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An Iraqi Perspective on Central Bank Reform

by Mark Dempsey

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This commentary was produced for the Legatum Institute's workshop on Economic Reform in September 2013. The workshop was part of 'The Future of Iran' project, which is designed to encourage Iranians to begin thinking about the challenges they will face if, or when, they suddenly find themselves in a position to carry out major political, social and economic reforms.[1]

The start of 2008 heralded a relatively peaceful time in Iraq following the brutal violence of the previous two years, particularly in 2006. Governor Sinan al-Shabibi of the Central Bank of Iraq had just approved for the Financial Services Volunteer Corps (FSVC) to undertake a two-year program of technical assistance for the Central Bank. The programme was worth $4 million and was financed by the US State Department. Through the programme the FSVC was given the mandate "to provide technical assistance to strengthen the capacity of the Central Bank of Iraq (CBI) so that it will be better able to drive reform and modernization of Iraq's financial sector, and in doing so bring benefits to the Iraqi economy as a whole. Particular emphasis will be given in the programme to restructuring the banking system".

From the US-led invasion of 2003, the Central Bank undertook a profound series of changes after the new Iraqi Constitution, which was drafted and later formally ratified by referendum in 2005, conferring independence on the Central Bank of Iraq. Article 103 of the Constitution states: "The Central Bank of Iraq, the Board of Supreme Audit, the Communication and Media Commission, and the Endowment Commissions are financially and administratively independent institutions, and the work of each of these institutions shall be regulated by law".

The constitution charted the challenges facing the newly installed Governor in the CBI; these were not insubstantial, as Iraq emerged after more than 30 years of operation in a closed-system. The Governor's principle priority was to bring inflation in-line and by 2008 he succeeded in reducing it from 36% to 6% for core-inflation (excluding oil)—a noteworthy achievement. The goal was achieved via a policy of monetary and exchange rate policy tightening. In mid-November 2006 and early January 2007, the CBI raised its policy interest rate (the rate at which the CBI lends to domestic banks) incrementally in two steps to 20%. The exchange rate was de facto pegged to the USD at 1460 Iraqi Dinar (IQD) from May 2004, It was allowed to depreciate in November 2006, resulting in a cumulative appreciation of 17% by December 2007. By offering a higher rate of return to dinar currency holders versus dollar holders by way of gradual appreciation, the CBI hoped to counter the dollarization trend and strengthen the effectiveness of monetary policy. The appreciation would- at the same time - directly reduce imported inflation (inflation resulting from increases in the prices of imports).

Governor Shabibi's policies appeared to succeed; increased demand in local currency led to reduced inflation with core-inflation declining markedly throughout 2007 and headline (including price of oil) declining more sharply. An overall drop in violence after 2006 and reduced food shortages abetted these decreases.

Table 1. Annual Consumer Price Inflation; Projections and Realizations, 2004–2007

	2004	2005	2006	2007
Projection				
Sept. 2004	7	15	12	10
July 2005	--	20	12	10
Dec. 2005	--	20	15	10
July 2006	--	--	30	17
March 2007	--	--	--	30
July 2007	--	--	--	30
Actual	31.7	31.6	64.8	4.7

Source: IMF, 2007.

Once single-digit inflation as a main concern for price stability had been achieved the CBI could dedicate its time to genuine capacity building and institutional reform. As an institution, the CBI suffered from an overwhelming lack of capacity amongst its staff. This lack of capacity was evident at all levels but particularly acute in the areas of banking supervision, reserves management and in the ability to deal with the international community. This included international financial institutions (IFIs) and international agencies such as the UN, IMF and World Bank, upon which the CBI was too reliant via Iraq's Standing Loan Agreements. With these dependencies in mind and with the gradual opening up of the economy, an influx of international banks would seek to take advantage of the hydrocarbon opportunities in Iraq. To counter these challenges, Governor Shabibi instigated the establishment of an international department that would not only deal with these issues, but also form a uniform communications policy for dealing with GOI (Government of Iraq) and the Ministry of Finance (MoF). The GOI itself would have to acclimatise to a regime where it could not access the ever-growing foreign reserves of the CBI to fund any government deficits or national infrastructure projects as it may have done previously. This would compromise the CBI's independent status and halt any further financing to the GOI through the IMF's standing loan arrangements with Iraq. During the course of Shabibi's tenure as Governor of the CBI, Prime Minister Al-Maliki's attempts to access the reserves for the GOI were a constant threat to the ever-disintegrating relationship between the two men and undoubtedly contributed to Shabibi's removal as Governor in October 2012.[2]

Another area where expertise was necessary was internal auditing and financial reporting. The CBI's public statements were insufficient and lacking. The CBI suffered from severe legacy issues including old sovereign debt along with the cost of instituting new currency, which were put onto the CBI balance sheet at the insistence of the MoF. Furthermore, the CBI is also responsible for the two central bank branches in Kurdistan but until recently, the only substantive interaction between them was to deliver currency. The need for urgent assistance became clear after an external auditor which had been selected by the MoF, examined the CBI books and issued a 'disclaimer of opinion' where they listed a number of caveats that meant they could approve the financial statements and accounts of the CBI. Clean and reconcilable statements are vital if the CBI is to inspire confidence from both its local constituents (Iraqi banks and the Iraqi people) and the international investment community.

Finally, reform of the banking supervision department was and remains a core reform objective of the CBI. The private banking community now numbers 43 banks and it is difficult to say how many of them would be in a position to withstand, for example, an oil shock, and have the necessary capital buffer to protect their customers' deposits from being impacted. Although the two state banks, Rasheed and Rafidain still control 90% of the banking assets of Iraq their balance sheets are in a weak state with large numbers of bad debts rendering them close to insolvent. The role of the private sector banks will continue to increase in the coming years and it is therefore vital that private sector banks are orderly supervised at the highest international standards (Basel III Accords) by the CBI. A significant capacity building effort is required from international agencies assisting the CBI and close collaboration between CBI supervision staff and banks' representatives to ensure mutual learning towards best practice on both sides.

Iran is in a similar position to Iraq but has the added burden of trying to contain inflation with the impact of economic sanctions that add to increasing import inflation. It remains to be seen if policy will change following the arrival of President Rouhani but it is apparent he is more open than his predecessor. The central bank still operates without an independent mandate and as such the government has steadily intervened in the implementing of monetary policy relegating the post of the governor to little more than a rubber-stamping civil servant.

REFERENCES

1. Under the session entitled "The Future of Money: Currency, Inflation and Political Transformation", the following papers were presented: "Iran's Central Bank and Future Challenges" —Ms Sima Motamen-Samadian, the Centre for the Study of Advanced and Emerging Markets (CSAEM); and "The Practice of Central Banking in the Islamic Republic of Iran: Is there Room for Reform?"—Mohammad R. Jahan—Parvar, the Federal Reserve Board, U.S.

2. Alleged irregularities in the operations of the CBI's daily currency auctions led to an arrest warrant been issued for Governor Shabibi in October 2012 when he was out of country at IMF meetings. The former Governor has not returned to Iraq since

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