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Article

Impact crowding out of the public sector in an exuberance of oil revenue on credit to the private sector for the period (2004-2024)

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Abstract: This paper investigates the impact of public sector crowding out on private sector in a way that the Iraqi economy is heavily reliant on oil as a main source in financing its budget, subjecting it to volatility in global oil prices, and hence we analyze the path of credit provision to government and to private sector as well as analyze the causes and the upward trend in the domestic debt during the period (2004-2024), using the official publications and reports of the Iraqi central bank and as well as some literatures, The study found evidence on the crowding effect as consequence of the Iraqi government to the domestic borrowing because of oil shock, and increasing government spending, an upsurge in domestic debt over the duration of study even with an increase in oil revenue in different years; increased levels of credit extended to government at rates nearly equal the credit extended to private sector which undermine the effectiveness of commercial banking. The researcher suggested to diversify sources of national income and reliance on local resources in activating the role of the other sectors of economy, and the support private sector, to participate in the economic development and attain good growth rates, and to reduce over-reliance on domestic borrowing, and to develop other developmental models through strategic planning.
Keywords: The effect of financial crowding out, Bank credit, government domestic debt.

1. Research Objectives :

1. Analysis of the indicators of the Iraqi banking sector and its credit to the public and private sectors

2. Analysis of the trajectory of domestic debt: The most important reasons, challenges and opportunities

3. The impact of financial crowding the government vs the private sector

4. To provide conclusions and recommendations which contribute to knowledge generation in and policy making for Iraq Significance of the Study

The significance of the study

is that borrowing from the banking sector directly affects and undermines private sector operation and consequently economic growth, and that borrowing as a result of declining oil revenues has an immediate impact on the Iraqi market and federal balancing act which reaches an adverse effect on the banking sector and thus a severe straining on the Iraqi economy

Research hypothesis

The research is based on a central premise that (Iraq's government is pressuring the banking sector as a result of soaring total domestic borrowing thereby undermining its effectiveness and it is doing so it the private sector)

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Research problem

The research problem is the following key questions

1.Why does the government resort to domestic borrowing and what are the repercussions on the private sector

2.Has the Iraqi banking sector been able to meet the needs of the public and the general and private institutions in the face of the shocks and crises that the Iraqi economy suffered

3.Did the increased domestic borrowing cause a financial crowding out effect on the private sector?

First requirement: theoretical framework.

Firstly: Concept of financial crowding out

The roots of go back to the eighteenth century, economist Adam Smith pointed in his book (Wealth of Nations 1776) to that private investment takes place through government spending, so increased government spending funded by debt or taxes couldd be negative as a result of higher interest rates, as it also draw resources away from the private sector, and in the twentieth century the discussed in his book The General theory of Employment, Interest and Money in 1936, That government spending may produce competition for resources from the public and private sectors, and this competition has an impact on the private sector's investment power, And government spending may have negative effect on private investment in a lot of ways for example change in the prices of resources, more contention for labor, or in the direction of investment away from the private, so the crowding out phenomenon emerge in response to an increase of government spending which equal to application of expansionary Fiscal Policy that is harmful because raises interest rates, thus reducing private investment and which in turn crowds out the private sector from the resources made available by the government, and it will be very clear this is the effect of crowding out when government finances its budget deficit by borrowing from domestic banks or individuals through issuance of government bonds at high interest rates, whereby crowding out of government by the private sector occurs, The rise in interest rates is, in fact, due to government deficit finance and, this leads to higher cost of borrowing and less investment spending by the private sector. Consequently, the concept of crowding out refers to an economic phenomenon in which an increase in government spending financed by borrowing reduces or impedes private investment and spending in the market.

Secondly: The crowding out effect of the Iraqi government sector on the private sector The financial theories of shock transmission mechanisms from oil markets to the banking sector are developed by tracking and analyzing the current account movements of the public and private sectors, oil revenue stability for commercial banks provides an opportunity to actually build up their liquidity reserves to support their resilience against sudden withdrawals from large investors (De Wit, 2012, p.145). This continuous and abundant flow, especially if it lasts for relatively long periods of time, will contribute to meet the credit demands of the domestic money market, which will definitely cause a diminishing competition between banks, and the non-bank financial institutions (investment and saving funds…..) in attracting short term savings from the public and this stability of the liquidity cost can be guaranteed within the financial sector, however the decline in oil revenues naturally generates rapid implications the most dominant of which is that governments begin borrowing from banks (the phenomenon of fiscal dominance or crowding out of bank credit, as referred too earlier) or even withdrawn from their deposits in banks and this may reflect on a percentage of depositors (private institutions, individuals, these can cause a great pressure on liquidity (Choudhry, 2014, p.278). To what extent does the role of the Iraqi government as competitor with the private sector is highly evident in this context when the government has been forced to borrow from the domestic market to finance expenditures one that is far from being stemmed due to the political interference, corruption, and many other problems and let's take help from the figures in the following table.

Indicator of the banking sector and domestic debt in Iraq for years 2004-2024 (Table 1) (The table is entitled one billion Iraqi Dinar) year The credit to the public sector(1) The credit to the private sector(2) Total credit(3) The ration of (1) to (3) (% The ration of (2) to(3)(%) Oil Revenues Domestic Debt The ration of the domestic debt to the oil revenues

2004	**0.204**	**0.620**	**0.824**	**24.7**	**75.2**		**32.627**	**5.92**		**18.14**
2005	**0. 56**	**0.115**	**0.171**	**32.7**	**67.2**		**39.48**	**6.25**		**15.83**
2006	**0.106**	**0.166**	**0.266**	**39.8**	**62.4**		**46.534**	**5.64**		**12.17**
2007	**0.107**	**0.238**	**0.345**	**31.0**	**68.9**		**51.701**	**5.19**		**10.03**
2008	**0.061**	**0.397**	**0.458**	**13.3**	**86.6**		**75.358**	**4.45**		**5.90**
2009	**0.104**	**0.464**	**0.569**	**18.2**	**81.5**		**48.871**	**8.43**		**17.24**
2010	**0.319**	**0.852**	**1.172**	**27.2**	**72.6**		**66.819**	**9.18**		**13.73**
2011	**0.898**	**1.135**	**2.034**	**44.1**	**55.8**		**98.09**	**7.44**		**7.58**
2012	**1.378**	**1.465**	**2.843**	**48.4**	**51.5**		**116.597**	**6.54**		**5.60**
2013	**1.3**	**1.694**	**2.995**	**43.4**	**56.5**		**110.677**	**4.25**		**3.84**
2014	**1.637**	**1.774**	**3.412**	**47.9**	**51.9**		**97.072**	**9.52**		**9.80**
2015	**1.868**	**1.87**	**3.675**	**49.8**	**50.2**		**51.312**	**32.14**		**62.63**
2016	**1.899**	**1.818**	**3.718**	**51.0**	**48.8**		**44.267**	**47.36**		**106.98**
2017	**1.85**	**1.945**	**3.795**	**48.7**	**51.2**		**65.071**	**47.67**		**73.25**
2018	**1.827**	**2.021**	**3.848**	**47.4**	**52.5**		**95.619**	**41.82**		**43.73**
2019	**2.101**	**2.104**	**4.205**	**49.9**	**50.0**		**99.216**	**38.33**		**38.63**
2020	**2.395**	**2.586**	**4.981**	**48.0**	**51.9**		**54.448**	**64.24**		**117.98**
2021	**2.339**	**2.957**	**5.297**	**44.1**	**55.8**		**95.27**	**69.91**		**73.38**
2022	**2.555**	**3.501**	**6.057**	**42.1**	**57.8**		**153.62**	**69.49**		**45.23**
2023	**2.963**	**3.961**	**6.925**	**42.7**	**57.1**		**124.43**	**70.55**		**56.69**
2024	**2.952**	**4.393**	**7.346**	**40.1**	**59.8**		**125.29**	**71.87**		**57.36**

• Source: Central Bank of Iraq, Statistical Department, Economic Reports Various Years • World Bank Group, Iraq Development Indicators, different years.

1. Credit facilities to public sector 1- Credit facilities to the public sector From the table (1) data we notice that credit granted to the public sector (including the government and public enterprises) was fluctuating This is to say that the total credit granted to the public sector (government and public enterprises) amounted to 204 billion IQD which plummeted to 106 billion IQD in 2006 as a result of being affected by the unstable political events . It then rose to 1378 billion IQD in 2010 and the government continued borrowing, reaching 2952 billion IQD in 2024. This indicates that a large part of the credit granted is allocated to the central government, and here its impact is to squeeze the government, despite the fluctuations in the oil revenue. 2- Credit extended to the private sector It is evident from the table (1) that the total credit to the private sector declined from 620 billion in 2004 to 115 billion in 2005 as a result of the bad security situation and the few working commercial banks at that time , then increased to 166 billion IQD in 2006 and increased gradually in the rest of years to reach 4393 billion IQD by 2024, indicating that there is trend of supporting the private sector however the amount of this credit as a

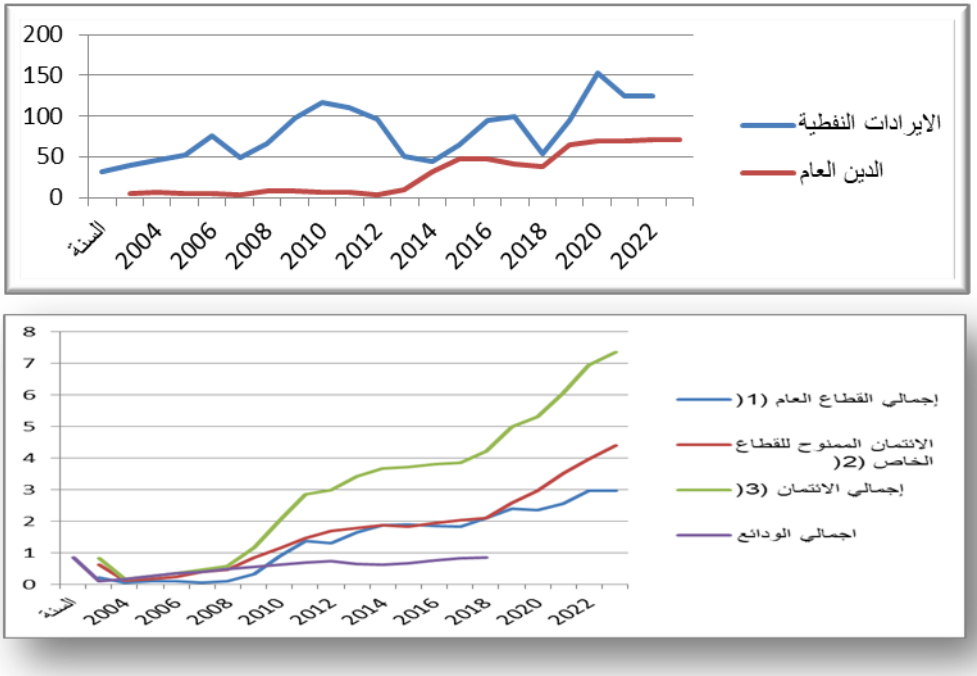
percentage of total credit to the economy is not to be considered great as we will see while analyzing the following paragraphs.

2.Credit to Private Sector It appears from the data of Table (1) that the total credit delivered to the private sector declined from 620 billion in 2004 to 115 billion in 2005 due to the deterioration of security and the scarcity of operating commercial banks. Thereafter, it rose to 166 billion dinars in 2006 to continue its upward trend throughout the remainder of the period to reach 4393 billion dinars in 2024. This indicates that there is a trend towards supporting the private sector, but the ratio of that credit to the total credit did not constitute a large percentage, as we shall see in the analysis of the following paragraphs

3.Total credit to the public and private sectors Referring back to the figures of Table (1), it is noted that total credit to the public and private sector fell during the first two years to reach 824 billion dinars in 2004, and then was considerably on the decline, reaching as low as 171 billion dinars in 2005. After that, total credit followed an ascending path, hitting 2034 billion dinars in 2011 and rising to 7346 billion American dinars by 2024 – a tremendous surge, which demonstrated how greatly commercial banks have developed and how their liabilities have grown in the light of their growing assets, since they have been able to adopt new enterprises besides their old traditional one, such as engaging in wide-ranging business outside through bank remittances and other outlets gained by them.

4.Total deposits Referring to the Table 1 data, it appears that total deposits were weak against the total credit, as total deposits were following upward path during the period, as the total deposits amounted to 86 billion Iraqi dinars to rise to 479 billion dinars in 2010, then total deposits continued to rise to 849 billion in 2020, as previously mentioned, the private and public sectors' abilities to retain deposits were weak due to low banking culture among the public, as well as the reflection of crises and political situations and the lack of confidence of the public in the banking sector, in addition towards real estate investment and the spread of the phenomenon of hoarding, which had greatly affected the decrease in the size of bank deposits and thus the dependency of commercial banks on their own liquidity to meet credit requirements, (1) may also be used to illustrate the path of bank credit and deposits. 5- General Public Debt
From the data in the table (1), it is clear that the total domestic debt formed an ascending curve during the period under study, though with variable rates, but despite the rise in total debt, oil revenues directly reflected on the ability to pay off some debt, it had reached 5.92 billion dinars in 2004 at a time when the debt ratio was 18.14%. Thereafter, the total debt increased to 9.52 billion in 2014 with a low ratio of 9.80% and this is due to the rise of oil revenues. The total public debt climbed dramatically in 2016 surpassing at 47.36 billion Iraqi dinars with a percentage of 106.98%, the most elevated debt proportion among the ones analyzed

And so to oil revenues, with the budget being financed by domestic borrowing, i.e., to cover increased expenditures as a result of terrorism control over some provinces of Iraq, and in later years, the government continued to borrow from commercial banks (Al-Rasheed Bank and Al-Rafidain Bank) thus exerting pressure on commercial banking. The total domestic debt reached 71.78 billion IQD in 2024, at a rate of 57.36%. To guide us, we can borrow from the two following figures: analysis:



The Figures are Prepared by the Author Based on Table (1) data. Figure (1) Credit path of bank credit and domestic debt in Iraq.

Secondly: The reasons of the internal public debt in Iraq . The causes of the rise in domestic debt are varied, but we can outline the most important challenges leading to the increase in the domestic debt are: 1 - Financing the federal budget deficit Accompanying the federal budget deficit since 2003 until the 2025 budget, this is the result of structural imbalance and excessive reliance on oil revenues without resorting to automation of all public revenues, when looking at the federal budget tables for all years we will find oil revenues listed as a major source for the budget in the Vegas public spending put the Iraqi economy under severe financial deficit, until forced successive governments to turn to the mechanism of borrowing internally and externally. Although there have been huge financial savings in the years of high oil prices, this has not become a concern for the governments in the best use of those financial resources and building Sovereign Fund, (this is true) This is the deep imbalance that is forcingMonetary Authority to narrow the monetary gap by mobilizing domestic savings from commercial banks.(Ali Ahmad Aldulaemy,2020,p.98) Source: Ali Ahmed Aldulaemy and Basim Mohammed Turki, 2020, p. 98. 2- Tthe operating and running costs are inflating Public expenditure is suffering from a rising share of operating costs as indicated by the analysis of the table ( ) and among its crucial components is the fees and wages dilemma as an inevitable consequence of adopting expansionary-consumption expenditure policies. Indeed, this outlay was accumulated in a fund to finance line items, including purchase of articles by the government with only the private sector in virtually non-existent in absorbed the massive numbers of graduates, leading to the shift from developmental investment to funding the current consumption to ward off social crisis.

Source: Central Bank of Iraq, Annual Economic Report, 2006, p. 73. 3-Fluctuating crude oil revenues and external shocks: The Iraqi economy has been intimately tied to global energy markets, which made it constantly vulnerable to external shocks from oil price volatility. Because any sudden collapse in prices was enough to increase the size of internal and external debt as well as turn the budget to a war budget while the terrorist groups controlled the some of the Iraqi provinces since 2014-2017, caused the sore to nail the treasury, in which it was nicking cash liquidity. And this is where governments were forced to borrow domestically through treasury bills as a quick emergency remedy to compensate the shortage in financing for their federal budgets. (Central Bank of Iraq, 2014, p30) Source: The Central Bank of Iraq, Annual Economic Report, 2014, P. 30 4-Political Unrest: Iraq has seen a

plethora of political events after 2003 including the sectarian war 2005-2008, terrorism in 2014, and the ongoing sectarian political violence, all of which have been reflected in increased military and security spending as the worsening security and military situation and political unrest have put extraordinary and immense financial strain on the state's public budgets. Internal debt soared to explosive levels in order to meet the needs of national defense, fighting wars against terrorism, and acquiring military devices and supplies. This financial bleeding forced the Ministry of Finance to tap commercial banks for funding the war budget at the expense of binding the state to huge extraordinary debts.

5. Misplanning and the absence of proper financial planning and planning failed to make the government pay for the workers of the agricultural sector and contractors, which is the government commitment to vital economic sectors, to pay the farmers for purchasing the wheat harvest, and this is the government debt, also to pay the contractors and companies that are carrying out investment projects and infrastructure projects. And to resolve this conundrum, the government resorted to forced domestic borrowing by issuing specialized debt instruments known as farmers' and contractors' bonds

6.Financial and administrative corruption and capital flightThe Iraqi economy witnessed an increase in the phenomenon of financial corruption and embezzlement of money to foreign countries to the extent that it became one of the problems and the great challenge facing economic reform, and millions of dollars were embezzled and stole to be hidden in neighbor states through the currency sale window, and remittances and other ways through some commercial banks until the most of them got international sanctions.(محمد اكرم شاهين، 2012،ص34) 7- The Stagnation The Iraqi economy in general was suffering from stagnation and contraction, due to the effects on local markets and producers of a series of political and security events that were reflected in the opening of credit lines under the name of social security expenses for poor households, and despite the fact that they had a slight positive effect on those poor families, they were not immune to the financial corruption that afflicted them as well as other expenses, which forced the government to turn to domestic loans as one type of operating cost.

Third: Domestic borrowing (the effect of crowding out) In considering the fiscal deficit a distinction should be made between temporary cyclical deficit and structural chronic deficit, and in the case of the Iraqi economy the two notions are intertwined very much so that while the deficit seems to be closely tied with the oil price cycle, the fact that it has lasted this long reveals an i deep rooted structural nature stemming from a distortion in the very structure of the public finances - (Iraqi Central Bank, 2022). And the danger with a structural deficit is that it doesn't automatically disappear when external market conditions get better, it says certain things about the needs to be changed in the financial architecture of the state, and that one has to suspect that it is in the financial structure that the solution will be found; the overreliance on oil rents means that the economy is denied access to flexible, sustainable taxation channels due to the weakness of alternative productive sectors (Krugman & Wells, 2018). This deficit is exacerbated by the continuous annual expansion of nonproductive current expenditure to sustain the administrative machinery of the state, thereby depriving the general budget of its role in stimulating economic growth and capital accumulation, which in turn forces the Ministry of Finance to the continued use of local borrowing instruments as the only option for closing the gap in liquidity (Iraqi Ministry of Finance, 2023). Despite the extensive reforms undertaken by the government, a combination of structural and management inefficiencies led to a need for domestic borrowing in Iraq, the was most notable among a number of factors were the fluctuations in oil revenue and external shocks come as well as the sector weakness of private sector in participating in the economic development which led to an increase in the poverty problem amid rising population and all that compounded the pressures placed on public finance (Krugman & Wells, 2018).This is evident from the rigidity and hardness of the current expenditure, as the budget is suffering from a rapid swelling in government consumption.

the direct cost, namely the salary bill of public sector employees, pensions and social safety nets, so that salaries accounted for approximately 80% of total public expenditure, which makes deficit inevitable when revenues fall (Blanchard, 2021). This is compounded by the weakness and limited non-oil revenues, as the tax and customs system suffers from a severe decline in efficiency and control due to the absence of automated systems, the expansion of

informal economic activities, widespread tax evasion, loss of sovereign fees at border outlets, depriving the treasury of stable sources of funding that could have strengthened the f the federal budget

Add to that the fact that the economy suffers from inflation and the bloated state apparatus, with government employment turning into a tool for soaking up unemployment and maintaining social peace in a haphazard fashion – without regard for the criteria of productivity or institutional efficiency or, in other words, any sort of planning, leading to the conversion of the public function into a sustainable financial burden that devours fiscal surpluses (Central Bank of Iraq, 2022). This was accompanied by a lack of economic diversification and production-base broadening, as neglecting the real goods sectors eroded their share in GDP, intensifying the oil dependence and turning the economy to a consumption market fully dependent on import covered by foreign currency generated by oil export (Mankiw, 2020). This is reflected clearly in the low level of efficiency and quality in financial allocation, since the budget crisis is related not only to how much money was spent but also to how the money was spent (public expenditure efficiency). (Greene, 2012).

When considering the effect of domestic borrowing-financing on the path of fiscal policy, the impact channels are dissimilar in the short and long terms from an economic theory viewpoint. In the short term domestic borrowing serves merely as means to cover the gap in current expenditure items but maintains a certain level of aggregate consumption demand in the market and prevents a sudden deflation which could threaten the social stability (Blanchard, 2021). In the long term, continued reliance on rold borrowing instruments upsets the directions and priorities of the fiscal policy due to the phenomenon of "financial crowding out", the government has gradually become a captive of the public debt and it is required to allocate an increasing share of its future revenues to pay up the installments and the interests of the debt it owes to the banking system (Reinhart & Rogoff, 2010). And since there are fixed costs which are currently frozen, the first part that is going to be strained and reduced is the investment budget, leading to decline in spending on infrastructure, deterioration of public services such as education and health and which harm capital accumulation and human infrastructure and undermine sustainable development foundations for next generations (Barro, 1990).

The diversification of high domestic public debt did not only affect the financial options of the state but also deeply interfered with the monetary policy and destabilized the National Currency, since the finance deficit through the local banking system amounted to “inflation finance” or hidden printing of currency that increases the monetary supply of the Iraqi Dinar with no equivalent growth in the supply of goods (Central Bank of Iraq, 2022).

The experiments showed a one-way causal relationship that runs straight from domestic public debt to the exchange rate, due to the devaluation the national currency was subjected to by the government, since with the repeated announcements of deficit and accumulation debt instruments it creates an impression of pessimism and inflationary expectations among the actors in the market related to the financial sustainability of the country and the strength of its currency (Mankiw, 2020). And since the economy relies on a large portion of imports to fill aggregate demand, the excess money supply in the Dinar due to deficit spending is immediately converted into demand for foreign currency to protect the purchasing value of savings and to cover import lines, which led to a huge gap between the official exchange market and the parallel market, and this accelerated demand kept pressing on foreign reserves to keep the monetary balance stable. If monetary instruments fail to contain them, the exchange value of the country's local currency falls leading to imported inflation waves, which harm the balance of payment and the general economic stability of the country, particularly in the Iraqi economy.

This means the drafting of solutions for the deficit issue and rising domestic debt has to move from temporary fixes to a radical, structural reform strategy based on four main theoretical trajectories: diversifying income sources, automating collection through introduction of tax system reforms, mandating full digitalization in customs offices and border crossings, and expanding the tax base to include parallel activities and multilaterals, with a view to constructing a steady sovereign revenue stream—one that could be isolated from oil price fluctuations (Greene, 2012). This is followed by a turn to program and performance budgeting, abandoning the traditional line-item budgeting based on historical spending, in favor of program budgeting which associates every financial allocation with a specific,

measurable output or service goal, thereby improving expenditure efficiency and mitigating channels for technical and financial waste (Ministry of Finance of Iraq, 2023).Reform also implies restructuring the civil service and energizing productive partnerships, by regulating government employment and limiting it to the actual and urgent needs of the institutions (abolishing a number of non-productive institutions and not employing in them) in tandem with the activation of legislative and financial packages that support the private sector so as to allow it to lead the investment movement and to absorb the energies of the labor market growth, in a manner which will lead to tightening the internal borrowing that is channeled towards current consumption and limiting issuing government bonds to financing strategic projects with high capital and operating returns such as those in infrastructure, energy, and logistics among others, thereby ensuring the generation of future cash flows that would be sufficient in servicing and repaying the debt without exerting pressure on the state treasury.

2. Conclusions

1-The research concluded a squeeze-out effect, as the Iraqi government resorted to borrowing domestically as a result of oil-shocks and a government expenditure increase.

2-Rising domestic debt over the period of the study, despite increasing oil revenue in different years,

3-A dramatic increase has been seen in the credit extended to the government relative to the private debtor which undermines the effectiveness of commercial banking.

4-Revenue oil is influenced by external shocks and domestic turmoil especially for the years (2008, 2015, 2020), and so it had caused a severe deterioration of revenue oil.

5-The ratio of domestic debt to oil revenues increased excluding the period (2011-2013) due to cash windfall stemming from high oil prices.

6-The lost of chances for construction due to the absence of strategic planning of the Iraqi government and wasting of moneys.

7-Bureaucratic red tape and unregulated government spending have been major reasons for the ballooning of domestic debt.

8-Wasted chances to establish sovereign funds thus boosting government revenues much like the surrounding oil-rich nations.

9-Almost total absence of any role for the private sector in contributing to economic development and achieve economic growth rates.

10-The phenomenon of financial and administrative corruption take a significant rising turn.

Recommendations

1- Diversification of internal sources of income and reliance on local resources for activating the role of other economic sectors.

2- Supporting the private sector to participate in the economic development and attaining good growth rates.

3- Reducing heavy dependence on domestic borrowing and finding other developmental models through strategic planning.

4- Fighting corruption in all its forms and resort to governance in the management of most public institutions to heal the breach.

5- Automating all the internal revenues to contribute to supporting the federal budget.

6- Channel the credit to income-generating investment outlets.

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