dollar Sales as Percentage of Total Dollar Supply and the Delta



Data as of the end of 2022.³⁹

IV Consultation Reports 2004-23'. Available at: <https://www.imf.org/en/Countries/IRQ>, and as provided by the CBI available at: <https://cbi.iq/news/view/725> (accessed 25 October 2023).

³⁹ Sources as in footnotes 36-8.

Essentially, irrespective of the data limitations, the data trends show that auction's dollar sales are consistent with the private sector's imports – crucially that the auction's cross-border dollar sales are less than the total costs of the private sector's imports (cost of goods plus freight and insurance); and that the auction's cash sales are less than the expenditures of Iraqi tourists. It also reveals that the overall evolution of the economy between 2012–22 has increased the availability of other sources of dollars for the private sector to meet its demand for imports.⁴⁰ However, the auction remains the most significant source of dollars to the private sector – and the only source at the official prices – more crucially its volumes influence demands for dollars at the parallel market's rates, consequently influencing the delta. This significance and the economy's structural imbalances have led to unsustainable compromises, arising from the need to accommodate two opposing dynamics. The first dynamic arises from the nature of the economy where transactions are both heavily dollarised and cash dominated, and where large informal sectors drive the bulk of economic activity.⁴¹ The second dynamic is the requirements for transactions conducted through the auction to comply with AML/CFT/SC/FC provisions – which can only be done effectively in an economy where banking transactions are the dominant norm, and not cash transactions. This can only be facilitated through the formal, not the informal, sector. In effect, addressing these opposing dynamics implies accommodating the contradiction of fulfilling the informal sector's demand for dollars through the formal mechanism of the auction. In other words, enabling the informal sector – which doesn't use the banking system – to access dollars formally through the auction using the banking system by indirect or alternative avenues.

These contradictions were likely accommodated through opaque payment structures utilising the lightly regulated *Hawala* system through MTCs who effect payments between a sender and a receiver of funds, as well as complicit banks who ultimately settle these payments as wire-transfers through the auction.⁴² Much of the workings of opaque wire-transfers came to light during statements by the prime minister and several of his advisors in the months following the currency's upheavals in November 2022 (reviewed in a later section).⁴³ Under such a hypothetical payment structure, an importer pays dinars

⁴⁰ The availability of other dollar sources has not been linear as the economy's evolution was impacted by periods of conflict and political uncertainty, and a series of financial crises with the last caused by the disruptions brought by COVID-19 in 2020.

⁴¹ The dollar is widely used as medium of exchange or legal tender alongside the dinar. For more information of dollarisation see: footnote 13, and Investopedia, 'Dollarization Definition, Impact, Example', *Investopedia*, 18 July 2022. Available at: <https://www.investopedia.com/terms/d/dollarization.asp> (accessed 15 July 2022).

⁴² Investopedia, 'What is Hawala? Money Transfer without Money Movement', *Investopedia*, 21 April 2023. Available at: <https://www.investopedia.com/terms/h/hawala.asp> (accessed 16 July 2023).

⁴³ Essentially, the revelations were that most wire-transfer instructions included forged invoices between the importer and exporter, made possible by complicit local banks, and MTCs, and as such failed the enhanced beneficiary disclosure requirements introduced by the CBI in November 2022. Moreover, in the past these were the conduit for the smuggling of dollars, especially to Iran in violation of US sanctions. The prime minister explained that currency smuggling was done through 'falsified invoices, and the money was coming out and being smuggled, and this is a reality, otherwise what would we have imported for \$300 million a day?' He added, 'Inevitably, this money was coming out of Iraq, and this

(equivalent to dollars at the parallel market rate) to an MTC which essentially functions as a *Hawaladar* (*hawala* broker) in Iraq. The *Hawaladar* then instructs a counterparty outside Iraq to pay an exporter in dollars or in equivalent local currency – with the *Hawaladar* counterparty likely to be located in a country different from that of the exporter. This is recorded as a debit and credit accounting entry between the *Hawaladars*, who would eventually settle this and other similar transactions through a lump sum transfer via the auction. This would require a fictitious import-export invoice, followed by the Iraq-based *Hawaladar* depositing dinars in a local bank, who in turn deposits them at the CBI. These are then processed as a dollar wire-transfer transaction in the auction, exchanged at the official exchange rate. Subsequently, the dollars are deposited into the local bank's account held at a bank outside Iraq, and further transferred to the counterparty *Hawaladar* in equivalent local currency or in dollars. Crucially, this transfer of dollars through the auction is made between the two *Hawaladars*, and not between the exporter and the importer who settled their transaction earlier.

Such a route is not only used by the informal sector, but likely used by a number of formal companies who seek to avoid the disclosure of the details of their imports or to avoid taxation.⁴⁴ Moreover, it is most likely the route by which payments are made for imports from countries on the global sanctions list, such as Iran and Syria.⁴⁵ This route is also used by individuals for payments such as the transfer of the proceeds of real estate sales or

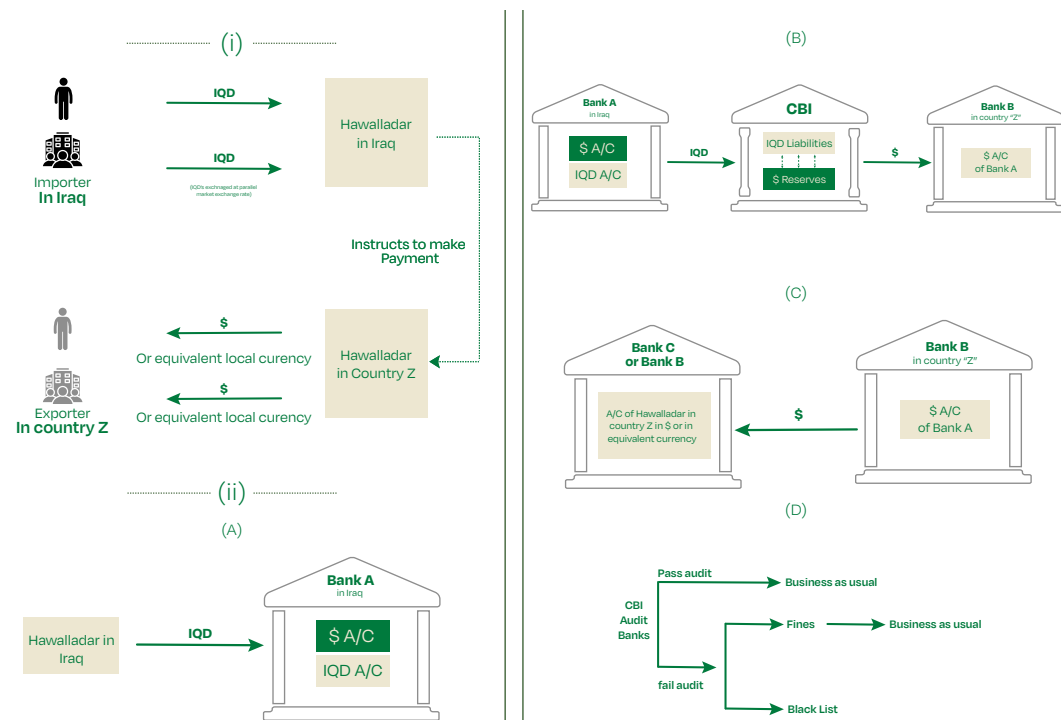
has been a chronic problem for years.' Mahmood Nabeel, 'Prime Minister: Yes, the Dollar was smuggled out of the Country with Forged Bills', *Al Sabah Al Jadeed*, 2 February 2023. Available at: <http://newsabah.com/newspaper/259671> (accessed 16 July 2023). Other comments with similar effect or providing more details: Al Mada Paper, 'Foreign Minister: The exchange rate crisis is on its way to a solution, and the national currency is still strong', *Al Mada Paper*, 21 February 2023. Available at: <https://almadapaper.net/view.php?cat=283990> (accessed 16 July 2023); NAS News, 'A Statement from the PM Advisor Regarding the Electronic Platform for External Transfer', *NAS News*, 19 April 2023. Available at: <https://www.nasnews.com/view.php?cat=105932#> (accessed 16 July 2023). Moreover, numerous research pieces on these revelations by the above advisor, and other economic experts, including an advisor to the CBI appear on the web site of Iraqi Economists Network, available at: <http://iraqieconomists.net/ar/> (accessed 16 July 2023).

⁴⁴ See footnote 28 on the issues with taxation and the auction.

⁴⁵ The private sector's imports of goods and services from Iran were discussed in a separate piece by the author: Ahmed Tabaqchali, 'The Dinar, and the Conundrum over the Dollar and Iran', *LSE Middle East Centre Blog*, 15 August 2023. Available at: <https://blogs.lse.ac.uk/mec/2023/08/15/the-dinar-and-the-conundrum-over-the-dollar-and-iran/> (accessed 15 October 2023). The need to finance trade with Iran and Syria was provided by comments from a CBI official during a conference stating 'The Central Bank of Iraq does not have a problem with the supply of the dollar, but the problem is with the demand, as we have a large volume of trade with countries that have restrictions regarding the dollar, including the Islamic Republic of Iran, with which the country's trade touches 10 billion dollars, and Turkey, with which our trade ranges between 12 - 10 billion dollars, as well as Syria, with which we have a volume of trade that requires dollar amounts, which raises the demand for dollars in the parallel market, due to the need for dollars to pay the dues of this trade, especially since it is not possible to grant dollars to any country that is prohibited from dealing in dollars.' The implication is that wire transfer may have been used to finance trade with Iran and Syria. Hussein Tmimi, 'Central Bank: The Rise in the Price of the Dollar is Due to the Large Volume of Trade with 3 Countries', *Al Sabah Al Jadeed*, 13 July 2023. Available at: <https://alsabaah.iq/80574-.html> (accessed 16 July 2023).

rental income, personal transfers such as those for education, medical treatment or family support and proceeds of foreign investments. Moreover, a very similar route, using the same mechanisms, was used for affecting cross-border transfers that could have been used to circumvent AML/CFT/SC/FC provisions as made clear in recent action by U.S. Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) of an Iraqi bank as ‘...a conduit for terrorist financing, as a foreign financial institution of primary money laundering concern’.⁴⁶ Finally, some of the physical dollars obtained through the auction’s cash section – for the Iraqis’ foreign travel expenditures – find their way back to the domestic market for payments in cash for imports of goods and services or other payments, however these would be much smaller than the *hawaladar* funded route due to the logistics of sourcing, transporting, and paying of cash.⁴⁷

Diagram 3: Mechanics of the *Hawaladar* Route.



Note: The diagram is a simplistic illustration, and not a full explanation of a complex process. See footnote 5 on where the CBI's foreign reserves are held.

⁴⁶ US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN), ‘FinCEN Finds Iraq-based Al-Huda Bank to be of Primary Money Laundering Concern and Proposes a Rule to Combat Terrorist Financing’, *U.S. Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN)*, 29 January 2024. Further details and background are available at: ‘The Central Bank Clarifies Judgment against of Al-Huda Bank...and Parliament Expects More Sanctions’, *Al Mada Paper*, 30 January 2024.

⁴⁷ This is based on a piece in Arabic written by an ex-deputy governor of the Central Bank of Iraq: Ahmed Ibrahi Ali, ‘Have window sales exceeded the range for imports and other current payments?’, *Iraqi Economist Network*, 26 February 2023. Available at: <http://iraqieconomists.net/ar/2023/02/26/دعم-الصادرات-التي-تجاوزت-الحد-المسموح-بها> (accessed 16 July 2023).

Seismic Shock to the System and Currency Upheavals

As part of their engagement with Iraq, the US Treasury and Federal Reserve Bank (FRB) have worked with external auditors on a long-term process of provisioning technical assistance to the CBI towards strengthening its procedures for cross border transfers to ensure that they are continuously compliant with the developments in AML/CFT/SC/FC provisions.⁴⁸ The latest instalment of the provisions took place in mid-November 2022, following two years of planning by the FRB, the US Treasury, the CBI, and the MoF.⁴⁹ Then, the CBI, under deadlines and in tandem with the FRB implemented new procedural requirements that would bring the dollar auction's cross-border transfers fully in-line with global standards.

The essential difference introduced by the new procedural requirements was in the sequencing of the provisioning of the cross-border transfers' disclosure requirements, that resulted in an enhanced application of the AML/CFT/SC/FC provisions, particularly for the ultimate sender and beneficiary (Diagrams 4 and 5). These were implemented with the use of specialist software applications – followed for years by most global banks but for the first time in Iraq – allowing for digital verification of disclosure documentations. This moved the verification process from an essentially paper-based to a digital-based process, leading to a meaningful tightening of AML/CFT/SC/FC provisions and controls. As such, the implementation impacted specific wire-transfers in the auction, which failed the new enhanced beneficiary disclosure requirements as a function of their participation in the opaque payment structure discussed earlier. Other wire transfers that failed these enhanced beneficiary disclosure requirements were those that were used to circumvent AML/CFT/SC/FC provisions.⁵⁰ Meanwhile, most LCs and some wire-transfers were unaffected by the implementation. The negative impact on these specific wire-transfers represented a seismic shock to the system, as they, with the benefit of hindsight, constituted a significant portion of overall transfers conducted through the auction. Moreover, these new procedural requirements now effectively function as a de-facto sanctions mechanism.⁵¹ The resulting sharp decreases in dollar cross-border transfers within the auction (green bars in upper half of Figure 6) had an immediate detrimental effect on overall dollar supply to the private sector. The decreasing supplies versus the continued high demand for dollars led to increases in the delta, i.e. depreciation of the parallel market price of the dinar versus the official dollar price (green, red lines in lower half of Figure 6).

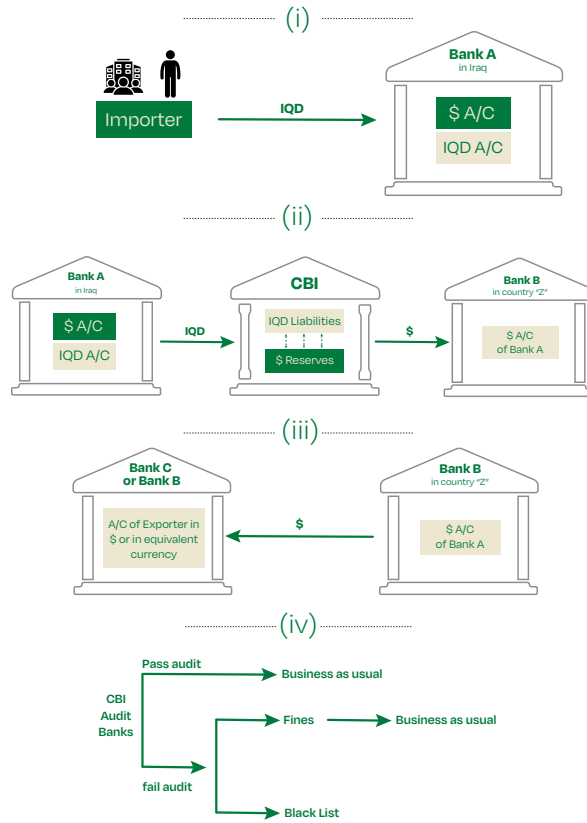
⁴⁸ IMF, 'Iraq: Article IV Consultation Reports 2004-23'.

⁴⁹ US officials were quoted as saying: 'They were implemented jointly in November after two years of discussions and planning by the Central Bank of Iraq, the US Treasury and the Fed.' Iraq's prime minister in February 2023 was quoted saying that he found in November, a month after assuming office, 'that these procedures were agreed upon two years earlier by the FRB, CBI, and MoF'. David Cloud, 'Iraq Economy Reels as U.S. Moves Against Money Flows to Iran', *Wall Street Journal*, 19 January 2023. Available at: <https://www.wsj.com/articles/iraq-economy-reels-as-u-s-moves-against-money-flows-to-iran-11674128633> (accessed 16 July 2023); 'Prime Minister: Sales of Dollars at the New Exchange Rate Begins Tomorrow, and there are no Red Line in Fighting Corruption', *Iraqi News Agency*, 7 February 2023. Available at: <https://www.ina.iq/177694--2023.html> (accessed 16 July 2023).

⁵⁰ See footnote 46 for more information. The CBI subsequently noted that FinCen's judgement based on the banks activities prior to mid-November 2022, and that the bank has not participated in the auction in 2023. 'Central Bank of Iraq: Sanctions on Al-Huda Bank due to its activities in 2022', *Central Bank of Iraq*, 30 January 2024. Available at: <https://cbi.iq/news/view/2509> (accessed 31 January 2024).

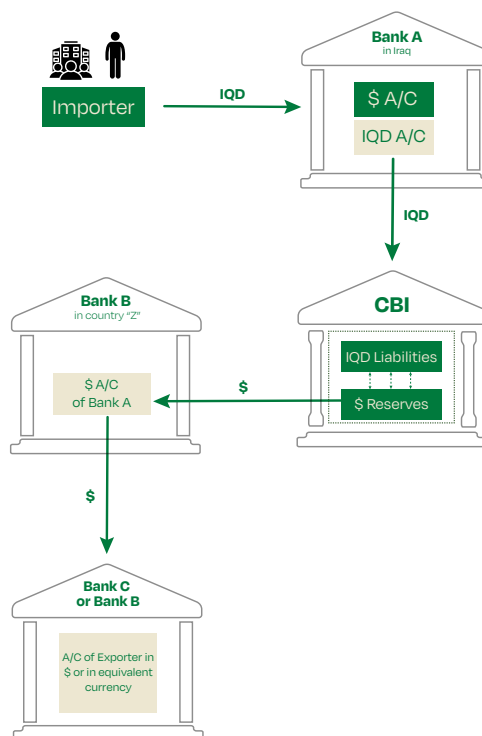
⁵¹ The CBI's note (footnote above) underscores the effectiveness of the new procedures, and illustrates their function as a de-facto sanctions mechanism.

Diagram 4: Cross-Border Transfers pre-November 2022



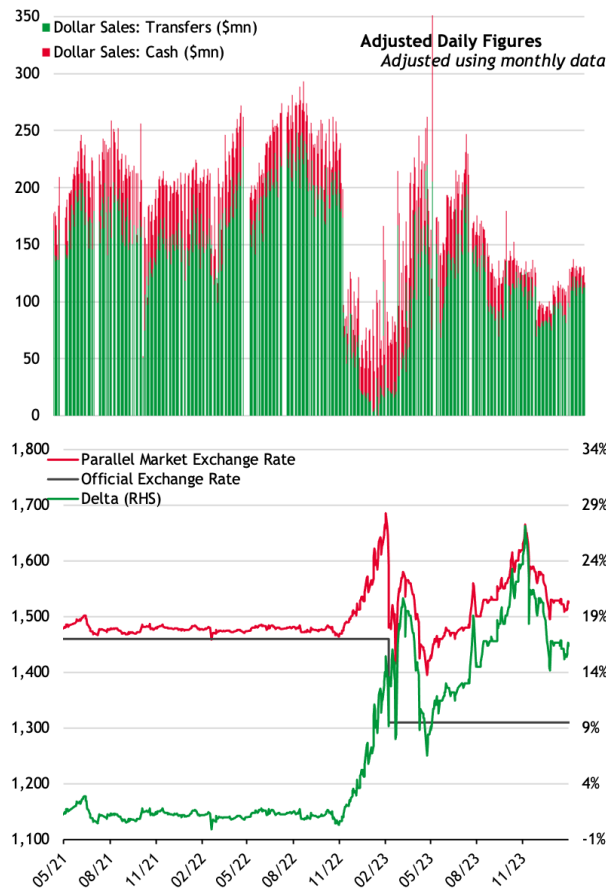
Note: The diagram is a simplistic illustration, and not a full explanation of a complex process. See footnote 5 on where the CBI's foreign reserves are held.

Diagram 5: Cross-Border Transfers post-November 2022



Note: The diagram is a simplistic illustration, and not a full explanation of a complex process. See footnote 5 on where the CBI's foreign reserves are held.

Figure 6: CBI Dollar Sales versus Dollar – Dinar Exchange Rate (Daily Data)



Source: CBI, data as of 31 January 2024.⁵²

The CBI and the government subsequently introduced a sequence of measures to simplify the bureaucratic procedures for transfers within the auction, to encourage the use of the banking system instead of cash, and to create demand for the dinar in domestic transactions instead of the dollar.⁵³ However, the effects of these measures would unfold

⁵² CBI Economic and Statistical Data. Available at: <https://cbiraq.org/> (accessed 31 January 2024). The volumes of transactions at the CBI’s auction (upper half of chart) are adjusted daily volumes based on monthly CBI data. Daily volumes data from the CBI changed after November 2022 in that daily volumes are those that were being processed, but not finalised and so don’t reflect the final volumes; while final volumes are reflected in the CBI’s monthly published volumes. For further info on this: Ziad Daoud, X, 19 November 2023. Available at: <https://twitter.com/ZiadMDaoud/status/1726186592463896599> (accessed 31 December 2023).

⁵³ The CBI’s measure included lowering its commission for dollar sales in the auction by half (from 10 dinar per dollar to five) for those importers who use LCs and for individuals to who use bank cards for their travel needs instead of cash. Others were to end the requirement that banks reports auction transfers to the tax and custom authorities, while some were to make it relatively easy for small traders to access dollars via the Trade Bank of Iraq (TBI) as long as they satisfied a number of requirements. The government on the other hand mandated that transactions for goods and services to be conducted in dinars instead of dollars, and crucially the Council of Ministers removed the use of assumed income for the purposes of taxation, and is now based on the company’s reported revenues and expenses (see footnote 28 on the issues with taxation). ‘CBI Instruct Banks Concerning the Collection of Custom Tariffs and Taxes’, *Iraqi News Agency*, 4 January 2023. Available at: <https://www.ina.iq/174753--.html> (accessed 16 July 2023); ‘The Council of Ministers Requires Government Agencies to Sell Goods and Services in Dinars’, *Rudaw*, 10 January 2023. Available at: <https://www.rudawarabia.net/arabic/middleeast/iraq/100120238>

over months and years, and thus had no immediate impact on dollar demand, and as such the delta continued to increase. This effect accelerated following the government's crackdown on MEBs in late January; by early February, the delta was about 16%, a stark increase from the average of around 1.2% that prevailed over the 18-month period preceding mid-November.⁵⁴ Pressured by the public's furore for immediate solutions, the CBI, spurred by populist rhetoric, and with the government's blessing, opted for a 10% revaluation of the official exchange rate of the dinar versus the dollar.⁵⁵ However, this was merely nominal and thus did not alter the relationship between the official and the parallel market exchange rates that existed pre-revaluation.⁵⁶

By mid-March the auction's cross-border transfer volumes began to recover materially as the market was gradually adjusting to the increased levels of transparency demanded by these new procedural requirements. The resultant increased dollar supply at the auction eased the pressures on the parallel markets' prices of the dinar versus the dollar, and the delta declined from earlier heights to a range of 11–13% through most of May–July. This progress was short-lived as the recovered cross-border transfer volumes at the auction included the processing of backlogs as banks were addressing the administrative and technical bottlenecks that arose with the November 2022 procedures. Moreover, following the sharp drop in cross-border transfers post-November, the CBI increased the supply

(accessed 16 July 2023); Central Bank of Iraq, 'The Central Bank of Iraq Issues the First Package of Facilities to Meet the Demand for Dollars', *Central Bank of Iraq*, 3 February 2023. Available at: <https://cbi.iq/news/view/2219> (accessed 16 July 2023); 'The Central Bank of Iraq Issues the Second Package of Facilities to Meet the Demand for Dollars', *Central Bank of Iraq*, 22 February 2023. Available at: <https://cbi.iq/news/view/2244> (accessed 16 July 2023); 'The Central Bank of Iraq Issues the Third Package of Facilities to Meet the Demand for Dollars', *Central Bank of Iraq*, 14 March 2023. Available at: <https://cbi.iq/news/view/2276> (accessed 16 July 2023); 'The Central Bank Promotes the use of Payment Devices (POS) in Accordance with the Decision of the Council of Ministers', *Central Bank of Iraq*, 1 June 2023. Available at: <https://cbi.iq/news/view/2348> (accessed 16 July 2023); 'Council of Ministers' Decisions', *Iraq Ultra*, 17 September 2023. Available at: <https://ultrairaq.ultrasawt.com/ماظنلا-بيبرضلا-مادجو-رادجو-بيبرضلا-ماظنلا> (accessed 16 October 2023).

⁵⁴ In late January, the authorities raided two of Baghdad's largest Forex trading houses/MEBs, which had a chilling effect on the market; most other Forex houses in the capital stopped providing quotes for the purchase and sale of dollars, resulting in a very illiquid market that exaggerated the currency's depreciation. 'Security forces raid Baghdad's central exchanges, arrest senior traders', *Shafaq News*, 21 January 2023. Available at: <https://shafaq.com/en/Iraq-News/Security-forces-raid-Baghdad-s-central-exchanges-arrest-senior-traders> (accessed 16 July 2023).

⁵⁵ 'The Council of Ministers approves the decision to amend the exchange rate of the dollar, equivalent to 1,300 dinars', *Iraqi News Agency*, 7 February 2023. Available at: <https://ina.iq/eng/24703-the-council-of-ministers-approves-the-decision-to-amend-the-exchange-rate-of-the-dollar-equivalent-to-1300-dinars.html> (accessed 16 July 2023).

⁵⁶ Fundamentally, the revaluation in nominally increasing the official exchange rate did not alter the relationship between the official exchange rate and the parallel market rate that existed pre-revaluation. See Ahmed Tabaqchali, 'Iraq Needs to Address the Economy's Structural Imbalances to halt the Dinar's Volatility', *Atlantic Council*, 21 February 2023. Available at: <https://www.atlanticcouncil.org/blogs/menaw-source/iraq-needs-to-address-its-structural-fault-lines-to-halt-its-currencys-exchange-rate-volatility/> (accessed 16 July 2023); Ahmed Tabaqchali, 'What's Happening with the Dinar? (An IER interview)', *Institute of Regional and International Studies (IRIS)*, February 2023. Available at: <https://auis.edu.krd/iris/sites/default/files/IER7%20-%20The%20Dinar%20&%20Al-Sudani's%20Agenda%20-%20Feb%2020,%202023.pdf> (accessed 16 July 2023); Ahmed Tabaqchali, 'Dinar Revalued Upwards, Market Shrugs', *Iraq Business News*, 12 March 2023. Available at: <https://www.iraq-businessnews.com/2023/03/12/tabqchali-dinar-revalued-upwards-market-shrugs/> (accessed 16 July 2023).

of physical dollars at the auction, which partially eased the overall dollar supply-demand mismatch. However, these cash sales gradually decreased over the following few months, and for August 2023–January 2024 are about 54% less than the levels that preceded the implementation of the new procedures (Table 2). By August 2023–January 2024, the auction’s cross-border transfers, which have recovered from the worst period in mid-November 2022 to mid-March 2023, are about 44% less than the levels that preceded the implementation of the new procedures (Table 2). Consequently, by August 2023–January 2024 total dollar sales (cross-border transfers and cash) are about 46% less than the that preceded the implementation of the new procedures (Table 2).

Table 2: Average Auction Daily Volume

Dollar Sales	Transfers (\$mn)	Cash (\$mn)	Total (\$mn)
18 month pre-Nov 22	173	40	213
Mid-Nov 22 – Mid-Mar 23	41	48	88
Mid-Mar 23 – End-July 23	143	43	186
Aug 23 – Jan 24	96	18	114

Source: CBI, data as of 31 January 2024.⁵⁷

The delta increased steadily in lockstep with the steady declines of the auction’s volumes; with the increase intensifying from late July reaching about 28 percent by early November, before recovering to about 14–17 percent. Exaggerating the negative effects of the auction’s volume declines and hence intensifying the delta’s increase, was a combination of government crackdowns to control demand for dollars in the parallel market, and by the CBI’s measures and plans for limiting dollar cash withdrawals from certain types of dollar bank accounts.⁵⁸ However, further measures by the CBI towards increasing the supply of physical dollars by allowing banks to import dollars to satisfy customer withdrawals, and reports that the FRB is continuing with the provision of physical dollars to the CBI, have eased the pressures on the delta.⁵⁹

⁵⁷ CBI Economic and Statistical Data. Available at: <https://cbiraq.org/> (accessed 31 January 2024).

⁵⁸ The government cracked down on and closed a number of wholesalers such as of cigarettes, alcohols, cosmetics who are believed to access these products informally without paying custom duties, taxes, and who source dollars from the informal markets. The CBI has decided the restrict withdrawals in dollars from certain types of dollar bank accounts (but allow withdrawals instead in equivalent dinars form these accounts) from 2024. Tareek Alshaab, ‘Cigarettes Prices Increase, while Merchants Close Shops’, *Tareek Alshaab*, 5 August 2023. Available at: <https://www.tareeqashaab.com/index.php/sections/report/9458-2023-08-05-19-33-06> (accessed 25 October 2023); Timour Azhari, ‘Iraq to End All Dollar Cash Withdrawals by Jan. 1 2024, CBI Official says’, *Reuters*, 5 October 2023. Available at: <https://www.reuters.com/markets/currencies/iraq-end-all-dollar-cash-withdrawals-by-jan-1-2024-cbank-official-2023-10-05/> (accessed 25 October 2023).

⁵⁹ ‘Iraqi Bank has Received Shipments of Millions of Dollars’, *Shafaq News*, 7 December 2023. Available at: <https://shafaq.com/en/Economy/Iraqi-bank-has-received-shipments-of-millions-of-dollars-source> (accessed 31 December 2023); Central Bank of Iraq, ‘The Delegation of the Central Bank of Iraq Ends its Meetings with the Delegation of the US Federal Reserve and the US Treasury in Dubai’, *Central Bank of Iraq*, 14 December 2023. Available at: <https://cbi.iq/news/view/2486> (accessed 31 December 2023).

The Evolution of the Auction

It is too early to assess whether the auction's current volumes represent a new normal for cross-border transfers, or to anticipate the subsequent implications for the private sector's demand for imports or for the economy's dollarisation. However, the November 2022 procedures and the subsequent measures introduced by the government and the CBI have led to three consequential breaks with the past. The first break is that the transfers that were processed through the auction were increasingly those that were affected by the top-quality banks who have correspondent banking relationships with major international banks. As such, their past transfers were already compliant with all global AML/CFT/SC/FC provisions and controls; and consequently, incorporated the November 2022 requirements within their existing procedures and ended up accounting for the bulk of transfers through the auction.⁶⁰

The second break is the effective end of the rent-seeking opportunities for the MTCs and banks that were involved in the cross-border transfer chain of the *hawaladar* route – at least in its present form. Pre-November 2022, these MTCs and banks benefited from pocketing the difference between selling the dollars at parallel market rates to the importer and buying dollars in a wire-transfer through the auction at the official exchange rate. But now, MTCs acting as *hawaladars* and counterparty *hawaladars* can no longer affect payments between sender and receiver of funds, as they are unable to settle these transactions as a wire-transfer through a complicit bank through the auction. Therefore, informal companies and formal companies that operated partly informally – as well those who need to transfer funds for other reasons – are unable to make cross-border payments through MTCs acting as *hawaladars*, and so need to source dollars through other avenues. One such avenue would be acquiring physical dollars domestically, which is not a viable solution as the logistics of sourcing, transporting and paying in cash would impose severe constraints on the amounts that can be transferred. Moreover, the cash dollar flows through the auction are too small to make up for the shortfalls in the transfers section (Table 2), and thus the need for physical dollars would place significant demands on the stock of physical dollars in the economy which would not sustain such demands for an extended period without replenishing.⁶¹ Compounding these constraints is that acquiring physical dollars outside the auction would be extremely costly given the still high delta. This cost constraint would apply in any potential new route – cash or any alternative cross-border transfer process – for acquiring dollars other than through the auction.

The third break follows from the second, in that the current high delta (lower chart Figure 6)

⁶⁰ Among private sector owned banks, only five that are majority owned by regional banks out a total of 25 banks, have international correspondent banking relations with major international banks either directly or through their regional majority owners. Similarly for the 16 local branches of international banks. A major reason is that the correspondent banking relationship means both banks need to manage the risks associated with the relationship between each other directly, and indirectly through each bank's underlying clients. Many major international banks have decided that Iraq is high-risk when it comes to AML/CFT/SC/FC provisions and controls. As such the few banks that have these relationships directly have satisfied three levels of due diligence levels: (1) at the Iraqi bank's level; (2) at the level of their clients and system for conducting due diligence; and (3) at the country level risk. For more information about correspondent banking see: Will Kenton, 'Correspondent Bank: Definition and How It Works', *Investopedia*, 2 May 2023. Available at: <https://www.investopedia.com/terms/c/correspondent-bank.asp> (accessed 16 July 2023).

⁶¹ The cash market, and the dollar stock in the economy will be covered in a future piece.

puts both the informal companies and formal companies that operate partly informally – as well as individuals – at a significant competitive disadvantage versus those operating formally (accessing dollars at the official exchange rate through the banking system and the auction). Consequently, incentivised by the economic benefits, the move to formality in accessing dollars through the auction at official exchange rate has started in earnest, as evidenced by the early financial results of some top banks processing this conversion and the ensuing cross-border transfers.⁶² However, due to the country's dysfunctional bureaucratic process and widespread informality, this move to formality would unfold slowly, measured in years not months.

The three breaks are moving the auction's mechanism away from being primarily processed through the CBI, to being primarily processed by banks with correspondent banking relationships with major international banks. This is taking place alongside the auction's regular functioning, with the CBI prefunding the dollar accounts of these banks held with their international correspondent banks, i.e. transferring dollars from its reserves to these banks' accounts held with correspondent banks in exchange for dinars before these banks apply to make transfers. Subsequently, these banks would affect transfers directly from these accounts in accordance with the auction's regulations and requirements.⁶³ The CBI is planning to move this evolution further, by effectively ending the auction in its present form in 2024, and moving the process fully to these banks, aiming to bringing cross-border transfers in line with global practises.⁶⁴ However, this does not alter the auction's primary function or purpose as the CBI's foreign reserves would still be source of dollar supply for such transfers which will still be conducted at the official exchange rate – this because the CBI is using

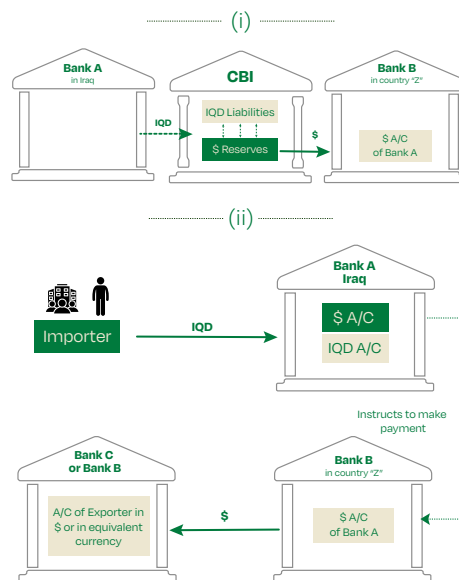
⁶² This is based on earnings data for the second and third quarters of 2023, and as such more data is needed to fully assess how the process of the conversion to formality, yet the early figures of these banks as regards to deposit increases, and commission income increases are a direct result of a number of informal companies opening bank accounts, and depositing funds for affecting cross-border transfers through these bank. Ahmed Tabaqchali, 'Banks to Fuel the Market's Next Phase', *Iraq Business News*, 5 September 2023. Available at: <https://www.iraq-businessnews.com/2023/09/05/taqchali-banks-to-fuel-the-iraqi-markets-next-phase/> (accessed 25 October 2023); Ahmed Tabaqchali, 'What Next after a Gangbuster Year ???', *Iraq Business News*, 8 January 2024. Available at: <https://www.iraq-businessnews.com/2023/09/05/taqchali-banks-to-fuel-the-iraqi-markets-next-phase/> (accessed 31 January 2024).

⁶³ Prefunding changes the sequence in the usual cross-border transfers through the auction, in that the CBI would sell dollars from its reserves to these banks and buy dinars from them before these banks apply to make transfers for their clients. These banks then would affect cross-border transfers for their clients using these funds. The amounts that the CBI prefunds are agreed upfront with these banks depending on their capacity and ability to handle the transactions. Thus, the process favours these banks that have correspondent banking relationships with major international banks, and ultimately strengthens the Iraqi banking system.

⁶⁴ 'Important Transformations in Cross-border Transfer Mechanisms', *Central Bank of Iraq*, 24 September 2023. Available at: <https://cbi.iq/news/view/2424> (accessed 25 October 2023). The CBI is trying to broaden the number of Iraqi banks with major international banks through indirect means: which is to create correspondent for certain Iraqi banks with a number of banks in the UAE, Jordan and Turkey who already have correspondent banking relationships with major international banks. The transfer of funds would be between these Iraqi banks and the banks in UAE, Jordan and Turkey, who would subsequently transfer funds directly with the major international banks. 'The Governor of the Central Bank Meets with the Chairman of the First Abu Dhabi Bank Group', *Central Bank of Iraq*, 14 December 2023. Available at: <https://cbi.iq/news/view/2483> (accessed 28 December 2023); 'The Central Bank Reveals the Discussions of the Joint Iraqi Delegation in Türkiye', *Central Bank of Iraq*, 2 December 2023. Available at: <https://cbi.iq/news/view/2478> (accessed 28 December 2023); 'Iraq will Bolster its Foreign Exchange Reserves to Finance Trade', *Sky News Arabia*, 11 November 2023. Available at: <https://www.skynewsarabia.com/business/1669442-قارءلا-ذزعيس-قارءلا-ءلوصأ-ززعيس-قارءلا> (accessed 28 December 2023).

these reserves to prefund the accounts of Iraqi banks with their correspondent banks, i.e., the change is in the sequencing of the transfers and not a fundamental change (Diagram 6).

Diagram 6: Mechanics of Prefunding



Note: The diagram is a simplistic illustration, and not a full explanation of a complex process. See footnote 5 on where the CBI's foreign reserves are held.

Crucially, these plans, as well as those to affect transfers in yuan and other currencies,⁶⁵ and the measures introduced by the government and the CBI, to create domestic demand for the dinar and to accelerate the adoption of banking in economic transactions, are long overdue and much needed. However, they do not alter the fundamentals of the government's oil export revenues constituting the most significant source of dollars to the country, or that domestic consumption is dependent on the imports of goods and services which are mostly provided by the private sector. Therefore, the auction (irrespective of its evolution in the prefunding mechanism) will continue to be the most significant source of dollars to the private sector, even if it moves fully to formality and away from dollarisation. The auction's significance can only be changed in time, by gradually shrinking the state's footprint in the economy, while laying the foundations for a diversified economy driven by a private sector led traded goods and services sectors. However, this requires a recognition that is lacking by both the political class and the society at large that the oversized role of the government in the economy and society is inextricably interwoven with the post-2003 political order and the country's social contract, and which has over twenty years persistently deepened and became more entrenched irrespective of the series of economic crisis that arose from this very oversized role.⁶⁶

⁶⁵ 'Iraq to Allow Trade with China in Yuan - State Media', *Reuters*, 22 February 2023. Available at: <https://www.reuters.com/business/iraq-allow-trade-with-china-yuan-state-media-2023-02-22/> (accessed 25 October 2023); Khalid Al Ansary, 'Iraqi Central Bank to Restrict Internal Trade to Iraqi Dinar', *Bloomberg*, 25 September 2023. Available at: <https://www.bloomberg.com/news/articles/2023-09-24/iraqi-central-bank-to-restrict-internal-trade-to-iraqi-dinar?sref=a9fBmPFG> (accessed 25 October 2023).

⁶⁶ Ahmed Tabaqchali, 'Missed Opportunities for Economic Reform', *Chatham House*, 5 May 2023. Available at: <https://www.chathamhouse.org/2023/03/iraq-20-years-insider-reflections-war-and-its-aftermath/missed-opportunities-economic> (accessed 16 July 2023); Ahmed Tabaqchali, 'What Iraq Needs: An Economy Diversified Away from Oil', *Atlantic Council*, March 2023. Available at: <https://www.atlanticcouncil.org/blogs/menasource/how-the-war-in-iraq-changed-the-world-and-what-change-could-come-next/-oil> (accessed 25 October 2023).

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Middle East Centre
London School of Economics
Houghton Street
London, WC2A 2AE



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Cover Image

A man exchanges US dollars for stacks of Iraqi dinar in the main Shurja market in central Baghdad, 14 January 2023.

Source: AP Photo/Hadi Mizban

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