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Iraq and the IMF

Press Release:
IMF Executive Board Approves First Ever Stand-By Arrangement for Iraq
December 23, 2005

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Iraq: Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

December 6, 2005

The following item is a Letter of Intent of the government of Iraq, which describes the policies that Iraq intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Iraq, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Baghdad, December 6, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

1. Despite a challenging security and political environment, we have strived to implement the ambitious policy agenda laid out in our economic program for 2004–5, which was supported by Emergency Post–Conflict Assistance from the IMF. The results of the program have been positive: GDP is estimated to have rebounded by nearly 50 percent in 2004, though driven mainly by the recovery of the oil sector; after a surge in inflation in late 2004 and early 2005, largely due to security–related shortages of essential goods, consumer prices have stabilized in recent months; the exchange rate has remained relatively stable since May 2004; and net international reserves have grown strongly and at end-September were about $8.5 billion, well above the EPCA floor of $4.8 billion for September 2005. Nevertheless, while we have had some success in keeping the macroeconomic situation relatively stable, progress in the area of structural reform has been hindered by the continuing security problems.

2. As we prepare for constitutional elections later in the year, we believe it is important to establish a framework for Iraq's economic strategy for the remainder of 2005 and for 2006. The overarching goal of our strategy will be to maintain macroeconomic stability while increasing our efforts to advance Iraq's transition to a market economy and establish the basis for sustainable growth in the medium term. Our program seeks (inter alia) to strengthen governance and administrative capacity, to prioritize resources toward regenerating the oil sector, and to move away from general subsidies toward providing better social and public services.

3. A cornerstone of our strategy is the reduction of subsidies on petroleum products and the expansion of the market that is open to the private sector. As part of that strategy, we have submitted to the National Assembly a law authorizing the importation of these products by the private sector for resale domestically at market prices. We are also poised to increase nationwide the official price of regular gasoline from ID 20 to ID 100 per liter, and of premium gasoline from ID 50 to ID 250 per liter.

4. The attached memorandum of economic and financial policies sets out the government of Iraq's economic and financial program for the remainder of 2005 and for 2006. The government of Iraq believes that the policies and measures described in the memorandum are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. The government of Iraq will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the memorandum, in accordance with the Fund's policies on such consultation.

5. In order to support the implementation and success of the program, the government of Iraq hereby requests a 15–month stand–by arrangement with the Fund (December 2005–March 2007) with access in an amount equivalent to SDR 475.4 million, or 40 percent of quota. We intend to treat the requested arrangement as precautionary (i.e., we do not intend to make the purchases under the requested arrangement that will become available upon its approval and after observance of its performance criteria and completion of its reviews).

Sincerely yours,

/s/ /s/

Dr. Sinan Shabibi
Governor of the Central Bank of Iraq

Dr. Ali Allawi
Minister of Finance of Iraq

IRAQ

Memorandum of Economic and Financial Policies for 2005–06

December 6, 2005

I. Introduction

1. With the transfer of power to an Iraqi sovereign government on June 28, 2004, the government of Iraq (GoI) embarked on the complex and challenging task of reordering the political and economic landscape of Iraq. Legislative elections were successfully held in late January 2005. This was an historic achievement, and occurred despite attempts by insurgents to disturb the process. A new constitution was approved in a national referendum on October 15. Elections for a new National Assembly (based on this constitution) are expected to take place on December 15, 2005.

2. In September 2004, the IMF provided Emergency Post Conflict assistance (EPCA) in support of macroeconomic and reform program to run through 2005. This program has been relatively successful in delivering macroeconomic stability, notwithstanding the relatively high rates of inflation reflecting supply shortages. However, a number of institutional and administrative reforms included in the EPCA–supported program have been delayed, mainly because of constraints arising from the difficult security environment. Furthermore, fiscal resources have had to be redirected and augmented in order to meet the higher costs of providing security and repairing infrastructure damaged by sabotage activities.

3. The international community continues to play a fundamental role in supporting Iraq's reconstruction efforts. Approval of EPCA by the IMF Board in late September 2004 opened the door for a comprehensive agreement with Paris Club creditors on significant debt relief. Furthermore, since EPCA approval, donors' meetings have taken place in Tokyo in mid-October 2004 and at the Dead Sea (Jordan) in July 2005. In connection with the latter meeting, Japan outlined an agreement to provide \$3.5 billion in low-interest loans for infrastructure projects as part of its efforts to meet its Madrid conference aid pledge. The World Bank announced a lending program of \$500 million over the next two years, while other donors reaffirmed their Madrid pledges for assistance.

4. Despite these efforts, grant-financed reconstruction expenditure in 2004 and so far in 2005 has fallen short of expectations. While most of the \$1.1 billion deposited in the Donors International Reconstruction Fund Facility for Iraq (IRFFI) has been committed to reconstruction projects, relatively little has been disbursed. Moreover, a large share of bilateral donor support is either not going into the domestic economy or is being used primarily to cover security outlays. To enhance aid effectiveness, the GoI agreed with donors at the Dead Sea in Jordan in July 2005 that reconstruction will be coordinated by the ministry of planning and economic development in the context of the national development strategy.

II. Developments Under the EPCA–Supported Program

5. As indicated above, while the GoI has had some success under the EPCA–supported program in achieving macroeconomic stability, there are some outstanding policy issues—particular in the structural reform area—where implementation has lagged behind and where progress is urgently needed to put the economy onto a sustainable growth path.

6. Early success in macroeconomic performance was reflected in a rebound in economic growth to nearly 50 percent in 2004, driven mainly by the recovery in oil production by nearly 75 percent to 2.0 million barrels per day (mbpd). The continuing insurgency and sabotage and the resulting delays in implementing oil investment projects have, however, stalled oil production in 2005 at around 2.0 mbpd. Inflation has been higher (and more volatile) than expected, but this is mainly due to special factors, including shortages of certain commodities also largely reflecting the continued violence. Overall, inflation has been slowing, from 32 percent through end-2004 to an expected 20 percent by end 2005.

7. An important element of stability has been secured through the monetary policy framework of the Central Bank of Iraq (CBI), based on maintaining a de facto exchange rate peg since May 2004. This framework has been supported by strict adherence to a policy of no central bank lending to the government, by appropriate actions in adjusting CBI interest rates, and by holding regular (daily) CBI auctions of foreign exchange. Under this policy, the CBI's foreign exchange reserves continued to grow during the first nine months of 2005, though at a slower pace than in 2004. Net international reserves at end-September were about $8.5 billion, well above the EPCA floor for September 2005 of $4.8 billion.

8. The GoI reached agreement with Paris Club creditors in late 2004. The vast majority of Paris Club claims have now been reconciled. Four out of 15 bilateral agreements have now been signed with Paris Club members, and the remaining ones should be signed by end-2005. The GoI has signed agreements with two of the 25 non-Paris Club creditors, and made notable progress with another seven, and looks forward to making similar progress with Gulf country creditors in due course. The GoI has made two largely successful cash offers in August and October to small private creditors (with claims of below $35 million per creditor), and expects to make a debt-exchange offer to larger private creditors by end-2005.

9. The fiscal deficit for 2004 was somewhat larger in dinar terms than envisaged under the EPCA program. While crude oil export revenues were larger than expected on account of higher oil prices, spending on goods and services was over budget, reflecting in part larger security outlays. The wage bill also increased relative to budget. Investment, by contrast, was below budget with the pace of reconstruction slowed by the continuing violence. The lack of security has also had a negative fiscal impact in 2005, resulting in a further increase of the wage bill and a slowdown of oil investment. The overall fiscal position in 2005 has, however, been much more comfortable than envisaged in the EPCA program because of higher oil prices as well as lower expenditures in certain areas. As a result, the year could end with a more positive DFI balance than envisaged under the EPCA program. Disbursements of grants have also accelerated.

10. Implementation of the EPCA commitment to increase domestic prices of refined oil products (originally scheduled for end-2004) was delayed until September 2005, when the official price of regular gasoline in Baghdad (previously ID 20 per liter) was unified with the official price of premium gasoline (ID 50 per liter) in Baghdad. This action marks the first step in the GoI's plan to gradually phase out the subsidy on domestic oil product prices. As a second step in the adjustment of oil product prices, the GoI intends shortly to further increase (nationwide) the official price of regular gasoline to ID 100 per liter, and increase the price of premium gasoline to ID 250 per liter, of diesel to ID 90, kerosene to ID 25 per liter, and LPG to ID 600 per canister. This measure will be taken before IMF Board approval (i.e., as a "prior action") of the stand-by arrangement (SBA) that the GoI is requesting in support of its economic program for 2006. As part of the GoI's strategy toward reducing the oil product subsidy, it has submitted a law to the National Assembly authorizing the importation of oil products by the private sector for resale domestically at market prices.

11. The implementation of structural benchmarks specified in the EPCA program was slower than scheduled. This has reflected both the difficult security situation and the need to prioritize better administrative and institutional reforms. Progress has been particularly slow in the budgetary and financial management area. The GoI's greatest concern, however, has been corruption. The GoI has therefore established a cabinet-level committee to review all tenders greater than $3 million and an integrity commission to investigate alleged corruption practices throughout the government. The ministry of finance has also taken steps to ensure that the disbursement of all funds are made strictly on the basis of budget appropriations.

12. In the financial area, the CBI has recently published the first monetary survey for Iraq, and has made some progress towards the introduction of a modern payment system. The GoI has contracted the firm Ernst and Young (E&Y) to audit the CBI's operations and balance sheet. The GoI expects E&Y to have finalized their audit of the CBI's international reserve position for end-June 2005 (including of reserve composition and location), as well as their assessment of the 2004 audit of the CBI conducted by the Supreme Board of Audit, and prepared a timetable for its conduct of the 2005 audit of the CBI as prior actions for the SBA.

III. Government Program for 2005/6

A. Macroeconomic Objectives

13. Notwithstanding the challenges presented by the security situation, the government believes that the economic strategy embarked upon in late 2004, and updated below, will generate positive macroeconomic results in the years to come. The main objectives of the program are to maintain macroeconomic stability, while laying the groundwork for sustainable growth over the medium term and making efforts to improve governance and advance Iraq's transition to a market economy. The program seeks (inter alia) to strengthen governance and administrative capacity, to prioritize resources toward regenerating the oil sector, to move away from general subsidies toward providing better social and public services, including in education, health, transportation, electricity, and security, and the reform of the social safety net into a more efficient and targeted system. The second stage of (30 percent) debt reduction under the Paris Club agreement triggered by the approval of the SBA should also help enhance fiscal and external sustainability over the medium term.

14. The program is based on the planned expansion of Iraq's main revenue source—the oil sector—through substantial investment and institutional and legal reforms. It aims at strengthening financial management of the government and the CBI. A cornerstone of the program will be a substantial reduction of domestic oil product subsidies, including by limiting government imports of petroleum products (which will be subject to an indicative target ceiling), and permitting the private sector to import premium gasoline. The program will also lay the groundwork for the reform of the social safety net and the public distribution system.

15. The program has the following macroeconomic objectives: an acceleration of real GDP growth from 2.6 percent in 2005 to 10 percent in 2006, driven by the expansion of oil production from 2.0 mbpd in 2005 to 2.3 mbpd in 2006; a reduction in inflation from 20 percent in 2005 to 15 percent in 2006; and a strengthening of the net international reserves position of the CBI with an accumulation of about $1.7 billion to $10.6 billion.

B. Macroeconomic Policies

16. For the remainder of 2005 and for 2006, the GoI's main macroeconomic policy objective will be to put Iraq on a path to continued growth, low inflation, and medium-term fiscal and external sustainability. In fiscal policy, the GoI will adopt a cautious approach, whereby expenditures will be constrained to available oil revenues, domestic tax resources (including those released by the reduction in domestic oil subsidies), and external financing with limited recourse to net domestic financing; monetary policy will continue to be geared toward ensuring price stability, supported by a more active use of domestic monetary policy instruments and an exchange rate intervention policy based on avoiding unwarranted exchange rate fluctuations; and the GoI will bolster its efforts in the structural reform area, most prominently in restructuring the oil sector, financial management, and the banking sector.

Fiscal policy

17. Rebuilding Iraq's economy and infrastructure, while at the same time protecting the standard of living of the population, will place significant demands upon the GoI's limited resources. While the long run prospects for Iraq are well supported by the country's substantial resource base, Iraq still faces enormous challenges in reconstructing its economy over the medium term, particularly as the security and political situation has yet to stabilize. For this reason, the GoI aims to put in place a fiscal strategy focused on an appropriate prioritization in the use of available resources, while containing recurrent expenditures, particularly on wages, pensions, transfers, and non-essential projects. In this connection, the GoI will also take steps to tackle the problem of eliminating existing price distortions, with a view towards both alleviating damaging market distortions and also generating additional budgetary resources to support priority sectors, such as education, health, and security

18. The overall government fiscal deficit for 2005 will be limited to ID 5.3 trillion (or 11 percent of GDP), and will be financed by available external financing in the amount of ID 3.2 trillion (mostly related to the use of resources in the Development Fund for Iraq (DFI), including recently recovered assets that had been previously frozen abroad, and the full use of outstanding letters of credit relating to the defunct oil–for–food program).

19. A budget in line with the program for 2006 has been adopted by the National Assembly. The budget contemplates an overall government deficit of ID 5.6 trillion (or 9.0 percent of GDP), and will be mostly financed by the use of most of the remaining resources in the DFI (ID 5.6 trillion). The primary budget deficits for 2005 and 2006 will be subject to a performance criterion under the SBA (see Table 1 for performance criteria under the program).

20. Revenues in 2006 are projected to increase to ID 47.5 trillion (including oil export revenues of ID 42.1 trillion projected on the basis of an oil export price of US$46.6 per barrel and oil export volume of 1.7 mbpd). The GoI is also committed to increasing domestic prices of oil derivative products on a quarterly basis during 2006. Moreover, the GoI will be developing a more concrete rules–based mechanism to adjust domestic oil prices in the future. The particular elements of this mechanism will be the focus of the discussions during the program reviews. This should generate ID 1.5 trillion in additional revenue toward total revenues of oil-related state owned enterprises, including revenues remitted to the budget (quantitative performance criterion) in 2006.

21. In order to enhance domestic tax revenue performance and in line with the GoI's commitments under the EPCA program, the GoI has adopted a uniform 10 percent import duty to replace the existing reconstruction levy (of 5 percent), effective April 2006, reduced exemptions, strengthened customs collection through arrangements with neighboring countries, and introduced additional levies and tax effective January 1, 2006.[1] The GoI will also develop, with technical assistance from bilateral and multilateral agencies, a plan to overhaul the tax system in the medium term, including through the introduction of a sales tax to be perceived first at the border, as an initial step towards introducing a value-added tax. The GoI will seek cabinet approval of this plan, and its subsequent adoption, by end-2006.

22. On the expenditure side, overall public expenditure in 2006 will be limited to ID 66 trillion, consistent with the overall resource envelope available from oil and other revenues, external grants, external financing, and no domestic financing. Off-budget expenditures will not be allowed, and any additional spending will be integrated into a supplementary budget, which will be fully funded ex–ante. The contingency allowance will be allocated only in consultation with IMF staff and after careful consideration of expenditure priorities and revenue developments. In the event of a large revenue shortfall, expenditure cuts may also need to be made in non-priority areas.

23. In view of the large increases that took place in the last couple of years, the wage and pension bill (except for wages of the defense and interior ministries) will be limited in nominal terms to ID 9.3 trillion in 2006 (and will be subject to a quantitative performance criterion). To support this objective, the GoI will complete a census of all public sector employees (including the military) by end-June 2006 (structural benchmark), and establish a mechanism to monitor the government employees roster. The GoI will also postpone any changes to the existing pension system, and will adopt by end-June 2006 a plan to be prepared with the technical assistance of the World Bank to make Iraq's pension system sustainable.

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[1] Private imports of gasoline (when these are liberalized) will be subject to the reconstruction levy, and to the import duty that replaces it.

24. The GoI is firmly committed to protecting the poor. In October 2005, a coupon system was introduced to enable all citizens of Baghdad to purchase at official prices at least one liter of kerosene and one canister of LPG per month. The goods are distributed at official gasoline stations in Baghdad. The GoI is also setting aside ID 500 billion in its 2006 budget for a special social assistance program to help ameliorate the impact of higher fuel prices on the poor. In the meantime, the GoI intends to ensure the continued monthly distribution of the commodity basket currently offered under the PDS. The GoI has begun to reform (with World Bank assistance) the administration of the PDS through enhanced financial monitoring and improved procurement procedures. The GoI is also preparing the ground for the eventual transformation of the in-kind PDS system into a cash transfer system, targeted at the poor, by introducing a modern payments system and completing a comprehensive household income and expenditure survey.

25. The GoI will develop a strategy to restructure state-owned enterprises and phase out government subsidies to them. The aim will be to restructure at least a quarter of these enterprises in 2006.

26. To ensure the projected expansion of the revenue base over the medium term, the budget includes large investment outlays in the oil sector in 2006 equivalent to ID 5.3 trillion. Capital projects (including those financed by donors) in priority areas such as defense, electricity, education, and health, will also be increased in 2006.

27. Despite delays, mostly relating to the security situation, the GoI remains committed to enhancing the effectiveness and transparency of budgetary management. In this connection and with assistance from the IMF and the World Bank, the GoI will: (i) continue to use the existing manual system for financial reporting for 2006; (ii) adopt by end-June 2006 a detailed budget classification and chart of accounts in line with the Fund *Government Financial Statistics* Manual *2001* (as a structural performance criterion), and initiate an extensive training program to ensure successful implementation of the new classification for the 2007 budget; (iii) complete by end-March 2006 an assessment of the Free Balance software installed by USAID contractors, and by end-September 2006 a report on any changes necessary to adapt it adequately to the needs of Iraq; (iv) prepare monthly government cash-flow projections; and (v) adopt by end-December 2005 implementing regulations for the financial management law in the area of budget preparation.

28. Improving transparency and governance and combating corruption is one of the government's priorities. In this regard, the GoI will establish by June 2006 an audit oversight committee, to become effective on or before December 31, 2006, including the participation of independent international audit experts, to continue the work of the International Advisory and Monitoring Board upon its dissolution in overseeing and making public audits of the Development Fund for Iraq and oil export sales (structural benchmark). With the technical assistance of the World Bank, the GoI is also reviewing its procurement system and procedures, and strengthening external audit through training programs.

Monetary and exchange rate policy

29. The current framework of exchange rate stability has provided a valuable steadying force for the economy. Although prices did not fully stabilize, this was partly because of special supply factors related to the ongoing insurgency. In maintaining the peg, moreover, the CBI has succeeded in accumulating a healthy level of foreign exchange reserves. In view of the success of this policy framework so far, we feel that the continuation of the exchange rate peg to the dollar remains appropriate. To support this framework, the CBI stands ready to supply the full amount of foreign currency demanded at the cutoff rate at the daily auction. Moreover, should there be any persistent downward pressure on the exchange rate, the CBI intends to tighten monetary policy, including by raising interest rates on its dinar deposit facilities, as needed. The CBI is also committed (as a performance criterion) to avoid the application of administrative measures in order to limit the quantity of dollars sold at auction.

30. To allow for more flexibility in managing monetary policy, the CBI has taken a number of steps to broaden the menu of available monetary policy instruments. On March 14, 2005, the CBI activated separate dinar and dollar overnight deposit facilities paying interest at 4 percent and 2 percent per annum, respectively. On April 1, 2005, the CBI reintroduced coverage of required reserves to include government deposits. More recently, the CBI also introduced deposit facilities with maturities of seven and fourteen days to allow banks to manage their liquidity position in a more effective manner and to reduce the liquidity risk for the central bank. On July 3, the CBI raised interest rates on the overnight facility to 5 percent, and introduced new 7-day and 14-day facilities paying 6 and 7 percent interest respectively. Eventually, the CBI hopes to be able to influence monetary conditions by means of open market operations. In light of the outcome of the audit of the CBI, outstanding central bank claims on the government will be restructured, with the aim of leaving the CBI with enough marketable instruments to be able to conduct open market operations. The CBI will also be capitalized according to the stipulated ID 100 billion (a structural benchmark for end-September 2006).

31. In order to facilitate the task of assessing the appropriateness of the current policy stance, the CBI has formulated a monetary program for 2005 and 2006. A key element of the monetary program is the projection for the growth of money demand. This projection is related to assumptions and forecasts on economic growth, inflation, and any potential structural shifts in money demand relating to further remonetization of the economy. The projected growth in currency in circulation is consistent with the projected accumulation in net international reserves of about US$1.7 billion and a policy of no lending to the government by the CBI. The program includes a floor on net international reserves (performance criterion). The monetary program may need to be adjusted during the program in light of the evolution of money demand and other developments.

32. As noted above, to enhance governance and transparency of the CBI, the GoI has appointed E&Y to audit the financial operations and statements of the CBI. The GoI expects to receive E&Y's final audit report of the CBI's 2005 balance sheet and operations by end-May 2006 (as a performance criterion). The IMF's off-site safeguards assessment of the CBI will be in process by the time of the IMF's first review of the program.

External sector policies

33. The GoI remains committed to an open trade and exchange system. In this connection, the GoI has provided legislation relating to trade and exchange transactions to the IMF for their review. The GoI intends to work toward accepting the obligations of Article VIII, Sections 2(a), 3, and 4 of the IMF's Articles of Agreement. Looking forward, the GoI will avoid imposing restrictions on payments and transfers for international transactions, introducing new or intensifying trade restrictions for balance of payments purposes, or resorting to multiple currency practices.

34. The GoI will maintain its policy of obtaining debt rescheduling terms for non–Paris Club and private creditors comparable to those agreed last year with Paris Club creditors. With assistance from our accounting advisors, the GoI has made significant progress in the process of debt reconciliation with official creditors. The GoI intends to finalize before end-2005 bilateral debt agreements with most of Iraq's Paris Club creditors and with as many as possible of Iraq's non-Paris Club official creditors. Contacts have been made with Gulf countries and there are indications that these countries are favorably disposed to providing debt relief on terms at least as favorable as those of the Paris Club. As regards private commercial creditors, as long as arrears to these creditors are outstanding, the GoI will continue to proceed with good faith efforts to reach collaborative restructuring agreements consistent with eliminating financing gaps and achieving medium-term sustainability. The GoI will take all necessary steps to maintain a constructive dialogue with all Iraq's private creditors, in a manner consistent with the Fund's lending into arrears policy. This dialogue should enable the GoI to explain the consistency of the debt restructuring with the government's macroeconomic and social policy, as well as provide an opportunity to respond to the concerns of private creditors. Progress toward reaching agreement with Iraq's private creditors will be reviewed in the context of (quarterly) financing assurances reviews by the IMF. We also plan to make fully operational by early-2006 the recently established debt management unit in the Ministry of Finance, and have now centralized government authority to contract new external and domestic debt at the Ministry of Finance.

C. Structural Reforms

35. The GoI will push ahead with its reform program, including by reinvigorating the reforms identified in the program supported by EPCA, which were delayed partly because of the continuing security problems.

36. The GoI plans to (i) implement (with US technical assistance) a metering system for oil production by end-September 2006; (ii) restructure oil sector operations toward putting oil sector enterprises on a full commercial basis and with the ministry of oil and industry regulator; and (iii) prepare a draft petroleum law in line with the new constitution and international best practice by end-December 2006 (this law would define the fiscal regime for oil and establish the contractual framework for private investment in the sector).

37. A modern payments system will be critical to enhance financial sector operations, improve government financial management, and facilitate fiscal reforms such as the monetization of the in-kind social safety net. In this regard, the GoI will implement payment systems regulations by end-August 2006 (as a structural benchmark); commence operations of the Real Time Gross Settlement system linking accounting systems of headquarters of commercial banks to the CBI by end-August 2006 (structural benchmark); and commence operations of a payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House by November 30, 2006 (structural benchmark). The government also intends to implement a regulatory framework for, and subsequent implementation of, a securities clearing and settlement system.

38. The GoI also intends to develop a restructuring strategy for the two main state-owned banks—Rasheed and Rafidain. Toward this objective, a report (prepared with U.S. technical assistance) on the status of these banks will be completed by December 2005, and it will be preparatory to a more comprehensive financial and operational audit of these banks (possibly by end-2006). The evolving development of strategy for these banks will be subject to IMF review under the program. The government is also working on a strategy to restructure the other commercial banks with a view to modernizing the sector as a whole, including through joint venture operations and the development of Islamic banking. This strategy will also be subject to IMF review under the program.

39. The CBI is also seeking to facilitate the formation of secondary market in treasury bills, and intends to establish a register of treasury bill holders and a repository for government securities at the CBI by June 2006. The CBI will seek the modernization of prudential banking regulations and the supervisory framework. The CBI will also begin enforcing reserve requirements for all commercial banks.

D. Statistics

40. The GoI is aware of the importance of preparing and disseminating comprehensive macroeconomic data, particularly for monitoring macroeconomic policies. The GoI is committed to meeting the data provision requirements of Article VIII, section V, of the IMF's Articles of Agreement, and remains determined to ensure regular reporting to the IMF of data on government budget execution, external debt, monetary and credit aggregates, inflation, real sector activities, and the balance of payments. While important progress has been made in this area, the GoI intends to bolster its efforts to improve the compilation and dissemination of macro-economic and financial statistics, with assistance from the IMF Statistics Department. The GoI will also ensure greater transparency in the production and dissemination of statistics by Iraq's participation in the IMF's General Data Dissemination System (GDDS) by September 2006.

41. The GoI plans to complete before end-2006 with the assistance of the World Bank a comprehensive income and expenditure household survey. The analysis of this survey would provide essential information for the development of a strategy to reduce subsidies and replace them with an efficient, targeted social safety net.

E. Medium-term Prospects

42. Iraq's medium term outlook appears favorable at the present juncture, particularly given the prevailing high levels of international oil prices. This assessment assumes the maintenance of a stable macroeconomic environment and the continuation of reforms, while proceeding with Iraq's reconstruction and transition a market economy. The GoI aims to achieve primary fiscal surpluses by 2009 through a steady increase of its revenues and further restraint of recurrent spending, particularly on wages and transfers. To this end, the GoI will invest heavily in the oil sector to reach a production level of 3.6 mbpd by 2010. We will also continue to increase domestic prices of petroleum products with a view to reaching their international level in the medium term.

43. At the same time, the GoI is aware of the significant downside risks that could adversely affect the medium term economic outlook but will make every effort to comply with the program notwithstanding these risks. First and foremost is the lack of security, which could threaten program implementation if it does not improve substantially. There are also risks related to the possibility of the stagnation of crude oil production levels, lower international crude oil prices, difficulties in managing and implementing a large public investment program, inherited weak governance practices, and potential additional costs and changes to budget formulation associated with the move towards a federal government structure.

IV. Program Monitoring

44. The GoI agrees that the program will be monitored through prior actions, five (quarterly) reviews (which will be combined with financing assurances reviews), quantitative performance criteria and indicative targets, and structural performance criteria and benchmarks. Quantitative performance criteria (PC) and indicative targets (IT) have been specified in Table 1 for revenues of oil related state-owned enterprises (including revenues transferred to the GoI budget) (PC floor), the general government's wage and pension bill (except wages for defense and security) (PC ceiling), the general government's primary fiscal balance (PC ceiling), CBI net international reserves (PC floor), CBI lending to the government and the private sector (PC ceiling), external arrears on new disbursements (PC ceiling), contracting and guaranteeing of nonconcessional external debt (PC ceiling), and government imports of petroleum products (IT ceiling). Prior actions, structural performance criteria and structural benchmarks are listed in Tables 2 and 3. Appropriate definitions for all key performance indicators are defined in the attached Technical Memorandum of Understanding (TMU).

45. The GoI also agrees that, in addition to the general focus of each of the five quarterly program reviews, the first review will focus, inter alia, on progress in further adjusting petroleum product prices. The second review will focus, inter alia, on progress made with increasing domestic prices of petroleum products, on the implementation of the law permitting private imports of gasoline, and on the completion of the audit of the CBI. The second review will also define quantitative performance criteria for end-September and end-December 2006. The third review will assess progress made with increasing domestic prices of petroleum products and in drafting a petroleum law. The fourth review will focus, inter alia, on progress made with increasing the domestic price of petroleum products.

Table 1. Iraq: 2005–06 Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement (SBA)
(In billions of Iraqi dinars, unless otherwise indicated)

	2005	Performance Criteria			Indicative Target 1/	
	9/30/05	12/31/05	3/31/05	6/30/06	9/30/06	12/31/06
Cumulative change from September 2005						
Net international reserves of the CBI (floor) (in millions of U.S. dollars)	8,500 2/	-1,000	-1,000	-1,000	-1,000	-1,000
Lending to the government and the private sector by the CBI (ceiling) 7/	5,100 2/	0	0	0	0	0
Cumulative flow from beginning of calendar year						
Government primary fiscal deficit (in billions; ceiling; deficit [+]/surplus[-]) 3/	...	5,400	1,950	3,600	4,850	5,300
Government wage and pension bill (ceiling) 3/4/	...	6,650	2,400	4,750	7,100	9,500
Revenue of oil related enterprises, including those remitted to the budget (floor) 3/ 5/	...	900	700	1,500	2,400	3,250
New medium-and long-term nonconcessional external debt (with original maturities of one year of more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 3/ 7/	...	500	500	500	500	500
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 6/	...	0	0	0	0	0
Indicative target						
Government imports of petroleum products (ceiling) 3/		6,000	1,700	3,400	4,000	4,200

1/ Indicative targets are to be set as performance criteria in the context of the first review under the SBA.
2/ Estimated.
3/ Flows for 12/31/05 are cumulative for 2005. Flows for 2006 are cumulative starting 1/1/2006.
4/ Excluding salaries paid by ministries of defense and interior (see attached Technical Memorandum of Understanding for precise definition).
5/ See attached Technical Memorandum of Understanding for precise definition.
6/ This will be monitored on a continuous basis.
7/ Rolling over t-bills does not constitute new lending.

Table 2. Iraq: Prior Action Under the Stand-By Arrangement (SBA)
(In Iraqi dinars per liter, unless otherwise indicated)

	September 2005	Prior Action
Official domestic price of petroleum products (equal to or above, by specified dates)		
LPG (in Iraqi dinars per 12 kg cylinder)	250	600
Regular gasoline	20	100
Premium gasoline	50	250
Kerosene	5	25
Diesel	10	90

Table 3. Iraq: Prior Actions, Structural Performance Criteria, and Structural Benchmarks
Under the Stand-By Arrangement

Policy Action	Date
I. Prior Actions	
Nationwide increase of official domestic price of petroleum products as follows: ID 100 per liter of regular gasoline, ID 250 per liter of premium gasoline, ID 90 per liter of diesel, ID 25 per of kerosene, and ID 600 for 12 kg of LPG.	
Work on audit of Central Bank of Iraq (CBI) according to international accounting and auditing standards to have progressed to an advanced stage. 1/	
II. Structural Performance Criteria	
Avoid administrative measures limiting participation or bids in the CBI's regular auction of foreign exchange other than screening related to anti-money laundering or counter-terrorism.	Continuous
Adoption of fully detailed budget classification and chart of accounts in line with the IMF's Government Financial Statistics Manual (GFSM) 2001, within a cash accounting framework.2/	June 30, 2006
Final audit of CBI 2005 Financial operations and statements.	May 15, 2006
III. Structural Benchmarks	
Implementation of payment system regulations.	June 30, 2006
Establishment of an audit oversight committee, to become effective on or before December 31, 2006, including the participation of independent international audit experts, to continue the work of the International Advisory and Monitoring Board (upon its dissolution) in overseeing and making public audits of the Development Fund for Iraq and oil export sales.	June 30, 2006
Completion of census of all public service employees (including military).	June 30, 2006
Commencement of operation of Real Time Gross Settlement system (RTGS) linking headquarters of commercial banks to the CBI.	August 31, 2006
Commencement of payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House (ACH).	November 30, 2006
Full capitalization of CBI to the stipulated ID 100 billion, based on the 2005 audited financial statements and taking into account the restructuring of outstanding claims on the central government that are on the December 31, 2005 balance sheet of the CBI.	December 31, 2006

1/ The audit would be deemed to be an advanced stage with (i) finalization of Ernst and Young's assessment of the 2004 audit conducted by the Supreme Board of Audit, (ii) finalization of the special audit on international reserves for end-June 2005; and (iii) finalization of a timetable for the completion of the 2005 audit.

2/ The budget classification and chart of accounts will be deemed in line with the IMF GFSM 2001 if it is consistent with the methodology and high level classification defined in the technical assistance report of the IMF's Fiscal Affairs Department entitled "Iraq Budget Classification Reform" (July 2005).

IRAQ

Technical Memorandum of Understanding

December 6, 2005

1. This memorandum describes the quantitative and structural performance criteria, benchmarks, and indicators for the Stand-By Arrangement (SBA) with the Fund. It also specifies the periodicity and deadlines for transmission of data to the staff of the International Monetary Fund (IMF) for program monitoring purposes.

I. Quantitative Performance Criteria and Indicators

2. The quantitative performance criteria are the following:

• a floor on net international reserves of the Central Bank of Iraq (CBI);

• a ceiling on lending to the government and the private sector by the CBI;

• a ceiling on the primary deficit of the government;

• a ceiling on the government wage and pension bill

• a floor on the revenue of oil-related state-owned enterprises, including those remitted to the budget

• a ceiling on external arrears on new borrowing; and

• a ceiling on contracting and guaranteeing of new medium- and long-term non-concessional external debt.

3. The quantitative indicative target is a ceiling on government imports of petroleum products.

II. Definitions

4. For purposes of monitoring under the program, a program exchange rate will be used. This program exchange rate will be set at ID 1,500 per U.S. dollar. The program exchange rate will be used to convert into Iraqi dinars the U.S. dollar value of all CBI foreign assets and liabilities denominated in U.S. dollars, as required. For CBI assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted in U.S. dollars at their rates prevailing as of September 30, 2005, as published on the IMF's website.

5. **Net international reserves (NIR)** are based on a net foreign asset concept and are defined as gross reserve assets minus reserve liabilities of the Central Bank of Iraq. Gross reserve assets of the CBI are claims of the CBI on nonresidents that are controlled by the CBI, denominated in foreign convertible currencies, and are immediately and unconditionally available to the CBI for meeting balance of payments needs, intervention in foreign exchange markets, and are not earmarked by the CBI for meeting specific payments. They include CBI holdings of monetary gold, SDRs, Iraq's reserve position in the IMF, foreign currency cash, and deposits abroad, except for the resources of the Development Fund for Iraq (DFI) but including the CBI DFI sub-account. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

6. Reserve liabilities shall be defined as foreign currency denominated liabilities of the CBI to nonresidents with original maturity of one year or less, and all liabilities to the Fund. They include: commitments to sell foreign currency arising from derivatives (such as futures, forwards, swaps, and options) and all arrears on principal or interest payments to commercial banks, suppliers, or credit agencies. As of August 31, 2005, net international reserves amounted to US$8.7 billion, comprising US$9.1 billion of gross reserve assets less US$0.4 billion of reserve liabilities.

7. **Claims of the CBI on the central government** comprises holdings by the CBI of treasury bills (including accrued interest) plus the outstanding balance in the government overdraft account at the CBI. Also included are the claims on nonbank public institutions and claims on commercial banks. As of end-August 2005, treasury bill holdings by the CBI amounted to ID 3,235 billion, the balance of the overdraft account at the CBI stood at ID 1,821 billion, claims on nonbank public institutions amounted to ID 0 and claims on commercial banks stood at ID 33.2 billion. The limit on claims on the central government will be fully adjusted in the event of any write-off resulting from the rescheduling agreement between the ministry of finance and the CBI.

8. **Wage and pension bill** includes all wage and pension payments made by the central government, excluding wage payments made by the ministries of defense and interior. Specifically, with reference to the 2005 budget classification, it includes expenditures under chapter 1 (except those for the ministries of defense and interior), chapter 9, and chapter 6, items 7(1), 7(3), 23, 33(1), 33(3), 33(5), and 33(7). The ceiling for end-2005 will be measured on a cumulative basis from January 1, 2005; the quarterly ceilings for 2006 will be measured on a cumulative basis from January 1, 2006.

9. **Revenues of oil-related state-owned enterprises** comprise all revenues (excluding crude oil proceeds transferred to the DFI and grants received from the Iraqi budget or donors, but including revenues from the sale of petroleum products remitted to ministry of finance) of the following enterprises (or of any companies undertaking their activities): the Northern Petroleum Company, the Southern Petroleum Company, the Oil Exploration Company, the

Iraq Oil Tanker Company, the Iraq Excavation Company, the Petroleum Products Distribution Company, the Oil Pipeline Company, the Gas Bottling Company, the Central Refineries Company, the Northern Refineries Company, the Southern Refineries Company, the Southern Gas Company, the Northern Gas Company, the Oil Projects Company, and the Oil Marketing Company. The ceiling for end-2005 will be measured on a cumulative basis from January 1, 2005; the quarterly ceilings for 2006 will be measured on a cumulative basis from January 1, 2006.

10. **The primary fiscal deficit** is calculated as the difference between primary government expenditure, which is total government expenditure excluding interest payments, and government revenue valued on a cash basis. Government expenditure include expenditure of oil sector-related state-owned enterprises (as defined above), expenditure financed by letters of credit issued under the UN oil-for-food program, and expenditure financed by donors' grant and external loans. Government revenues include revenues of oil sector-related state-owned enterprises (as defined above), donors' grants, oil export revenues transferred to the Development Fund for Iraq (DFI), and interest on assets held in the DFI, but exclude all other transfers to the DFI. The ceiling for end-2005 will be measured on a cumulative basis from January 1, 2005; the quarterly ceilings for 2006 will be measured on a cumulative basis from January 1, 2006.

11. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) August 24, 2000), the term "debt" will be understood to mean a current liability (i.e., not contingent), created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits), and temporary exchanges of assets that are equivalent to fully collateralized loans, under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement, excluding those payments that cover the operation, repair or maintenance of the property. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

12. For purposes of the program, the guarantee of a debt arises from any explicit legal obligation of the government or CBI or any other agency acting on behalf of the government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or CBI to cover a shortfall incurred by the loan recipient.

13. The limits on **medium- and long-term external debt** apply to the contracting or guaranteeing by the government of new, nonconcessional external debt with an original maturity of more than one year, excluding obligations to the IMF. This limit applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. External debt will be considered to have been contracted at the point the loan agreement or guarantee is ratified by the Iraqi parliament. Excluded from this limit are leases of real property by Iraqi embassies or other foreign representations. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on September 30, 2005, as published on the IMF's website.

14. Concessionality will be based on currency-specific discount rates based on the Organization for Economic Co-operation Development (OECD) commercial interest reference rates (CIRRs). For loans of an original maturity of at least 15 years, the average of CIRRs over the last 10 years will be used as the discount rate for assessing the concessionality of these loans, while the average of CIRRs of the preceding six-month period will be used to assess the concessionality of loans with original maturities of less than 15 years. To the ten-year and six-month averages of CIRRs, the following margins will be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–30 years; and 1.25 percent for over 29 years. Under this definition of concessionality, only loans with grant element equivalent to 50 percent or more will be excluded from the debt limits. The debt limits also will not apply to loans contracted for debt rescheduling or refinancing.

15. **Government imports of petroleum products** shall comprise all imports of petroleum products (including diesel, kerosene, LPG, and gasoline) made directly by the Government of Iraq, or by oil enterprises on its behalf. The indicative ceiling for end-2005 will be measured on a cumulative basis from January 1, 2005; the quarterly indicative ceilings for 2006 will be measured on a cumulative basis from January 1, 2006.

III. Provision of Information to the Fund Staff

Data

16. To monitor developments under the SBA, the authorities agree to provide the Fund, the information specified below after SBA approval. The program is designed with quarterly quantitative performance criteria and the actual outcome should be provided within eight weeks following the end of the quarter. However, in order to facilitate regular monitoring, many of the indicators should be provided with the frequencies indicated below.

- CBI gross foreign exchange reserves (weekly) and balances of the DFI held at the FRBNY. This should be reported no longer than 2 weeks after the end of the reference week.

- The monthly balance sheet of the CBI, with a month lag.

- The monthly consolidated balance sheet of the other depository corporations (commercial banks), with an eight week lag.

- The depository corporations (monetary) survey of all commercial banks and the CBI (quarterly), with eight weeks lag.

- Weekly preliminary monetary and financial aggregates, including exchange rate data (daily), currency in circulation, transferable and other deposits held at commercial banks, balances on government accounts at the CBI, interest rates on loans and on deposits at commercial banks, holdings of government securities, and credit outstanding to the public and private sectors. The data, excluding exchange rates, should be reported no longer than three weeks after the end of the reference period.

- Consumer price index (CPI), including indices for main cities (monthly). These should be reported no longer than a month after the end of the relevant month.

- Detailed revenues, operating and capital expenditure, and financing items of consolidated fiscal and oil operations, and overall fiscal balance. These data should include the execution of the Iraqi budget, operations of the oil-related state-owned enterprises, disbursements of external assistance and loans, execution of letters of credit financed under the UN oil-for-food program, all operations of the DFI, balances of all government accounts held at the CBI and the commercial banks, and outstanding stock of government securities (including treasury bills). These data should be reported on a monthly basis and reported no more than eight weeks after the end of the reference month.

- Detailed data on disbursement of external assistance from the US Supplemental and other donor assistance, including by recipient sector; foreign debt amortization and interest payments made; and total outstanding domestic and external debt. These data should be reported on a monthly basis and reported no more than eight weeks after the end of the reference month.

- List of short, medium, and long-term government or government-guaranteed external loans contracted during each quarter, identifying for each loan: the creditor, the borrower (ultimate obligor), the amount and currency, the maturity and grace period, repayment terms, and interest rate arrangements (monthly).

- Foreign trade statistics (imports, exports, re-exports) (quarterly). This should be reported no longer than eight weeks after the end of the reference period.

- Indicators of oil activity on crude oil and gas production and use, production and sales (export and domestic) of petroleum products, including heavy residuals (monthly). These data should be reported no longer than eight weeks after the end of the reference quarter.

- Indicators of non-oil real economic activity (quarterly), including production of cement and electricity. These data should be reported no longer than eight weeks after the end of the reference quarter.

STRUCTURAL REFORMS

17. Review of the structural reforms specified in the memorandum of economic and financial policies and as prior actions, structural performance criteria, and structural benchmark (Table 3). The authorities will prepare and send to the IMF reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial planning, and specifying expected revised completion dates.

OTHER INFORMATION

18. Other details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff, for consultation or information.