

# THE INFLUENCE OF ECONOMIC PERTURBATIONS WITHIN IRAQ ON THE ORIENTATION OF FISCAL AND MONETARY STRATEGIES

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**Abstract.** Although rationalization of public expenditure and the restoration of fiscal sustainability are fundamental priorities, medium- to long-term structural reforms remain necessary to address the economic challenges that have emerged since 2014. While such reforms are typically associated with developed economies, Iraq's structurally distorted economic system lacks the diversification required to meet sustainability conditions. Fiscal constraints have significantly reduced the state's policy space, while increasing costs have effectively turned monetary policy into a de facto stabilizing instrument. The rising level of government debt, reflected in the Central Bank's balance sheet, has created a disconnect between monetary policy objectives and the financing costs of public debt. Debt rollovers and politically driven fiscal pressures, largely insensitive to inflation dynamics, have undermined central bank autonomy and entrenched a regime of fiscal dominance. Under conditions of fiscal dominance, monetary policy becomes largely ineffective. Combined with persistently high oil dependency, this situation poses substantial risks to economic stability. Iraq's experience highlights the urgent need for institutional reforms, temporary fiscal adjustment measures, and a broader diversification of public revenues beyond oil-dependent employment systems. Without such reforms, structural imbalances may deepen, leading to private sector displacement and large-scale labor market disruptions.

**Keywords:** Iraq, fiscal policy, monetary policy, oil dependence, investment.

# ВЛИЯНИЕ ЭКОНОМИЧЕСКИХ ВОЗМУЩЕНИЙ В ИРАКЕ НА НАПРАВЛЕННОСТЬ ФИСКАЛЬНОЙ И МОНЕТАРНОЙ ПОЛИТИКИ

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**Аннотация.** Несмотря на то, что рационализация государственных расходов и восстановление фискальной устойчивости являются ключевыми приоритетами, в средне- и долгосрочной перспективе необходимы структурные реформы для решения экономических проблем, возникших после 2014 года. Хотя подобные реформы обычно характерны для развитых экономик, структурно деформированная экономика Ирака не обладает необходимой диверсификацией для достижения устойчивого развития.

Фискальные ограничения существенно сократили пространство экономической политики государства, тогда как возрастающие издержки фактически превратили монетарную политику в де-факто инструмент стабилизации. Рост государственного долга, отражающийся в балансе Центрального банка, привёл к расхождению между целями денежно-кредитной политики и стоимостью финансирования государственного долга. Ролловеры долга и политически обусловленное фискальное давление, слабо чувствительное к инфляционным процессам, подрывают независимость центрального банка и закрепляют режим фискального доминирования.

В условиях фискального доминирования монетарная политика становится в значительной степени неэффективной. В сочетании с сохраняющейся высокой зависимостью от нефти такая ситуация создаёт существенные риски для макроэкономической стабильности. Опыт Ирака подчёркивает необходимость институциональных реформ, временных мер бюджетной консолидации и более широкой диверсификации государственных доходов, выходящих за рамки нефтезависимой занятости. Без таких реформ структурные дисбалансы могут усилиться, что приведёт к вытеснению частного сектора и масштабным нарушениям на рынке труда.

**Ключевые слова:** Ирак, фискальная политика, монетарная политика, зависимость от нефти, инвестиции.

## **1. Introduction**

The security shock of mid-2014, combined with the collapse in global oil prices, significantly disrupted economic and investment activity in Iraq. In December 2014, the OPEC basket price averaged approximately USD 26.5 per barrel. During this period, Iraq also faced severe security and governance challenges, which further intensified fiscal pressures.

According to several international reports, the emergence of armed non-state actors significantly affected economic stability by disrupting production, trade, and fiscal revenues in affected regions.

This study examines the fiscal and monetary policy responses to oil-related shocks in Iraq since mid-2014, and assesses their broader economic implications, with particular attention to fiscal sustainability, monetary stability, and structural vulnerability.

## **2. Objective of the Study**

This study aims to analyze the impact of oil-related shocks on fiscal and monetary policy directions in Iraq, as well as their broader economic consequences, particularly in terms of macroeconomic stability and public debt dynamics.

### **3. Research Methodology**

The study employs a descriptive-analytical approach to examine structural economic conditions in Iraq and a qualitative policy analysis framework to assess fiscal and monetary responses to external shocks. The hypothesis is tested through systematic interpretation of macroeconomic indicators and policy developments.

### **4. Iraqi Fiscal and Monetary Policies and Economic Stability (revised)**

Since 2003, Iraq has experienced significant fluctuations in economic activity, driven largely by oil price volatility and post-conflict reconstruction dynamics. Although exports increased following the lifting of sanctions and the expansion of investment contracts, imports also rose sharply, reaching approximately 65% of domestic output, particularly in consumer goods.

This trade structure contributed to a shift from a production-based economy to a consumption-driven model, increasing external dependency and weakening domestic productive capacity. Consequently, economic policy has often lacked coherence, with limited coordination between fiscal and monetary authorities.

Despite some improvements in foreign investment indicators, fiscal policy has remained heavily oriented toward public sector employment rather than productive investment. A large share of public expenditure is absorbed by wages and operational spending, limiting fiscal space for development-oriented projects.

The public sector has expanded significantly, with millions of employees and pensioners dependent on state income. However, this expansion has not translated into proportional productivity gains, contributing to structural inefficiencies in the labor market.

Unemployment remains elevated, particularly among youth, reflecting weak absorption capacity in the private sector. Structural weaknesses are further evidenced by the declining contribution of agriculture and industry, which together represent a marginal share of GDP.

The dominance of the oil sector has led to the contraction of non-oil productive activities, reinforcing characteristics commonly associated with the “Dutch disease.” The economy has become increasingly import-dependent, with limited domestic industrial and agricultural output.

Overall, these structural imbalances highlight the urgent need for economic diversification, strengthening of the private sector, and a shift toward a production-oriented growth model rather than a consumption-driven fiscal structure.

#### **4.1 General Balance and Growth Under Oil and Security Shocks: Fiscal Dominance and Monetary Policy Inconsistency**

In mid-2014, Iraq experienced a severe and sudden security shock that had an immediate and profound impact on economic activity, investment flows, and overall macroeconomic stability. Simultaneously, global oil markets entered a period of sharp decline. By the end of 2014, the OPEC basket price had fallen to approximately USD 26.5 per barrel, representing a decline of more than 65% compared to previous levels. By January 2016, the average annual oil price had dropped below USD 50 per barrel, compared to more than USD 100 per barrel in April 2014.

These combined shocks—security instability and oil price collapse—significantly weakened Iraq’s fiscal position and exposed the structural vulnerability of a rentier economy highly dependent on hydrocarbon revenues.

During this period, non-state armed actors also emerged as significant destabilizing forces, affecting economic infrastructure, disrupting production chains, and generating substantial financial losses. According to international assessments, these groups developed complex financial structures and diversified revenue streams,

including taxation, extortion, asset seizure, and control over strategic resources such as oil fields and agricultural land. Their estimated financial capacity reached billions of US dollars annually, highlighting the scale of informal and illicit economic flows during the crisis period.

In parallel, labor market conditions deteriorated significantly across the region. According to the World Bank (2018), unemployment rates among young males (aged 15–29) remained persistently high, reflecting structural weaknesses in labor absorption capacity. In Iraq, these dynamics were amplified by weak institutional capacity, limited private sector development, and rising fiscal pressures.

Macroeconomic instability was further reflected in persistent inflationary pressures and widening budget deficits, largely driven by inconsistencies between fiscal expansion and monetary policy constraints. Since 2003, Iraq has experienced recurring fiscal imbalances associated with oil price volatility and pro-cyclical spending patterns.

Over the period 2003–2016, the budget deficit increased significantly. Estimates indicate that the deficit rose from approximately 4.6 trillion dinars in 2003 to 24.1 trillion dinars in 2016, representing a substantial deterioration in fiscal balance. Similarly, internal public debt increased sharply from approximately 5.5 trillion dinars in 2003 to around 46.5 trillion dinars in 2015, before exceeding 48 trillion dinars in 2016. This represents a more than sevenfold increase over the period.

The continuous accumulation of domestic debt placed considerable pressure on the monetary system, reducing fiscal space and increasing inflationary risks. In addition, the growing reliance on domestic borrowing contributed to increased vulnerability of public finances to oil price fluctuations and limited the effectiveness of countercyclical fiscal policy.

Overall, these developments illustrate the presence of fiscal dominance, where fiscal policy constraints significantly influence monetary policy decisions, thereby

reducing the independence and effectiveness of monetary stabilization mechanisms. This situation has contributed to time inconsistency in policy implementation and weakened the capacity of macroeconomic institutions to stabilize output and inflation.

**Table (1) Internal public debt and Debt Gap Data on the Iraqi government, 2003–2015 (billion dinar)**

Year	Treasury transfers in commercial banks	Public debt to the Ministry of Finance	Total internal public debt	The amount of budget deficit	Debt gap to budget deficit
2003	1555276	3988408	5543684	4636200	907484
2004	1242023	4683038	5925061	11928405	-6003344
2005	1200070	5055508	6255578	7022560	-766982
2006	251500	5055508	5307008	5570857	-263849
2007	519000	4674705	5193705	9662938	-4469233
2008	500050	3955519	4455569	9086892	-4631323
2009	4478530	3955519	8434049	18757308	-10323259
2010	5225287	3955519	9180806	22922155	-13741349
2011	3891340	3555519	7446859	15727976	-8281117
2012	3392000	3155519	6547519	14796032	-8248513
2013	1500030	2755519	4255549	19127944	-14872395
2014	7064500	2455519	9520019	23775889	-14255870
2015	19311704	2555519	46580280	25414065	21166215

**Source:** Ministry of Finance, Public Debt Department; Annual Reports of the Central Bank of Iraq (various years).

This increase in internal public debt is attributed to two main components recorded in 2015: treasury bonds amounting to approximately 14,525 billion dinars and loans from financial institutions valued at approximately 10,461.057 billion dinars. As a result, total internal public debt reached approximately 46,580.280 billion Iraqi dinars.

**Table (2): Fiscal Dominance and Monetary Policy Credibility**

Years	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Actual expenditure trillion	32.1	26.2	38.8	39	59.4	52.5	70.1	78.7	105.1	119.1	113.5	70.4
Quantities	6	10.4	11.1	15.9	25.8	33.9	36.1	39.7	48.6	53.2	51.7	44.3

sold billion												
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**Source:** Prepared by the researcher based on the Central Bank of Iraq, *Annual Statistical Bulletin*.

This fiscal dominance of the Iraqi government has resulted in a gradual loss of credibility of monetary policy, particularly the currency auction mechanism as a key stabilization tool. This is partly reflected in the sharp increase in Central Bank foreign currency sales, which rose from approximately USD 6 billion in 2004 to USD 53.2 billion in 2013, before declining to USD 44.3 billion in 2015 due to fiscal constraints introduced under Article 50 of the 2015 Federal Budget Law.

These developments indicate that fiscal and monetary authorities have faced increasing difficulties in maintaining price stability and stabilizing the Iraqi dinar exchange rate, particularly in the aftermath of the 2014 security and oil price shocks.

Overall, these trends highlight a persistent structural budget deficit, where both domestic and external public debt have become permanent instruments of fiscal financing rather than temporary stabilization tools. Public debt management, relying heavily on borrowing and debt issuance, remains constrained by the absence of a well-functioning secondary debt market. This situation underscores the need for stronger coordination between fiscal and monetary authorities, as well as a greater emphasis on monetary policy targeting to enhance control over inflation and price stability.

#### **4.2 Fiscal and Monetary Costs of the Dual Shocks (Oil and Security): Net Impact on Balance and Growth**

The Iraqi economy has been subject to significant fiscal and monetary pressures resulting from the combined effects of domestic security instability and the sharp decline in global oil prices. The collapse of oil prices from nearly USD 120 per barrel to below USD 30 significantly reduced government revenues, given that oil exports account for approximately 98% of total export earnings.

At the same time, military operations against terrorist groups increased public expenditure requirements, thereby intensifying fiscal imbalances. In addition, disruptions in oil production caused by insecurity, including the temporary loss of control over certain oil fields, further reduced output and weakened overall economic performance.

In response to rising fiscal deficits, Iraq increasingly relied on external financial assistance, including loans from the World Bank and the International Monetary Fund (IMF). This dependence on external financing further reflects the depth of the fiscal and monetary policy crisis. Estimates suggest that military-related expenditures reached approximately USD 35 billion in the post-2003 period, with daily conflict-related costs in earlier phases reaching significant levels. Combined with declining GDP, restricted foreign trade, and reduced aggregate supply, these pressures contributed to a multi-dimensional recessionary environment.

Under these conditions, both fiscal and monetary policies became severely constrained. The independence of the Central Bank was limited, particularly in its ability to manage liquidity and stabilize monetary aggregates. While the currency auction mechanism initially served as an important confidence-building tool for exchange rate stability, its extensive use over time reduced its effectiveness and weakened its stabilizing capacity.

Although fiscal consolidation and expenditure rationalization are essential, Iraq's structurally distorted economy—characterized by weak productive sectors and high oil dependence—has limited the effectiveness of reform efforts. As a result, the economy has remained trapped in a cycle of fiscal dominance and reduced central bank autonomy.

Without significant structural adjustments, Iraq faces the risk of prolonged macroeconomic stagnation. Conversely, maintaining the current policy framework without reform would further entrench economic vulnerability. These conditions

highlight the urgent need for structural transformation aimed at reducing oil dependency and building a more diversified and resilient economic system capable of absorbing external shocks.

## **5. Conclusions**

The conflict with ISIS (Da'esh) in Iraq imposed substantial economic costs on the country. Direct economic losses were estimated at approximately USD 35 billion, representing more than 15% of GDP. Military expenditures reached nearly USD 25 billion in 2017 alone. According to IMF assessments, the conflict imposed an average daily economic cost of approximately USD 10 million, which significantly constrained economic growth, reducing it by around 1 percentage point.

Alternative estimates suggest that the overall economic, social, and human costs of the conflict range between USD 300–500 billion. During this period, Iraq's GDP declined from USD 75.6 billion (with growth of 5.5% in 2013) to USD 70.9 billion in 2014 (with negative growth of -2.4%). In addition, trade volumes contracted by approximately 44.6% between 2013 and 2015.

In rentier economies such as Iraq, fiscal policy remains structurally dominated by oil revenues, limiting the autonomy of monetary policy. Despite formal legal provisions supporting central bank independence, monetary policy remains heavily influenced by fiscal requirements and oil-driven budgetary cycles. This fiscal dominance restricts the Central Bank's ability to control money supply and maintain macroeconomic stability.

A sustainable macroeconomic framework requires a strong institutional balance between fiscal and monetary authorities, ensuring central bank independence and reducing reliance on monetary financing of budget deficits. Without such reforms, fiscal pressures may continue to undermine monetary stability and long-term development objectives.

The development of financial markets is particularly important for economies in transition from state-led to market-oriented systems, as it provides alternative sources of financing and strengthens macroeconomic resilience. In Iraq, the continued reliance on oil revenues has increased vulnerability to external shocks and reinforced the pro-cyclical nature of fiscal policy.

Macroeconomic instability in Iraq is further driven by persistent budget deficits and structural imbalances in production. Heavy dependence on oil revenues has weakened non-oil revenue sources and increased exposure to global oil price fluctuations. As a result, fiscal volatility translates directly into instability in macroeconomic indicators, discouraging investment—particularly in non-oil sectors—and limiting long-term economic diversification.

### **Recommendations**

Policymakers in Iraq should prioritize strengthening the independence of the Central Bank and ensuring effective monetary policy autonomy to reduce fiscal dominance. At the same time, reducing dependence on oil revenues is essential to enhance macroeconomic stability and resilience to external shocks.

The development of domestic financial markets should be encouraged to provide alternative financing mechanisms for public investment and reduce reliance on oil-funded budgets. Strengthening fiscal discipline, improving public expenditure efficiency, and expanding non-oil revenue sources—particularly through tax system reform—are critical for achieving sustainable fiscal balance.

In addition, comprehensive post-conflict reconstruction strategies are required to restore productive capacity and support long-term economic recovery. Private sector development should be actively promoted to enhance employment generation and reduce dependence on public sector employment.

The establishment of sovereign wealth funds and stabilization mechanisms is also essential to mitigate the effects of oil price volatility and ensure more stable

fiscal planning. Finally, strengthening coordination between fiscal and monetary authorities, alongside structural reforms aimed at improving productivity and economic diversification, is necessary to achieve sustainable long-term economic growth in Iraq.

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