



**مركز البيان للدراسات والتخطيط**  
Al-Bayan Center for Planning and Studies

# **Stumbling in Economic Reform Opportunities: An Analysis of the Impact of US Treasury Decisions on Iraq's Recovery Efforts**

**Research Department**



**Al-Bayan Center Studies Series**

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Al-Bayan Center pursues its vision by conducting independent analysis, as well as proposing workable solutions for complex issues that concern policymakers and academics.

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# Stumbling in Economic Reform Opportunities: An Analysis of the Impact of US Treasury Decisions on Iraq's Recovery Efforts

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## Research Department

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### Summary:

- The measures taken by the US Treasury will hinder international efforts towards economic transformation in Iraq towards adopting a market economy system, making the Iraqi market less responsive to economic reform methods.
- The Iraqi government will have to engage in negotiation efforts on behalf of the national private sector, specifically towards parties affected by sanctions, for which there is no supporting evidence for the accusations.
- Iraq has postponed nearly all efforts aimed at enhancing financial inclusion, gradually shifting its priorities away from the global economic reform agenda, including financial inclusion, climate change, and the shift towards a green economy and energy transitions.
- Iraq's air transport sector will be affected by the ban on Fly Baghdad, as the company is the largest national carrier in the private sector and has proven successful in providing jobs for more than a thousand employees, serving as a gateway for investors entering the local market. Therefore, investment conditions in Iraq may be affected by this decision.
- The strong financial linkage of Iraq with the US dollar, alongside the economic linkage and the excessive confidence of decision-makers in the US dollar, has created an unexpected shock that can be addressed

by diversifying the currency basket in the Central Bank's foreign exchange reserves with Iraq's main trading partners.

- Iraq may not be able to sustain momentum with various international entities in economic diversification through financial reforms and easy access to financing.
- The actions of the US Treasury will lead to the normalization of economic conditions in Iraq with other economic actors in the world.

### **Introduction:**

Iraq relies entirely on the US dollar as an international currency for settlement in local transactions. This dependence stems from crises, including wars and economic sanctions, that have undermined confidence in the Iraqi dinar. Furthermore, the Iraqi economy is considered to be unidimensional, depending heavily on natural resource revenues to finance economic activity. The years of war, terrorism, and crime have fostered an increasing reliance on the US dollar. Due to the prolonged sanctions imposed on Iraq, along with the conditions of occupation, terrorism, and political instability, the US Federal Reserve has been able to exert influence over the flow of dollars to Iraq. Most of Iraq's oil revenues and deposits are held in a special account by the Iraqi Ministry of Finance in the United States, and the Central Bank of Iraq, responsible for setting the exchange rate and managing Iraq's foreign financial reserves, purchases these dollars from the Iraqi Ministry of Finance to deposit in the Central Bank's account at the US Federal Reserve.

Despite the Iraqi funds not being subject to arbitrary authority by the US government, recent actions reveal an intention to use the US dollar as an economic tool to hinder Iraqi recovery efforts. It is well known that the Central Bank of Iraq sets the dollar exchange rate in the local market and works to maintain its stability through various tools, notably

the injection or sale of foreign currency through the currency window, along with accepting transfers and other operations. Although the tools used by the Central Bank were not highly efficient in absorbing growth in international economic transactions and developments in the money and financial markets, these measures represented the best reality because they maintained a stable exchange rate alongside securing daily dollar transaction requirements and maintaining an acceptable level of economic stability as a monetary policy that aligns with the infrastructure reality of Iraq's financial system.

However, the current measures followed by the US Treasury Department will have a range of short and long-term implications on the economic conditions in Iraq, as the economic priorities for the Iraqi government change to take actions that align with the impact and nature of the sanctions or penalties imposed on economic establishments to avoid any negative reflections on the overall situation in the country.

### **Weakening the Private Sector's Capacity for Growth:**

The private sector is a fundamental contributor to economic development in the country. Despite its limited role in Iraq, it is the largest employer, with about 60% of the Iraqi workforce, amounting to 6.5–7 million people, working in this sector. For many years, this sector has primarily depended on the country's overall economic conditions and the degree of government spending. It also thrives on import capacity, which, in turn, relies on the stability of the local currency. The fluctuations in the national currency rates against the main currency in international transactions have led to a decline in emerging businesses in the markets. Large projects owned by individuals have also been affected by exchange rate fluctuations and sanctions imposed on some private banks. Many commercial projects have resorted to replacing their accredited banks and entering new import procedures, affecting the smoothness of operations in these projects and often limiting their

planned growth.

Additionally, some small and medium-sized enterprises have had to lay off employees due to decreased sales and shrinking profit margins. Failures in the private sector that limit growth capacity will mathematically reflect on the business, meaning that the chain of value-added businesses will decline due to market disturbances. Given that imports in Iraq constitute about 40% of the Gross Domestic Product (GDP), the ability to maintain existing businesses in markets, which harmonize with the nature of the import-dependent economic system, will decrease. This implies that significant segments will be forced into unemployment due to economic downturns.

Moreover, the Consumer Price Index (CPI) in Iraq rose to 122.80 points in November after being at 122.60 points in October of 2023. The average Consumer Price Index in Iraq was 103.85 points from 2009 to 2023, reaching its highest level ever at 123.20 points in January 2023 and its record low at 86.50 points in March 2009, as shown in Figure 1.

### **Risks to the Transportation Sector:**

Growth in the transportation sector is crucial for economic development worldwide, serving as a gateway to comprehensive progress across land, rail, maritime, and air transportation. The Iraqi air transport sector, essential for the country's overall development, faces numerous challenges that necessitate development, including the need for training qualified individuals in leadership and control roles. Despite the relatively high cost of air transport in Iraq, several emerging private companies have rapidly grown and succeeded. Among these is Fly Baghdad, which has faced challenges due to sanctions imposed by the US Treasury Department. Fly Baghdad is a private Iraqi airline headquartered at Baghdad International Airport and owned by an Iraqi

investor. It boasts a fleet of 11 Boeing aircraft, all American-made, and employs about a thousand individuals. Founded in 2015, Fly Baghdad embraced the latest technology and electronic payment systems by 2017, adopting “Lower price... More travel” as its motto. According to 2022 data, the airline transported 961,948 passengers across 10,218 flights to 32 international airports in 15 countries, including Lebanon, Syria, the United Arab Emirates, Turkey, and India. Estimates for 2023 suggest that it transported around 1.5 million passengers, positioning it as the second-largest Iraqi airline. The company operates under Iraqi Aviation Authority laws and adheres to strict aviation safety and security standards. Despite its compliance and international operations, including transactions with entities from countries that have imposed the sanctions, Fly Baghdad was included in the US Treasury Department’s sanctions list.

The risks to the transportation sector could diminish the desire to enter the Iraqi market, and targeting the largest national carrier will inevitably affect the general reputation of the business environment in Iraq. A company of this size, seriousness, and reliability, if sanctions continue, will have consequences on the general business environment in Iraq, not to mention reflecting on the cost of transportation in Iraq and harming this vital and important sector.

### **The Evolution of Informality in the Economy:**

One of the considerations the Iraqi government is working on, in cooperation with international efforts, is to end the informal nature of private sector activities, enabling individual private enterprises to be more systematic and formal. Governments usually resort to attaching or converting informal projects to formal ones by providing incentives, including financial measures that contribute to the ability to access financing and offering loans, along with financial grants and technical assistance. The sanctions imposed on the activities of the private

financial sector in Iraq will weaken the private banks' ability to offer loans. Moreover, state banks are likely unable to fill this gap for several reasons, including the large bureaucratic procedures followed by state banks and the inability to provide financial havens for these projects due to changing priorities for state banks.

Figure 1. Evolution of Consumer Prices in Iraq during 2020–2023



Source: Trading Economics, Iraq Consumer Price Index, <https://tradingeconomics.com/iraq/consumer-price-index-cpi>

### **Decline in Financial Inclusion Efforts:**

Iraq aimed to provide more than 30 million dollars in loans and direct grants to expand the capital of small and medium enterprises, leading to an estimated 80% increase in business revenues. More than 1.5 million dollars were allocated to loans to support companies in their recovery efforts from the impact of COVID-19. Private investments attracted 41 million dollars to expand local businesses in technology, commerce, and the industrial sector. The first informal coordination



platform was established, in coordination with the donor community and financial institutions, to address financing access issues and provide new financing opportunities for small and medium enterprises.

In November 2022, the Central Bank of Iraq implemented regulatory changes to international transfers through the currency auction mechanism for the US dollar, following pressures from the US Federal Reserve. These regulatory changes led to an increase in the gap between the official and parallel market exchange rates due to speculation and manipulation of the currency among other factors. On February 7, 2023, the Cabinet approved the Central Bank of Iraq's decision to raise the official exchange rate of the Iraqi dinar against the US dollar from 1450 dinars per dollar to 1300. These uncalculated actions created what is called an informal parallel market, which became active in speculating with the US dollar, making the gap range between 11–17% between the official and unofficial rates.

Although banking sector reform was a priority of the IMF's Stand-By Arrangement for Iraq, the Iraqi government did not prioritize it due to changing priorities and was forced to address urgent issues. Thus, only gradual success was achieved in reforming the country's two largest state-owned banks, Al-Rafidain and Al-Rasheed.

In fact, the Iraqi economy still relies primarily on cash. The banking system faces significant challenges, with paper banking services still prevalent in some of the country's largest state-owned banks. Iraq ranked 186 out of 190 in the ease of getting credit in the World Bank's Doing Business report. Although lending from private sector banks is growing, most private banks are conducting more wire transfers and other fee-based exchange services.

Iraq's capacity to keep up and fulfill its financial commitments to financial inclusion and project financing will decrease, and progress

in this regard will be difficult to continue, as public policy priorities in the country will focus on achieving financial stability and ensuring the continuation of public financial measures that do not affect public satisfaction or have a negative reflection on the general situation. Therefore, issues such as fairness in financing access, inclusion of small and medium private enterprises, and ease of access will not represent a general priority at the moment.

### **Decline in the Ability to End Economic Informality:**

The informal nature of the Iraqi economy makes tracking the flow of dollars in daily transactions in local markets impossible. The private sector in Iraq is emerging, and the appearance of a parallel market for the local currency priced in dollars makes the expansion of the informal sector possible. Since most operations in the private sector, especially in small projects, are informal, the government's ability to include these projects within the formal framework will be challenging. The decline in financial inclusion efforts will reduce private projects' desire to organize their businesses with government entities, and the ability to regulate markets will be hampered due to the reformation of private businesses under fragile conditions. The weak capacity of the private sector to manage its affairs will be present due to the absence of regulatory capacity and increased fragile conditions, accompanied by a limited role of government entities in providing more incentives to these businesses.

### **Limited Capacity for Revenue Diversification:**

Iraq is committed to providing financial alternatives to oil revenues. Creating new financial revenues is largely linked to financial and monetary stability, and this creates the capacity to implement new programs capable of diversifying revenues. Financial diversification programs are, of course, the result of international efforts, financial agreements, and

local programs. If these elements are not prepared according to stable economic conditions, they cannot proceed. Therefore, it is expected that Iraq will postpone the implementation of economic diversification programs at present due to unstable conditions, which will have an impact on local situations in the country and on general social stability. It is illogical to continue relying on natural resource revenues alongside the increasing number of people entering the labor market, and the risks generated from this may lead to instability in the country and region more broadly.

### **Decline in Reform Efforts and Climate Agenda:**

The decisions by the US Treasury Department represent the greatest challenges faced by the government of Mohammed Shia' Al-Sudani in the economic field. The impact of these sanctions reflects on the implementation of the government's program and could potentially lead to its stalling. These circumstances may lead the government to be uncommitted to implementing the international reform agenda, including efforts towards economic transformation, legislative and legal reform, and the necessary policies. The government will not be capable of balancing international requirements in reform efforts, financial inclusion, or even issues related to climate change and preventing displacement due to desertification.

The Iraqi government may be unable to reconcile addressing the risk of climate changes and providing sufficient space for programs, efforts, and measures to tackle climate change. Fragile conditions might lead the government to overlook unfair water practices in the agricultural sector or the irregular use of water consumption and possibly even polluting practices and migration, which ultimately represent a transboundary problem.