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Success Story: CBI Pushes Through Reforms to Reserve Requirements

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USAID economic advisors work with the Central Bank of Iraq (CBI) to develop monetary policy in line with international best practices

After 18 months of effort, USAID Economic Governance II advisors working with CBI staff have finally won support from the Iraqi Ministry of Justice to enact changes in the CBI reserve requirement regulation that will help maintain price stability in Iraq.

The reserve requirement is used by all central banks as the primary monetary policy tool. In cash-based economies like Iraq's, the absorption of excess liquidity in the market is best accomplished through volume tools.

Project advisors and the CBI have worked to educate their colleagues in the Justice Ministry on the importance of sound monetary policy and the necessity of revising regulations governing reserve requirements. Winning their backing and assent has made this significant reform possible.

Correcting flaws in existing regulations will limit bank use of vault cash to meet reserve requirements. Excess reserves in the form of vault cash put banks at an unacceptable and avoidable risk for robbery and employee theft. Levels of vault cash held by banks can vary erratically as they are subject to changes in savings and spending habits by businesses and consumers.

Until corrected, applicable regulations encouraged inefficient asset management. Converting vault cash to current accounts at the CBI, a more acceptable reserve instrument, will improve treasury management.

The reserve requirement is the primary tool used by the CBI to draw liquidity from the financial system. Increases in both Dinar and foreign currency deposits at banks have led required reserves to grow 87 percent since May 2005.

During the same period, with guidance on treasury management from the CBI Agreements and Loans staff, excess current account balances have declined 42 percent, indicating a significant and measurable improvement in the use of liquid resources by banks.

The amended reserve requirement regulation tightens definitions of qualifying assets and limits the use of foreign-currency current account deposits at the CBI to meet the requirement. Limiting vault cash will allow the CBI to shorten reserve periods and to respond more quickly to deposit and market liquidity trends.

Only two out of 31 banks in the Iraqi banking system failed to meet their reserve obligations over the last months. CBI staff from the Agreements and Loans departments and the Banking Supervision team, supported by USAID advisors, have worked closely with all the banks, including new entrants, to ensure compliance with the new regulation and to promote better overall treasury management.

The hard-won amendments to the reserve requirement regulations and increased capacity of the CBI are key steps towards improved monetary policy.