The Dutch Disease and Iraq's Foreign Exchange Rate. By Dr. Zeki Fattah *

Economists who studied the reasons for the low per capita growth of GDP in developing countries that rely on revenues from abundant natural resources, (called 'resource curse'), found it was actually caused not by high exchange rates, but by wrongly conceived economic policies over a long period of time. We will visit this point again at the end of the paper. Meanwhile, and until recently, monetary economists in Iraq explained the fall in the Dinar exchange rate against the Dollar (a change within the expected norm) as a passing event caused by falling oil prices, and trepidation in the markets in the wake of COVID-19. This explanation whilst went some way toward dampening the need for currency devaluation for a while, it didn't help the Iraqi Government to raise the cash it needed to meet its obligations. Recently, the Government had to reduce the Dinar exchange rate against the Dollar considerably to increase the Dinars it receives from the Central Bank in exchange for the Dollar it receives mainly from oil exports.

This paper considers the Dinar-Dollar exchange rates in its historical perspective. It argues that the root of the persistent call for devaluing the Iraqi Dinar in the period before the recent devaluation lies outside monetary economics. It lies in the belief that the Iraqi economy is suffering

from Dutch Disease; a phenomenon often identified by high exchange rates for the national currency.

In the first part, it explains why the Dutch Disease phenomenon does not apply to the Iraqi economy or the economies of developing-oil-exporting countries; and in the second, it argues that, in light of frequent fluctuation in oil prices, and the considerable dollar leakages from the country, it is in Iraq's interest to adopt a flexible exchange rate fluctuating within a narrow range instead of a fixed rate.

Why the Dutch Disease doesn't apply to developing oil-exporting countries?

The Dutch disease phenomenon describes what happens to an advanced industrial economy when it receives massive earnings of foreign exchange from export of newly found natural resources (Gas). When revenues from the export of gas entered the Dutch economy, it was mature with well-developed non-gas economic sectors. Exports from non-gas tradable sectors (agriculture and manufacturing) dominated the country's trade, representing approximately 75 percent of the GDP.

The economy was regulated by market forces. These forces determined the movement of production factors between the economic sectors. Interest rates, profit rates, wage rates and exchange rates, were stabilized around comparable rates in the international market. These rates influenced the sectoral composition of the economy affecting movement of resources between the sectors. The short run impact of the earnings from gas export, with labor being the only mobile factor, was to create a spending effect and

a resource movement effect. The revenues from the gas export destabilized the internal rate of interest and the exchange rate of the national currency. The former, for obvious reasons, declined below the rate in the international market, and the latter increased sharply. These two changes combined led to destabilize the equilibrium in the Dutch economy. This destabilization in turn released forces, both on the supply side and demand side, leading to the emergence of Dutch Disease in the economy.

On the supply side, as the expanding gas sector was offering comparatively higher wages to attract qualified workers; it attracted labor away from non-gas and conventional export sectors. With the economy operating at close to equilibrium, and in order to keep workers in the non-gas-tradable and non-gas-export sectors, wages had to be raised in these sectors. These wage increases, however, were not accompanied by improvements in productivity. They, therefore, increased the unit cost of goods and services in the non-gas sectors, which in turn raised the price of Dutch non-gas exports in the international market and rendered them less competitive.

Meanwhile, and with ease of access to (gas) funds, the Dutch government was increasing expenditure in the economy without raising taxes. This un-taxed based expansion of public expenditure gave rise to a higher household income and private expenditure, and raised the internal demand for goods and services in the economy. As a result, the demand for non-tradable activities (transport, services, and utilities), as well as for goods destined for exports, increased, causing further rises in the price of Dutch goods destined for the international market.

At the same time, and thanks to abundant revenues from gas exports, Dutch producers were borrowing money at an artificially low interest rate. They were not, therefore, under any pressure to improve factor

productivity to maintain profit or match the productivity performance of their international competitors.

In addition to the factors just mentioned, which made the cost and price of supply of Dutch exports comparatively higher in the international market, there were also forces at work on the demand side pushing the price of Dutch non-gas exports up even further. The influx of revenues from gas exports was raising the demand for Dutch currency substantially, and this was raising its exchange rate vis-à-vis foreign currencies. Dutch currency was becoming more expensive for foreigners to buy to pay for Dutch non-gas exports.

In other words, Dutch exports were increasingly pricing themselves out of the international market. This combination of factors caused a contraction in the share of Dutch non-gas exports, losing its export markets to its competitors. The share of Dutch non-gas tradable goods sectors in the GDP was now shrinking. In other words, the influx of earnings from gas exports was pushing the Dutch economy towards de-industrialization and de-agriculturalization; this phenomenon is described as the Dutch Disease.

How does the Iraqi economy work?

None of the analysis above applies to the Iraqi economy, or indeed to the economies of any of the developing oil exporting countries in the world. The Iraqi economy does not have and never had dominant non-oil export sectors (be it industry, agriculture or services).

Moreover, because it is a developing economy, neither its sectoral composition nor utilization of its production factors are at, or close, to the

state of equilibrium. In other words, production sectors can be expanded, and utilization of production factors can be increased without running into the problems which haunted the Dutch economy. As for the economic rates (e.g., interest rate, wage rate, profit rate) in the Iraqi economy, they are largely determined by government policies and not by market forces.

Those who argue that the Iraqi economy suffers from Dutch disease point to the 'high' exchange rate of its national currency, supported by substantial dollar earnings from the export of oil, and to Iraq's current poor non-oil export records for a long number of years?

This argument, however, does not stand to scrutiny. First, had the Dinar exchange rate been determined by the same forces operating under the Dutch Disease, the rate would have been much higher -because of international demand for its oil. Second, Iraq's non-oil exports was much higher (in the nineteen fifties and sixties) when the Dinar exchange rate was three times higher than its current rate.

Therefore, to say that the Iraqi economy suffers from the Dutch Disease because of the 'high exchange rate' of its national currency- as was the case in the Dutch economy, is like saying all surgical operations in medicine are the same because they use anesthetic.

To suggest, therefore, that the Iraqi economy suffers from the Dutch Disease is an inaccurate diagnosis of its illness, and inaccurate diagnosis of an illness produces an inaccurate prescription for its remedy.

This is clear in the suggestion that the price of the Iraqi Dinar in US Dollar was over stated. This suggestion is erroneous because it disregards the fact

that the post 2003 exchange rate of Iraqi dinar against US dollar was set, with the help of IMF, when the Iraqi economy was suffering from the following three major problems:

An astronomic foreign debt left over from the previous regime;

Low level of international foreign currency reserve; and

a low levels of oil production and exports in the period 2003-2006 when the current Dinar/Dollar rate was set.

Many years after the exchange rate of the Dinar was set, significant developments took place in the Iraqi economy. Its foreign debt was substantially reduced, its foreign currency reserve appreciably increased, and its oil production and exports markedly improved.

The exchange rate determined for the Iraqi Dinar, therefore, did not and still does not accurately reflect Iraq's economic reality. This rate is not in Iraq's interest. It served, and still does, only the interest of foreign countries. Therefore, it is high time now to adopt a flexible exchange rate for the Dinar vis-à-vis the US Dollar: i.e., raise it when its national reserve of foreign currencies is high, and lower it when the reserve is low; benefiting the country on the way up and on the way down.

There are a number of reasons to believe that a flexible exchange rate for the Iraqi Dinar against the Dollar, would be in Iraq's favor. While it is unlikely the exchange rate appreciation would make any of Iraq's non-oil exports more expensive (because they are of very small value), it would certainly improve Iraq's terms-of-trade and improve the purchasing power of Iraqi households, by making the price of imported goods and services

much cheaper. This is an important gain in its own right as imports consume a big chunk of Iraqi households' income.

Undoubtedly, the exchange rate adjustment would lead to a run on the country's foreign reserve. However, this would-be counter balanced by improvements in the country's terms-of-trade through higher exchange rates, lower import bills, and increasing Petro-dollars from oil exports. (Oil export is unrelated to the exchange rate).

In addition, the exchange rate adjustment would help to reduce the inflation rate. This rate in Iraq has always been fed by high import prices. The exchange rate adjustment, therefore, would, in the final analysis, improve the purchasing power of the Iraqi households, and contribute to fair distribution of benefits from oil-revenues among the population: objectives that have been at the heart of the economic policy of every Iraqi government.

Finally, coming back to the 'oil curse' in the opening paragraph, Iraq provides a perfect example. The continuing and disproportionate size of government employees' payroll and pension in the national income, illustrates phenomenon. In 2020, 98% of government income came from oil revenues, representing 25% of the GDP. Revenues from taxes represented a meager 1.5 percent of the GDP. (In the same year, the number of government employees represented a disproportionate 74% of the total labor force, up from 10 % in 2004). Iraq's expenditure on government payroll and pension in 2020, increased to 120 percent of the oil revenues, up from 88 percent in 2016.This presented a

severe financial problem for the government, and forced depreciation of the national currency by 20 percent.

Conclusion

First, the Dutch Disease phenomenon doesn't fully explain Iraq's foreign exchange misalignment, nor is it the cause behind Iraq's poor economic performance.

Unlike corona virus which is the same in developed and developing countries, and calls for the same treatment in both; the Dutch Disease phenomenon calls for different type of treatment in developing countries from that in developed countries. This is because the exigencies on the ground in developing oil-exporting countries do not support the mechanism described under the Dutch Disease; therefore, the phenomenon cannot be used as a directive for policy measures in these countries. For example, given the exchange rate, and, because of unemployment and disguised unemployment, movements of production factors are neither constrained nor do they produce the effects postulated under the Dutch Disease in these countries.

Second, Iraq's economic failure is caused by a combination of external and internal factors; including war damages caused by ISSIS, irrigation water problems, fall in oil prices, lack of foreign investment, economic mismanagement, corruption, socio-political instability, and a bloated public sector chronically pursing ineffective economic policy.

These problems cannot be dealt with by manipulating the country's exchange rate. They call for stability, sound economic policies, suitable and

effective development strategy that can engage the country's institutions and production forces in creating wealth and generating taxes.

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