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The role of domestic credit in promoting economic growth in Iraq for the period 2018-2023

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Abstract : This research aims to demonstrate the impact of domestic credit on economic growth indicators in Iraq for the period 2018-2023. It is based on the premise that credit changes in Iraq have not had a clear impact due to the realities and nature of the banking system, which remains constrained by numerous economic and political limitations.
The research focuses on defining the concept of domestic credit and its dimensions, as well as its nature in Iraq. The relationship between domestic credit and economic growth indicators in Iraq for the period 2018-2023 was estimated using annual data based on several standard indicators. The research found a significant correlation; however, the unstable conditions of the Iraqi economy prevented the available results from being fullyrealized.

INTRODUCTION:

Monetary policy is one of the most important drivers of economic activity, encompassing one of its broadest areas. As a tool of monetary policy, its effectiveness is determined by the performance of the real economy and the strength of monetary policy influence, which depends on the degree of independence enjoyed by the central bank. Many countries have consistently adopted financing and credit policies with varying maturities, aiming to achieve an acceptable level of economic performance. However, the intermediary variables through which monetary and financial policies are implemented differ in their approaches and limitations. Undoubtedly, credit exerts an influence on economic variables, and its study necessitates examining economic factors and assessing their changes based on assumptions of monetary reality. This research attempts to investigate the implications of domestic credit in Iraq and its impact on economic growth.

Research Significance: The research is significant because it defines the concept of domestic credit and its dimensions. It also focuses on the nature of domestic credit in Iraq and assesses the relationship between domestic credit and economic growth indicators in Iraq for the period 2018-2023, using annual data based on several standard indicators.

Research Problem: Can domestic credit enhance the effectiveness of economic growth indicators in Iraq؟

Research Hypothesis:

This research is based on the hypothesis that credit changes in Iraq have not had a clear impact due to the realities and nature of the banking system, which remains constrained by numerous economic and political limitations.

Research objective: To study the impact between domestic credit and economic growth variables in Iraq for the period 2018-2023.

First: The Concept of Domestic Credit

Domestic credit is among the priorities of monetary and credit policy set by the central bank in order to achieve the desired rate of economic growth. In other words, it is the framework that includes regulations for the process of granting credit and banking facilities, which aims to determine investment priorities in a way that ensures the achievement of banking profitability and consistency with the development goals of the country. The World Bank defines domestic credit to the private sector as "the financial resources available to the private sector, such as those available through loans, purchases of securities other than equity shares, trade credits, and other accounts receivable, which form the basis for a claim for repayment. For some countries, these claims include credit extended to public institutions" (for more information in Formation, 2017, p. 12).

Guarantees in domestic credit are a cornerstone of domestic lending theory. The borrower is obligated to repay the principal plus interest in a way that allows the bank to achieve profitability, avoid losses, and recover its funds. This concept refers to what is known as credit facilities for bank loans (Abdul Hamid, 2000, p. 11).

Since the objective of domestic credit is to stimulate the financial system, it operates within a framework led by the central bank. The central bank occupies the heart of the regulated financial system and is responsible for controlling changes in the money supply and monitoring financial activities in all countries (except Liberia and African countries that rely on the financial system). (French) (Malcolm, 2009, p. 33). On the one hand, domestic credit is of great importance in global and Arab markets. It is a fundamental pillar for the stability of the economic system. On the other hand, it constitutes a risk factor that may cause a country to experience economic crises whose impact affects the entire economy. During the Southeast Asian crisis, domestic credit was one of the factors that reduced Indonesia's ability to overcome the crisis, as the phenomenon of non-performing loans became widespread. The entire surplus liquidity was invested in Indonesian treasury bills and bonds due to the sluggish performance of domestic credit in producing expansionary effects in the deployment of funds (Rizq, 2020, p. 211).

As for the Arab countries, the impact of credit behavior in Arab markets has been determined according to the reflections of the credit system and the currency system. From a financial economics perspective, what affects currency systems has repercussions on credit systems. Therefore, the value of the currency is determined according to the nature of the credit system. Similarly, international currency systems are affected by the global credit system. The instability of the value of the currency in light of the continued decline in the value of assets has led to The US dollar's role as a reserve currency for payments has changed. This has resulted in other countries bearing unjustifiable domestic costs to maintain growth rates and, consequently, living standards. The influx of capital into emerging economies has had unfavorable consequences, as their dollar-denominated capital surpluses have been a disruptive factor in the growth equations of healthy economies in various countries (Dagong, 2011, p. 27).

SOURCE: International Monetary Fund, April 2012, Statistical Appendix, pp. 216-218.

Second: Gross Domestic Product (GDP)

According to statistics from the Iraqi Ministry of Planning, GDP at current prices increased by 16% during the period 2018/2019, while per capita GDP increased by 12.7% during the same period. Meanwhile, GDP at constant prices (base year 2018) increased by 8.5%, and per capita GDP increased by 5.4% during the same period (2).

Data issued by the Arab Monetary Fund indicates that GDP began to grow in the years following 2003, compared to the preceding years, as a result of Iraq's opening up to the outside world in the areas of foreign trade and the oil sector, and the concerted efforts to reduce or write off a large percentage of its external debt incurred as a result of the senseless wars Iraq waged with its neighbors and the resulting sanctions and economic embargo that lasted for more than 13 years. In November 2004, the Paris Club announced a deal to write off 80% of Iraq's debt. When fully implemented, the agreement will relieve Iraq of $100 billion of its debt, providing a significant boost to long-term economic growth. Iraq has also completed more than three years of standby arrangements with the International Monetary Fund (IMF) and finalized the terms of its Paris Club debt reduction agreement. In December 2004, the World Trade Organization (WTO) agreed to open negotiations on Iraq's membership. Since February of that year, Iraq has held observer status in the WTO, and a working group has been established to examine Iraq's application. The WTO General Council met for the second time in April 2008 to continue reviewing Iraq's foreign trade regime. Iraq hopes to achieve full membership in the coming years (International Monetary, 2012, p. 11).

Table (1) Gross Domestic Product (GDP) rates in Iraq for the period 2018-2023 (Figures in millions of dinars)

Gross Domestic Product (GDP)	years
249574276	2018
254443953	2019
251661517	2020
53235359	2021
73533599	2022
77120032	2023

Source: Publications of the Central Bank of Iraq, Department of Statistics, various years

Despite the International Monetary Fund's (IMF) optimistic projections of 6.7% growth for the Iraqi economy starting in 2021 and continuing for the next five years, reality has shown that this growth rate has not been achieved in the true sense of the word. Although Iraq's GDP rose from $138 billion in 2019 to $201 billion in 2021, and is projected to reach $218 billion by 2023 according to IMF estimates, the real growth rate declined from 7.7% in 2019 to 6.9% in 2021 as a result of the COVID-19 pandemic. It is likely to fall further to 6.7% in 2023, according to the same estimates, due to the decline in the value of the US dollar and its reduced purchasing power compared to the euro and other major currencies during this period.

Third: Monetary and Fiscal Policy in Iraq

Iraq is characterized by an undefined monetary environment. Monetary and fiscal policy directions generally depend on the necessities of the real economy, which is itself an unstable foundation in Iraq.

The economic transformation in Iraq has led to an expansion of the banking sector and the emergence of banking capacity for credit expansion, whether for commercial or specialized purposes. When comparing Iraq's creditworthiness with the average in less developed countries, one of the most important tools for measuring domestic credit is the M2 money supply index. This index comprises the components of the narrow money supply (M1) plus deposits with non-cash banking institutions, which represent one of the most important components of the monetary and banking structure in the country. Table (2) indicates that money supply reached 75.5 trillion dinars at the end of 2019, registering an increase of 4.6% compared to 2018, equivalent to an increase of 72.7 trillion dinars (Al-Zubaidi, 2021, p. 30). Tables (2) and (3) provide a review of the data on the volume of monetary credit and the money supply in Iraq, quarterly data.

Table (2): The development of the volume of cash credit in Iraq during the period 2018-2023 (million dinars)

Years	monetary credit	growth rate %
2018	38.4	1.3
2019	42.05	9.3
2020	49.81	18.5
2021	52.97	6.4
2022	55.88	8.9
2023	53.22	7.8

.Source: Central Bank of Iraq, Central Bank of Iraq Monetary Policy Report for 2024, p. 4

Figure (1)

The development of cash credit in the Iraqi economy for the period2018-2023

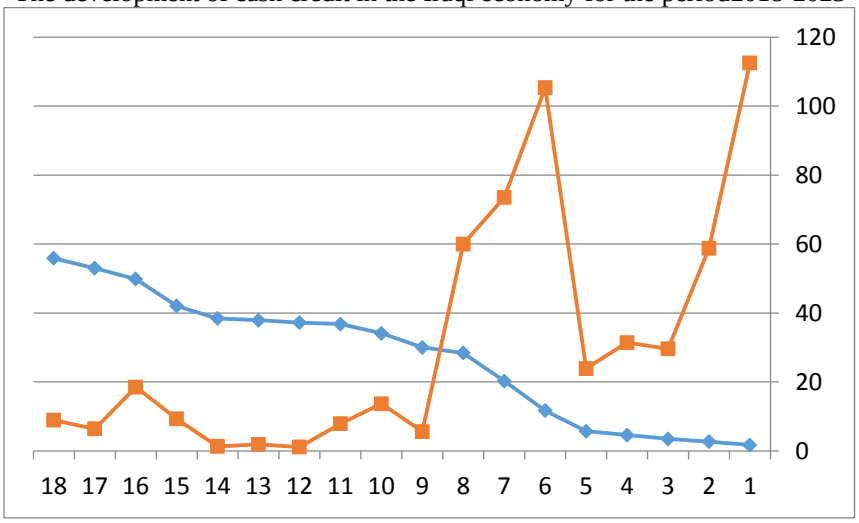

Table (3): Development of the money supply in Iraq for the period 2018-2023. Figures in millions of dinars

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110805.90	2018
117143.61	2019
125543.08	2020

164456.02	2021
169870.08	2022
178863.66	2023

This large increase does not indicate a real increase in deposits and money supply, but rather it is apparent, and its real origin is the significant rise in the general price level and the exposure of the Iraqi economy to waves of rampant inflation .

Third: The Developmental Effects of Expanding Monetary Credit

Bank credit plays a crucial role in the local and national economy. Expanding credit increases productive capacity, assuming a reasonable flow of resources. In such circumstances, it boosts production and employment by investing borrowed funds in high-yield productive projects. Loans are considered the most important means for banks to invest their financial resources and avoid leaving them idle (Al-Zubaidi and Sadr, p. 44). The returns on these loans constitute the largest aspect of the credit process, i.e., the expansion of economic activity, by achieving multiple objectives. Loans aim to increase production in terms of both quantity and quality, and to raise production rates to achieve economic growth and stability, reach a production surplus, and promote exports while reducing imports. 1. The Monetary Effects of Domestic Credit

First Monetary Effect: Expectations and Trends in Monetary Policy

Domestic credit exerts its effects on the real sector based on the impact of direct deposits on the volume of credit itself. In cases of financing government deficits, a possible scenario is that the monetary base directs long-term credit, which promotes investment in desired projects according to the state's methodology for allocating capital as required. In such cases, investment is largely linked to bank liquidity resulting from direct deposits and monetary policy measures in the open market. This creates a correlation between actual deposits, which are liabilities of banks, and the tendency of a range of economic units to turn to the secondary market to generate profit based on expectations of interest rate trends.

Although deposit operations may seem small compared to investments by the commercial banking system, the growth of private projects creates bank liabilities that support the financial position of the actual deposits component. This enhances the effectiveness of monetary policy in financing private projects. In addition to being both a source of financing and a means of saving, it also helps mitigate inflationary effects that may arise, especially in the early stages of investment, when net investment is likely to decline. This is because there will be an increased flow of goods into the markets at this stage, leading to lower prices. The expectation of falling prices will be reinforced by a contraction in the money supply, as productive enterprises will be able to sell their output and consequently increase, thus increasing the corresponding cash flow. This reduces the credit operations carried out by banks in terms of lending to the private sector, and the multiplier effect of bank credit creation decreases. This means a decrease in the overall monetary supply injected into the economy, which in turn reinforces the decline in the general price level.

A decline in the general price level to a low level is not a good indicator, especially during the growth period, because it reduces the incentive for expansion in the real sector. Signs of recession may reappear in the economy.

Thus, these effects, when combined, create a buffer against inflation on the one hand, and strengthen the means of financing and bank investment on the other. The second monetary effect: The expansion of credit and its repercussions on growth indicators.

In the context of net domestic credit conditions, a net inflow of primary deposits into the banking system is expected. This serves as a direct instrument and a vehicle for financing lending operations, often manifested as the conversion of cash from its liquid form into withdrawable deposits. This financing undoubtedly involves the transmission of monetary policy effects through the intermediary tool of interest on loans. The resulting downward pressure on financing costs (credit interest) will ultimately contribute to financing development operations, the ultimate goal of monetary policy.

Such effects will undoubtedly lead to further credit expansion, but only if there are optimistic long-term expectations. This means that any opportunities to achieve expansionary effects on consumption, investment, and demand rates require a high degree of certainty in the possibility of future profits and a greater degree of confidence in achieving desired rates of economic growth.

1. Effects on Investment

This situation illustrates the impact on public investment, as credit growth leads to increased investment since credit is the core of investment. Given that fixed capital formation is a function of increasing profits on the one hand, and decreasing the minimum required to cover unfavorable expectations on the other, the expansionary effect of investments on income, consumption, and price indicators is determined by the impact investment has on the real economy. In a country, the index of ownership of capital assets, factories, equipment, and advanced technology can be identified as an indicator of increased economic growth.

1. Financial Stability

Increased government spending plays a compensatory and competing role with credit policy. Undisciplined fiscal policy eliminates the potential for achieving the desired expansionary credit effects due to the desire to maintain state control and strengthen the economy by injecting more government funds. This reinforces the centralization of the Iraqi economy and distances it from the concept of financial and economic liberalization. This compensatory fiscal trend encourages negative feedback loops between financial variables and real economic variables. This is further confirmed by what happened in Japan, a significant example in this regard, where the move towards compensatory fiscal policies resulted in a series of diminishing fiscal packages that ultimately led to a significant decline in the responsiveness of macroeconomic variables (IMF, 2018, p. 29).

3. Transmission of Some Effects Through the Price System

This refers to the use of credit ceilings to secure financing regardless of the anticipated short-term inflationary effects. A general cap on credit expansion is a successful means of controlling the domestic component of the money supply. However, a credit ceiling does not provide an effective tool for controlling the aggregate component of the money supply, especially under stable exchange rates, because the monetary authority will be unable to control the foreign component of the money supply.

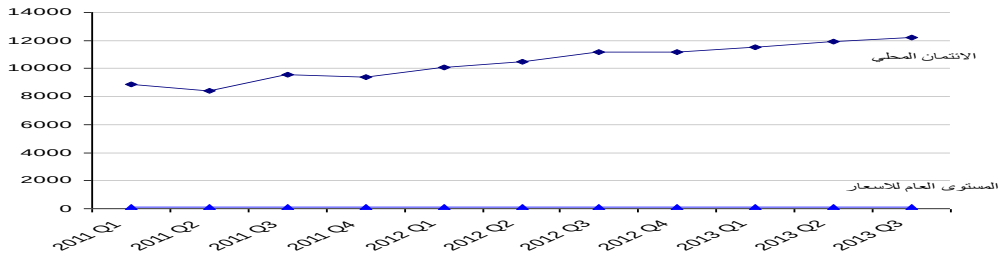
Therefore, a relative increase in prices is expected, which will undoubtedly affect consumer goods and production inputs, thus raising the cost of imported goods entering the Iraqi market. The exchange rate channel will also contribute to the effects on the real sectors. Changes in the prices of imported inputs will, in the medium term, lead to an increase in the amount paid in local currency, even if denominated in dollars. This ultimately means a decline in the local currency's exchange rate.

2. Effects on the Inflation Rate

The anticipated shock to the price mechanism will affect the structure of the price index in Iraq due to the high marginal propensity of consumption. A rise in the inflation rate, even if temporary, will cause an imbalance in the weighting of the price index. This is because the increase in prices of high-weighted consumer goods included in the index will affect the overall index and, consequently, the consumer, especially given the resulting rise in expectations for the general price level across many of the index's components. This shock will be exacerbated by the decline in the local currency's exchange rate. This trend represents a circular interaction between the price structure, the exchange rate, and future prospects, making Iraq more vulnerable to the impact of shocks in real variables resulting from the potential escalation of global crises. Furthermore, Iraq, as a country facing persistent imbalances in its external payments and confusion in determining its revenues due to its reliance on a single rentier resource, will find it difficult to manage chronic, creeping inflation. This is because the anticipated impact of setting upper limits on financing ceilings is far less significant than the effects of the instability that will result in declining international reserves.

Figure 2 shows that the impact of credit on price inflation appears weak. This is attributed to the decline in inflation rates in the Iraqi economy due to the commodity balance provided by uncontrolled commodity imports. This is not a positive factor, as its consequences for the real economy and employment rates are beginning to indicate a decline in the performance of the local economy.

Figure 2: Development of the volume of domestic credit during the period 2018-2023 and its impact on inflation rates



4. Impact on the Nature of Development and the Real Sector

The growth of these returns has had an impact on the financial market that is no less significant than other factors in terms of its effect on economic diversification. To understand the mechanism, it is necessary to examine the effects on a range of variables. We find that the increase in the size of returns in the financial market in general leads to an impact on the effective demand for goods and services in the real market within the real sector. Such effects have appeared in countries with active financial markets where returns have increased and whose markets are more mature, most notably the Saudi and Emirati markets. The most important result of this is an increase in average prices in the

real market. Naturally, the decrease in the purchasing power of money leads to an increased need for financing, which is usually followed by an increase in interest rates on loans (J. Weston, 2021, p. 77). However, the effect of liquidity and its reflection on returns, and subsequently on interest rates, means that the effects are transferred from the financial market to the banking sector. Therefore, it is likely that the rise in interest rates will lead to a decrease in the rate of long-term borrowing by the private sector. Even if public finances were to direct fiscal incentives, such as creating tax loopholes for alternative income-generating activities, the burden would fall on the state rather than the private sector. This would mean a return to reliance on state resources, which are largely rent-based.

Looking at the nature of credit in Iraq and its connection to financial markets, we find a tendency to resort to and invest in financial markets to a greater extent than in the real sector. Given the financial surpluses, which translate to a high ratio of liquidity to GDP, this surplus will exacerbate currency instability. Monetary policy, which relies on intermediate objectives, avoids setting excessive interest rates, as this would reduce its ability to attract surplus liquidity. Therefore, the general expectation is for a conservative monetary policy aimed at attracting savings. However, the main difficulty lies in the fact that investors' funds tend to flow outwards rather than inwards. Domestic flow is limited to the proceeds from oil revenues.

1. The Impact of Domestic Credit on GDP

$CR = \alpha + \beta\ GDP$ …… (1)

Where CR is domestic credit, GDP is gross domestic product, the regression result is as follows:

The regression equation is

CR = 7049 + 0.263 GDP

Predictor	Coef	SE Coef	T	P
Constant	7049.2	570.4	12.36	0.000
GDP	0.26273	0.04212	6.24	0.000

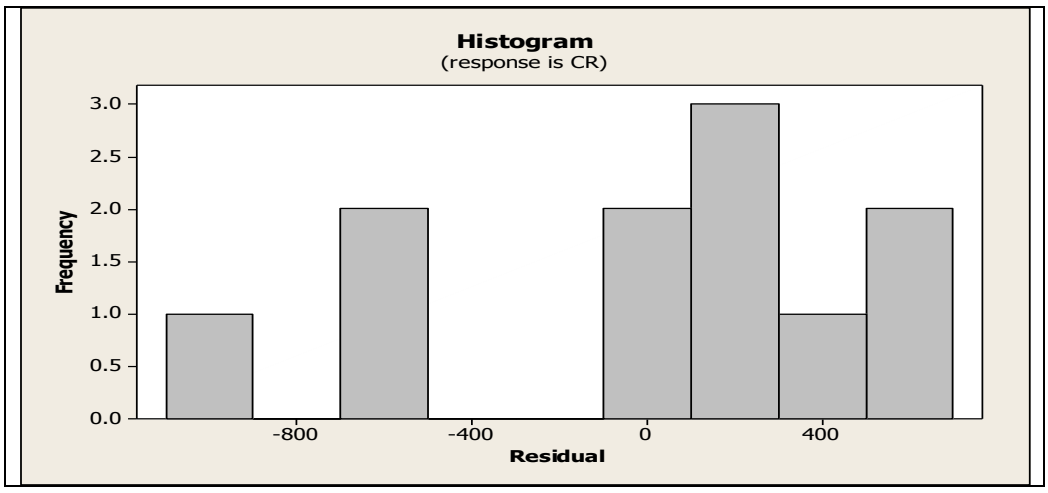
S = 581.623 R-Sq = 81.2% R-Sq(adj) = 79.1%

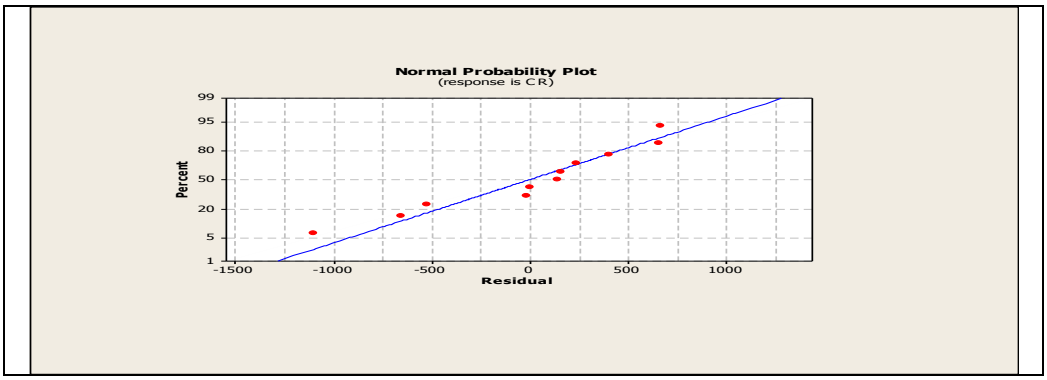
Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	13160441	13160441	38.90	0.000
Residual Error	9	3044570	338286		
Total	10	16205011			

Unusual Observations

Obs	GDP	CR	Fit	SE Fit	Residual	St Resid
2	9321	8400	9498	231	-1098	-2.06R





2. The impact of domestic credit on the growth of investment and the real and commodity sectors in Iraq

$$CR = \alpha + \beta 1\, GS + \beta 2 TS + \beta 3\, SS \ldots\ldots (2)$$

Where it is the output in the commodity sectors, it represents the output in the distribution sectors group.
SS is the output in the services sector within the GDP. The results of the multiple regression were as follows:

Regression Analysis: CR versus GS; TS; SS

The regression equation is

CR = 3984 + 0.259 GS + 2.82 TS - 0.31 SS

Predictor	Coef	SE Coef	T	P
Constant	3984	7205	0.55	0.597
GS	0.2587	0.2770	0.93	0.381
TS	2.821	1.583	1.78	0.118
SS	-0.314	1.473	-0.21	0.837

S = 886.740 R-Sq = 66.0% R-Sq(adj) = 51.5%

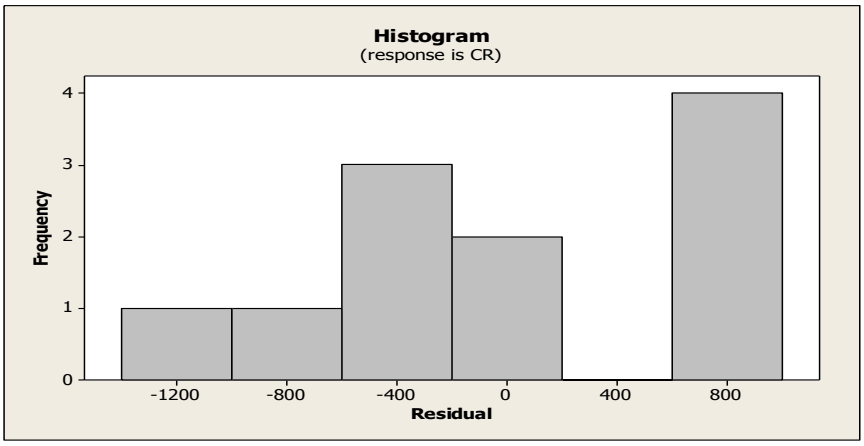
Analysis of Variance

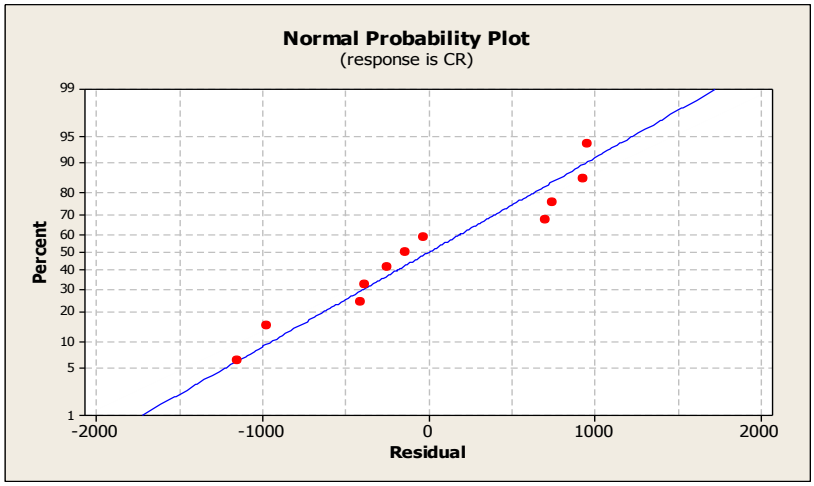
Source	DF	SS	MS	F	P
Regression	3	10700855	3566952	4.54	0.046
Residual Error	7	5504156	786308		
Total	10	16205011			

Source	DF	Seq SS
GS	1	7782456
TS	1	2882645
SS	1	35754

Unusual Observations

Obs	GS	CR	Fit	SE Fit	Residual	St Resid
11	12237	12233	11531	832	702	2.30R





By examining the results of models (1) and (2), we find that, according to the regression analysis, the relationship between domestic credit in Iraq and GDP is strong. R2 reached approximately 81% in model (1), while it reached 66% in model (2). However, this result clearly indicates that a larger financial flow than credit is what influences GDP growth, and the relationship between domestic credit and sector outputs explains this fact.

In other words, the results of model (2), which shows the impact of financial flow, clearly point to the effect of government spending. This is a phenomenon that occurs in most oil-rentier countries, where banking policy remains captive to revenues, just as credit policy is. This creates a financial and credit cycle whose primary reference point is sovereign state funds, making expectations in the money market affected by economic problems, including fluctuations in the country's revenues resulting from its almost sole source of income. The impact of credit on the economy depends on how banks grant loans to finance diverse economic activities. This type of credit financing achieves two important objectives: first, it reduces the likelihood of expected losses, and second, it contributes to the expansionary effect of credit in achieving a reasonable level of investment in sectors that diversify the economy.

Financing policies aimed at developing a specific sector or group of sectors within the economy are merely one component of a package of measures targeting a set of desired development goals. This raises the question of how to establish a causal relationship between credit and development. Development is a comprehensive process that necessitates development policies to achieve general objectives. Consequently, it encompasses several measures, the most important of which are those that stimulate the economy. However, these policies should not be designed from the outset to reduce dependence on a single resource, meaning that this should not be an inevitable outcome of development. However, this may not be entirely true. Development can be achieved through structural transformations driven by diversifying income sources, leading to changes in demand that increase market size and stimulate foreign trade. This, in turn, enhances the efficiency of resource allocation, positively impacting achieved growth rates (Al-Saadoun, 2012, p. 19).

3. The Impact of Domestic Credit on Small Projects

This is known in economic literature as microfinance. It involves banking investments that start with the poorest borrowers and reach those who are relatively well-off. Traditionally, and to a large extent, it reaches secure clients. Countries like Morocco and Kenya have developed this type of financing and established legal frameworks to regulate it. The impact of such financing may evolve to reach the level of total domestic credit in terms of its long-term expansionary effects (Al-Saadoun, 2012, p. 44). Many less developed countries rely heavily on small businesses for their economic activity. According to recent studies, these businesses constitute, on average, one-third of the GDP, and they absorb 40-70% of the workforce (ibid., p. 47).

The financing requirements for these businesses are microfinance, intended to secure the purchase of goods, mitigate fluctuations in the local market, or cover labor costs. The challenge with bank financing lies in the relatively high cost of loans due to their small size (Al-Saadoun, op. cit., p. 27). The Bangladeshi experience provides a notable example in this regard. The lending system was established with the founding of Grameen Bank in 1976. It financed investment in villages, particularly in the purchase and trade of livestock. Its lending policy was based on borrowers' repayment commitment. By 2009, the bank had over 300 branches in 5,400 villages, serving 250,000 individuals, 75% of whom

were women. The loans were small, under $100. The bank's sustainability is further supported by the fact that 97% of its loans are repaid within one year (according to an IMF report).

Recommendations

1. The local credit in Iraq can achieve expansionist effects on the formation of fixed capital, if the broad and scaling government financing policies are in their correct and thoughtful form.
2. . Through the findings of the statistical approach, it was found that the impact of credit on the growth rates in Iraq was not at the required level in light of the growing government expenditures. Corruption and economic and administrative inefficiency remained prevalent.

(1) For more information see:
http://data.albankaldawli.org/indicator/FS.AST.PRVT.GD.ZS.

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(2)The International Monetary Fund, Journal of Finance and Development, Issue (2), Volume (44), Al-Ahram Center for Translation, June 2007, pp. 44-45.