Avoid the Iraqi dinar as an investment

Since 2003, Iraq has progressed in rebuilding its political system and economy. One important milestone was the 2004 reintroduction of the currency, called the dinar. The dinar’s weak exchange value against the U.S. dollar has reflected Iraq’s post-war chaos, but some investors hope that Iraq’s progress may lead Iraq’s monetary authority, the Central Bank of Iraq, to revalue the dinar – that is, to reset the dinar’s exchange rate at a much more favorable value. This report considers why we believe the hope is misplaced and the Iraqi dinar is a poor long-term investment.

Investment recommendation

Expectations for the dinar to gain significant value against the dollar have been disappointed repeatedly since 2004. Considering the illiquidity and fraud risk, Wells Fargo Bank has no plans to trade in the Iraqi currency. Moreover, considering that Iraq remains a dangerous place with an uncertain future, we strongly advise investors against buying Iraqi dinar as an investment. We offer many alternative recommendations that we believe present less liquidity, fraud, and principal risk.

Today’s Iraq does not look like 1960’s West Germany

Precedents exist for war-torn countries to rebound strongly and, eventually, to revalue their currencies. West Germany in the 1960s had recovered enough from destruction and partition after World War II to revalue its currency, the deutsche mark. Germany revalued following a period in the late 1950s in which the country was selling more abroad than it was buying abroad, which meant that growing export earnings, when converted into marks inside Germany, raised the local money supply and fueled economic growth. At the same time, the German economy was operating at close to full employment.

The revaluation helped break the inflationary combination of money supply and wage growth.

The similarity with today’s Iraq is limited, however. In late 2012, Iraq’s oil production hit 3.5 million barrels per day, its strongest pace since 1979, but the pace since then has slumped. The pace has failed to expand while Iraq’s infrastructure suffers from chronic bottlenecks and antiquated production technology. Oil exports do help balance Iraq’s exports and imports, but Iraq is nowhere near the trade surpluses that allowed Germany to revalue its currency.

Unlike Germany, the Iraqi economy is far from full employment, and a revaluation could block job creation. Revaluing the dinar would raise the cost of doing business for non-oil Iraqi exporters. Equally important, revaluing the dinar could inhibit foreign investment. Iraq needs roads, bridges, oil facilities and factories to replace those lost during wartime. Foreign investment could develop that infrastructure, but foreign investment likely comes in dollars. A revaluation means that foreign dollars buy less labor and material in Iraqi dinar. In other words, a revaluation lowers the return to foreign investment entering Iraq in dollars at precisely the time that Iraq most needs foreign investment to rebuild and create jobs.
The Kuwaiti revaluation is also a poor precedent for Iraq

Some investors cite Kuwait’s revaluation after the Iraqi 1990 invasion as a useful precedent for Iraq, but we see more differences than similarities. War-ravaged Kuwait was able to revalue its currency after regaining its freedom in large part because its security situation improved quickly. By contrast, Iraq’s security situation is tenuous and may worsen in the coming years.

The competition among Shia, Sunnis, and Kurds blocks cooperation, and the security situation continues to deteriorate. Al Qaeda-affiliated militants have clashed with Iraqi army units, and sectarian violence in central and northern Iraq may continue. Moreover, the prospects for political consensus are worsening. Iraq has had two national elections under its new constitution of 2005 – and both produced Shiite majorities – but the political balance is fragile.

With the national government in Baghdad heavily engaged in keeping the country together, Iraq’s autonomous Kurdish region is pursuing plans to sell oil to Turkey, with or without approval from Baghdad. The Kurdish region and Ankara are even discussing building a pipeline that circumvents Baghdad’s pipeline system. A revenue sharing deal with Baghdad may eventually emerge, but the possible dilution of Iraq’s economic resources maintains the prospect that Iraq may yet fracture and is negative for the dinar.

Against the backdrop of an improved but still uncertain future, the Iraqi central bank has held fixed the value of the dinar against the dollar since 2009. The peg appears to be a defensive measure that supports the dinar while Iraq rebuilds. Put differently, the peg holds up the dinar at a time when market pressure would force the value lower in value, not higher. In light of the Iraqi government’s tenuous control, a revalued Iraqi dinar seems remote into the foreseeable future.

The dinar poses elevated risks of illiquidity and fraud

Illiquidity is another risk for potential dinar investors. The dinar is still available only in paper form, meaning that the investor buys physical dinar banknotes. Once the investor decides to sell, there may be few parties willing to buy the dinar. Those alternatives that exist may be expensive. The cost of shipping, handling, and even finding a wholesale dealer make buying or selling the dinar particularly expensive – a strong negative factor when considering an investment that we believe has a negative return outlook. As an illustration, an investor who bought the dinar on April 30, 2004 would have earned a return of 19.1 percent through February 28, 2014. However, the costs for buying or selling the dinar may run between 20% and 30% of the investment and may take up the investor’s return.

A major reason for the illiquidity of the dinar is that few banks outside the Middle East have relationships with Iraqi banks. Thus, most U.S. banks do not buy or sell the Iraqi dinar. Wells Fargo Bank currently does not accept business in the dinar and has no plans to do so. In fact, price quotes on the Iraqi dinar often come from only a handful of banks, including the Central Bank of Iraq and a few banks in the Middle East – not U.S. banks.

Because U.S. banks do not generally deal in the dinar, internet trading companies have stepped in to offer the currency. Some dealers sell the dinar as a collectible, and this is legal in the United States. Other dinar dealers register with the U.S. Treasury as money service businesses and, as such, may offer currency exchange. However, no U.S. government agency supervises the money service businesses as investment advisors. That is, no government agency ensures that the dinar has a reasonable basis for investment.

Unfortunately, some of the U.S. Treasury-registered internet dealers sometimes give misleading investment advice biased towards buying the dinar.
For example, some cite the fact that the dinar at one time had an official exchange rate of three-to-one against the dollar as evidence of potential future appreciation. This sales pitch neglects to mention that Saddam Hussein decreed the three-to-one official, pre-1990 value; that the dinar’s actual trading value was closer to 2,500-to-one to the dollar, after Iraq’s defeat in the first Gulf war; and that pre-2003 dinar is no longer a valid currency. It is highly unlikely that the dinar introduced in 2004 will ever trade against the U.S. dollar at the 3:1 rate that prevailed only in Saddam Hussein’s widely ignored official decrees.

In addition, the dealers are not always reliable. For example, the Better Business Bureau of Northern Illinois reported consumer complaints that at least one web-based dinar dealer was accepting investor payments for dinar but neither fulfilling the orders nor refunding the customers’ money.1 Also, the Utah Department of Commerce in 2006 listed the Iraqi dinar trade among its top 10 frauds of the year.2 Nor are cases of fraud limited to the United States: Japanese authorities have also reported on internet sellers who take investors’ payments but never actually give the investor the dinar notes in exchange. Not all internet sellers have been accused in this way, but this risk of fraud is significant in any transaction involving dinar dealers.

**Summary**

News reports about Iraq regularly spawn revaluation speculation that sweeps quickly across internet chat rooms and blog sites. Investors should remember that revaluation historically has required much stronger internal security and economic momentum than are likely in Iraq for the foreseeable future. Unless and until Iraq secures political stability and generates enough foreign earnings to drive economic growth and wages, investors should avoid buying the dinar, and current holders should divest as quickly as possible.

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