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An analytical study on the impact of oil revenues on the foreign exchange reserves of the Central Bank of Iraq

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Abstract

The research aims to identify the role played by oil revenues to influence the foreign exchange reserves of the Central Bank of Iraq as it is dominant without other sectors contributing to the achievement of added value, which constitutes a positive impact on the foreign exchange reserves, Drawing up a monetary policy on buying and selling currency with the Ministry of Finance through the currency window, as this effect was clarified by presenting an analytical study over a period of time (2014-2020).

Keywords: Oil, foreign exchange reserves, Central Bank, Iraq

Introductions

Oil revenues play an important role in achieving economic stability, especially with regard to foreign exchange reserves with the Central Bank of Iraq, as the bank seeks through its role in preserving its cash reserves, as it seeks to make optimal use of the reserves by expanding the diversification of public revenues. Oil revenues on foreign reserves, and this study represents a positive relationship, and the effect of this on the internal public debt has an opposite effect on them, and the study also explains the reasons that lead to imbalances in the reserves resulting from the impact of oil revenues on it, and this is caused by the vulnerability of those revenues to changes in the level of crude oil prices And unexpected economic crises, and the research used in its analysis of the relationship a specific time series (2014-2020), indicating the impact and causes, and finally reached a number of conclusions and recommendations.

Research objective: The research aims to clarify the theoretical aspect

- Of oil revenues and changes in them.
- Foreign reserves of money and the role of the central bank in preserving it.
- The practical side of the research is an analytical study of the impact of oil revenues on foreign exchange reserves.

Research importance: The importance lies through the following

- Statement of the importance of oil revenues and their role in enhancing foreign exchange reserves and its growth.
- The role of the Central Bank and the Ministry of Finance in providing reserves.
- Clarify the relationship between oil revenues and foreign exchange reserves by presenting an analytical study of them.

Research problem: The research shows its problem, which is the dependence of Iraq in its economy on the oil sector, and this sector is exposed to imbalances and economic crises that affect it negatively, preventing economic growth and not achieving economic stability through its oil revenues that are exposed to imbalances, which has a direct impact in reducing foreign exchange reserves The result of this problem is to increase dependence on internal public debt.

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Research hypothesis: The research assumes that oil revenues have a direct impact on the foreign exchange reserves of the Central Bank, as its effect is represented by a direct relationship with the reserves and an inverse relationship with the internal public debt.

Literature review

The first topic: The theoretical aspect of oil revenues and foreign exchange reserves

First // the theoretical aspect of oil revenues

The importance of oil revenues: Public revenues are an important aspect of the general budget and they represent various sources, including natural ones represented by crude oil revenues from oil exports and other unnatural ones represented by taxes and fees. In Iraq, oil revenues dominate the rest of the revenues as they represent the largest contributor to Operating expenditures for the public budget as it has the largest role in developing the gross domestic product, and Iraq is considered one of the oil countries that occupies a privileged position among the Arab and international countries, due to the huge reserves of it, and it is also one of the founding member states of OPEC, so the oil sector in Iraq is one of the most important pillars The Iraqi economy (Asmaa, 2007) ^[3], and oil revenues in Iraq are exposed to some changes and imbalances, which affect the general budget, the balance of payments, and the rest of the economic variables, causing financial and economic instability.

Reasons for the change in oil revenues

In light of the changes that occur in oil revenues, there are reasons for it, the most important of which are:

- International oil prices, which are directly proportional to oil revenues, as their rise leads to an increase in revenues and economic growth. Its revenues led to a continuous financial deficit, causing a decline in the gross domestic product, in addition to the global Corona pandemic, which caused during recent years (2018-2021) a decline in the global economy, causing a decrease in crude oil prices, and this negatively affected the Iraqi economy, which caused a decline in Oil revenues and the continued fiscal deficit of the public budget.
- Climate changes: - They affect the levels of demand for oil. In consuming countries, levels of demand decrease as a result of high temperatures, and those levels rise in the winter season.
- The exchange rate of the US dollar: - Crude oil is priced in US dollars, being the currency that is dealt with internationally, so the rise or fall of the dollar exchange rate affects the economies of oil-producing countries, as its decline causes a decline in the value of the dollar and this leads to a rise in crude oil prices (Ali 2016) ^[1].
- The size of oil reserves: - It is one of the factors affecting oil revenues through its direct impact on oil prices, as the discovery of new oil reserves is extracted at economic costs commensurate with the level of crude oil prices prevailing in the market, as it affects the level of oil prices and revenues in it (Siham, 2013) ^[8].

Second // the theoretical aspect of foreign exchange reserves

1. What are foreign reserves for cash: - Foreign exchange

reserves are external financial assets that the monetary authorities can control at any time in order to finance the imbalance in the balance of payments or influence the currency exchange rate through intervention in the exchange markets (International Monetary Fund, 2001) ^[6]. It represents the total difference between the foreign currency window sales and the Central Bank's purchases of foreign currency from the Ministry of Finance. There are many influencing factors, some of which enhance the reserve balance and some of which negatively affect it, and here comes the role of monetary policy through the intervention of the Central Bank of Iraq by following several measures to maintain the balance of foreign exchange reserves.

2. The role of the central bank is one of the factors that enhance the reserve balance (Department of Economic Modeling, 2018) ^[4].
 - The bank buying dollars from the Ministry of Finance: - This mechanism leads to an increase in the foreign reserves of the Central Bank, as the more the bank purchases dollars from the Ministry of Finance, the greater the volume of foreign currency cash reserves.
 - How to deal with the profits of the Central Bank: - Through Article (8) of the Central Bank of Iraq Law, where it specified the distribution of bank profits at a rate of 80% to the foreign reserve account with the bank, i.e. transferring part of the surplus profits to it to enhance its balance in the bank.
 - External borrowing: This is what the state obtains from international and regional organizations due to insufficient national saving or for the purpose of importing, the state resorts to foreign currencies.
 - Revenue: It is the sum of the funds that the state obtains to cover public expenditures and includes tax and non-tax revenues. The increase in it affects the reduction of the depletion of foreign currency reserves, given that it provides sufficient liquidity to cover its public expenditures without resorting to internal public debt.

There are factors that negatively affect the cash reserves that the Central Bank follows to maintain the reserves, which are (Department of Economic Modeling, 2018) ^[4]:

- Dollar sales to the Central Bank of Iraq: - The bank resorts to selling the dollar through the sale window for the currency, and this sale leads to the withdrawal of part of the foreign reserves, and this expresses the inverse relationship between the quantities sold for the dollar and the reserves, that is, the more quantities sold, the lower the volume of the reserves.
- Internal public debt: - It expresses the money that the state resorts to obtaining from the public or banks in return for its pledge to pay annual interest on the amounts paid, and the debt indirectly affects the foreign reserves due to the increase in the money supply of the currency, and the state resorts to the currency window when using the reserve to withdraw the surplus part from the money supply.
- External shocks and manipulation of the dollar exchange rate: - Here, the Central Bank seeks to confront any external shock through its control over the foreign exchange rate of the currency, as it tries to reduce the exchange rate and avoid increasing foreign loans in order to secure its economy as well as its

attempt to attract foreign investment, which results in the accumulation of reserves. For foreign exchange, which would be a reason to address the economic recession and achieve growth in the gross domestic product (Hamdi, 2022) [5].

The second topic // the analytical aspect of the impact of oil revenues on foreign exchange reserves for the period (2014-2020)

First:- Analysis of the components of foreign exchange reserves and the percentages of participation in it (Jinan, 2018) [7]:

1. Gold: - Gold is one of the most important components of foreign reserves, as it is characterized by having a high degree of liquidity, easy use, commercial exchange, and acceptance in commercial exchanges.
2. Foreign exchange (currencies) in the bank's treasury: - It is characterized by the fact that the country issuing the currency is economically and politically stable, and that its financial markets are integrated with global markets, in addition to the fact that the currency is distinguished as a means of storage.
3. Investments of Iraqi foreign reserves in foreign central banks: - such as investment in bonds and current and fixed deposits.

Table 1: Contribution percentages of foreign exchange reserve components to total reserves for the period (2014-2020)

The years	Gold %	Foreign exchange in the bank's treasury %	Investment abroad %
2014	6.69	7.99	85.32
2015	5.77	3.37	90.85
2016	7.52	4.42	88.06
2017	7.8	3.1	89.1
2018	6.16	3.24	90.6
2019	6.97	1.46	91.57
2020	7.28	1.72	92.23

The source of the table is from the work of the researcher based on the data of the Central Bank.

We note from Table (1) that the percentage of gold's contribution to total reserves recorded its highest percentage in 2016, when it reached (7.52%), then this percentage decreased to record its lowest level in 2018, when it reached (6.16%). In 2020, it increased again, reaching (7.28%).

As for foreign exchange, its contribution to total reserves in 2016 was about (4.42%), then it declined until it reached below its levels in 2019 by (1.46%).

While the percentage of investment contribution to total reserves abroad recorded (88.06%) in 2016 and then gradually increased to record (92.23%) in 2020, which means that Iraq depends on oil revenues and the components of foreign reserves with the bank and diversifying its investment in foreign banks. For the purpose of maintaining monetary stability and liquidity at the central bank, the bank distributes cash reserves in balanced proportions, because an increase in one of its components causes a decrease in the contribution of the components.

Second // Analysis of the impact of oil revenues on the foreign exchange reserves of the Central Bank of Iraq for the period (2014-2020)

1. Analysis of the impact of oil revenues on foreign

exchange reserves:

Oil revenues in Iraq constitute (86%) of total public revenues for the period (2014-2020), as they contributed a large percentage to total public revenues amounting to (92%). It will have an impact on changing revenues, especially in countries that depend in their economy on crude oil revenues, being rentier on the one hand, and suffer from an imbalance in their production structure in the rest of the sectors on the other hand.

Table 2: Shows the economic indicators of oil revenues, internal public debt and foreign exchange reserves for the period (2014-2020) (trillion dinars)

The years	Oil revenues	Domestic public debt	Foreign exchange reserves
2014	97.072410	9.520549	13.169462
2015	51.312621	32.142805	11.217256
2016	44.267063	47.362251	9.222801
2017	65.071929	47.678,796	11.600361
2018	106.569834	41.822918	12.912070
2019	107,566995	38.331548	14.374171
2020	63.199689	64.246559	13.235138

The source of table (2) is the annual statistical releases for different years of the Central Bank of Iraq

In table (2), we note that oil revenues amounted to (97.072410) trillion dinars in 2014, after which it began to fluctuate and decline in 2016, when it recorded a decrease of (44.267063) trillion dinars, which reflected negatively on the internal public debt, as it increased during the period (2014). - 2016) from (9.520549) in 2014 to (47.362251) in 2016, and the reason for the decrease in revenues is due to the decrease in crude oil prices due to the impact of the global crisis, as it caused a gap between revenues and expenditures, as expenditures were higher than revenues, which negatively affected the incidence of The financial deficit of the budget, in addition to Iraq's dependence on imports to meet its needs, which made the state resort to internal public debt by resorting to the public and granting loans in return for annual interest, which put pressure on the foreign exchange reserves of the Central Bank, since the bank is through the window of selling the currency He sells part of his reserves to cover his debts, and thus the foreign reserves of cash decreased, as it recorded a decrease of (9.222801) trillion dinars for the year 2016 compared to what it was in previous years. During the period (2017-2019), oil revenues witnessed a slight increase, reaching (107.566995) trillion dinars in 2019, which had an impact on reducing the internal public debt to (38.331548) trillion dinars for the same year, and this had a positive impact on the increase in reserves by (14.374171) trillion. Dinars, however, in 2020, oil revenues decreased again due to the Corona pandemic crisis, which led to the collapse of global trade and the decline in global oil prices, which led to an increase in public debt to (64.246559), and as a result, foreign exchange reserves decreased to (13.235138) trillion Dinar. By analyzing the indicators, we notice that oil revenues have a positive effect represented by a direct relationship with foreign exchange reserves and the reflection of changes in oil revenues on the internal public debt, as it is represented by an inverse relationship, where the higher oil revenues lead to a reduction in internal public debt and an increase in foreign exchange reserves and vice versa. If it decreases, it will lead to an increase in debt, and as a result, the foreign exchange reserves of the central bank will decrease.

Conclusions and Recommendations

Conclusions

- a) The occurrence of changes in oil revenues according to external factors that the financial authorities do not have the ability to control.
- b) Oil revenues are represented by a direct relationship with foreign reserves of cash and an inverse relationship with the internal public debt.
- c) In the event of recovery, the central bank purchases the foreign reserves represented by the Ministry of Finance to increase its reserves, and in the event of financial deficit and recession, the bank sells part of its reserves through the sales window to the Ministry of Finance.
- d) Foreign exchange reserves consist of gold and foreign exchange represented in currencies and the investment of that money abroad.

Recommendations

- a) Coordinating between fiscal and monetary policy to address fiscal deficit imbalances by squeezing expenditures, encouraging investments, and diversifying revenue sources, given that oil revenues are subject to external fluctuations.
- b) Work on the establishment of huge production projects, for example, the project of establishing petrochemical industries derived from the existing oil industries and the establishment of electrical generation stations from them, as well as the establishment of the Al-Faw port project, which is an industrial and commercial project because it is a global commercial site that connects the geographical borders of Iraq with the commercial countries of the world, which helps to achieve this Huge and diversified revenues that achieve high growth rates and economic stability for the country.
- c) The need to diversify foreign reserves in several currencies for fear of the loss that specific currencies may be exposed to in dealing internationally.
- d) Develop a forward-looking financial policy to know the priority projects for the national economy.
- e) In the event of a financial deficit, the state must issue long-term bonds, after coordinating between the financial and monetary policies, allocating the revenues generated from them to the completion of investment and service projects that are suspended from implementation.

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