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The Iraqi dinar as a currency investment

Some investors are curious about the Iraqi currency as a potential investment. Expectations for the currency to significantly gain in value against the dollar repeatedly have been disappointed since its introduction in 2004. Considering the illiquidity and fraud risk, Wells Fargo Bank has no plans to trade in the Iraqi currency, and considering that Iraq remains a dangerous place with an uncertain future, we strongly advise investors against taking the risk of buying Iraqi dinar as an investment.

Since the fall of the Saddam Hussein regime in 2003, Iraq has made important strides towards rebuilding its political system and economy. One important milestone was the 2004 introduction of a new currency, called the dinar. The dinar's initial, weak exchange value against the U.S. dollar reflected Iraq's post-war political and economic chaos, but the country's rebuilding progress has sparked hope for a brighter future. A significant part of that hope revolves around the expectation that better security and economic growth may lead Iraq's monetary authority, the Central Bank of Iraq, to revalue the dinar – that is, reset the exchange rate at a much more favorable value for the dinar. Many investors wonder about the dinar's prospects as a potential investment, and this report examines the rationale and the risks involved in that investment decision.

The historical precedent for revaluation and our Iraq outlook

Precedents exist for war-torn countries to experience a strong economic rebound and, eventually, the need to revalue their currencies. West Germany rose from destruction and partition after World War II and had recovered enough by the 1960s to revalue its currency, the deutsche mark. More recently, Kuwait repeatedly revalued its dinar in the years after the 1991 war to expel the Iraqi invasion. In both cases, the countries that had suffered invasion and the destruction of war rebounded, and their currencies regained value after sinking during the war. Today, dealers who offer the dinar for sale often claim that Kuwait's experience may apply to Iraq.

The investment advice is predicated on a view that Iraq's economy and security have improved enough to warrant a revalued dinar (which traded at 1,165 dinar per U.S. dollar as of the close on Feb. 17, 2012). In December 2010, Iraq's three principal ethnic groups – Sunni Muslims, Shiite Muslims, and Kurds – forged a deal to form a government. We agree that a unity government is necessary first step for Iraq to accelerate its recovery. However, the unity among the three main ethnic groups appears to be yielding to a deepening political struggle as the United States military exits Iraq. The competition among the Shiites, Sunnis, and Kurds once more has taken a violent turn, as bombings have increased in neighborhoods and shopping centers. Foreign influences should continue to aggravate the tension. Iran, Turkey, and Saudi Arabia all have strong interests in which ethnic group emerges as the strongest. Of those three outside influences, Iran's appears to be the strongest.

In our opinion, the most serious risk to unity comes from past and future Iranian interference in Iraqi politics. Between 1980 and 1988, these two countries fought a war, which worsened into a war of attrition in its final three years. The great loss of life on both sides remains a painful memory in both countries. Just as important may be the strategic value to Iran of upsetting the U.S. policy goal of a stable, prosperous and democratic Iraq. Iran is a Shiite country and Iraq has a Shiite majority. There is evidence that Iran provided weapons to Shiite militia and provides funds and training to Iraqi Shiite politicians. Iran's interests are likely to clash with the interests of other groups in Iraq, further complicating Iraq's search for long-term stability.

In sum, Iraq's post-war experience shows much stronger ethnic divisions than was the case in Germany or Kuwait, prior to their currency revaluations. Without more political unity, the Iraqi

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economy should continue to struggle under uncertainty and sectarian violence. While the economy grapples with violence, the prospect of a currency revaluation seems remote.

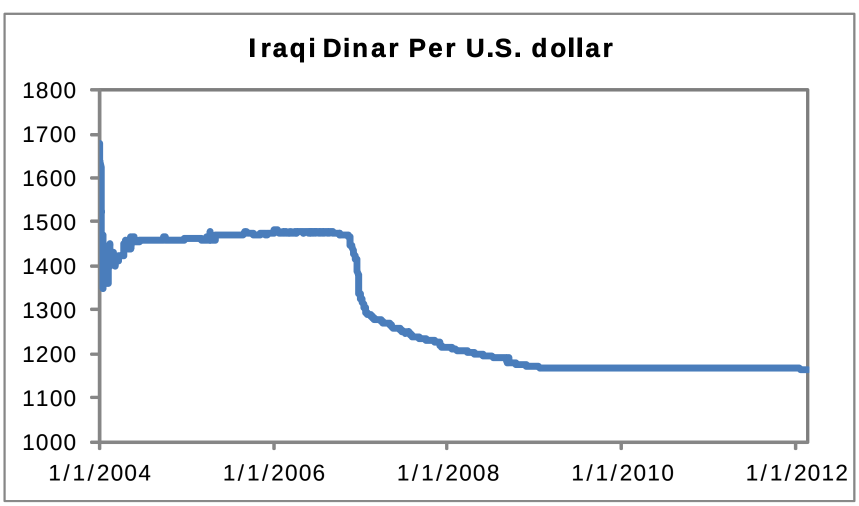
Against the backdrop of an improved but still uncertain future, the Iraqi central bank has held fixed the value of the dinar against the dollar for the past two years, as illustrated in the chart below. The peg may be seen as a defensive measure that supports the dinar while Iraq rebuilds. Put differently, the peg supports the dinar against depreciation pressure during the current period of sectarian violence. The dinar is accepted in exchange for business deals transacted locally, and between Iraqis and people in neighboring countries, such as Jordan. But much business is transacted in dollars, reflecting the general suspicion of the dinar's longevity, and the explicit demand for dollars weighs on the dinar's value. The central bank tries to counter this negative momentum by conducting regular auctions of dollars. The auctions supply the market with dollars and stabilize the dinar's exchange rate against the dollar. The auctions may continue for as long as demand for the dinar remains weak in Iraq. In light of the Iraqi government's still-tenuous control, we believe the probability is low that the Iraqi dinar will revalue in the foreseeable future.

Illiquidity and risk of fraud

Illiquidity is another risk for potential dinar investors. The dinar is still available only in paper form. (In the most typical scenario, 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. As an illustration, an investor who bought the dinar on April 1, 2004 would have earned a return of 18.2 percent through January 31, 2012. However, the costs for buying or selling the dinar may absorb most or even all of an investor's return. All dealers in banknotes charge their customers for the cost of shipping, handling, and buying or selling the dinar in a wholesale market. There is not currently any widely recognized or available wholesale market for the dinar. 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.

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, the chart below is based on the rates quoted by only two banks, the Central Bank of Iraq and an Italian bank.

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.



Sources: Bloomberg and Wells Fargo Advisors
Data Sample: Daily data, Jan. 1, 2004 - Feb. 17, 2012

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, evidence of how much the current dinar may appreciate in the future. 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.

Investment recommendation

Considering the illiquidity and fraud risk, considering that expectations for a large dinar revaluation have been disappointed continually since 2004, and considering that Iraq remains a dangerous place with an uncertain future, we strongly advise investors against taking the risk of buying Iraqi dinar as an investment. We suggest many recommendations that we believe have much less liquidity, fraud, and principal risk.

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[1] "BBB Warns That Iraqi Dinar Investment is Creating Concerns and Complaints" Better Business Bureau of Northern Illinois, http://www.bbb.org/us/article/bbb-warns-that-iraqi-dinar-investment-is-creating-concerns-and-complaints-690

[2] "Top Ten Investment Scams Predicted for 2006", State of Utah Department of Commerce, Division of Securities, http://www.securities.utah.gov/press/topscams.pdf.

Important Disclaimers

- Past performance is not necessarily a guide to future performance.
- An index is not managed & is unavailable for direct investment.
- Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.
- Investments that are concentrated in a specific country increases its vulnerability to any single economic, political or regulatory development. This may result in greater price volatility.

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