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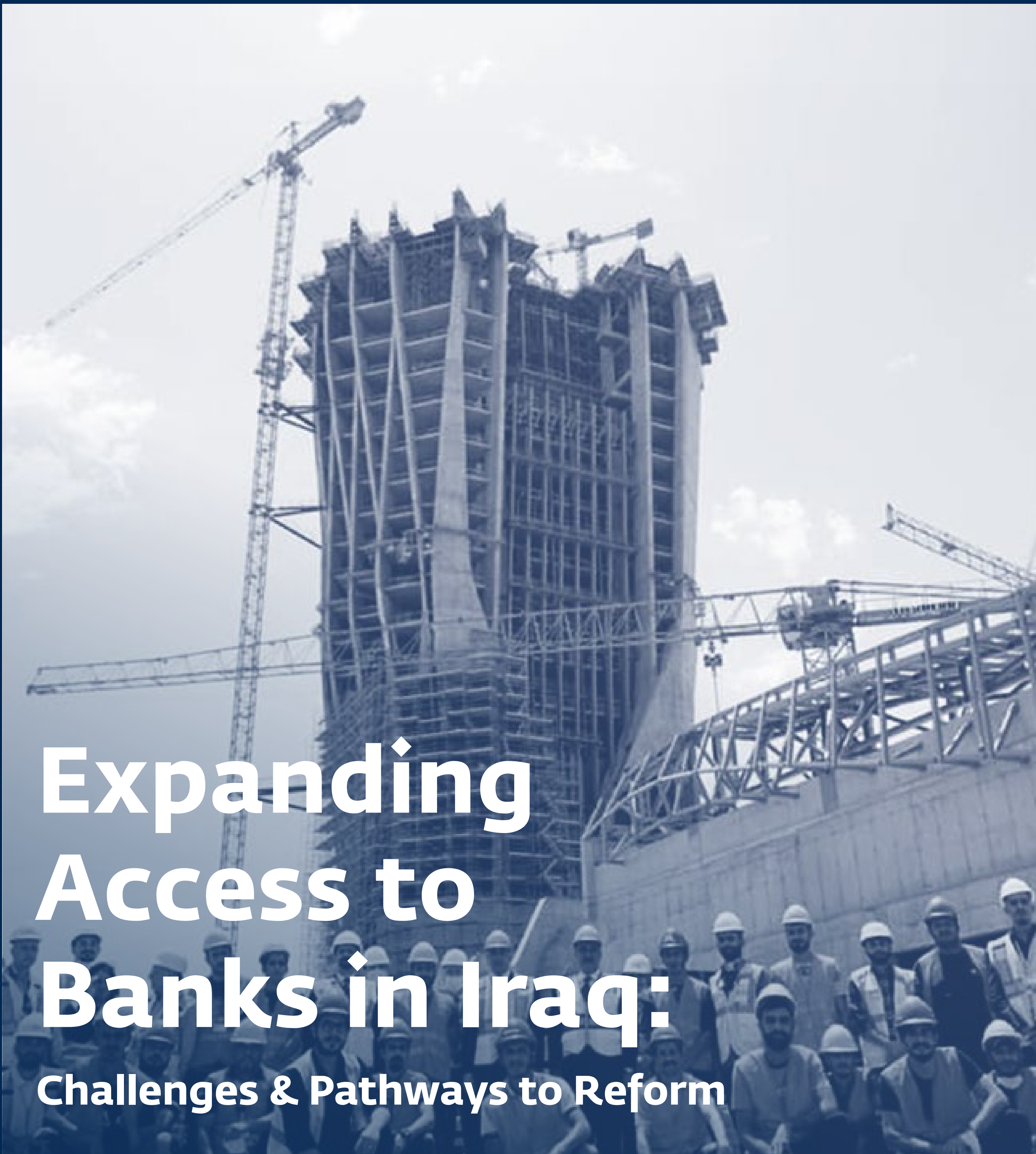

Expanding Access to Banks in Iraq:

Challenges & Pathways to Reform

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ABOUT IRIS

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ABOUT THE IRAQ ECONOMIC REVIEW

The policy discourse on economic development in Iraq has often rested on the assumption that the non-oil private sector must expand, thereby granting economic agency and autonomy to members of the population at large. But what this expansion would entail for Iraq, a country under cyclical waves of conflict and instability, remains almost entirely undefined. Now that Iraq and the Middle East region as a whole face the prospect of a long-term decrease in demand for oil, the need for understanding Iraq's economic dynamics and challenges have never been greater. Funded by the National Endowment for Democracy (NED), the Iraq Economic Review (IER) aims to direct the national policy conversation toward a sustainable economic vision and provide loc al civil society actors with the necessary knowledge and tools to press for changes in the governmental approach to the economy. Published by the Institute of Regional and International Studies (IRIS) at the American University of Iraq-Sulaimani, the IER is a one-stop-shop for understanding major economic trends. The Review couples analysis of the economy's main potential growth areas with a close examination of the legal frameworks, public infrastructures, and financial systems needed to ensure that growth transpires in an inclusive fashion.

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Central Bank of Iraq, Baghdad.

OUTLINE

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SECTION I

Cash is King: Money and the Banking Sector in Iraq

Ahmed Tabaqchali

INTRODUCTION

One of the major obstacles to the development of the private sector in Iraq is the lack of access to finance to support its growth. The consensus view is that this is a consequence of Iraq's underdeveloped banking sector, which is dominated by the state. While this diagnosis is, to a certain extent, true, a more accurate way of framing the problem would be to say that Iraq simply does not have a banking system, at least in the way that banking is globally understood or practiced. Iraq has institutions which are referred to as "banks" and indeed, they perform certain functions that resemble banks; however, with a few limited exceptions, Iraq's banks do not perform the essential functions that characterize a modern banking system. Whereas banks globally play a major role in the provision of credit and in the functioning of payment systems, banks in Iraq play second fiddle to cash.

A cash-based economy has major implications for charting a path to develop a fully-functional banking system. Iraq's international stakeholders have pursued "reform" of the banking sector in Iraq since 2003 through regulatory reform and restructuring of the dysfunctional major state banks. As worthwhile as this reform may seem, it nevertheless is futile when there is, in fact, no meaningful banking sector to begin with. A parallel but a different approach is needed – one that addresses the larger structural obstacles preventing the emergence of a viable banking sector. The big elephant in the room is cash. So long as cash dominates, there is little room for a robust banking sector to emerge. In addition to reforming a banking sector that exists mostly in name, Iraq and its international stakeholders should focus on creating incentives for citizens and companies to move away from cash, and towards settling economic transactions via private-sector owned banks, and use these banks to safeguard their savings.

CASH IS KING

Cash, in the form of currency in circulation, dominates the Iraqi economy both as a store of value – that is physically saved in by the public,[1] or in vaults of commercial banks – and as the means of settling economic transactions. The dominance of cash bypasses the need for a fully-functioning banking system, apart from the provision of rudimentary services. Consequently, the issuance of credit to the public,[2] either for current consumption or for investment spending, is very limited. Accordingly, the economy misses out on the extra purchasing power provided through the generation of what is known as "commercial bank money" via the issuance of credit.

Globally, money takes two forms. The first is referred to as "central bank money": the currency or cash (notes and coins) in circulation, held by the public, and stored in bank vaults and ATMs. Central bank money also includes commercial banks' deposits that are held with the central bank – referred to as "central bank reserves."[3] The second form of money is "commercial bank money" which is generated through the combination of accepting deposits and the issuance of credit to the public.[4] The crucial difference between the two forms of money is that central bank money is legal tender, and is available both to the public as cash and to commercial banks as cash in vaults and central bank reserves.[5] Commercial bank money, on the other hand, derives its value from public confidence that it can be converted into central bank money in the form of cash withdrawals – though in reality, this conversion is not guaranteed.

The combination of cash held by the public, and commercial bank money (i.e., money the public can access as cash, and as bank deposits), is referred to as "broad money."[6] The growth and size of broad money, relative to central bank money is highly influenced by the development of the banking sector, given the role banks play in the creation of commercial bank money through the issuance of credit. Without a viable banking sector, cash is king.

Iraq's lack of a viable banking sector and over-reliance on cash has been papered over by the constant flow of oil money. Increasing oil revenue over the years has enabled the government's increased spending on public-sector payroll, goods and services, and¬¬ (to a lesser extent) infrastructure spending, which ultimately led to an increase in the money supply in the economy,[7] as well as to the development of rudimentary banking.[8] Figure 1 shows a significant increase in loans and deposits over an 11-year period.

1 The "public" refers to individuals, households, companies, and the public sector. In the case of Iraq, the public sector represents ministries, their sub-units, independent government bodies, and state-owned enterprises (SOEs).

2 The terms "loan" and "credit" are used interchangeably here. The issuance of credit, or the provision of loans, have the same meaning.

3 The Central Bank of Iraq (CBI), like many central banks worldwide, mandates that banks keep a portion customer deposits as deposits with the CBI to ensure that banks can meet unexpected withdrawals. These are known as "statutory reserves". Iraq's minimum statutory reserve is 15% for current deposits, 10% for fixed deposits, and 5% for Islamic Banks. Banks usually maintain funds beyond these percentages with the CBI, funds known as "excess reserves". The combination of statutory and excess reserves is referred to here as "CBI reserves".

4 The issuance of credit creates money in the form of new/additional bank deposits for the borrower that are used to make economic transactions either by converting them to cash or transferring them to other banks. Deposits are either made in cash or are transferred from other banks. In accepting cash deposits, banks create new/additional digital deposits, and stores the cash in vaults.

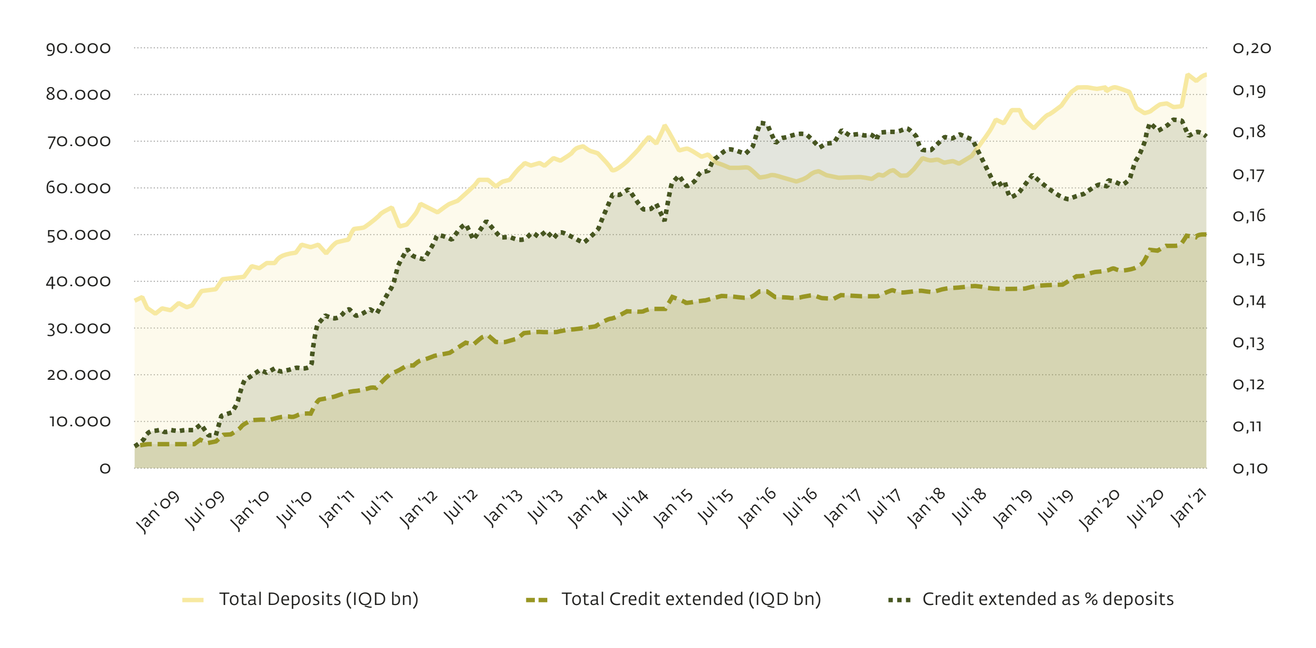
5 The combination of cash in commercial bank vaults, and their central bank reserves, is referred to as "bank reserves".

6 There are varying definitions of what constitutes "broad money", but the term generally reflects the amount of what constitutes money that is held by the public as means of exchange, or as a store of value.

7 In essence, money supply comes from the creation of: 1) new Iraqi Dinars (IQD) by the CBI in its exchange of USD oil export revenues, which eventually are deposited into bank accounts or paid in cash as the government makes payments for the public-sector payroll, goods and services, and domestic infrastructure spending; and 2) commercial bank money as commercial banks accept deposits and issue credit.

8 The banking sector in Iraq consists of state-owned banks (SOBs) and private sector-owned banks (PSOBs).

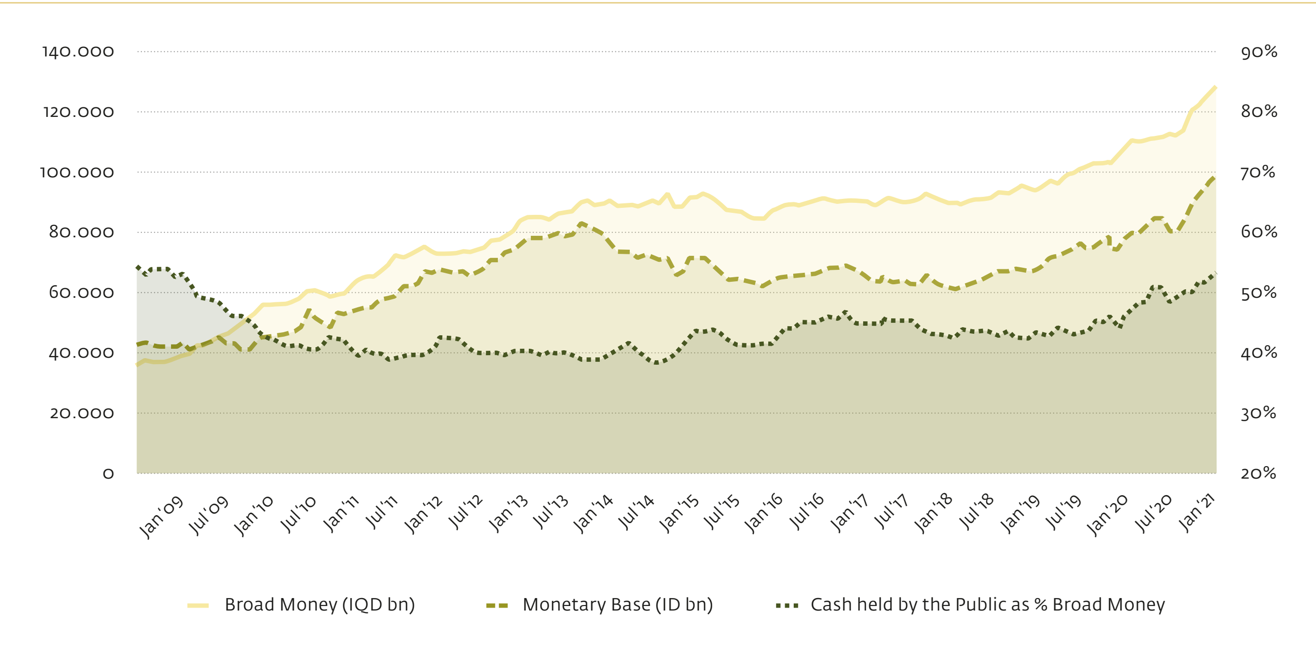
Figure 1: Total of Deposits and Credit Extended



Source: CBI, Ministry of Oil. March 2021.

During these years, cash remained of paramount importance, with only a minor role for banking. In Figure 2 below, the dominance of cash can be seen from the high ratio of the monetary base to broad money. This reflects the continuing importance of cash for the public as a store of value and as a means of economic exchange, which underscores the limited role of the banking sector, particularly in the creation of commercial bank money through the issuance of credit, and as means of an economic exchange.

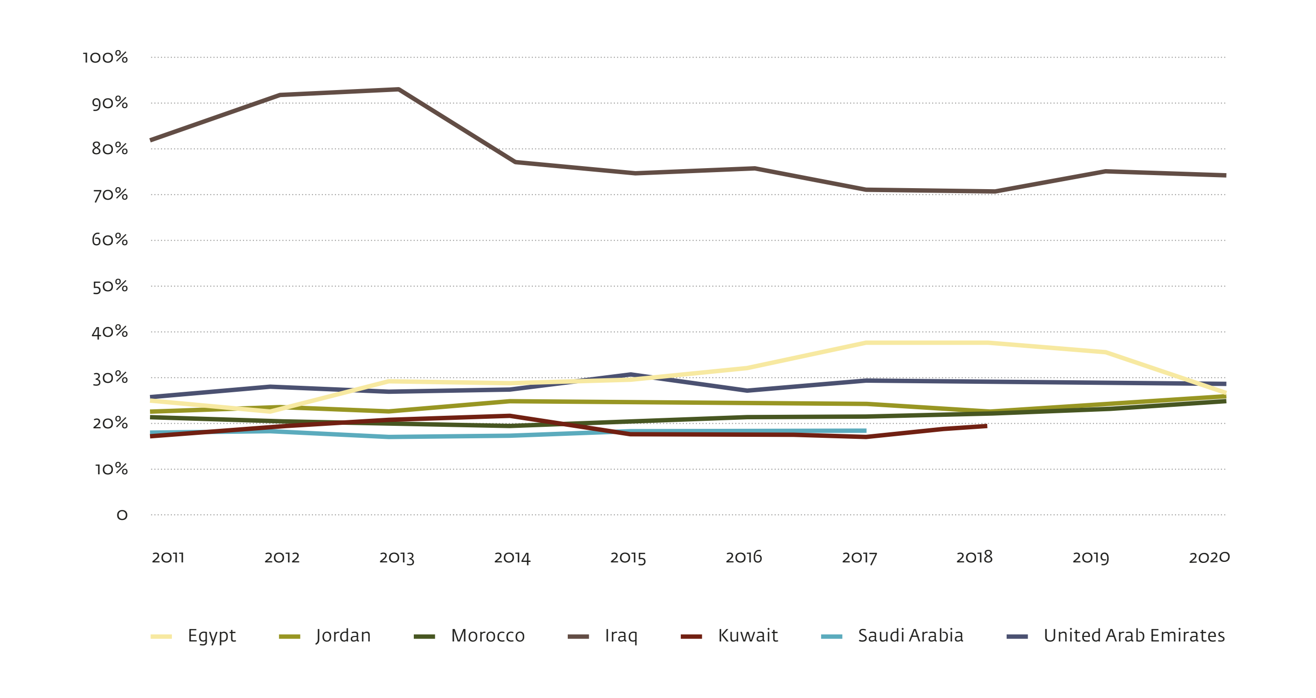
Figure 2: Monetary Base vs. Broad Money



Source: CBI, March 2021.

The extent of this limited role for the Iraqi banking sector can be seen when considered in a regional context by comparing the ratio of monetary base to broad money with oil-importing countries such as Egypt, Jordan, and Morocco; and oil exporting countries such as Kuwait, Saudi Arabia, and the UAE (see Figure 3, below). The contrast is striking. Over 70% of Iraq's money supply exists in the form of central bank money (over 60% of which is cash held by the public),[9] while in other major Middle East and North Africa (MENA) economies, the number ranges between 15% and 40%, as their more developed banking sectors have significantly expanded the money supply through the creation of commercial bank money. This disparity produces huge differences in the forms of economic activity, and, in particular, in domestic industries and projects which require long-term investments and the extension of credit.

Figure 3: Monetary Base as % of Broad Money



Source: [CBI](), [IMF Monetary & Financial Statistics](), data 2011-2020.

In Iraq, however, the vital importance of cash for the public requires banks to adopt a highly constricting short-term business model.[10,11] In short, Iraqi banks hold a high proportion of client deposits as bank reserves to be able to meet any unexpected withdrawals – the probability of which is very high given the role that cash plays in the economy. Over the last decade, between 40% and 70% of deposits were held as bank reserves. Additionally, banks hold sizable percentages of client deposits as cash equivalents, i.e., in liquid assets – that can be converted easily into cash – in the form of deposits held with other commercial banks both domestically and internationally, and as holdings of government bonds.

This limitation has meant that the credit that can be prudently loaned is insubstantial, and biased towards the

9 See footnote 8 for definition of the term 'money supply.'

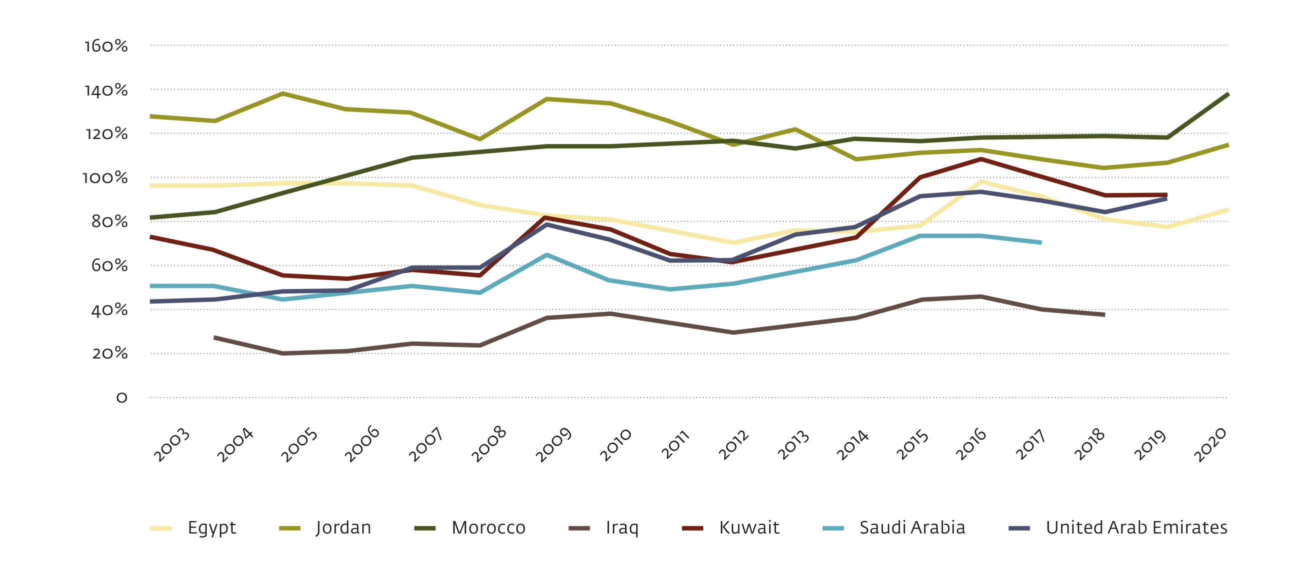
10 That the importance of cash is also related to the level of conflict and economic crises, mainly due to the increased utility of cash during crises, as well as to the need to withdraw cash from deposits to finance spending, which takes place in cash. As such, the relative role of cash increases during crises and decreases during economic stability.

11 For a review of the business model of Iraqi banks, see Mark A. DeWeaver, "Inside Iraq's Cash Economy: Fully Reserved Banking in a Monetary Dystopia," *IRIS Iraq Report*, IRIS. April 2016. https://auis.edu.krd/iris/sites/default/files/IRIS%20Iraq%20Report%20IIR_Mark%20DeWeaver_Inside%20Iraq's%20Cash%20Economy_2016_0.pdf.

provision of short-term loans. Most of the credit entering the economy is short-term. It finances current consumption or projects that generate returns relatively fast such as projects in agriculture, construction, and retail. The prevalence of short-term credit limits the availability of financing for long-term investments, which are likely to be stronger catalysts of durable economic growth. This mismatch contributes to the scarcity of much-needed infrastructure projects in the country.

An increase in broad money can be correlated with an increase in economic activities, which are partly or wholly funded by credit. This relationship can be seen by looking at the ratio of broad money to GDP for Iraq as compared to its regional peers. As Figure 4 displays below, broad money as a percentage of GDP in Iraq, which stands at around 40%, is much lower than the corresponding percentage in oil-exporting regional countries, and significantly lower than Jordan (around 120%) and Morocco (around 140%). This clearly indicates that credit-funded economic activity, as well as goods-and-service production in the economy, are severely limited in Iraq compared to regional countries, whether oil- or non-oil-exporting.

Figure 4: Broad Money as % of GDP



Source: World Bank, 2017-2020.

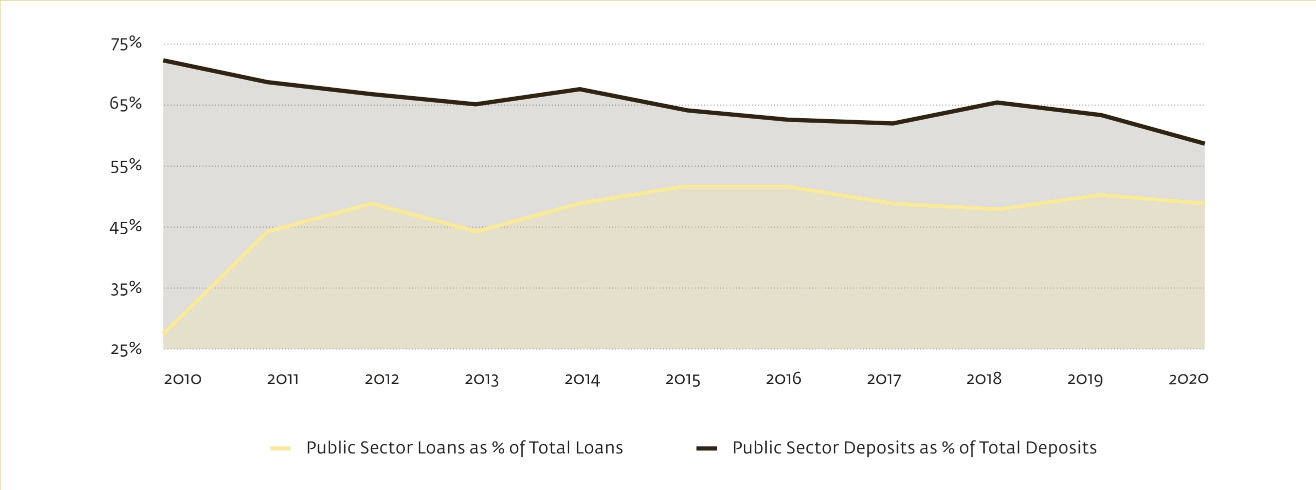
IF CASH IS KING, THE STATE IS QUEEN

Iraq's banking sector is dominated by state-owned banks (SOBs). SOBs possess approximately 87% of total deposits, and about 84% of total credit extended in the economy. This comes firstly from the monopoly position SOBs enjoy with the public sector as holders of its deposits and extenders of credit. Secondly, most private-sector loans and deposits are held by SOBs, instead of by private sector-owned banks (PSOBs). In this arrangement, SOBs benefit disproportionally from their monopoly position with the public sector, and critically, from the state's implicit guarantee that deposits with SOBs are fully convertible into cash.

The public sector, similarly, dominates total deposits and total credit extended. Over the years, public sector deposits as a percentage of total deposits declined, in part reflecting the growth of private-sector deposits. As Figure 5 shows below, the public sector's share of total extended credit grew significantly and remained high following the collapse of government revenues in the wake of the twin shocks of the ISIS conflict and the crash in oil prices 2014-2017; loans stayed elevated until the end of 2020.[12]

12 Within this growth, public-sector demand for loans competes with the private sector for the availability of credit, in a process referred to as "crowding out" the private sector.

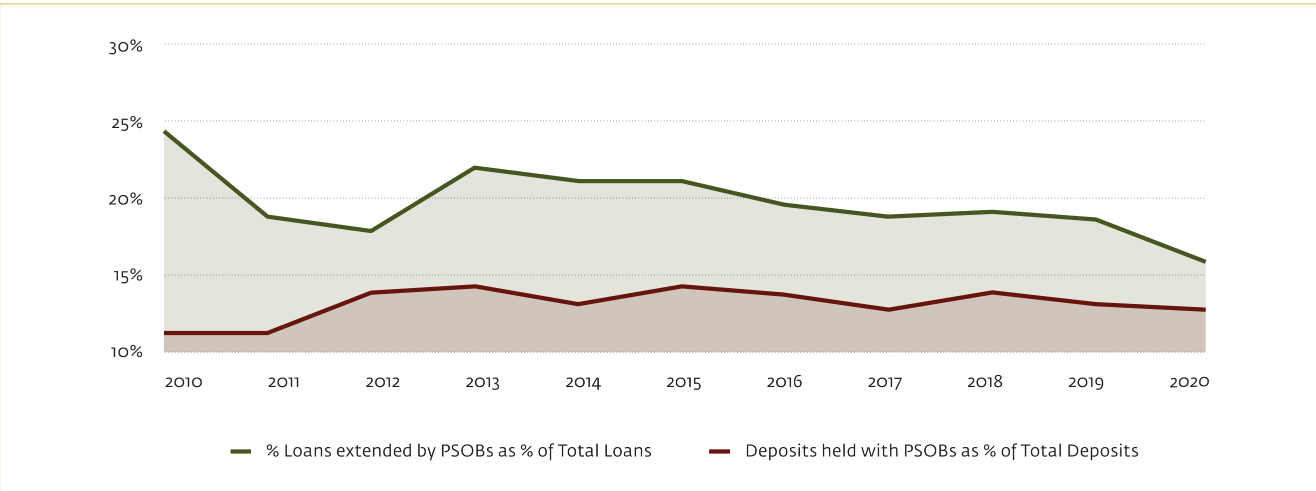
Figure 5: Public Sector Deposits & Credit Extended as % of Totals



Source: CBI, Annual Statistical Bulletins for 2010-2020.

The flipside of the dominance of SOBs of the banking sector is the small market share of PSOBs in total deposits and loans. The monopoly position that SOBs enjoy with the public sector, as well as their disproportional scale, limits the ability of PSOBs to compete for private-sector deposits and loans. However, even this space is mostly dominated by the SOBs due to the structural advantages discussed above. Moreover, a sizable proportion of individual loans against salaries are provided by the SOBs to public-sector employees.[13]

Figure 6: Private Sector-Owned Banks (PSOBs) Market Share



Source: CBI, Annual Statistical Bulletins for 2010-2020.

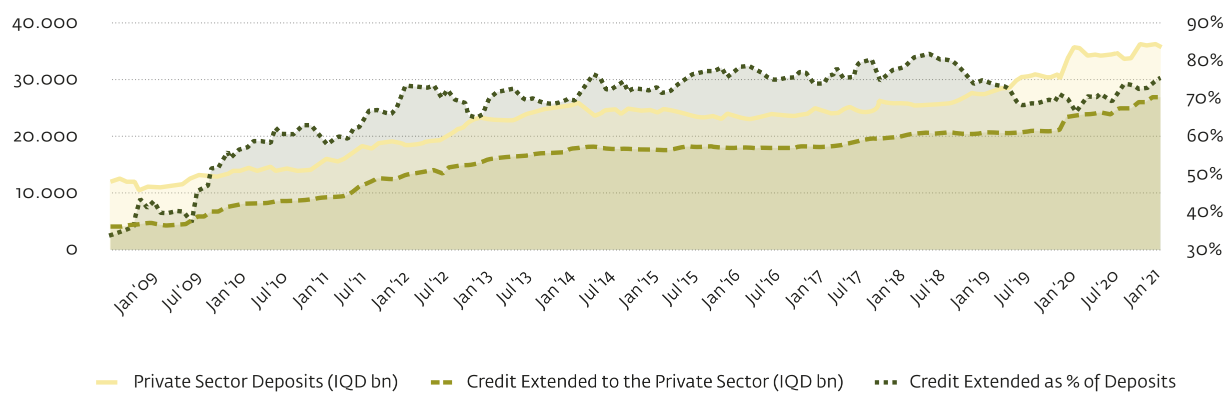
As a consequence of the dominance of the SOBs of the banking sector, PSOBs had a small deposit base of IQD 10.7 trillion at the end of 2020, most of which (74%) is in the form of current accounts and demand deposits. Such a small deposit base constrained the availability of credit by the PSOBs to IQD 8.0 trillion by end of 2020 – a figure that is too small to support the expansion of the private sector, and also constrained to provide short-term lending at the expense of long-term lending.

13 Public-sector employees when engaged in banking transactions as individuals, count as part of the private-sector category.

A PAWN THAT IS YET TO BECOME QUEEN

Private-sector loans and deposits grew in line with the growth in total deposits and loans as shown in Figure 1. In fact, the private sector was the main driver in the growth of total loans and deposits in the past two years.[14] The acceleration in private-sector deposit growth in 2019 was spurred by economic growth as a consequence of the expansionary 2019 budget, which drove consumer spending. The continued growth in private-sector deposits and the pick-up in loans in 2020 was spurred by the adoption of an accommodative monetary policy by the CBI to counter the effects of COVID-19 pandemic-induced economic disruptions. These will likely continue to grow due to the expansionary 2021 budget passed in March 2021, and the recovery in oil prices on the back of the global economic rebound from disruptions in the wake of COVID-19.[15]

Figure 7: Private Sector: Deposits & Credit Extended



Source: CBI, data as of March 2021.

The total size of credit extended to the private sector – even taking into account the sizeable personal loans provided by SOBs to public-sector employees – at IQD 26.5 trillion at the end of March 2021, is small, relative to the size of the economy, hovering around 10% of the IMF's estimated 2021 GDP (IQD 255.6 trillion).[16] The ratio of total credit extended to the private sector, as a percentage of GDP, is used here as proxy for the role of the private sector, enabled by access to credit, to drive economic activities.

This comes into sharp focus when comparing Iraq to its regional peers among oil-importing countries such as Egypt, Jordan, Morocco, and oil-exporting countries such as Kuwait, Saudi Arabia, and the UAE in the provision of domestic credit to the private sector (see Figure 8, below). Kuwait and Morocco take the lead in the provision of credit, and all six countries far exceed Iraq. This disparity underscores the very small amount of credit, relative to GDP, available to Iraq's private sector. Moreover, it helps explain the small overall size of Iraq's private sector relative to its regional peers, and its poor ability to compete against regional peers within its own domestic economy.

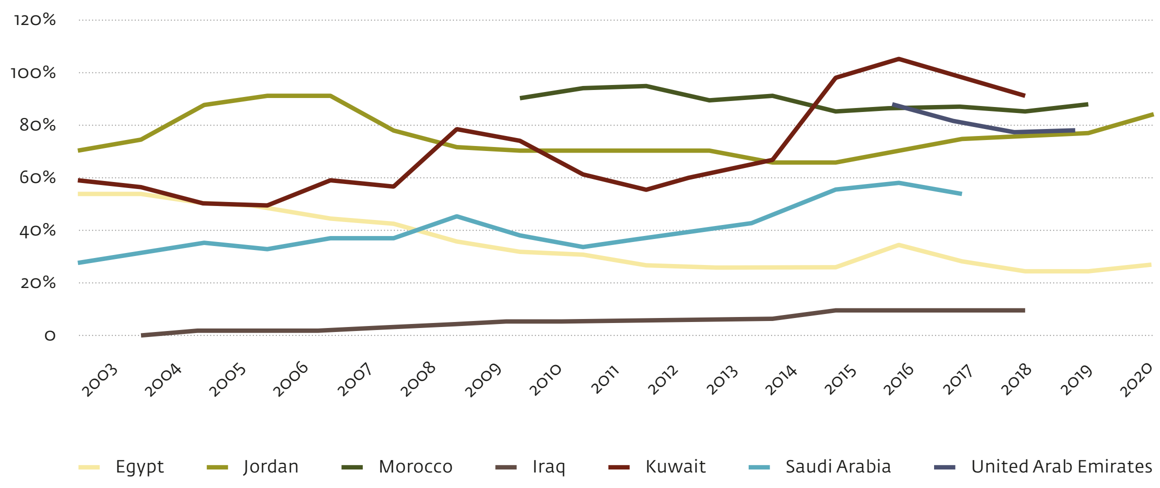
Without access to credit the private sector cannot replace the public sector as the driver of the economy.

14 Ahmed Tabaqchali, "Market Review: Private Sector Deposit & Loan Growth Continues," *Iraq Business News*, December 6, 2020. https://www.iraq-businessnews.com/2020/12/06/market-review-private-sector-deposit-loan-growth-continues/.

15 Ahmed Tabaqchali, "Market Review: On the Economics of Coiled springs, Crouching Tigers, and Chicken Lickens," *Iraq Business News*, May 3, 2021. https://www.iraq-businessnews.com/2021/05/03/market-review-on-the-economics-of-coiled-springs-crouching-tigers-and-chicken-lickens/.

16 Wafa Amr, "IMF Executive Board Concludes 2020 Article IV Consultation with Iraq," *Press Release*, International Monetary Fund. No. 21/37. February 11, 2021. https://www.imf.org/en/News/Articles/2021/02/11/pr2137-iraq-imf-executive-board-concludes-2020-article-iv-consultation.

Figure 8: Domestic Credit to the Private Sector (% of GDP)



Source: World Bank, 2017-2020.

CONCLUSION

The dominance of cash in Iraq's economy has hindered the development of a viable banking sector which has deprived the economy of the positive effects of growth drivers with the very limited ability of the banking sector to provide financing to the economy. The way forward requires a dual approach: moving away from cash and creating space for PSOBs. Specifically:

1. Individuals and companies must be incentivized to move away from cash. Such measures can build upon the government's 2016 Tawteen initiative,[17] which aimed to replace cash-based payments (for public-sector salaries and pensions) with electronic payments deposited into the beneficiaries' bank account or into their Qi card-linked accounts. Additionally, payments for the state's provision of essential services such as electricity and water can be made electronically instead of being paid in cash. The correct mix of incentives for making such payments can eventually overcome the public's current distrust of the banking sector.

2. PSOBs are ideally placed to provide commercially-driven credit allocation as their own viability and sustainability is similarly based on commercial considerations. There is always room for SOBs in providing credit to socially-driven activities, to projects for the delivery of public service, or for social development (as opposed to commercially-driven activities). Yet in Iraq, the SOBs' subordination to the Ministry of Finance leaves them ill-equipped to provide financing on commercial terms to private-sector companies. Moreover, their role has been further complicated by the very nature of the country's wrapped political system that places enormous pressures on these SOBs to extend credit, based on the political considerations of the competing ethno-sectarian parties–each pursuing its own interests in exerting pressures on SOBs to lend to constituencies and patronage networks.

17 See the Council of Ministers decision to pay public sector employees electronically, November 2, 2016 https://cbi.iq/static/uploads/up/file-153794729481421.pdf.

SECTION II

Surviving "Off the Grid": MSMEs and Banking in Iraq

Hamzeh al-Shadeedi

INTRODUCTION

With successive economic crises Iraq, the international community and the Government of Iraq (GoI) are united in the opinion that the public sector cannot adequately address the country's massive employment, and that the future economy must rely on a robust private sector. Though today's private sector in Iraq is small, over 90% of its jobs are provided by micro, small, and medium enterprises (MSMEs).[18] Little attention has been paid to factors inhibiting private sector growth, and to economic areas that would be most strategic for growth. Chief among the constraints is the fact that the vast majority of MSMEs in Iraq resort to operating "off the grid" i.e., outside the global banking system.

Poor access to banking services severely reduces MSME access to capital and limits the prospects of long-term expansion of market share and a customer base. So what accounts for this poor access? What alternative means do MSMEs rely upon to access capital, and conduct business transactions? How might improving access to banking allow currently "off-the-grid" MSMEs to grow and expand employment to Iraqi citizens? This section attempts to answer these questions based on five qualitative interviews with entrepreneurs who run fully operational MSMEs in Baghdad, Erbil, Sulaimani and Kirkuk. These MSMEs provide goods and services in the areas of education, agri-business, fashion, jewelry, and home decoration.

18 This low rate is the second lowest in the Middle East and North Africa (MENA) after Sudan, with an average of more than 20 MSMEs per 1,000 people in Sudan, Libya, Iraq, Algeria, Yemen, Jordan, Palestine, Egypt, Lebanon, and Tunisia. See "The White Paper for Economic Reform: Vision and Key Objectives" [Arabic], Emergency Cell for Financial Reform, Government of Iraq, October 22, 2020. https://gds.gov.iq/ar/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/.

OUTSIDE LOOKING IN: REGULATORY AND FINANCIAL OBSTACLES

Iraqi entrepreneurs face many burdens in day-to-day MSME operations,[19] but lacking access to credit and banking services tops the list. In order to open a corporate bank account, all companies must first be registered with their provincial Chamber of Commerce,[20] a process that requires applicants to occupy a brick-and-mortar office (as distinguished from an at-home/online space), and to have a documented attorney and accountant on retainer;[21] such expenses are often prohibitive for small companies that could otherwise operate from home or online with minimal staffing overhead. Registration costs with the Chamber are also expensive. As one interviewee reported, "With lawyer fees and bribes here and there, the costs could add up to around $2,000." Consequently, many MSME entrepreneurs opt not to register at all. Short of registration, none of the MSMEs interviewed could open a corporate bank account, rendering business loans also beyond reach. Two interviewees reported:

> ***My colleagues and I can produce jewelry from the comfort of our homes, but we cannot afford to pay all these fees and then be forced to pay taxes if we register.***
>
> *– Entrepreneur, jewelry company*

> ***We provide tech support for farmers. We can do this from home, or we can visit farmers on their farms. We want to register but we cannot afford all the associated costs.***
>
> *– Entrepreneur, agri-tech company*

Beyond arduous requirements for registering a company, the Iraqi legal framework does not recognize entrepreneurs and freelancers as "employees" per se. Banks prefer account holders to be either public-sector employees themselves, or those who can offer a public-sector employee to serve as guarantor. One entrepreneur explained that she could not open a personal bank account on her own, "Even though my MSME provides me with a stable income, the bank considers me unemployed because my company is not registered." She relied upon her husband, a public-sector employee, to sponsor her application to open a bank account to avail herself of banking services. While this arrangement allows banks to readily deduct any debt from public-sector salaries, it leaves MSME entrepreneurs without bank services to fend for themselves by leveraging personal savings, family assistance, a mortgaged personal property, or limited and finite assistance from NGOs and entrepreneurship incubators (e.g., Takween Accelerator and Oxfam) to establish or expand services and products.

Even if an MSME has secured a bank account, access to credit can be difficult. An Iraqi banking official explained that the lack of a credit rating system in Iraq is a significant impediment that "challenges banks to judge which entrepreneurs to trust" and "which idea to fund" because there is "no possible way to check an entrepreneur applicant's credit history."

ALTERNATIVES: MSMEs FIND WORKAROUNDS

Facing steep challenges in access to conventional banking services and credit, MSME entrepreneurs interviewed for this project developed workarounds to conduct basic business operations such as reaching consumers and conducting financial transactions across the country. MSME owners indicated that their customers in the immediate environs pay cash-on-delivery (rather than using credit and debit cards) for services or products rendered. However, to reach customers beyond the immediate environs of an MSME, these companies use local couriers to transport goods across governorates, and to receive batched periodic payments via these couriers from customers.

19 For more, see: Aaron Bartnick, "Obstacles and Opportunities for Entrepreneurship in Iraq and the Kurdistan Region," Institute of Regional and International Studies (IRIS), July 2017. https://auis.edu.krd/iris/publications/obstacles-and-opportunities-entrepreneurship-iraq-and-kurdistan-region.

20 Chambers of Commerce are provincial-specific parastatal entities that regulate business, trading, and commercial activities within Iraq.

21 Alice Bosley and Patricia Letayf, "The 5 Challenges to Tech Entrepreneurship in Iraq," Five One Labs, October 26, 2019. https://fiveonelabs.org/blog/2019/26/the-5-challenges-to-tech-entrepreneurship-in-iraq09.

One interviewee explained the process as follows:

> *It is really like you have a bank account with these couriers. My company has an account with them, and they receive my products twice a week and ship them across Iraq. They also collect payments [from my customers] in cash and update the value of funds in my [courier] account accordingly. They pay me a lump sum periodically, either weekly or monthly, as per [our] agreement.*
>
> *– Entrepreneur, home decorations company*

While MSMEs develop creative and necessary mechanisms to reach markets and collect payments for goods and services, this informal banking system relies on trust among entrepreneurs, couriers, and customers. There is no insurance mechanism, and the potential is often high for loss of product in transit, loss of payments, and disputes involving the same.

Some MSMEs rely upon payment methods linked to telecommunication companies (e.g., Asia Hawala and Zain Cash). These options also enable MSMEs to charge on a recurring basis. One MSME owner noted that most of her target market customers do not have bank accounts, and Western Union commissions are too expensive for receiving smaller payable amounts from customers. Asia Hawala and Zain Cash, by contrast, have enabled her trainees from across the country to pay subscription fees. She explained:

> *Now I can have trainees from across the 18 provinces of Iraq and they can pay through their phones. It is easier for them, and I won't feel guilty about asking them to go through the burden of transferring a small amount through exchange offices.*
>
> *– Entrepreneur, capacity-building education*

While local couriers and mobile payment methods have greatly enlarged the space available for Iraqi MSMEs to conduct business, these limited mechanisms have neither a global reach nor the technical sophistication necessary to access suppliers or potential customers outside Iraq. As such, MSMEs reliant upon these alternative banking mechanisms remain largely cut off from the broader global economy.

TRUST AND RELIABILITY: BANKING THAT BOLSTERS MSME GROWTH AND EMPLOYMENT

Despite being able to circumvent many of the challenges arising from an inaccessible banking system in Iraq, MSME entrepreneurs expressed a preference for banks over the less formal workarounds. They noted that access to banking would help them reach customers and suppliers outside Iraq. One interviewee said:

> *I have already tried to find ways to sell my products abroad and I have realized that it is, in theory, possible. It is possible to sell products through retailers in Europe or via online shopping platforms such as Amazon, but this is conditioned upon having a corporate bank account.*
>
> *– Entrepreneur, jewelry company*

A home decorations entrepreneur similarly shared that while her current market is limited to Iraq, access to markets abroad would help her company grow and employ more people. Incoming international Western Union transfers (limited to $1,500 per day), are rarely accepted by retailing platforms, and the fees are too hefty for individual buyers.

The international market inaccessibility is not the only issue. In general, banks make it easier for companies to more reliably pay suppliers and sell in bulk whether domestically or internationally. One interviewee explained:

> *Even if I accept the fact that my customers cannot pay me through debit/credit cards or bank transfers, I would rather pay my suppliers or receive payment for bulk purchases through banks. This generates more trust among my suppliers and bulk-buyers and is also easier for both parties.*
>
> *– Entrepreneur, fashion company*

The interviewee noted that she occasionally resorts to using her personal bank account to make such transactions, even though transferring funds between individual accounts and corporate/institutional accounts is rarely straightforward. Further, individuals can only transfer a fixed amount of money per month, usually $5,000. In the absence of a consumer base ready to pay with credit cards, access to corporate bank accounts would introduce greater flexibility and allow entrepreneurs to conduct transactions with suppliers and bulk buyers at levels that correspond to demand.

The importance of conventional banking systems has become more pressing during the COVID-19 pandemic due to the exponential rise of e-commerce, including in the MENA region. MSMEs in Iraq are increasingly vying for online market share. Bank accounts would be of immediate benefit to online service and retail providers, as these MSMEs seek clients from all over the globe. One interviewee explained:

> ***Due to the COVID-19 pandemic, I am now delivering my training sessions on Zoom. With a bank account, I could easily hire trainers from any part of Iraq and pay them to deliver the sessions from the comfort of their home. I could also have customers from outside Iraq, if I could only link a payment method to my website. I now have two trainees from outside Iraq but I feel hesitant to ask them to transfer the small fee so [instead] they participate for free. With a bank account they [would] simply pay with their debit/credit cards.***
>
> *– Entrepreneur, capacity-building education*

CONCLUSION

In the *White Paper for Economic Reform*, the Government of Iraq (GoI) expresses a desire to support MSMEs and private-sector development, and the Kurdistan Regional Government (KRG) publicly espouses the same view. To date, this rhetoric has not borne fruit on the ground. Most MSMEs in Iraq continue to function outside the conventional banking system. Iraq has more than 50 public and private banks, but as has been detailed in the first section of this Review, very few of them perform even the most basic functions associated with global banking. State-owned banks either provide credit to public-sector employees, or to the government. The handful of semi-functional private banks are small and do not have enough capital to engage in private-sector development; beyond that they are bound by Iraq's restrictive laws on corporate registration.

While the COVID-19 pandemic has presented new challenges to MSMEs in Iraq (e.g., reducing production, limiting access to customers, necessary downsizing), the global crisis has also transitioned many MSMEs to more nimble online operations.[22] Agri-businesses have already found ways to help farmers remotely, and many education companies have switched classes to online platforms like Zoom. The GoI and the KRG should be equally responsive. Federal and regional governments should relax registration processes and push to legislate the necessary legal frameworks that regulate the operations of online-based businesses. Banks should also think of innovative ways to attract MSMEs that currently function "off the grid". If proof of monthly wages is not available, banks could assess MSME viability by alternate means (e.g., a company's documented performance records, business or personal references, an established online presence), gradually working with these companies to build their financial profile. Without taking tangible steps towards restructuring the registration process, and compelling banks to engage in development activities, any government-led initiative to support MSMEs will amount to nothing more than political rhetoric with negligible impact on the ground.

22 For an analysis on the effects of the COVID-19 pandemic on SMEs, see "Panel Study: Impact of COVID-19 on Small- and Medium-Sized Enterprises in Iraq – Main Findings," IOM, FAO, and ITC, April 8, 2021. https://iraq.iom.int/publications/panel-study-impact-covid-19-small-and-medium-sized-enterprises-iraq.

SECTION III

Building Trust in Iraq's Banking Sector

Muhammad Al-Waeli

INTRODUCTION

Trust in financial institutions is absolutely vital for the development and growth of a healthy economy. Public trust in banks and their services is premised on the banks' reliability, their commitment to industry rules and regulations, and a drive to serve the interests of the consumer.[23] In Iraq, the banking sector suffers from a severe trust deficit, as evidenced by the fact that in 2020 only around 22.7% of Iraqis have bank accounts.[24] Many wealthy Iraqis are inclined to open bank accounts abroad, while most middle- and lower-income citizens still prefer to keep their money "under the pillow." This paper analyzes the lack of consumer trust in banks and proposes a few solutions that could increase trust and, consequently, usage. These suggestions are limited in scope but have the potential to improve the banking sector in the medium- and long-term future.

ORIGINS OF THE TRUST DEFICIT

The disfunction of Iraq's banking systems traces to the pre-2003 era. The banking sector under Saddam Hussein was controlled by the Ministry of Finance, which essentially allowed a small number of banks to form an oligopoly.[25] Iraq's banking sector was not able to escape this legacy after the collapse of Saddam's rule, despite the establishment of a "free market" in Iraq. Today, Iraq's largest banks—the Trade Bank of Iraq, al-Rafidain, and al-Rasheed—are all state-owned.

23 Raija Anneli Järvinen, "Consumer Trust in Banking Relationships in Europe," *International Journal of Bank Marketing* 32, no. 6 (August 26, 2014): p. 551-566. doi:10.1108/ijbm-08-2013-0086.

24 "The World's Unbanked Population" *Acuant*, November 25, 2020. https://www.acuant.com/blog/the-worlds-unbanked-population.

25 Akel Al-Ansari, "Analysis of the Hindering Factors of the Iraqi Banking Sector," *Business Landscape*, no. 2, March 15, 2021. https://kapita.iq/content/issue/business-landscape-magazine-edition-2.

The heavy-handed role of the state in their operations complicates the picture of banking in Iraq, given the pervasive mistrust of state institutions among Iraqis.[26]

Public trust in private banks is not necessarily better and stories of bank failure circulate widely in the general public. For example, a private university launched in 2010 and was committed to the idea of remitting staff and faculty salaries directly to their personal bank accounts; employees were thus required to open one in order to receive their rightful compensation. Problems surfaced almost immediately. The debit card issued to account-holders by the bank was difficult to obtain and was useless since many retail stores do not accept cards. The only option to use the card was via online shopping. However, many international retail websites do not accept card payments from Iraq, a country listed as being of high risk for financial transactions. All in all, the debit cards were effectively useless. Eventually, the bank went bankrupt within a year for reasons unclear to its customers, many of whom retrieved only a fraction of total account balances. These cases, even if isolated, encourage wary perceptions, and diminish public trust in private banks across the country.

GENERATING TRUST WITH TARGETED REFORMS

Generating broad trust in the banking sector will be a task of decades and not years, but policymakers might at least consider targeted initiatives. First and foremost, the ease and predictably of e-banking must be improved. E-banking is at the center of the consumer experience of banks. Unfortunately, Iraq is still behind in this area although the basic infrastructure for e-banking, and more specifically mobile-banking, is mostly present.

Recently, telecommunication operators have introduced 4G networks in Iraq.[27] Moreover, Iraq has a relatively high percentage of internet penetration–approximately 75% in 2020. The number of mobile connections in January 2020 was the equivalent of 103% of the population.[28] Furthermore, while only about 23% of citizens had bank accounts in 2020, around 19% sent or received funds through digital transfers, which indicates a high potential for e-banking.[29]

Studies have shown that high-quality e-banking increases customer loyalty and trust in financial institutions.[30] Focusing on online banking will modernize the banking sector and reduce reliance on cash transactions, which are a major enabler of corruption. Iraqi youth are tech-savvy and constitute the majority of the population.[31] E-banking services are likely to be popular among youth who would continue to be deprived of such services if cash-reliant system conditions remain status quo.

Second, policymakers must work towards instilling a culture of saving, particularly among youth. Only public-sector jobs offer retirement pensions, and insurance services remain limited as well. The discipline of saving money, especially if practiced by youth working in the private sector, enables individuals to invest in their future while simultaneously providing banks with more capital to circulate. In her book *How to Change*,[32] behavioral economist Katy Milkman describes an initiative introduced by Green Bank, one of the largest retail banks in the Philippines, to encourage its customers to procrastinate on expenditures and save money. Customers voluntarily opted into "locked" bank accounts where they could not withdraw funds until a date of their choosing, or until they met a savings goal. Customers who chose to engage in

26 Meften Ahmed Qasim, "Societal Challenges for Iraq's Lived Reality: Policy Perspectives," *Friedrich-Ebert-Stiftung*, 2020. http://library.fes.de/pdf-files/bueros/amman/16593.pdf.

27 "Zain, the First Telecommunications Company to Launch 4G-LTE Services 'Trial Phase' [throughout] Iraq After Fulfilling All Licensing Conditions," Zain Iraq (website-posted press release), January 27, 2021. https://www.iq.zain.com/en/4g-press-release.

28 Simon Kemp, "Digital 2020: Iraq" DataReportal, February 18, 2020. https://datareportal.com/reports/digital-2020-iraq.

29 "ILO'S Financial Inclusion Strategy in Iraq: An Entry for Decent Jobs," Prospects, International Labor Organization (2020): p. 2. https://www.ilo.org/wcmsp5/groups/public/---arabstates/---ro-beirut/documents/publication/wcms_775892.pdf.

30 Amit Shankar, Charles Jebarajakirthy, "The influence of e-banking service quality on customer loyalty: A moderated mediation approach," *International Journal of Bank Marketing*, February 13, 2019. https://doi.org/10.1108/IJBM-03-2018-0063.

31 According to the World Bank, nearly half of the 38.5 million Iraqis were under 19 years old in 2018, and about a third were between 15 and 29 years old. See: "Iraq: Engaging Youth to Rebuild the Social Fabric in Baghdad," *Feature Story*, World Bank, December 2, 2020. https://www.worldbank.org/en/news/feature/2020/12/02/iraq-engaging-youth-to-rebuild-the-social-fabric-in-baghdad.

32 Katy Milkman, How to Change: *The Science of Getting from Where You Are to Where You Want to Be* (New York, NY: Portfolio/Penguin Random House LLC, 2021): p. 61-65.

the initiative saved 80% more than customers who did not opt in. This tactic is what behavioral scientists would call a "commitment device" whereby customers achieve their financial goals by restricting their at-will bank withdrawals. Whether or not such an initiative would work in the Iraqi context is difficult to say without conducting a pilot study, but the point is that policymakers need to think more creatively about ways to encourage customers in the practice of saving money.

Banking in Iraq suffers from a trust deficit. In order to achieve the ultimate goal of increasing the usage of banking services, policymakers must begin the slow and meticulous work of restoring this trust through targeted interventions. Improving e-banking would appeal to a young population that is already tech-savvy and highly literate with online functions. Introducing creative modifications of the products offered, such as an optional "locked" bank account, could encourage customers to save money, which will translate into more business for banks and provide better financial security for customers. These reforms have a limited focus but could meaningfully contribute towards creating a robust and sustainable banking sector in Iraq.

Central Bank of Iraq, Baghdad.

SECTION IV

How Iraq's Proposed Economic Reforms Would Impact Iraqi Women

Marsin Alshamary

In October 2020, the Government of Iraq released the *White Paper on Economic Reform*,[33] a sprawling report outlining the reforms that the government should undertake to prevent Iraq from economic collapse. The impetus to issue the report stemmed from the twin economic earthquakes of the COVID-19 pandemic and the subsequent collapse of oil prices. The *White Paper* synthesizes expert recommendations made over the years, many of which have not been implemented due to a lack of political will and the government's anxiety about stoking public anger by rolling out unpopular policies.

Although the report is deliberate in detailing policies that are ostensibly designed to protect the most vulnerable members of the population, it does not specifically anticipate the impact of the proposed economic reforms on Iraqi women. A closer examination of the report indicates that some reforms are likely to disproportionately hurt Iraqi women (e.g., cuts to public-sector employment) while other measures (e.g., digitization) may help women overcome unique challenges to their economic participation and productivity. The reforms of the *White Paper* present a catch-22: while they are arguably necessary to strengthen Iraq's economy as whole, they largely erode the interests of Iraqi women. Reforms that may support women's integration into the labor force are not enough to offset the harm wrought by others.

While Iraq presently has one of the lowest female labor force participation rates (FLFP) in the world, the World Bank predicts that increasing it to the level of other middle-income countries would increase Iraq's GDP per capita by almost 31%.[34] According to another World Bank report that examines women's legal economic rights,[35]

33 The full title of the article is, "White Paper for Economic Reform: Final Report of the Crisis Cell for Financial and Fiscal Reform," and is called the "White Paper" hereafter. For more on this report, visit https://gds.gov.iq/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/.

34 Wael Mansour, Majid Kazemi Najaf Abadi, Ashwaq Natiq Maseeh, "Iraq Economic Monitor: Seizing the Opportunity for Reforms and Managing Volatility," (English) Iraq Economic Monitor, World Bank, May 1, 2021. http://documents.worldbank.org/curated/en/552761621369308685/Iraq-Economic-Monitor-Seizing-the-Opportunity-for-Reforms-and-Managing-Volatility.

35 "Women, Business and the Law 2020," World Bank (doi:10.1596/978-1-4648-1532-4), 2020. https://openknowledge.worldbank.org/bitstream/handle/10986/32639/9781464815324.pdf?sequence=10.

Iraq ranked amongst the lowest globally in its "Women, Business, and Law" score but still outranked other countries in the region, including Kuwait, Syria, Yemen, Iran, Jordan, Oman, Qatar, and Sudan.[36]

Organizations working on the ground in Iraq, such as the UN's International Organization for Migration (IOM), have identified barriers to women's economic equality. IOM's 2019 report on economic opportunities for Iraqi urban women demonstrates that barriers to economic advancement fall into three categories: normative, consequential, and practical.[37] The IOM report defines consequential barriers as the anticipated mental, physical, social, and financial harms that can impact women on account of their economic participation. They define practical barriers as logistical ones, including difficult work hours and lack of job opportunities. Finally, normative barriers are cultural constraints that, for example, prevent women from working in mixed-gender settings and being outside of the home during certain times, or that might result in them bearing the burden of both housework and childcare. These cultural constraints impact women differently across segments of Iraqi society, but nevertheless constitute the greatest barriers to women's participation in the labor force. The presence of such barriers highlights the fact that economic reform policy cannot be disassociated from the social reality of the country. This does not necessarily mean that the *White Paper* should address cultural considerations in its text, but that the reforms it proposes should be implemented with full awareness of these barriers.

Normative constraints in Iraq have resulted in two economic phenomena for women:

1. Public-sector employment is seen by the society at large as the only "acceptable" option for urban and educated women; and
2. Potential exists for exploitation within the proliferation of informal-sector and low-paying private-sector employment for non- or under-educated women.

With regards to the latter, the legal mechanisms that were described in the World Bank report do not extend to women in the informal sector.[38] With regards to the former, educated women prefer the public sector because of its limited, day-time work hours, its relative stability, and its reputation as a respectable form of employment for women. With a scarcity of public employment, college-educated women suffer the highest unemployment rate among Iraqi women.[39] This level of joblessness will be exacerbated by the public-sector reductions proposed in the *White Paper:* such cuts will decrease the already scarce work options available to educated Iraqi women, thereby disempowering the very segment of Iraqi society most likely to promote rights for women and girls. After all, it is educated, urban women with financial resources who are most able to devote themselves to advocacy and civil society.

Other suggested reforms–if implemented carefully and in tandem with other strategies–may offset some of the more deleterious effects of a decrease in public-sector employment. For example, the *White Paper* proposes a national strategy for education and training that links future labor needs with educational inputs. Another proposed reform provides skills training and capacity building for the private sector (outside of the education sector). These reforms can have a positive effect on women whose job opportunities are directly linked to their educational level, and can reshape the way women and their families approach education as a whole. If the goal of education can be well-regarded public-sector employment and lucrative, private-sector work, women will enjoy a wider horizon of economic opportunity. However, this strategy will not manifest in immediate employment gains, but rather may help create generational shifts in economic thinking and a shift away from a socialist mentality.

36 These scores measure the existence of laws that allow women to access the workplace, but do not measure underlying cultural barriers.

37 "Perceptions on Women's Economic Opportunities in Urban Areas of Iraq: Motivations and Mechanisms to Overcome Barriers," IOM, June 24, 2019. https://iraq.iom.int/publications/perceptions-womens-economic-opportunities-urban-areas-iraq-motivations-and-mechanisms.

38 "Women, Business and the Law 2020."

39 "Iraq Economic Monitor", p. 22.

Another proposal aims to support the private sector, including the micro, small, and medium sized enterprises (MSMEs) most at risk during the COVID-19 pandemic. Within MSMEs, women-run businesses tended to focus on textiles (e.g., sewing) or food-related services, both of which allow women to work from home. It is therefore important to not only support Iraq's MSMEs (which are the beneficiaries of support from many international organizations) but to encourage diversification of options for women with lower educational levels by redirecting educated women towards leadership in the private sector.

Reforms in the banking sector, also outlined in the *White Paper*, can play a crucial role in expanding women's role in the private sector and protecting their wealth and assets. Even though many Iraqis acknowledge the existence of Islamic precepts that protect women's property and wealth, patriarchal social customs prevail in most settings and prevent women from fully controlling their own resources. The application of international accounting practices, as well as mobile banking and re-generating citizen trust in banking infrastructure may help women retain ownership of their own resources and better control their wealth and economic well-being. A modern banking system may allow more women to access the resources necessary to create their own projects. One example of such banking practices is the "women's only" branch of the Trade Bank of Iraq in Najaf, which eliminates some of the normative and consequential barriers women face. In highly socially and religiously conservative societies like Najaf, the presence of the bank branch means that women can readily access their accounts, apply for loans, and use other banking services in person rather than relying on male relatives to function in their stead.

Women in Iraq also face the challenge of shouldering more household tasks and childcare duties, which makes working outside the home difficult. Controlling the informal sector and imposing laws that protect women who have no choice but to seek home-based employment is a necessary first step. This includes, for example, implementing laws governing minimum wage, work hours, and health and safety standards. In addition, reforms that impact daily life–like improving electricity infrastructure–can have positive impact on the everyday lives of women by creating more hospitable environments at home that increase efficiency and create time to pursue other activities. If the digital economy is expanded, as proposed in the *White Paper*, and more work-from-home opportunities are created for both educated and non-educated women, this may overcome normative and practical obstacles that Iraqi women face and allow them to transition more seamlessly into the labor force.

As the Iraqi government considers its options for reform, it would be well advised to consider the potential impact of a higher FLFP rate on the wealth and health of the country and enacting reforms accordingly. If the reforms in the *White Paper* are implemented as proposed, Iraqi women will inevitably suffer from decreases in public-sector employment; other proposed reforms will not be able to offset these job losses in the immediate term. In the long term, however, adopting reform initiatives that provide skills training and re-imagine the path from education to employment may launch more Iraqi women into the labor force and offset at least a portion of the losses from the public sector.

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