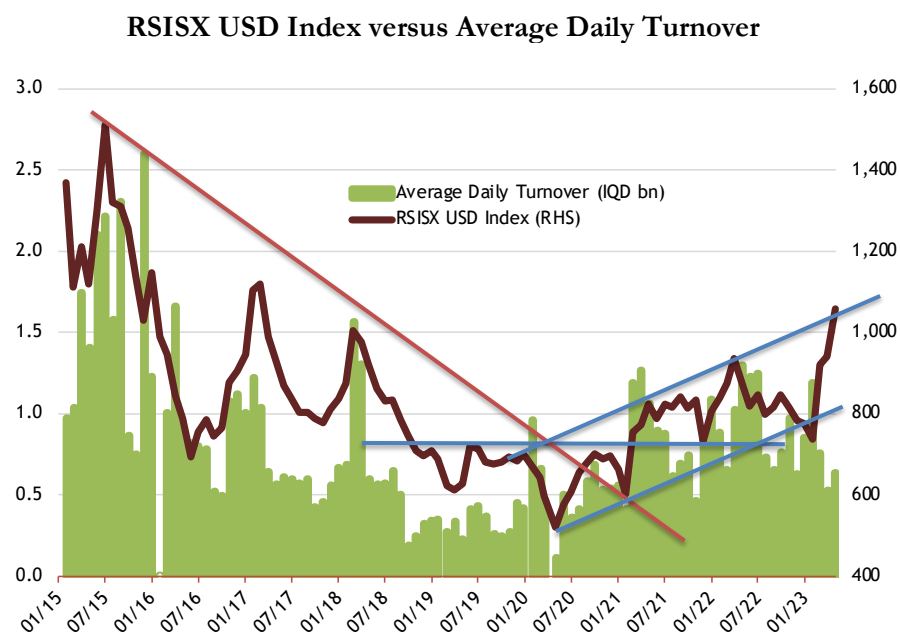


“Tag Ends of Currency Upheaval Sparks Market Rally”

Ahmed Tabaqchali, May 6th, 2023

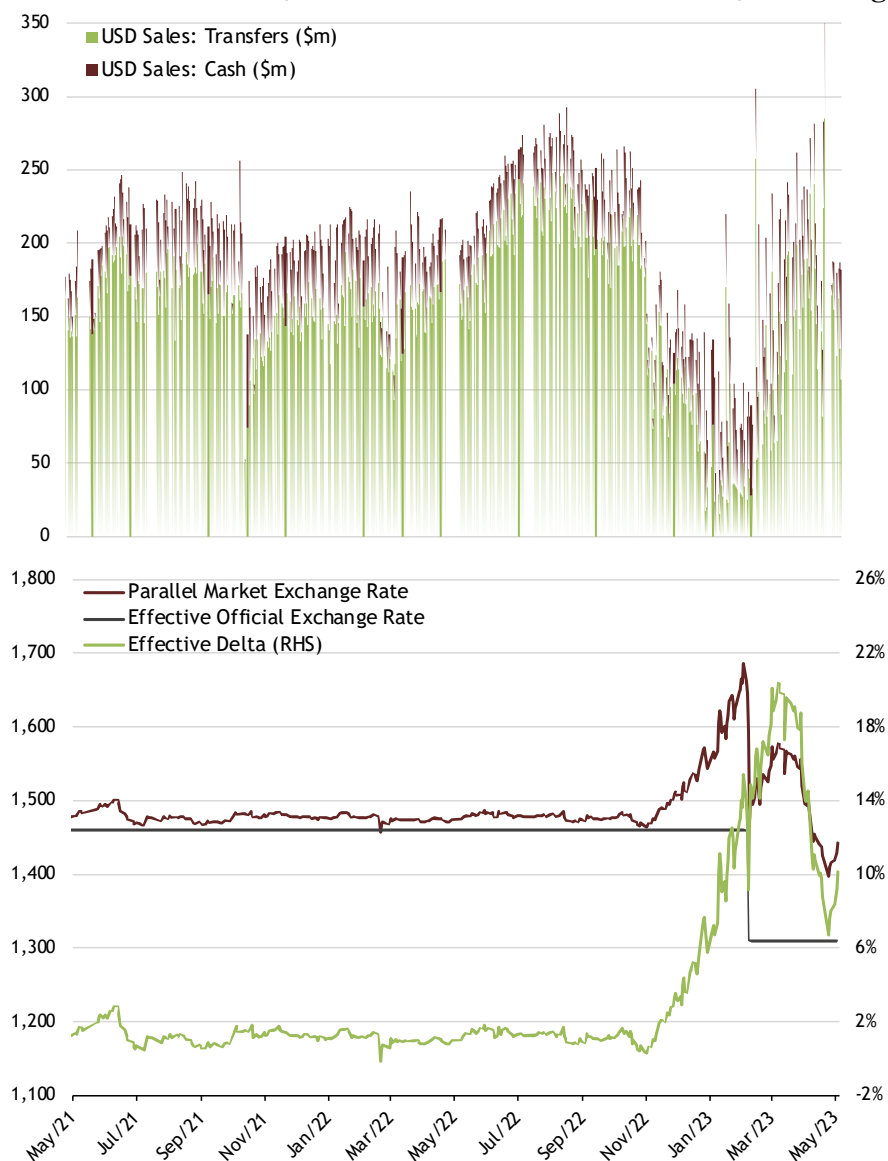
The market, as measured by the Rabee Securities RSISX USD Index, was up 12.5% for the month, and up 36.7% for the year. The market’s solid performance for the second month in a row on the back of February’s [super performance](#), enhanced by a revalued currency, underscores the underlying strength of the recovery that has discounted the currency’s upheaval, as discussed here [recently](#), and is beginning to discount its stability. The market’s technical picture continues to be positive, and the macroeconomic fundamentals discussed [here](#) last year argues that this uptrend will likely remain in force; however, its upward slope might moderate or even go sideways as it is currently above the upper band of its 36-month up-trending channel.



(Source: Iraq Stock Exchange, Rabee Securities, AFC Research, data as of April 30th)

The currency’s upheaval – sparked by the Central Bank of Iraq’s (CBI) introduction of new procedural requirements to those for its provisioning of US Dollars (USD) for importers in November 2022 (*) – have subsided considerably as the combination of the government’s and the CBI’s measures to create demand for the Iraqi Dinar (IQD), and for furthering the adoption of banking, have been effective in accelerating these shifts. These, coupled with the market’s gradual and ongoing adjustments to the increased levels of transparency demanded in the CBI’s new procedural requirements, have resulted in the recovery of volumes in CBI’s daily USD-IQD transactions for cross-border fund transfers (upper half of chart below). This, in turn, has resulted in a 10% appreciation in the market price of IQD versus the USD, as can be seen in the narrowing of the premium of the market rate over the official rate from a peak of around 20% in early March to about 9% by the end of the month (green line in the lower half of the chart below) – but has crept higher to about 10% by May 4th.

Volumes in CBI's USD-IQD Transactions versus the USD/IQD Exchange Rate

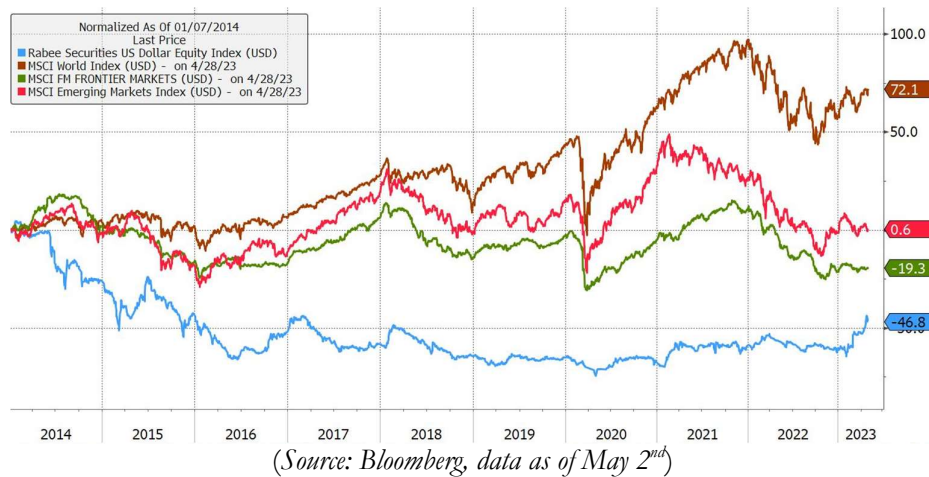


(Source: CBI until February 7th, Baghdad FX exchange houses from February 8th, AFC Research, daily data as of May 4th)

The current premium of the market exchange rate over the official exchange rate at around 10%, is still high compared to 1-2% levels that prevailed in the recent past (green line in the lower half of the chart above). As such, given the country's high dependence on imports, it still offers a significant competitive advantage for companies operating formally versus those operating informally; consequently, providing the economic inducement for informal companies to transfer to formality and to access the banking sector for the first time. These incentives, and the high transparency levels demanded by the CBI's procedural requirements introduced in mid-November 2022, have benefited the higher-quality banks whose infrastructures are able to deal with the inflow of new clients and the subsequent increased volumes of cross-border transactions. These developments are accelerating: (1) the shift away from informality that dominates the bulk of economic activities; and (2) the adoption of banking away from the dominance of cash as both a store of value and a means of economic exchange – a process that is positive for the investment thesis for the banking sector in Iraq as discussed here in "[Banks & the Iraq Investment Thesis](#)" in February 2022. However, the still high degrees of informality, cash, and the dollarization in economic activities mean that these developments will continue to unfold over time; and the premium of the market rate over the official rate is still in the early stages of stabilisation and settling into a range – that is higher than the past, but likely near the current levels.

The year-to-date performance of the market, as measured by the RSISX USD Index, signify the diversification benefits of frontier markets, which have a low correlation with global markets, especially during this period of global market volatility and macroeconomic uncertainty. Furthermore, even after the strong year-to-date performance, the index is still about 49% below its 2014 peak and shows solid signs of recovery – all of which indicate that its risk-reward profile is very attractive compared with most global markets (chart below).

Normalized Returns for the RSISUSD Index vs MSCI World Index, MSCI Emerging Markets Index and MSCI Frontier Markets Index



* **Background to currency upheaval:** As written here last [month](#), the CBI, as part of an ongoing process of encouraging the move towards the adoption of banking and away from the informality that dominates economic activity, implemented in mid-November 2022 new procedural requirements to those for its provisioning of USD for importers. These procedural requirements would bring the country's cross-border fund transfers in-line with global standards, which require a high level of transparency. However, they represent a seismic shift to the country's cash-dominated economy, in which large informal sectors drive the bulk of economic activity. As such, the introduction of the new procedural requirements immediately affected the volumes of the CBI's daily USD-IQD transactions for cross-border fund transfers, which led to a supply-demand mismatch and consequently to a depreciation in the market price of the IQD versus the USD, and with that currency upheavals as discussed here over the last few months.

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