Research Paper

مركز البيان للدراسات والتخطيط
Al-Bayan Center for Studies and Planning

Can Iraq Replace U.S. Dollar Reserves with Gold and Precious Metals for Monetary Stability?

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Can Iraq Replace U.S. Dollar Reserves with Gold and Precious Metals for Monetary Stability?

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About

Al-Bayan Center for Planning and Studies is an independent, nonprofit think tank based in Baghdad, Iraq. Its primary mission is to offer an authentic perspective on public and foreign policy issues related to Iraq and the region.

Al-Bayan Center pursues its vision by conducting independent analysis, as well as proposing workable solutions for complex issues that concern policymakers and academics.

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Summary:

Gold reserves have significant geopolitical implications, as the distribution of these reserves among countries reflects power dynamics in the global economy. This influence extends to trade negotiations, international agreements, and relations, making the topic strategically important.

Countries like China, Russia, and Iran are actively seeking to reduce their dependence on the dollar by increasing their gold reserves. This shift provides them with greater flexibility in foreign policy and economic strategy while freeing them from the restrictions imposed by dollar-based transactions on both domestic and foreign policies. For these nations, gold is considered the safest option as it can be used in international trade and strengthens partnerships with trading allies, especially in the face of sanctions.

While replacing dollar reserves with gold and precious metals may not be the optimal solution, it could form part of a more secure strategy. However, this shift requires careful examination of the associated risks and challenges to avoid issues related to liquidity and fluctuations in gold prices.

Despite major global challenges, such as the Russia-Ukraine war and the rising influence of China, along with Iraq's need to maintain financial independence from external monetary control, the dollar is unlikely to lose its dominance in the foreseeable future.

Iraq's significant gold reserves must be paired with a long-term strategy to mitigate future economic crises and enhance the effectiveness of its monetary and financial policies.

The dollar remains the preferred international settlement currency due to its flexibility and liquidity. It is less susceptible to price volatility compared to gold, especially in urgent transactions, and presents fewer risks related to storage and handling. The dollar will continue to play a vital role in international monetary strategies and with arbitration bodies.

Gold, on the other hand, cannot be influenced by interest rate policies, quantitative easing, or international decrees that central banks may implement. Central banks base their monetary policies on the most dominant global currencies, with the dollar and other currencies from major economies being the primary influences.

Introduction:

There is no doubt that the U.S. dollar represents the world's primary currency due to the strength of the U.S. economy, and it is considered a safe-haven currency. The U.S. dollar gained a prominent position in the global economy following the Bretton Woods Agreement of 1944, replacing gold and the British pound as the main means of payment in international transactions. The dominance of the U.S. dollar did not occur overnight; it underwent a long journey, beginning with the introduction of the "greenback" when European settlers migrated to the U.S. in 1620.

However, the decisive moment for the dollar's rise came with the 1944 Bretton Woods Agreement, where 44 member states established a global economic system led by the United States. This marked the official beginning of the U.S. dollar's global dominance, transforming it from a local currency to a global one that dominated international trade in the new post-Bretton Woods financial system established by the U.S. and its greenback. The dollar became the main reference for determining other countries' currencies, as the United States held 75% of the world's gold reserves after World War II. At that time, the dollar was the only currency in the world backed by gold, while other countries abandoned the gold standard after experiencing inflation in their economies. This led many nations to accumulate U.S. dollars, replacing their gold reserves with dollars as a future reserve.

Many countries began using the dollar as a foreign currency reserve, and the Bretton Woods system maintained exchange rates pegged to the dollar until 1971, when the U.S. stopped converting dollars to gold. Since then, demand for the dollar as a reserve currency and for international trade has grown due to its widespread use and the size of the U.S. market.

To answer the question: Can Iraq abandon its dollar reserves and replace them with gold and precious metals? We must first understand the historical importance of gold and precious metals in the global economy in general, and then focus on the Iraqi economy specifically, which can be explained as follows:

First: The Historical Importance of Gold in Currency Reserves

The historical importance of gold in currency reserves is deeply rooted, spanning thousands of years from ancient civilizations to the modern era. Gold has played a critical role in finance and economics, contributing to the stability of economies and influencing global power dynamics due to its role as a store of value and a key element in currency reserves held by nations. For example, the Egyptians and Greeks used gold coins as a form of currency over two millennia ago. Its rarity, durability, and intrinsic value made it a unique medium of exchange, establishing gold as a vital component in modern currency reserves.1

In the 19th and early 20th centuries, the gold standard was adopted, marking a period known as the "Gold Standard Era," characterized by stability in the international financial system. Nations held gold reserves to ensure the convertibility of their currencies into gold when needed, which reinforced trust in monetary systems. Gold remained a cornerstone of global reserve currencies even after the gold standard collapsed in the 20th century and the Bretton Woods Agreement was established. Under Bretton Woods, countries continued to hold significant gold reserves, and the U.S. dollar was tied to gold, while other currencies were pegged to the dollar.2

By the late 20th century, some nations began reducing their gold reserves, with critics arguing that gold was a less diverse asset compared to foreign currencies and government bonds. Holding large gold reserves was seen as limiting national wealth that could otherwise be used more effectively. However, in recent years, countries like Russia and China have resumed increasing their gold reserves. This resurgence can be explained by a desire to diversify reserves and growing concerns about the stability of the global financial system. During times of uncertainty and economic instability, gold is regarded as a safe haven. For example, during the 2008 financial crisis, central banks increased their gold holdings as a precautionary measure against market disruptions.3

1 Al-Ameer, Fuad Qasim: The Role of the Dollar and Its Impact on Gold, Oil, and Other Currencies: Iraq's Future Role in Oil Pricing, 1st Edition, Al-Ghad Publishing House (2014).

2 Luqman, Maazouz, Abdelkader, Brish: Strategic Challenges Facing the U.S. Dollar: An Analytical Study on the Present and Future of the U.S. Dollar, Journal of Human Research and Studies, Issue (9), (2014).

3 Hanes، C.، & Rhode، P. W. (2013). Harvests and financial crises in gold standard Ameri-

Thus, achieving balance in investment portfolios requires a diversified approach to handling currency reserves by combining different assets such as foreign currencies, government bonds, and gold. The main objective of this approach is to increase liquidity and reduce risks, which underscores the recognition of gold's ability to adapt to the complexities of the modern financial world.4

It is also worth noting that gold reserves can have geopolitical implications. The distribution of gold reserves among countries reflects power dynamics in the global economy, influencing trade negotiations, agreements, and international relations, making it a strategically important topic. Beyond its financial value, gold holds cultural significance for many societies, symbolizing wealth and status for centuries, which further solidifies its historical importance in currency reserves. Gold is universally accepted and is considered one of the most valuable assets nations have accumulated.5

Therefore, despite historical events that diminished its role due to the collapse of previous monetary systems, gold remains capable of functioning as an international currency due to its stable value. Gold could potentially take on a central role in international trade, as it possesses certain characteristics:6

It can be converted into any desired form while maintaining its integrity and resisting damage.

It can easily be divided into quantities as needed.

It is naturally occurring and relatively rare, with a small amount holding significant value.

ca. The Journal of Economic History، 73(1)،pp. 201-246.

4 Demidova-Menzel، N.، & Heidorn، T. (2007). Gold in the investment portfolio (No. 87). Frankfurt School-Working Paper Series. P. 2

5 Mionel، V.، Mionel، O.، & Moraru، A. (2015). Sovereign Gold Reserves. Geopolitics or economic calculation?. Knowledge Horizons. Economics، 7(2)، p. 84.

6 Boudri, Sharif: The Future of the U.S. Dollar as an International Currency in Light of the Shift Toward Other Global Currencies, Academy for Social and Human Studies / Department of Economic and Legal Sciences, Issue (13), (2015).

These attributes have reinforced trust in gold, making it the "king of currencies" due to its broad international acceptance, whether by governments, institutions, or individuals. This is why many advocates of reforming the international monetary and financial system call for a return to a gold-backed mechanism to unify the currencies of different nations.

Second: Why Central Banks Hold Gold Reserves

Central banks are regarded as entities with various broad functions, such as managing government banking operations, supervising and regulating financial institutions, overseeing payment and settlement systems, formulating monetary policy, and promoting financial stability (Jadhav, 2003:2). It is difficult to assess which function is the most important due to the interdependence of these roles. However, the central bank's primary goal is to serve the public interest as much as possible without focusing on profit-making. The key functions of central banks include managing government banking, overseeing financial institutions, managing the financial system, formulating monetary policy, providing emergency liquidity to financial institutions during crises, managing foreign currency reserves, and maintaining financial stability.7

One of the central bank's most important functions is managing foreign exchange reserves. The central bank plays a key role in organizing, managing, monitoring, and determining how the country's foreign currency reserves—including gold, convertible foreign currencies, and Special Drawing Rights (SDRs)—are utilized. The significance of these reserves lies in their function as backing for the currency issued, providing flexibility to address balance-of-payments imbalances, settle international financial and trade transactions, and maintain exchange rate stability.8

To understand why central banks hold gold reserves, we can refer to Figure 1, which illustrates the reasons behind this decision.

Figure 1. Reasons Why Central Banks Hold Gold Reserves

7 Zahraa Kazem Majid: The Currency Window and Its Impact on Certain Indicators of Bank Performance in Iraq, Master›s Thesis, College of Administration and Economics, University of Karbala (2020).

8 R.McConnell، Compbell & L.Brue، Stanley، Economics، McGrawHill،، 17th ed، United States Of America،2008، p. 237.

Source: Compiled by researchers based on: Ghosh, A. (2016). What drives gold demand in central bank's foreign exchange reserve portfolio? Finance Research Letters, 17, 146-150.

In addition to gold, other precious metals such as silver, platinum, and palladium also provide diversification when holding financial assets and help reduce the risks mentioned earlier. These metals act as hedges against market fluctuations, especially during financial crises affecting a country's economy. They also offer liquidity, meaning they can be easily bought and sold, even during times of market instability. For thousands of years, precious metals have been considered stores of value due to their rarity and durability, unlike paper currencies, which can be printed at will. Precious metals cannot be created from nothing, making them reliable stores of value capable of weathering economic downturns.9

Regarding Iraq's Economy: To answer the question: Can Iraq abandon its dollar reserves and replace them with gold and precious metals?

As of February 2024, according to data from the International Monetary Fund (IMF), Iraq increased its gold reserves by 3.079 tons, bringing the total to 145.661 tons.10 The Central Bank of Iraq also confirmed its plans to purchase additional gold as part of its strategy to manage its assets, aiming to achieve the highest levels of stability and the ability to handle local and international economic changes. Gold is one of the most important assets held by central banks and international financial institutions and is considered a safe haven during uncertain times due to its widespread global acceptance.11

It can be said that foreign currency reserves, particularly in U.S. dollars, are vital for national economic stability. They ensure the state's ability to meet international obligations and pay off foreign debts. Countries like Russia and China have increased their gold reserves as part of their strategy to diversify foreign reserves, yet they have not abandoned the dollar. Holding U.S. dollars

9 Ghosh، A. (2016). What drives gold demand in central bank›s foreign exchange reserve portfolio?. Finance Research Letters، 17، p. 146-150.

10 Iraq Increases Its Gold Reserves by About Three Tons in February 2024, May 14, 2024, https://www.skynewsarabia.com.

11 Central Bank of Iraq, https://cbi.iq

provides several advantages, summarized in Figure 2.

Figure 2. The Advantages of Using the U.S. Dollar in Currency Management:

Figure 2. Benefits of Using the U.S. Dollar in Currency Management Source: Compiled by researchers based on: Cooper, R. N. (2009). Future of the Dollar (No. PB09-21). Washington, DC: Peterson Institute for International Economics.

The idea of replacing the dollar with gold and other precious metals is not new. However, several challenges accompany this replacement strategy, and many countries, with varying economies, have faced these challenges. The following are some of the key challenges:12

Limited Liquidity: Converting gold into cash requires time and may incur additional costs, making it less liquid compared to the U.S. dollar.

Price Volatility: Gold prices are influenced by global supply and demand factors, similar to any commodity. They are also affected by changes in monetary policy, making gold more volatile compared to the U.S. dollar.

Storage and Insurance Costs: Holding large quantities of gold and other precious metals requires proper infrastructure for safe storage, along with high insurance costs.

Usage Limitations: Gold cannot be used directly in daily commercial transactions as easily as the dollar. Its use in trade may be impractical and undesirable for some. Central bank policies significantly affect gold reserves, as central banks are major players in the gold market. For example, if a central bank announces its intention to increase its gold reserves, this can trigger a positive reaction in the market, leading to higher prices. Additionally, changes in central bank policies regarding gold, such as easing ownership restrictions or promoting gold-backed currencies, can influence demand and the value of gold reserves.

Impact of Central Bank Monetary Policies on Gold Reserves: When a central bank pursues expansionary monetary policies, such as lowering interest rates or engaging in quantitative easing, the value of fiat currencies declines. As a

12 Luqman, Maazouz, Abdelkader, Brish: The Strategic Challenges Facing the U.S. Dollar, previously cited source, pp. 175-178.

result, the central bank may increase its gold reserves to diversify its holdings and protect against currency depreciation. Conversely, if the central bank adopts contractionary monetary policies, such as raising interest rates, gold prices may decline due to reduced demand from central banks.

Key Factors the Central Bank of Iraq Should Consider When Replacing Dollar Reserves with Gold and Precious Metals:13

Liquidity and Ease of Trading: The U.S. dollar is the most liquid and widely used currency in international trade. Holding dollars allows Iraq to easily conduct trade and settle international debts.

Price Stability: Gold and other precious metals are subject to significant price fluctuations, while the dollar tends to be relatively more stable.

Diversification: The Central Bank of Iraq can gradually diversify its reserves by increasing its gold and precious metals holdings without completely abandoning the U.S. dollar. This reduces risks and provides better protection against currency volatility and economic crises.

Returns and Investment: Holding gold and precious metals does not generate interest or investment returns, unlike dollars, which can be invested in assets that yield additional returns.

Risk Analysis: The Central Bank of Iraq should thoroughly study the risks associated with relying on gold and precious metals reserves and abandoning the U.S. dollar. This includes analyzing price fluctuations, storage and insurance costs, and conducting financial and economic feasibility studies to assess the long-term impact of such a shift.

The Dollar's Strength and Global Economic Policies: The U.S. dollar holds a prestigious position in the global financial system. Major changes in reserves could impact Iraq's economic and political relationships.

Strategic Planning: A well-studied strategic plan is required by the Central Bank of Iraq to diversify its reserves. This plan should involve financial and economic experts to evaluate and assess the impact of abandoning the U.S. dollar while ensuring the sustainability of foreign reserves for future generations and their

13 Wheatley، A. (2017). The Power of Currencies and Currencies of Power. Routledge.2017)). The Power of Currencies and Currencies of Power. Routledge. P.28

availability in times of need.

In conclusion, replacing dollar reserves with gold and precious metals may not be the optimal decision, but it could be part of a safer strategy for diversifying reserves. This shift requires careful study of risks and challenges, along with comprehensive strategic planning to avoid issues related to liquidity and gold price fluctuations. A well-planned diversification strategy could provide Iraq with greater protection against economic crises and contribute to national economic stability. While abandoning dollar reserves in favor of gold and precious metals is a potential option, it carries complexities and risks. The focus should be on gradually increasing the share of gold and precious metals as part of a broader strategy to diversify foreign currency reserves.

Examples of Countries Holding Large Gold Reserves: Russia and China

The strategy of holding large amounts of gold and precious metals in national reserves serves two purposes: diversifying reserves and boosting confidence in the national economy. With global attention focused on the tensions between the United States and China, the potential for these two countries to sever ties, Russia's invasion of Ukraine, and the polarized dysfunction in the U.S., along with the increasing use of financial sanctions, reports frequently speculate on the future of the U.S. dollar's dominance in the international monetary system. Questions arise about whether the U.S. dollar will lose its global dominance. Although there are growing calls to move away from the U.S. dollar, it remains the world's leading currency. Despite widespread speculation and major headlines predicting the potential decline of the U.S. dollar's dominance, the reality is that the dollar is likely to retain its position for the foreseeable future. Evidence suggests that the dollar remains the most dominant currency by a significant margin, with liquidity, security, and investor protection unmatched by competing currencies. The U.S. benefits both economically and geopolitically from the dollar's dominance, as it allows the U.S. to impose more effective sanctions. For example, Russia and China have their own views on altering their strategies concerning dollar reserves.14

14 Kamin، S.، & Sobel، M. (2024). Dollar dominance is here to stay for the foreseeable future: The real issue for the global economy is how and why (No. 2024-02). AEI Economics Working Paper Series.p.2.

The main reasons that have driven these two countries to adopt policies of diversifying their reserves and increasing their gold holdings can be summarized as follows:15

Diversifying Reserves: The primary purpose of reducing dependence on the U.S. dollar is to diversify reserve risks. Gold, as a safe-haven asset, operates independently of paper currencies, helping to reduce exposure to dollar price fluctuations.

Protection Against Economic Fluctuations and Stability During Crises: Gold has the unique ability to retain its value even during times of economic crises and currency market fluctuations.

Enhancing Confidence in the National Economy: Holding large amounts of gold instills stability and confidence in countries' financial systems. This strengthens their financial systems and portrays an image of a stable and strong economy, helping to attract foreign investments and support the value of the national currency.

Reducing Dependence on the Dollar: China and Russia aim to lessen their reliance on the U.S. dollar by increasing their gold reserves, giving them greater flexibility in foreign policy and economic strategies.

Countering Economic Sanctions: Russia, in particular, faces economic sanctions, making gold the safest asset for them. Gold can be used in international trade, strengthening ties with trading partners despite sanctions.

Long-Term Strategy for Economic Preparedness: Holding large gold reserves is a long-term strategy to prepare for future economic crises and enhances the ability to manage monetary and fiscal policies more effectively.

Iran's Approach to Gold Reserves: Iran has a different perspective on changing its reserve strategy and reliance on the U.S. dollar, driven by multiple factors:16

U.S. Sanctions: Sanctions imposed by the United States, including freezing Iranian assets and restricting access to global markets and dollar transactions,

15 Arslanalp، S.، Eichengreen، B.، & Simpson-Bell، C. (2022). The stealth erosion of dollar dominance and the rise of nontraditional reserve currencies. Journal of International Economics، 138، 103656. P.3.

16 Central Bank of Iran's Gold Holdings. https://www.cbi.ir/default_en.aspx

have caused Iran difficulties in international trade. Consequently, Iran has sought to increase its gold reserves as a means of protecting its economy and ensuring liquidity, since gold is not subject to these restrictions and sanctions.

Reducing Risks of Dependence on a Single Currency: Increasing gold reserves is a step toward reducing the risks associated with relying on a single currency. Iran seeks to establish and develop trade relations with other countries using currencies other than the U.S. dollar, such as the euro, Chinese yuan, and Russian ruble. Iran also aims to enhance bilateral trade agreements with partners like China and Russia using local currencies.

Enhancing Economic Stability: Iran's strategy of holding large amounts of gold is intended to protect its economy during difficult times, making the Iranian economy more resilient by reducing external influence.

Diversification of Reserves: Reducing dependence on the U.S. dollar by diversifying reserves gives Iran greater flexibility in dealing with sanctions and economic fluctuations, potentially opening up new investment opportunities.

Conclusion

In summary, if Iraq adopts a strategy to increase its gold reserves and reduce its reliance on the U.S. dollar, it would strengthen the country's ability to protect its economy from external control over economic decisions. This would enhance Iraq's economic independence. However, the challenges of liquidity and storage should be taken into consideration. Holding large amounts of gold requires suitable infrastructure for safe storage, and gold is less liquid for commercial transactions compared to the dollar.

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