Selling the Currency Window in the Central Bank of Iraq and Exchange Rate Risks: An Analytical Study for the Period from 2016 to 2019[1]

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ABSTRACT

The foreign currency window ensures demand for foreign currency, and in order for banks to carry out their task on the demand side, they open accounts for this purpose at the central bank, which they use for monetary policy purposes in general and foreign currency auctions in particular. Although auctions are primarily used for the purpose of imports through private banks, the mechanism by which the currency auction operates is that offers are made by officially authorized banks and exchange companies from the central bank in a sealed envelope. These offers represent the quantities requested by the banks and the central bank does not intervene alone in determining them, while prices are determined by the central bank. The window is also one of the largest open market operations in controlling and managing liquidity, containing public expenditures generated by the general budget and, in particular, current expenditures. However, criticisms of the foreign currency window have increased with this mechanism, as it costs millions of dollars daily and is therefore a waste of the central bank's reserves.

INTRODUCTION

Foreign currency in Iraq has its primary source in oil exports, and on the monetary supply side, it is represented by the Central Bank of Iraq. On the demand side, it encompasses a wide range of beneficiaries and traders. Therefore, the exchange rate is determined by the Central Bank and not left to the market, as the Central Bank represents the supply side in the market, and the foreign exchange system operates on a fixed exchange rate regime. Both the public and private sectors continue to engage in import activities to meet local demand. The private sector has taken on the role of importing for the entire non-governmental economy, including investment, production, and consumption. Additionally, the government procures some of its needs through imports. When the Central Bank ceases selling dollars to the private sector, the purchasing power of the local currency (dinar) rapidly declines, leading to inflationary pressures in the market due to the depreciation of the foreign exchange rate. There is no separate foreign currency market independent of the Central Bank in the Iraqi economy. Therefore, concepts such as floating exchange rates and managed float, in practical terms, have shown that the foreign currency sale window serves as a channel for supplying foreign currency and implementing a monetary policy to stabilize the exchange rate. The Central Bank ensures the availability of foreign currency supply equal to the demand, which means that it cannot control the sale of foreign currency for other purposes. Considering the reliance on a single source, which is oil exports, to obtain foreign currency and the consequent increase in the percentage of commodity imports to meet local demand, there has been an increased dependence on foreign currency to cover imports. This has led the Central Bank of Iraq to utilize the foreign currency sale window to achieve monetary stability.

Research problem

The Iraqi economy faces several challenges, including structural imbalances in economic sectors and dependence on a single source, which is oil exports, to obtain foreign currency. As a result, there is a high percentage of commodity imports to meet domestic demand, leading to increased reliance on foreign currency to cover import demand. This has

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resulted in the foreign currency sale window being used as a means of currency smuggling instead of achieving monetary stability, which is the objective of the Central Bank of Iraq.

Research objective

The research aims to : **(1)** Explain the mechanism of the foreign currency sale window used by the Central Bank of Iraq. **(2)** Examine the role of the Central Bank of Iraq in using monetary policy tools to achieve stability in the exchange rate. **(3)** Investigate the role of the Central Bank of Iraq through the foreign currency sale window in achieving monetary stability.

CONCEPTUAL FRAMEWORK

Foreign Currency Sale Window

The concept of "floating" refers to a foreign exchange rate that is determined by supply and demand in a free market for foreign currency. It implies that both supply and demand exist independently of government authorities. However, it is important to note that such a market for exchange does not exist in Iraq because the supply is monopolized by the government.

Therefore, the theoretical concept of floating exchange rate, including managed float, is not applicable in Iraq. Instead, the Iraqi exchange rate system is characterized by fixed exchange rates with the possibility of intervention by the central bank through buying and selling foreign currency to influence the exchange rate. Before floating or managed float can be implemented, a market independent of the public sector needs to exist. This concept emerged in Western market economies with private ownership and was associated with government regulation of private sector activities during the reconstruction period after World War II. In general, floating exchange rates, managed float, and intervention in the Iraqi monetary market have no place in this context. With a fixed exchange rate regime, the movement of foreign currency is restricted according to its requirements. As a result, no central bank can control domestic liquidity if it adheres to a fixed exchange rate. This is because selling dollars equates to buying local currency (dinars) and the central bank cannot refuse to buy dollars from the Ministry of Finance upon request. At the same time, it cannot refuse to sell dollars to the private sector according to demand. Thus, the central bank cannot fully control the domestic liquidity, which increases when purchasing dollars from the Ministry of Finance and decreases when selling them to the private sector. In this case, the Ministry of Finance supplies the central bank with dollars from oil resources based on its financing needs in Iraqi dinars (Al-Jubouri, 2015: 23).

After 2003, the Iraqi economy witnessed a new monetary policy for selling the US dollar, introducing a foreign currency window known as the "currency auction." One of the reasons for the emergence of the currency window is attributed to the fact that the Iraqi economy relies on oil revenues in US dollars to cover general federal budget expenses. This is due to imbalances in the economic sectors, whether industrial, agricultural, or services, and the lack of productive base for various economic sectors to meet domestic demand. As a result, the monetary authority in the Central Bank of Iraq has used a new mechanism since 2003 to sell the dollar, known as the "foreign currency window." This mechanism aims to cover the demand for dollars in the local market and control the exchange rate of the Iraqi dinar. The sale is conducted between this window and beneficiaries through the channels of the Central Bank of Iraq,

Through the window mechanism, the central bank is able to impose a stable exchange rate and meet the required quantities derived from the financing needs of Iraq's private sector trade. The window is considered one of the largest open market operations in terms of controlling and managing liquidity and containing public expenditures generated by the general budget, especially current expenditures.

Criticisms of the foreign currency window

Criticism of the foreign currency window has increased due to the millions of dollars that are wasted daily, either being sent abroad or used for money laundering, as the window is exploited for purposes other than its intended ones or for speculation. Moreover, many doubts arise about the currency window and the actual volume of imports entering the country and the amount of dollars that go to the parallel market instead of being used for imports, especially considering that the Iraqi banking sector and legislation are not advanced, making the central bank's auction vulnerable to administrative and financial corruption. This waste does not contribute to economic stability objectives.

The concept of monetary stability and its determinants.

Monetary stability refers to the stability of the general level of prices of goods and services and the stability of the exchange rate of the local currency. The fixed exchange rate system with the US dollar is considered the cornerstone of monetary policy. The goal of the central bank's monetary policy is to maintain monetary stability, which is evident through economic growth, stability, and a reduction in unemployment rates, stable prices of goods and services, exchange rate stability, and improvements in the balance of payments. These objectives are achieved through the implementation of both direct and indirect monetary policy tools. (Central Bank of Iraq Report, 2013: 35).

Furthermore, economic stability is used to describe the financial system of a country and its ability to maintain minor fluctuations in growth and consistently low inflation rates. Often, the policies and measures implemented by the central bank contribute to the economic stability of an advanced country. For effective economic performance, inflation should be at a low and stable level, which the monetary authority strives to maintain. (Joseph Stiglitz, The Euro, 2016 : 147).

Alternative Options to the Foreign Currency Window

There are several alternative options to the foreign currency window, and each alternative has its own advantages and disadvantages. The following are some of the key points: (Al Alaq, 2016: 4)

1. Setting a Dollar Sales Ceiling: Setting a limit on the sale of dollars helps control the quantity of dollars sold and reduces the depletion of foreign reserves to combat waste and smuggling. However, a decrease in the supply of dollars to meet local demand may lead to an increase in the parallel market exchange rate and widen the gap between the official and parallel exchange rates. This may result in greater profits for speculators and brokers. Additionally, there may be cases of non-delivery of genuine documents to obtain dollars, along with weak supervision, considering the large number of banks and money transfer companies, which can deplete financial resources.

2. Partial Restriction Approach: The alternative relies on verifying the legitimacy of the funds used by banks and companies in transfer and sales operations, without requiring documents for sales and transfers from banks and companies. The positive aspect is that it helps control the quantity of dollars in circulation and avoids involving the central bank and banks in document-related processes. However, the negative aspect is that it may lead to an increase in the exchange rate of the dollar, resulting in a rise in domestic prices.

3. Not setting a ceiling for foreign currency sales. This alternative does not allow for covering operations that are not included in the Central Bank's regulations. This alternative has several advantages that contribute to achieving exchange rate stability. It complies with the principles of the International Monetary Fund and the Central Bank's law regarding the non-setting of ceilings. However, the negative aspect is that allowing freedom of purchase for specific purposes can lead to higher utilization of foreign currency reserves, which increases the risk of depleting the central bank's foreign currency reserves. It does not comply with the directives of the International Monetary Fund.

4. Not restricting the quantities supplied and responding to the demand for foreign currency. One of the advantages of this alternative is exchange rate stability and price stability, preventing speculation and avoiding significant differences between the official and parallel exchange rates. The negative aspect is that it may lead to a decrease in foreign currency reserves, which has more significant effects. This alternative encourages further currency transfers abroad.

PRACTICAL APPLICATION

Displaying data

The following table shows the currency selling prices in the central bank window, the exchange rates in the parallel market, the arithmetic mean, and the standard deviation, and shows the Z value, which represents the risk. For research years 2016, 2017, 2018, 2019.

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variants / study duration	Currency sale window sales (billion dollars)	The official exchange rate in the window (JD)	Exchange rate in the parallel market (JD)	The percentage of the amount of change in the parallel exchange rate	The gap between window and parallel market prices	Exchange rate risk (normative (z) in the parallel market
December 2- 2016	3.992	1177	1222	0%	45	-0.75578
February	3.423	1183	1222	0%	39	-0.75578
March	4.713	1190	1222	0%	32	-0.75578
April	4.232	1190	1218	-0.3%	28	-0.87433
May	4.266	1190	1222	0.3%	32	-0.75578
June	4.721	1190	1213	0.7%	23	-1.02253
July	3.660	1190	1214	0.1%	24	-0.99289
Dad	5.154	1190	1213	-0.1%	23	-1.02253
September	4.931	1190	1204	-0.7%	14	-1.28927
October 1	4.143	1190	1207	0.2%	17	-1.20036
October 2	4.573	1190	1200	-0.6%	10	-1.40782
Canon 1	3.920	1190	1205	0.4%	15	-1.25963
average	4.311	1188	1214	0.7%	26	-1.09292
January 2-2017	2.828	1190	1221	0.6%	31	-0.78542
February	1.598	1190	1241	19.9%	51	-0.19265
March	2.581	1190	1270	2.3%	80	0.666864
April	3.078	1190	1298	2.2%	108	1.49674
May	3.366	1190	1309	0.8%	119	1.822762
June	4.956	1190	1305	-0.3%	115	1.704209
July	4.999	1190	1230	-5.7%	40	-0.51867
Dad	5.464	1190	1217	-1.1%	27	-0.90397
September	3.656	1190	1223	0.5%	33	-0.72614
October 1	3.670	1190	1220	-0.2%	30	-0.81506
October 2	4.693	1190	1219	-0.1%	29	-0.84469
Canon1	3.415	1190	1216	-0.2%	26	-0.93361
average	3.692	1190	1247	2.5%	57	-0.05804
January 2-2018	3.319	1190	1234	-1.0%	44	-0.40012
February	2.496	1190	1240	0.5%	50	-0.22229
March	2.072	1190	1260	1.6%	70	0.37048
April	2.232	1190	1277	1.3%	87	0.874333
May	2.574	1190	1283	0.5%	93	1.052164
June	3.070	1190	1266	-1.3%	76	0.548311
July	2.210	1190	1273	0.5%	83	0.755779
Dad	3.012	1190	1280	-1.3%	90	0.963248
September	2.316	1190	1289	0.6%	99	1.229994
October 1	3.211	1190	1298	0.5%	108	1.49674
October 2	3.445	1190	1295	0.7%	105	1.407825
Canon1	3.568	1190	1303	0.7%	113	1.644932
average	2.794	1190	1275	-0.2%	85	0.010116
January 2-2019	3.593	1190	1292	0.6%	102	1.318909
February	3.366	1190	1272	-2.1%	82	0.726141
March	3.908	1190	1254	1.3%	64	0.19265
April	3.683	1190	1250	0%	60	0.074096
May	2.735	1190	1250	-0.16%	58	0.014819
June	3.484	1190	1248	1.0%	71	0.400119
the average	3.583	1190	1261			
SMA			1247.5			
standard deviation			33.74			

Research hypotheses testing

This topic shows the statistical analysis of the study variables for the period from January (2016) to December (2018). This analysis deals with the correlation and influence relationships between the window sales of foreign currency for the dollar and the risks of fluctuations in the exchange rate of the dollar in the parallel market.

First - Analysis of the correlation between the variables of the study according to the correlation coefficient (Pearson)

Table 2 shows the correlation relationship according to Pearson's correlation coefficient and the (T-Test) between the sales of the foreign currency selling window of dollars and the risk of exchange rate fluctuations for the period of the study; It is clear from Table 2 that there is an inverse correlation between the two variables; The change of one unit of sales of the foreign currency selling window leads to an inverse change in the risk of exchange rate fluctuations of (-0.467) up or down. We also find when testing (T-Test) that the value of (T) amounted to (-3.237); It is greater than the tabular value of (T), which is (2.021); And the level of significance (0.002 = Sig), which is smaller than the level of significance of the test, which amounts to (0.05); This indicates that there is a statistically significant relationship for window sales of foreign currency and the risk of dollar exchange rates fluctuations in the parallel market; These results indicate the acceptance of the first hypothesis, which is that there is a significant relationship with statistical significance between the sales of the window selling foreign currency in the Central Bank of Iraq in dollars and the exchange rate risks.

Schedule (2)

Testing the correlation between foreign currency selling window sales and exchange rate risk fluctuations in the parallel market

		Total currency sales	exchange rate risk
Foreign currency sales window	Pearson Correlation	1	-.467-**
	Sig. (2-tailed)		.002
	N	42	42
exchange rate risk	Pearson Correlation	-.467-**	1
	Sig. (2-tailed)	.002	
	N	42	42

]T-Test[

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.803	.557		3.237	.002
	window sales Foreign currency	-.001-	.000	-.467-	-3.343-	.002

a. Dependent Variable: The risk of exchange rate fluctuations

Source: Prepared by researchers according to (Spss) program.

Second - Analyze the effect of the study variables using simple linear regression

Table 3 shows the results of the simple linear regression test, according to the statistical program (Spss), the effect of foreign currency selling window sales on the risk of exchange rate fluctuations; It is noted that the coefficient of determination (R-Sq) has reached (0.128), and this means that the sales of the foreign currency selling window explain (22%) of the change in the risk of exchange rate fluctuations, and when testing (F-Test) we find that the value of (F) amounted to ((11.173), which is greater than the tabular (F) value, which is (4.08), and at a significant level (Sig = 0.002), which is smaller than the test significance level, which amounts to (.0050) This indicates a significant effect between the two variables, and these results indicate Acceptance of the second hypothesis, which states that there is a statistically significant effect between the sales of the foreign currency selling window of dollars and the exchange rate risks.

Table (3)

The results of testing the effect of foreign currency selling window sales on the risk of exchange rate fluctuations

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.467[a]	.218	.199	.8954043538

a. Predictors: (Constant) Foreign currency sales window

]F-Test[

Model		Sum of Squares	Df	Mean Square	F	.Sig
1	Regression	8.958	1	8.958	11.173	.002[b]
	Residual	32.070	40	.802		
	Total	41.028	41			

a. Dependent Variable :The risk of exchange rate fluctuations

b. Predictors: (Constant) :Foreign currency sales window

Source: Prepared by researchers according to (Spss) program.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

1-The intervention of the Central Bank of Iraq in meeting the needs of the private sector in foreign currency through the window of selling the foreign currency led to achieving a relative stability in the exchange rate of the foreign currency (the dollar) against the Iraqi dinar, through its active role in achieving a balance between the forces of supply and demand for foreign currency.

2-It became clear through the results of the study that the sales of the foreign currency sale window are one-way, that is, from the foreign currency sale window to the local market; This means that the main source of foreign currency is the Central Bank of Iraq.

3-It was found from the results of the study that there is a strong correlation with statistical significance between the sales of the foreign currency selling window and the exchange rate risks, and that the nature of this relationship is an inverse relationship; As the gap between the parallel exchange rate and the official exchange rate decreases, it leads to a reduction in the exchange rate risk, which indicates the rationality of the relationship and correlation; This proves the validity of the first main hypothesis.

4 -The results of the study proved that there is a strong, statistically significant effect relationship between the sales of the foreign currency selling window of the Central Bank of Iraq and the exchange rate risk; We conclude from this that foreign currency sales through the foreign currency sale window contributed effectively to maintaining great

relative stability in the foreign currency exchange rate throughout the time period covered by the study; This supports the validity of the fourth main hypothesis of the study, which states that there is a statistically significant effect between the sales of the foreign currency window in the Central Bank of Iraq in dollars and the exchange rate risks.

5 -The reserve of foreign currency at the Central Bank of Iraq is considered as the basis through which the bank can control the supply of foreign currency (dollar) and because this reserve is supported to a large extent by oil revenues, and therefore the supply of foreign currency is closely related to the rise and fall in prices and quantities source oil.

6-The central bank's achievement of its primary goal of stabilizing the exchange rate of the Iraqi dinar against the US dollar is directly linked to the security and political stability in the country.

7-The relative stabilization of the exchange rate of the Iraqi dinar against the US dollar, by following the policy of the fixed and pegged exchange rate, has resulted in achieving relative stability of exchange rates, and thus improving the standard of living for members of Iraqi society.

8-The fixed and pegged exchange rate system was imposed by the rentier economy approach followed in Iraq, which is mainly linked to crude oil sales and prices. As well as the large volume of operating spending compared to investment spending in the federal budget.

-9The exchange rate is mirrored, which reflects the country's commercial position with the outside world through the relationship between exports and imports; Therefore, any significant change in the value of the local currency against the foreign currency will negatively affect the economy as a whole.

Recommendations

1 - The study confirms the necessity of continuing the work of the foreign currency sale window for the Central Bank of Iraq, due to the successful and effective impact of this window in providing the foreign currency (dollar) to the private sector, as well as achieving remarkable relative stability in exchange rates throughout the period of time studied.

2 - The need to seek to attract foreign currency into the country by facilitating investment operations, especially for the Iraqi community outside the country to diversify the sources of obtaining foreign currency.

3 - Work to reduce the price differences between the selling price of the window and the selling price of the parallel market, and tighten control over banks, money transfer companies and exchange companies working with the window to ensure that foreign currency reaches the final beneficiary at the lowest prices.

4 - Seek to link the Iraqi dinar to a basket of foreign currencies and not be limited to the US dollar only.

5 - The research recommends the importance of reconsidering the total sources of foreign currency in the country and not being limited to revenues from the sale of crude oil by paying attention to the sectors of industry, agriculture and tourism and encouraging exports to diversify sources of obtaining foreign currency.

6 - Work to increase the number of banks and money transfer companies dealing with the foreign currency sale window, for the following reasons:

A- Reducing monopoly opportunities in selling the foreign currency.

B- Ease of stopping the work of any bank or company that violates the instructions.

7- Continuous activation of the supervisory effect on the conduct of foreign currency sale window operations to prevent waste of foreign currency and reduce the activities of smuggling foreign currency outside the country to preserve the reserves of the Central Bank of foreign currency.

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