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Research Paper

Circumventing the Impact of Public Expenditure on Foreign Currency Sales

Triennial General Budget: A Case Study

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Executive Summary

- Government spending is one of the tools used to guide a country's economic policies, meeting basic needs and fostering economic development. The Iraqi dinar is the currency upon which the Iraqi economy relies in its daily transactions, and the exchange rate is merely an indicator that responds significantly to various influencing factors, including monetary and fiscal ones.
- An increase in government spending leads to an expansion of the money supply, resulting in higher prices and, consequently, inflation, which negatively affects the value of the Iraqi dinar and lowers the local currency's exchange rate. As a result, the Central Bank intervenes through foreign currency sales to absorb excess liquidity, i.e., sterilizing the money supply by selling dollars in exchange for dinars.
- Furthermore, increased public spending leads to a rise in currency issuance, especially if there is a deficit in the general budget, which is financed through domestic public debt via treasury transfers discounted at the Central Bank. This generates inflationary pressures within the economy due to expansionary fiscal policy.
- The relationship between public spending and foreign currency sales results from the government's monopoly over foreign currency on one hand, and the Central Bank's monopoly over the dinar on the other. The majority of public expenditures are in local dinars, while most public revenues are in US dollars. Therefore, the government exchanges dinars for dollars at the Central Bank to fulfill current and investment budget commitments.

Context

First: Theoretical Framework of the Relationship Between Public Spending and Foreign Currency Sales

Iraq uses the currency sale window to intervene in the foreign exchange market and to facilitate foreign trade operations. The currency sale window can be defined as a mechanism adopted by several central banks and is one of the tools used to intervene in the foreign exchange market, covering the gap in local demand for foreign currency and thereby stabilizing the exchange rate [1]. There are several mechanisms for operating the foreign currency sale window, including the two-way currency window, where the central bank intervenes in the exchange market as both seller and buyer directly and in proportions that achieve the set goal while ensuring exchange rate stability. The second mechanism is the one-way currency window, known as the "currency sale window," which is followed by the Iraqi Central Bank. In this case, the central bank intervenes in the exchange market as a seller only, aiming to meet local demand for foreign currency for import purposes. Here, the government monopolizes sources of foreign currency supply, which primarily applies to all rentier countries suffering from structural economic imbalances and deficiencies in local production, thus relying on imports to meet consumption needs. The central bank, as the primary source of foreign currency, sells it to the private sector through commercial banks at a pre-announced price. Thus, the currency window becomes the foreign exchange market, and the central bank is the primary influencer of exchange rate changes [2].

1. Cuevas, Con Alfredo and Werner Alejandro M. (2001) «The Mexican Experience with a Floating Exchange-Rate Regime» IMF working paper, Washington DC.
2. Ali Mohsen Al-Alaq, (2015), Foreign Reserves and the Currency Sale Window at the Central Bank of Iraq, published research, Central Bank of Iraq.

Figure 1: Mechanism of the One-Way Currency Sale Window

Source: Prepared by the researcher

It is essential to note that crude oil revenues influence public spending, which in turn determines effective aggregate demand through the multiplier mechanism. When public spending increases, as in Iraq with successive general budgets, effective aggregate demand rises to a new level, aligning with government consumption and investment. The latest volume of aggregate demand is distributed across various types of goods and services, some of which are produced domestically, while others are imported from abroad.

Hence, there is a clear relationship between public spending and foreign currency sales: high oil revenues → increased government spending → increased effective aggregate demand → inflationary pressures due to limited domestic productive capacity → increased production costs in local currency with a fixed exchange rate → increased production costs in foreign currency → reduced competitiveness and shrinking investment and production base → increased tendency to import and invest abroad → increased demand for foreign currency [3].

There is a significant connection between government spending and the exchange market, stemming from the oil-based nature of the economy. The general

3. Mahmoud Mohammed Dagher, (2018), Macroeconomics: Theories and Policies, First Edition, Dar Al-Sisban for Publishing and Distribution.

budget is financed by oil revenues, which are in foreign currency, while domestic public spending is in Iraqi dinars. The government exchanges oil dollars for dinars at the Central Bank, which then obtains the equivalent of annual domestic government spending in foreign currency. Thus, domestic government spending becomes a determinant of foreign currency supply in the exchange market via the Central Bank, which responds to private sector demand through banks. The difference between the Central Bank's purchases from the Ministry of Finance and its sales to the private sector ultimately ends up in international reserves, which supplement the supply when it is insufficient. The difference accumulates as net foreign assets at the Central Bank of Iraq, which are its international reserves. In Iraq, these reserves are typically larger than the purchases because they do not need to be wholly owned by the Central Bank.

Second: Analysis of the Triennial Budget's Impact on Foreign Currency Purchases and Sales

Due to the Iraqi economy's reliance on oil revenues, public spending is tied to these revenues. The Central Bank mainly exchanges local currency with the Ministry of Finance to obtain foreign currency, given the government's increasing demand for local dinars to cover domestic expenditures. This increases the money supply, and since the money supply is directly proportional to government spending, this creates inflationary pressures. Due to weak production and limited domestic GDP, these effects are reflected in the exchange rate of the Iraqi dinar, necessitating Central Bank intervention to sterilize the money supply by injecting more foreign currency to absorb the liquidity surplus generated by public spending. Thus, when the Central Bank sells dollars, it is conducting monetary, not commercial, policy to mitigate inflationary effects.

Table 1 shows the increase in foreign currency sales during 2020–2024. Public spending reached 198.91 trillion dinars in 2023, resulting in foreign currency sales of $56.1 billion, driven by increased foreign currency inflows supported by the government's strong disposal of oil revenue. This was to cover both current and investment sides of the general budget, settle external obligations, and meet rising demand from individuals and institutions for foreign currency to cover various needs. In 2024, public spending increased to 211.88 trillion dinars, accompanied by a rise in Central Bank foreign currency sales to $80.97 billion, a 44.3% increase, to meet the private sector's demand for imports. Generally, the Ministry of Finance's sales to the Central Bank exceeded private sector demand, and private sector purchases increased more regularly than the currency entering the Central Bank.

Table 1: Development of Public Expenditures, Revenues, and Central Bank Purchases and Sales

Year	Public Expenditures (trillion dinars)	Public Revenues (trillion dinars)	Central Bank Purchases (billion USD)	Central Bank Sales (billion USD)
2020	76.08	63.20	30.73	44.08
2021	164.21	93.16	45.99	37.09
2022	116.96	161.60	53.36	46.81
2023	198.91	134.55	64.00	56.10
2024	211.88	147.84	68.65	80.97

Source: Ministry of Finance, Budget Directorate – Central Bank of Iraq, Statistics and Research Directorate.

Third: Impact of the Triennial Budget on Issued Currency and Money Supply

Public spending affects both the issued currency and the money supply. One of the key challenges is the relationship between government spending and the issuance of currency; the issuance of currency rises with increased government spending, even when the general budget is balanced. However, it increases even more in the event of a deficit, as the funding gap is covered by monetary policy through treasury transfers. Due to Iraq's rentier economy, there is pressure on the issue of currency, even if both the government's general budget and the balance of payments are balanced. However, pressure intensifies on the issued currency channel in the event of a dual deficit, financed through discounted transfers, with a greater impact on reserves and the exchange rate.

Table 2 shows that as spending increased, issued currency rose from 66.03 trillion dinars in 2020 to 100.54 trillion dinars in 2024 (an increase of 52.2%). Notable implications of public spending include its effects on the monetary base and money supply, with the link between these relationships being the net credit provided by the Central Bank to the government and net foreign reserves. The impact of these relationships is reflected in demand through the issuance of currency, and the effect is more pronounced when the Central Bank discounts transfers on the issued currency channel during periods when revenues do not cover actual expenditures. This makes the money supply an internal variable influenced by fiscal rather than monetary policy. Table 2 shows that as public spending increased, the money supply rose from 103.35 trillion dinars in 2020 to 151.96 trillion dinars in 2024.

Table 2: Development of Public Spending, Issued Currency, and Money Supply

Year	Public Expenditures (trillion dinars)	Issued Currency (trillion dinars)	Money Supply M1 (trillion dinars)
2020	76.08	66.03	103.35
2021	164.21	76.56	119.94
2022	116.96	87.56	146.49
2023	198.91	101.48	160.32
2024	211.88	100.54	151.96

Source: Ministry of Finance, Budget Directorate – Central Bank of Iraq, Statistics and Research Directorate.

Fourth: Impact of Public Spending on the Exchange Rate

Government expenditures are the primary driver of aggregate demand for goods and services within the domestic economy. Since aggregate demand depends on government spending, financing public expenditures is responsible for expanding liquidity in Iraq. Despite the significant increases in public budgets after 2003, the required development was not achieved due to a shortfall in domestic supply relative to demand, resulting from increased public spending, particularly in current expenditures. This led to increased imports, higher prices, and rising inflation, which in turn led to a decline in the local currency's exchange rate. The exchange rate is one of the economic variables that change continuously in response to supply and demand for currencies. The exchange rate can sometimes be an independent variable affecting dependent variables, and at other times it is itself dependent on other changes.

The official exchange rate changed twice between 2020 and 2024, but the gap between the official and parallel rates widened, increasing from 44 dinars in 2020 to 190 dinars in 2024. Thus, the exchange rate is affected directly and indirectly by fiscal policy. Expansionary fiscal policy leads to increased incomes, aggregate demand, and prices, then a decline in the local currency's value. This, in turn, leads to increased demand for imported goods and foreign currency, further lowering the local currency's value (i.e., more units of local currency are required to purchase one unit of foreign currency), and the reverse holds for contractionary fiscal policy.

Table 3: Development of Public Spending, Official and Parallel Exchange Rates

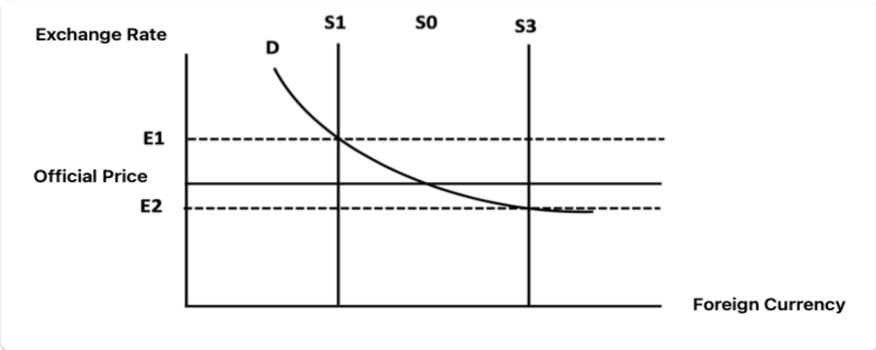
Year	Public Expenditures (trillion dinars)	Official Exchange Rate	Parallel Exchange Rate	Difference
2020	76.08	1190	1234	44
2021	164.21	1460	1474	14
2022	116.96	1460	1482	22
2023	198.91	1310	1490	180
2024	211.88	1310	1500	190

Source: Ministry of Finance, Budget Directorate – Central Bank of Iraq, Statistics and Research Directorate.

Fifth: The Real Value of the Iraqi Dinar and Exchange Market Equilibrium

Purchasing power parity (PPP) of the exchange rate is considered a measure of market efficiency and exchange rate policy. However, deviations from this standard are widespread, and it is often difficult to prove a natural tendency to return to PPP equilibrium in the long term. Another concept for studying exchange market performance and exchange rate policy is "Exchange Market Pressure," which refers to pressure to change the exchange rate or deplete international reserves to maintain it. Interest in this concept has grown due to the desire to avoid currency crises or fear of currency collapse, known as a "successful attack" when it leads to currency depreciation. Conversely, monetary policy may resist speculation by supplying foreign currency from international reserves, i.e., exchanging reserves for exchange rate stability. This form of intervention logically depends on the size of global reserves, excess demand, and the duration of the excess. Figure 1 illustrates the relationship between Central Bank sales and the equilibrium quantity, and can also represent the relationship between the Ministry of Finance sales to the Central Bank and the latter's sales to the private sector. The official exchange rate occurs at the intersection of the demand curve (D) with the supply of foreign currency from the Central Bank to the private sector (S0). If supply drops to (S1), the equilibrium price (market rate) becomes (S0), and the supply shortfall equals the distance between S0 and S1. If the Ministry of Finance sells the amount (E1), reserves must be depleted by the area between S0 and S1. Typically, the Ministry of Finance's sales to the Central Bank (S2) and the Central Bank's sales to the private sector (S0) lead to the accumulation of international reserves at the Central Bank.

Figure 1: Supply and Demand for Foreign Currency

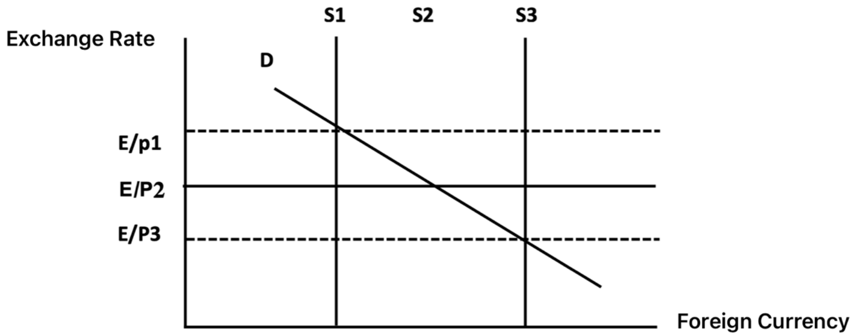


Source: Prepared by the researcher based on:

- Mankiw, G. (2009) "Macroeconomics", Harvard University, New York

The following chart explains the decline in the purchasing power of the dollar's exchange rate inside Iraq due to the rise in the general price level in Iraq relative to the general price level abroad (P). As the level rises from (P1) to (P2) and then to (P3), the real exchange rate of the dollar decreases, i.e., when the dinar and dollar are measured in constant purchasing power units, the real exchange rate of the Iraqi dinar rises, meaning the real exchange rate of the dollar against the dinar becomes cheaper. All else being equal, this leads to increased demand for foreign currency, as there is an inverse relationship between the real exchange rate and demand for foreign currency, so demand rises from (S1) to (S2) and then to (S3). This explains the demand for foreign currency in Iraq.

Figure 2: Supply and Demand for Foreign Currency and the General Price Level



- Mankiw, G. (2009) "Macroeconomics", Harvard University, New York

In Iraq, foreign currency is supplied through the Central Bank window, which is the primary source. Demand for foreign currency can be classified into two categories: private sector imports of goods of various types and private sector imports of services (including transport and insurance, to a limited extent, as well as travel, tourism, medical, and educational services). Banks typically play a dual role, buying and selling on their behalf and for their clients simultaneously. However, Iraqi banks mostly purchase foreign currency from the Central Bank for their clients, as the source of foreign currency is governmental. The foreign exchange market in Iraq remains simple: the private sector buys from the government through banks, and there is no speculation in holding foreign currency for arbitrage purposes (anticipating price changes). However, some may purchase foreign currency for resale at higher prices because the ultimate beneficiary may not be able to obtain foreign currency from its source. Iraq lacks clear legal rules and regulations to govern external transactions in and out. It is necessary to enact comprehensive legislation for foreign currency trading and current and capital external transactions, drawing on suitable experiences from other countries. Such legislation would provide a basis for required documents and reports, define violations, and empower oversight bodies to enforce compliance.

Conclusion

Government spending has a positive relationship with foreign currency sales. Increased reserves resulting from higher oil revenues enable the sale of foreign currency to maintain the stability of the Iraqi dinar's exchange rate and provide the government with liquidity to meet its current and investment budget commitments. To mitigate the pressure of public spending on Central Bank sales, it is necessary to direct and control government spending by setting specific criteria for public spending priorities, as this is the primary factor determining aggregate demand. This would reduce demand for imports. Given the high marginal propensity to consume over invest, most of the increase goes to higher demand for goods and services, which is financed through imports via foreign currency sales. It is essential to diversify Iraq's sources of foreign currency, rather than relying solely on the oil sector, and to strengthen the role of tax and customs policy to support the general budget with additional resources and reduce dependence on oil revenues. Finally, a clear import program must be established to ensure the import of essential and productive goods according to the country's needs and to limit the import of unnecessary luxury goods that have contributed to the depletion of foreign currency.

Sources and References

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(3) Ministry of Finance, Budget Directorate, Federal General Budget Law, various years.

(4) Central Bank of Iraq, Statistics and Research Directorate, Statistical Bulletin, various years.

(5) Cuevas, Con Alfredo and Werner Alejandro M. (2001) "The Mexican Experience with a Floating Exchange-Rate Regime" IMF working paper, Washington DC.

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Note

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The center aims to utilize the vast amount of potential in Iraq's human resources by organizing programs to prepare and develop promising young people, including leaders capable of proposing, adopting and implementing visions and future plans that advance society and preserve its value-system based on the commitment to a high moral standard and rejection of all types of corruption.

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