# Iraq: 2005 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Iraq

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Iraq, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 13, 2005, with the officials of Iraq on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 8, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of July 25, 2005 updating recent economic developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 1, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Iraq.

The document listed below has been or will be separately released.

Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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## INTERNATIONAL MONETARY FUND

#### **IRAQ**

# Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with Iraq

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July 8, 2005

- The 2005 Article IV consultation mission took place from June 6 to 13, 2005. The staff met with the Minister of Finance and the Governor of the Central Bank of Iraq, who were accompanied by officials from the Ministry of Finance, Ministry of Oil, and Central Bank of Iraq.
- Although Iraq continues to avail itself of the transitional arrangements under Article XIV, it is unclear whether Iraq maintains any restrictions subject to Fund jurisdiction (Appendix I).
- The quality and coverage of economic data at the present time is low and only just adequate for macroeconomic policy assessment (Appendix III).
- Summaries of Iraq's relations with the Fund and the World Bank are provided in Appendix I and II, respectively. Statistical issues, including on data provision adequacy, are reviewed in Appendix III. Appendix IV provides an external debt outlook.
- It is proposed that Iraq be on the standard 12-month consultation cycle.

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#### **EXECUTIVE SUMMARY**

This report is for the first Article IV Consultation with Iraq in 25 years. The last Article IV Consultation was in 1979. The last time the Board met to discuss Iraq was on September 29, 2004 for the approval of Emergency Post Conflict Assistance (EPCA) in support of Iraq's economic program for 2004 and 2005. The authorities hope to enter into a stand-by arrangement later in 2005.

The statistical information that the Iraqis have been able to provide is just adequate for surveillance. There is sufficient data on the oil sector (which comprises three quarters of GDP) but very little on non-oil economic activity. Inflation data is timely, but incomplete in geographical coverage. Monetary data is currently available only for the Central Bank of Iraq (CBI) balance sheet. Fiscal data availability is subject to significant lags.

Because of the ongoing insurgency and the slow pace of reconstruction, implementation of the EPCA program has been slow. Nevertheless, the authorities have achieved a degree of macroeconomic stability and have initiated some reforms. The exchange rate has been de facto pegged to the US dollar since May 2004, reserves ended the year well above the floor specified in the EPCA program, and the fiscal deficit for 2004 was only slightly higher than projected in the EPCA program.

The exchange rate has come under some pressure in recent months. The authorities have responded to this by rationing the supply of dollars on a few occasions. The staff have urged them to satisfy the demand for dollars in full, in view of the comfortable level of reserves, and to raise interest rates as needed. The authorities have been advised to avoid the use of restrictions.

A large ex ante fiscal financing gap is emerging for 2005 and 2006, reflecting additional spending pressures and the delay in implementing the reduction on domestic oil product price subsidies. The staff have urged the authorities to take action to significantly reduce domestic petroleum subsidies to raise revenue, and to ensure that spending is kept under control so as to avoid the accumulation of payments arrears.

The authorities understand the need to ensure that all of Iraq's external debt should be resolved in a manner comparable and consistent with the Paris Club agreement of November 2004. The authorities have made progress in reconciling external claims with Paris Club creditors, though progress with non-Paris Club creditors has been relatively slow. They understand the need to engage private creditors in good faith should Iraq enter into a stand-by arrangement in line with the Fund's lending into arrears policy.

**Iraq is encouraged to build on its track record of policy implementation by continuing to follow the EPCA program.** Iraq needs to move forward, in improving the flow of timely and reliable data, auditing of the central bank according to International Standards of Auditing, and implementing a plan to significantly reduce the very substantial domestic petroleum product subsidy.

#### I. Introduction

- 1. The last (1979) Article IV Consultation with Iraq was concluded on February 29, 1980. A staff report for the 1983 Article IV consultation was issued to the Executive Board on August 5, 1983, but there was no Board meeting.<sup>1</sup>
- 2. On September 29, 2004, the Executive Board approved a request by the Government of Iraq for a purchase in an amount equivalent to SDR 297.1 million (25 percent of quota) under the Fund's policy on Emergency Post Conflict Assistance (EPCA).<sup>2</sup> In addition to facilitating negotiations with the Paris Club on debt relief, the approval of EPCA was intended to help Iraq meet some of its urgent balance of payments needs. In their request for EPCA, the authorities indicated that they planned to seek further financial support from the Fund in the form of an upper credit tranche stand-by arrangement in 2005, on the assumption that sufficient progress had been made in strengthening administrative and institutional capacity under the program.
- 3. Upon the approval of EPCA, Directors welcomed the authorities' commitment to a comprehensive economic and financial program. Directors commended the authorities' strategy of caution in projecting oil revenues in 2005, but stressed that it was important for the authorities to adhere to their commitment to prioritize any windfall oil revenues in favor of additional reconstruction investment, and/or help meet budgetary needs in 2006 and beyond. Directors also welcomed the commitment of the authorities to begin to increase the domestic price of petroleum products. Directors urged the authorities to make monetary policy more adaptable by widening the menu of instruments for managing liquidity conditions. Directors further emphasized the need for the authorities to focus their structural reform efforts in areas including tax administration, payments and settlements systems, stateowned enterprise restructuring, and governance and transparency of the oil sector.

#### II. BACKGROUND

# A. Social and Human Development Indicators

4. There has been a marked deterioration in Iraq's human development indicators over the last twenty years. In 1990, Iraq was ranked 50<sup>th</sup> on the United Nations Development Program's (UNDP) Human Development Index; just over a decade later it was ranked 126<sup>th</sup>. Moreover, compared to other countries in the Middle East, Iraq now scores low relative to the UN Millennium Development Goals (Box 1).

<sup>&</sup>lt;sup>1</sup> Iraq continues to avail itself of the transitional arrangements under Article XIV. Additional information on Iraq's foreign exchange laws, regulations, and practices is being sought to determine whether Iraq maintains any exchange restrictions subject to Fund jurisdiction.

<sup>&</sup>lt;sup>2</sup> IMF Country Report 04/325.

# Box 1. Iraq and the Millennium Development Goals

A survey of living conditions was conducted in the second half of 2004 by the UNDP, in collaboration with the Iraqi Ministry of Planning and Development. This survey found that the policies of the former regime, the three military conflicts since 1980, and the long period of sanctions, have taken a significant toll on the welfare of Iraq's people, on the provision of basic services, and on infrastructure.

- Goal 1. **Eradicate extreme poverty and hunger.** Reliable data on household income is limited. However, the UNDP survey reports that, using subjective measures of poverty, about 7 percent of households are considered poor. Moreover, about 96 percent of households receive monthly food rations. Malnutrition is widespread: 23 percent of children aged between six months and five years suffer from chronic malnutrition, 12 percent suffer from general malnutrition, and 8 percent suffer from acute malnutrition.
- Goal 2. **Universal primary education.** Net primary school enrollment in Iraq is 79 percent, compared to 93 percent in Jordan and 96 percent in Syria. Overall, 22 percent of the adult population in Iraq have never attended school and 15 percent have not completed primary school. The youth (15–24 years) literacy rate is 74 percent, and the adult literacy rate is 65 percent.
- Goal 3. **Gender equality.** Presently, girls have a significantly lower enrollment rate in primary schools than boys: 40 percent of girls in rural areas are not enrolled in primary education, compared to 20 percent in urban areas. The number of women aged 25–34 years who have not completed elementary school is now 36 percent. The ratio of literate females to males is 50 percent, compared to 60 percent in Yemen and 100 percent in Jordan.
- Goal 4. **Reduce child mortality.** Under five years mortality is estimated at 115 (compared to 33 in Jordan and 107 in Yemen). Infant mortality is currently estimated at 102 per 1,000 live births, compared 105 in sub–Saharan Africa.
- Goal 5. **Improve maternal health.** Maternal mortality is relatively high at 193 per 100,000 births (compared to 41 in Jordan but below 350 in Yemen). The level of postnatal care is low, with 58 percent of women not receiving any health checks in the 40 days following delivery.
- Goal 6. Combat HIV/AIDS, malaria and other diseases. Typhoid, cholera, and malaria are endemic. The reported incidence of tuberculosis (at 132 per 100,000 people) is very high relative to neighboring countries. Iraq is categorized as highly vulnerable to HIV/AIDS, but the number of cases remains low.
- Goal 7. **Environmental sustainability.** Major risks include the lack of appropriate sanitary landfills; open burning of solid waste, lack of working sewage infrastructure, oil fires, and excessive car emissions.
- 5. **Unemployment remains very high in Iraq.** There are a number of different estimates of unemployment in Iraq. The UNDP survey of living conditions in Iraq in 2004 estimates unemployment—calculated on the basis of the International Labor Organization (ILO) methodology—at about 10.5 percent.<sup>3,4</sup> Of particular concern is the UNDP report's

<sup>&</sup>lt;sup>3</sup> Iraq Living Conditions Survey 2004, UNDP and ministry of planning and development cooperation.

<sup>&</sup>lt;sup>4</sup> The ILO definition refers to the complete absence of work; this figure also excludes discouraged workers.

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estimate of 37 percent unemployment among the educated young (including discouraged workers). A much higher unemployment rate is suggested by estimates produced by the ministry of planning (28 percent); the Coalition Provisional Authority (30 percent); the Brookings Institution (30–45 percent); and Baghdad University (70 percent).

6. The coverage of public services has improved, but reliability remains a serious problem. According to the UNDP survey, 98 percent of households are connected to the electricity grid, although three-quarters of households report their electricity supply to be extremely unreliable; 78 percent of homes have access to piped water, and 37 percent of all homes are connected to the sewage system, but two-thirds of households report poor reliability in the provision of safe water and sewage services.

# **B.** Political and Security Environment

- 7. The political process has proceeded more gradually than originally envisaged. Parliamentary elections for the new Transitional National Assembly (TNA) were held on January 30, 2005, but negotiations toward forming a government were protracted. Eventually, on April 4, the TNA elected its leadership, including Jalal Talabani as Iraq's President. On April 7, the Presidential Council nominated Ibrahim al–Jaafari as Prime Minister, who was subsequently ratified by the TNA. On April 28, the TNA approved the cabinet submitted by the prime minister. The new government was sworn in on May 3, 2005.
- 8. **A TNA committee (comprising 55 members) is assigned to work on drafting a permanent constitution for Iraq** (as envisaged under the Transitional Administrative Law (TAL)). The draft constitution, which is expected to be finalized and approved by August 15, 2005, would be submitted to public referendum by October 15, 2005. If approved, elections for a new government under the constitution should be held by December 31, 2005.<sup>5</sup>
- 9. **Persistent violence continues to hamper economic and social recovery.** Although attacks on coalition forces have diminished to some extent, attacks on Iraqi civilians and security and police forces have escalated. The violence has deterred trade and investment flows. The lack of a secure environment has also impeded the effectiveness of reconstruction spending, with contractors and donors reporting security and insurance outlays in the range of 30–50 percent of total costs.

<sup>5</sup> The general referendum will be successful and the draft constitution ratified if a majority of the voters in Iraq approve and if two-thirds of the voters in at least three governorates do not reject it. The TAL allows for a one-time six–month extension of the August 15 deadline for submission of the draft constitution for approval by the TNA, if requested by the constitutional committee.

<sup>&</sup>lt;sup>6</sup> For example, to date, none of the foreign banks granted licenses in 2003 have started operations in Iraq.

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# C. Institutional and Administrative Capacity

- 10. **Iraq lacks a fully functional statistical framework.** The statistical information that the Iraqi authorities are able to provide to the Fund is only just adequate for surveillance purposes. While data on the oil sector, which comprises three-quarters of Iraqi GDP, is generally good and timely, there is very little information on non-oil economic activity or on the balance of payments. Consumer price data are available with relatively short lags, but the data do not cover the Kurdish region.
- 11. Timely and accurate assessments of the fiscal and monetary stance in 2004 and early 2005 has been problematic. This reflects a lack of progress in establishing proper financial management mechanisms and in developing adequate data reporting frameworks. Fiscal monitoring has suffered from long reporting lags and coverage gaps in data concerning transactions and balances of the Development Fund for Iraq (DFI), expenditure financed by letters of credit issued under the UN oil-for-food program (OFFP), current and capital spending financed by donors, and government balances in the banking system. In the monetary area, a full-fledged monetary survey (including deposit corporations) has yet to be completed. In the meantime, the Central Bank of Iraq (CBI) has had to assess monetary developments chiefly on the basis of its own balance sheet, which has not yet been prepared in line with internationally accepted accounting standards or audited in line with International Standards on Auditing (ISA).
- 12. The International Advisory and Monitoring Board (IAMB) was established on October 21, 2003, pursuant to United Nations Security Council Resolution 1483, for the purposes of overseeing audits of the operations of the DFI and oil export sales. Membership of the IAMB was expanded in June 2004 to include a member designated by the Government of Iraq. In its most recent review (May 2005), the IAMB has noted the audit report findings of evidence of major weaknesses in the administration of DFI resources and oil operations.<sup>7</sup>
- 13. The Fund continues to implement its off-site technical assistance work program for Iraq toward improving Iraq's administrative capacity. Over the past year, and in coordination with the World Bank and bilateral donors, Fund staff has provided advice on fiscal federalism issues, tax regimes for the oil sector, budget classification, public expenditure management, banking supervision, payment systems, macroeconomic statistics, and macroeconomic policy training (see Appendix I).

<sup>7</sup> These weaknesses include: (i) incomplete DFI accounting records; (ii) untimely recording, reporting, reconciliation and follow-up of spending by Iraqi ministries; (iii) incomplete records maintained by U.S. agencies, including disbursements that were not recorded in the Iraqi budget; (iv) lack of documented justification for limited competition for contracts at the Iraqi ministries; (v) unreconciled quantities of oil and oil products exported indicating a lack of control and possible misappropriation of oil revenues; (vi) non-deposit of proceeds of export sales of petroleum products into the appropriate accounts, and (vii) significant difficulties in

ensuring completeness and accuracy of Iraqi budgets and controls over expenditures.

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# **D.** Recent Economic Developments

- 14. Gross domestic product (GDP) is estimated to have rebounded by nearly 50 percent in 2004, driven mainly by the recovery of the oil sector (Table 2). Oil production expanded by 74 percent from 1.2 million barrels per day (mbpd) on average in 2003 to 2.0 mbpd in 2004 (although this is still below the pre-war production level of 2.5 mbpd and slightly below EPCA program projections). Non-oil GDP is estimated to have expanded more moderately in 2004, as lack of security, electricity shortages, and poor communications hampered the recovery in private sector activity. Some state-owned enterprises (mainly in construction and petro-chemicals) have reactivated production.
- 15. Consumer price inflation in the year to December 2004 reached 31.7 percent, compared with a projected 7 percent under the EPCA program. During the first half of 2004 prices were broadly stable, but inflation picked up sharply in August and remained high for the remainder of the year. This surge in prices appears to have been related primarily to supply shortages of key goods (gasoline and food) consequent upon the intensification of violence in the run up to the elections in January, 2005. After another large jump in January, prices fell from February through May as the supply of goods improved, and the cumulative increase for the first five months of 2005 was reduced to 4.7 percent. Year-on-year inflation in May 2005 was nonetheless still quite high at 33.9 percent, and well above the EPCA program objective of 15 percent for end 2005.
- 16. The fiscal deficit for 2004 was slightly larger than envisaged under the EPCA program (Tables 3 and 4). Oil export prices averaged \$31.6 per barrel in 2004, compared to \$30.5 per barrel assumed under the EPCA program, while oil export volumes were close to target, resulting in an additional ID1 trillion in oil export revenues in 2004 relative to the amount of ID25.3 trillion assumed in the program. While wage and pension outlays were slightly lower than budgeted for 2004, spending on goods and services was higher than under the budget (reflecting in part contractual commitments made by the Coalition Provisional Authority (CPA) prior to its dissolution and not included in the budget).
- 17. **Investment overall was in line with the budget, but grant-financed (non-oil) reconstruction expenditure in 2004 fell short.** Donors to the International Reconstruction Fund Facility for Iraq (IRFFI)—a two—window trust fund facility administered by the World Bank and the UN—deposited about US\$1 billion into this facility. Most of these funds have already been committed to reconstruction projects. Disbursements under these large projects will take place over a number of years, but in 2004 (the launch year) only about \$103 million was actually disbursed to finance projects. Moreover, the largest direct bilateral donor (the United States) reportedly spent about \$2.2 billion in 2004, but only two-thirds of these funds are estimated to have been spent in the domestic economy (and up to one-half of this was on

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<sup>&</sup>lt;sup>8</sup> GDP is believed to have halved between 1999 and 2003 (the year of the conflict).

<sup>&</sup>lt;sup>9</sup> The consumer price index does not cover the three Northern (Kurdish) Governorates.

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security). By contrast, investment in the oil industry (mainly financed out of the Iraq's own resources) was slightly higher than programmed.

- 18. The 2005 budget was based on a cautious oil revenue projection. Oil prices in 2005 were assumed to be only \$26 per barrel, significantly below what might have been expected based on the prevailing WEO projection when the program was designed (September 2004). Oil exports were projected to increase from 1.4 mbpd in 2004 to 1.8 mbpd. The budget also assumed that a start would have been made in reducing the domestic petroleum subsidy by the beginning of the year. Spending plans were constrained so as to ensure that the budget would be fully financed from revenues and available balances abroad (in the DFI and from the winding up of the OFFP).
- 19. Oil export revenues in the first five months of 2005 were broadly in line with the program, but only because lower oil export volumes were offset by higher oil prices. Oil export volumes in the first five months of 2005 remained at an average of 1.4 mbpd (the same as the average outturn in 2004 and well below the program target), while average oil export prices rose to \$36.4 per barrel. The increase in Iraqi oil prices during this period was significantly less than the increase in oil prices generally, reflecting a substantial widening of the price differential on Iraqi oil relative to world market prices. The differential relative to the WEO benchmark oil price (an average of Brent, West Texas, and Dubai) increased from \$6.4 per barrel on average in 2004, to \$13.4 per barrel in the first quarter of 2005, before narrowing to \$8.6 per barrel in April–May 2005. The reasons for these movements in the differential are not well understood. The authorities were able to provide an explanation for part of the change in the differential, but not for all of it. 10
- 20. Implementation of the EPCA commitment to increase domestic prices of refined oil products has yet to occur. Under the EPCA timeline, the authorities were supposed to have begun the adjustment of domestic prices by the end of 2004 (see Box 2). Gasoline prices in the black market have risen to very high levels recently, but the authorities continue to supply gasoline locally at heavily subsidized prices (about 1.3 US cents per liter of regular gasoline), including by importing these products at international prices (private imports of petroleum products are not permitted).

<sup>10</sup> Movements in the differential can be partly (but not wholly) explained by oil "spiking" which lowers quality, escalating freight cost clauses, increased perceived delivery risk, and temporary competition for sweeter crudes from U.S. refineries in early 2005 which depressed prices for more sour crudes from Iraq and Saudi Arabia.

#### Box 2. Iraq: Subsidies on Petroleum Products

Official prices for refined petroleum products sold in Iraq are set well below international prices. In addition to subsidizing sales from domestic production, the government imports petroleum products (\$3.2 billion in 2004) for sale domestically at subsidized prices. This results in a substantial loss of revenues for the budget, equivalent to nearly \$8 billion (or some 30 percent of 2004 GDP).

Iraq: Domestic Petroleum Product Sales Valued at Domestic and International Prices (volumes as of 2004, prices as of June 2005)

	-	, , , , , , , , , , , , , , , , , , ,					
	LPG	Gas	Gasoline		Diesel	Total	
		Regular	Premium				
Daily production (in millions of liters/cylinders) 1/	0.3	8.0	_	5.3	9.7		
	_						
Daily imports (in millions of liters/cylinders) 1/		-	11.0	3.1	8.2		
Daily consumption (in millions of liters/cylinders) 1/	0.3	8.0	11.0	8.4	17.9		
Official price (in ID per liter/cylinder) 2/	250	20	50	5	10		
Official price (in US cents per liter/cylinder) 2/3/ Price on international markets (in US cents per	16.7	1.3	3.3	0.3	0.7		
liter/cylinder) 2/	420	42.7	48.1	44.3	45.7		
Ratio of Iraq price to international price (in percent) Annual sales at official prices (in millions	4.0	3.0	6.9	0.7	1.5		
of US dollars)	20	39	134	10	44	247	
Annual sales valued at international prices (in billions of US dollars)	0.5	1.2	1.9	1.4	3.0	8.0	
Difference between total sales valued at official and international prices (in billions of US dollars)	0.5	1.2	1.8	1.3	2.9	7.8	

<sup>1/</sup> Based on 2004 figures.

21. The growth in reserve money supply in 2004 was rapid, but largely mirrored by the expansion in the CBI's external reserves. Reserve money in 2004 grew by 117 percent, exactly in line with the EPCA projection (Table 5). With the CBI prohibited from lending to the government, almost all the increase in reserve money derived from higher external reserves, reflecting dollar purchases from the government net of auction sales of dollars to the market. Currency in circulation increased at a slower rate (at 75 percent for the year, compared with the EPCA projection of 118 percent). The difference in the growth of the two measures of money was reflected in a large build up in banks' free reserves with the CBI.

<sup>2/</sup> As of June 2005. Comparable prices for a liter of regular gasoline (including tax) for countries in the region include 10 US cents (Iran), 50 US cents (Jordan), 145 US cents (Lebanon), and 46 US cents (Syria). 3/ Using an exchange rate of ID1500/dollar.

- 22. **The CBI has recently broadened its range of monetary policy instruments and tightened liquidity conditions.** 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. This initiative was influenced, in part, by a desire to mop up some of the banks' excess liquidity and thereby preempt pressures on prices and/or the exchange market. As of end-May, banks had deposited ID1.7 trillion in the dinar facility and \$540 million in the dollar facility. By end-March, reserve money growth had slowed appreciably to only 6 percent in the first quarter of 2005. On April 1, 2005, the CBI also reintroduced coverage of required reserves to include government deposits (which had been lifted in the context of the unification of reserve requirements that went into effect in November 2004). 12
- 23. Interest rates at the CBI's bi-weekly treasury bill auction averaged 4 percent in 2004, but rates began to rise in May 2005, reaching 7 percent by mid-June. The low rate of interest emerging from these auctions in 2004 was believed to relate to either (i) the high level of bank liquidity, or (ii) collusion between public sector banks so as to lower the government's funding costs. The increase in the interest rate in May/June could reflect the tightening of monetary conditions described above.
- 24. After appreciating in early 2004 following the new currency's introduction, the exchange rate of the dinar has been de facto pegged to the U.S. dollar since May 2004. The exchange rate has lately come under some pressure: while the volume of dollar sales at the daily CBI foreign exchange auctions was relatively stable during 2004 and early 2005 at about \$25 million per day, dollar sales increased sharply to about \$50 million a day from mid-April. The CBI responded to this sharp increase in sales by, on a few occasions, rationing the supply of dollars at auction.
- 25. External reserves held by the CBI grew strongly during 2004, ending the year at \$7.4 billion (net), well above the EPCA target of \$4 billion. Reserves increased further in January and February 2005, but fell back in March to \$7.7 billion. Reserves are estimated to have stayed around this level through end-May. The rise in dollar sales, and the relative stability of the CBI's reserves suggests that the growth in money demand is slowing—perhaps indicating a slowing rate of growth in the economy by comparison to 2004.

<sup>11</sup> The rate of interest on the dollar facility was increased to 2.5 percent on June 1, 2005. The rate of interest on the dinar overnight facility was raised to 5 percent on July 3, 2005, and new 14 day and 30 day deposit facilities were also introduced at this time, with interest rates of 6 and 7 percent respectively.

<sup>&</sup>lt;sup>12</sup> A planned restructuring of CBI claims on the government, which might have subsequently led to the creation of additional (marketable) monetary policy instruments, has been shelved pending a review of the proposal by the new minister of finance in light of a forthcoming audit of the CBI balance sheet.

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26. **The balance of payments is dominated by oil exports.** There is relatively little firm data on the balance of payments other than on oil exports, government imports of goods and services, and external reserves. There were large current account deficits in 2004 and 2005, reflecting high levels of imports related to reconstruction and recovery. These current account deficits were financed chiefly from assets held abroad, including in the DFI. An estimated balance of payments is shown in Table 6.

#### E. External Debt Management

- 27. On November 21, 2004, the Paris Club agreed to debt reduction terms for Iraq, equivalent to 80 percent in net present value terms (NPV), in three stages. The first stage comprised a 30 percent debt reduction and interest deferral on the outstanding balance and went into effect upon signing the agreement. The second stage will comprise a further 30 percent debt reduction and will go into effect upon approval of an upper credit tranche arrangement (expected by end-2005). The final stage will comprise an additional 20 percent debt reduction, and will follow completion of the IMF's Executive Board's final review of three years of one (or more) upper credit tranche arrangement(s).
- 28. With the first stage of debt reduction, Iraq's debt is still estimated to be some \$78 billion (reduced from \$114 billion pre-Paris Club), or the equivalent of three times GDP. Appendix IV shows that Iraq's debt will remain unsustainable in the absence of the additional stages of debt reduction envisaged under the Paris Club agreement.
- 29. The Iraqi Government has (with their legal and financial advisors) begun to engage with official creditors in line with the Paris Club agreement. The vast majority of Paris Club claims has now been reconciled. By contrast, the proportion of non-Paris Club official debt reconciled so far is still small. Negotiations with Gulf country creditors are being handled separately from other non-Paris Club official creditors. Discussions are also ongoing toward securing bilateral agreements, and all creditors will be expected to agree terms either equivalent to (or more favorable than) those defined under the Paris Club agreed minutes. <sup>13</sup>
- 30. The Iraqi authorities met with private creditors in Dubai on May 4, 2005. The authorities made clear their intention to apply Paris Club comparability in settling claims and adhere to the principle of equal treatment for all creditors. An official website has been created inviting private creditors to submit their claims. So far a total of about \$10 billion of claims have been submitted for consideration. The majority of private creditor claims (in value as well as quantity) relate to supplier credits. Some of the banks (which represent a much smaller group) have convened a "London Club Coordinating Group" to represent their interests, and have pressed Iraq to recognize this group as a separate entity.

<sup>&</sup>lt;sup>13</sup> The only bilateral agreement signed so far is with the United States (in November 2004), which granted Iraq 100 percent debt cancellation. A further five Paris Club members are very close to signing agreements. There is also agreement in principle with four of the 48 non-Paris Club creditors, and notable progress with another nine.

# F. Trade and Exchange Rate Regime

31. **Iraq maintains an open trade and investment regime** (Box 3). Iraq applies a 5 percent custom duty ("reconstruction levy") on imports, but there are many exemptions. According to the 2003 law on foreign direct investment, all sectors are open for foreign investment, except direct and indirect ownership of natural resources involving primary extraction and initial processing. Iraq otherwise permits 100 percent foreign ownership and provides equal treatment for domestic and foreign investors. Iraq's exports to the United States receive preferential treatment under the Generalized System of Preference (GSP). Iraq applied for WTO membership in 2004.

#### Box 3. Iraq: Trade and Investment Policies

Since April 2004, Iraq has applied a 5 percent custom duty ("reconstruction levy") on all imported goods except some commodities including food, medicine, clothing, and goods delivered as humanitarian assistance. Imports by coalition forces, nonprofit organizations, foreign governments, and foreign companies undertaking reconstruction projects in Iraq are also exempt.

In September 2004, Iraq submitted a formal request for WTO accession to the Director General of the WTO. In December 2004, the General Council of the WTO established a working party to examine the membership applications of Iraq. However, the working party has not yet met and Iraq has not yet submitted a Memorandum on the Foreign Trade Regime.

Regarding inward investment, Iraq permits 100 percent foreign ownership and applies equal treatment for foreign and domestic investors. Foreign investment may be made in any part of Iraq, and foreign investors may open trade representation offices and branches in Iraq. All economic sectors in Iraq are also open for foreign investment, except direct and indirect ownership of natural resources involving primary extraction and initial processing. Foreign investors involved in the retail sector are required to deposit US\$100,000 in a non-interest-bearing account at an Iraqi bank for the duration of the retail activity. Foreign investors may hold long-term and renewable leases of real property, but not ownership.

32. **Iraq maintains a broadly liberal exchange regime in practice**, though (as noted above) it is unclear whether there remain any exchange restrictions in the regulations subject to Fund jurisdiction. The authorities confirmed that a number of exchange regulations (dating from the previous regime) that might constitute restrictions are no longer enforced, although these regulations have not been formally revoked. Box 4 summarizes the staff's findings on the current practice in foreign exchange arrangements.

## G. Structural Reform

33. Implementation of structural benchmarks specified in the EPCA program has been delayed relative to schedule (Table 8). Reforms related to the development of a functioning payments system, the full implementation of a financial management information system (FMIS), and the establishment of an automated payroll system, are likely to take

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considerably longer than originally expected. This is due to the continuing lack of security, communications problems, and the need to tailor the required systems to the circumstances of Iraq. Nevertheless, progress has been made with Fund staff assistance in developing a monetary survey, drafting a new payments system legislation, and improving the banking regulatory framework.

# Box 4. Iraq: Foreign Exchange Arrangements 1/

**Exchange arrangements:** the currency of Iraq is the Iraqi dinar, with an exchange rate determined in the foreign exchange market; auctions are held daily, and eligible bidders may buy and sell foreign exchange at freely determined rates; all final transactions are allocated at a single settlement price.

**Payments and receipts:** settlement can be made in any convertible currency; there is no control on the use either dinar or foreign currency for transactions in Iraq; there are no bilateral and regional payment arrangements; payments to and receipts from Israel are prohibited.

Controls on trade in banknotes: Iraqi citizens may take out of the country up to 100,000 dinars in dinar banknotes and up to \$10,000 in foreign currency notes; foreigners may take out foreign currency up to the amount they declare when they enter Iraq; both Iraqis and foreigners may bring in foreign currency banknotes (except Israeli currency) in unlimited amounts, provided that they declare it; amounts not intended to be taken out of the country are exempt from declaration.

**Resident and nonresident accounts:** residents and non-residents are allowed to open foreign currency accounts at commercial banks and use balances in these accounts without restriction; non-residents are allowed to open domestic currency accounts.

**Payments for current and capital transactions:** there is no restriction on payments as long as underlying transactions are supported by valid documentation.

1/ Information on practice collected during policy discussions with the authorities. Some regulations and laws may exist which, although not enforced, comprise restrictions.

34. Budgetary management remained weak in 2004, although some improvements have been made in 2005. In 2004, the ministry of finance began to receive reports on budget outturns from line ministries and treasury branches in governorates, although the reporting lag is still more than three months. The continuing problems in large part reflect the fragmentation of fiscal operations (Box 5). Fiscal monitoring and execution in 2004 suffered from the multiplicity of DFI subaccounts, limited reporting by donors on their spending, and budget reallocations toward security spending made outside the budgetary process in the last quarter of 2004. From 2005 onwards the authorities are committed to approve additional spending only in the context of a supplementary budget. Is

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<sup>&</sup>lt;sup>14</sup> A modern financial management law was adopted in 2004, but implementing regulations still need to be introduced.

<sup>&</sup>lt;sup>15</sup> Some limited allowances for hazard duty were approved outside of the budget in early 2005.

# Box 5. Iraq: The Fragmentation of Iraq's Fiscal Accounts

Iraq fiscal operations comprise the following:

The government's official budget: this covers recurrent and capital spending in Iraq's 18 governorates, though the Northern governorates allocate their spending autonomously and send only limited reports on their budget outturns to the central government. The budget is financed by tax and non tax revenues and by Iraqi assets held in the *Development Fund for Iraq* (DFI), an account managed by the Central Bank of Iraq at the New York Federal Reserve on behalf of the Iraqi Ministry of Finance. The DFI receives Iraqi assets frozen abroad during the period of sanctions, outstanding balances from the oil-for-food program, and 95 percent of Iraq's oil export sales (the other 5 percent are used for the payment of war reparations to Kuwait).

Spending made by the United States Government out of the DFI: in the second half of 2004 and 2005 the U.S. continued to be responsible for (mostly capital) spending financed from two DFI subaccounts, the "vested" account to which Iraqi assets previously frozen in the U.S. had been transferred in late 2003, and the "transaction" account created on June 28, 2004, (pursuant to United Nations Security Council Resolution 1546) to finance contractual commitments made by the CPA, and replenished by funds transferred from the main DFI account. The U.S. is also in charge of spending financed by cash assets "seized" from the Saddam Hussein regime in April 2003.

Letters of credit (LCs) issued under the oil-for-food program managed by the UN: these LCs are fully financed by proceeds of past oil exports sequestered in a bank account at the Banque National de Paris. If LCs expire before they are executed, the funds are to be transferred to the UN treasury account in New York, and from that account to the DFI.

**Expenditures financed by donors:** these include bilateral and multilateral grants to Iraq, in particular: (a) U.S. assistance to Iraq which is either disbursed abroad in U.S. dollars or paid directly in U.S. dollar bank notes in the country to finance investment projects as well as wages, goods, and services; and (b) other donor assistance which is paid directly to suppliers abroad, or to correspondent banks of Iraqi banks. The sums are then transferred directly to the individual ministries' accounts. The Iraqi Strategic Review Board, which is chaired by the ministry of planning, has been assigned the responsibility of coordinating these programs with the Iraqi budget, but has received limited reports from donors, who have often dealt directly with individual ministries. The Transitional Government is reassessing its donor coordination strategy.

Operations of oil-related state-owned enterprises not included in the budget: these cover mainly domestic oil sales which finance oil-sector operating expenditures.

# H. Banking Sector Issues

- 35. Iraq's banking system is barely functional, with weak institutions and little financial intermediation. Iraq's banking system comprises the CBI and 26 chartered banking institutions:
- Two state-owned commercial banks (Rafidain and Rasheed) account for over 90 percent of commercial banking assets and 75 percent of the branch bank network. These banks are heavily overstaffed, and staff skills are weak;

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- Four specialized, state-owned banks serving the agriculture, industry, real estate, and social sectors, respectively;
- 19 private commercial banks; and
- A trade bank established in the aftermath of the war to provide U.S. dollar letters of credit for imports.
- 36. The banking system in Iraq reportedly has the equivalent of only around \$2 billion in aggregate assets (about 7 percent of GDP), and is undercapitalized. Most of the banks' assets are in the form of treasury bills. These features underscore the marginal role played by this sector in the past either as a financial intermediary for the private sector or as a store for financial savings. The banks' loan portfolio is very small and bank staff do not have the expertise needed to offer appropriate credit facilities or assess the risks involved.
- 37. **The payment system in Iraq is outdated and lacks an appropriate technical infrastructure.** The banking sector is unable to process payments electronically and has a rudimentary check clearing system. <sup>16</sup> Businesses tend to settle large payments in cash, while households have no incentive to use the banking system other than to hold savings. The CBI is in the process of trying to modernize the payment infrastructure.
- 38. Banks are subject to both on-site (security permitting) and off-site supervision. The CBI has been receiving technical assistance from the IMF and the World Bank as well as other governments, mainly focusing on introducing best supervisory practices and for moving from a rule-based to a prudential-based system. Prudential regulations are in the process of being revised.
- 39. Iraq adopted modern central bank, commercial bank, and anti-money laundering (AML) laws in 2004. Related implementing regulations are in the process of being finalized.

#### III. REPORT ON THE DISCUSSIONS

40. The discussions with the authorities were productive, and there was a considerable convergence of views on many issues. The discussions were conducted in the special circumstances defined by the transitional nature of the present government, by the evolving political situation and ongoing preparation of the constitution, and by the continuing insurgency. Despite some continuing problems with data provision (due to long lags in their production), the mission received just sufficient data to allow staff to prepare an adequate assessment of the economic situation and the current economic policy stance.

<sup>&</sup>lt;sup>16</sup> Anecdotal evidence suggest that while checks in Baghdad could take up to 10 days to be cleared, those outside Baghdad could take as much as a month.

41. The two issues that currently confront the authorities and which dominated the discussions concerned (i) the possibility of (unfunded) spending increases in the 2005 budget and (ii) recent pressure on the exchange rate. Because of (inter alia) delays in raising domestic petroleum prices (originally slated for end-2004 in the EPCA program), an incipient financing gap is emerging for the 2005 budget. In addition, pressures are mounting for additional fiscal spending (to be included in a supplementary budget) without sufficient identified funding. Perhaps reflecting political uncertainty and increasing security concerns, the exchange rate has been under pressure since late April. CBI sales of dollars at the daily auction have increased, but the CBI has also intensified the screening of bids prior to auction and occasionally rationing the supply of dollars offered at the auction cut-off price.

#### A. Macroeconomic Framework for 2005

- 42. The authorities and staff agreed on an updated short-term outlook, with real GDP growth in 2005 revised down to 4 percent (from 17 percent in the program). This reflects downward revisions to oil production, now expected to reach only 2.0 mbpd in 2005 (compared with an original program goal of 2.4 mbpd) because of the continuing sabotage of installations and the resulting halting of oil exports from the north (amounting to 0.3 mbpd).
- 43. The inflation projection for end-2005 has been revised up to 20 percent (compared with a goal of 15 percent under the EPCA program). Although there has been some easing in inflationary pressures in the first half of 2005, supply shortages could resume in the second half. The reconstruction program may also continue to put upward pressure on (mainly nontraded) goods prices. The authorities believe that there could also be some upward effect on prices if there were to be adjustments to domestic petroleum prices.
- 44. The authorities agreed that a large fiscal financing gap could emerge in the second half of 2005. In line with lower production, oil export volumes for 2005 as a whole have been revised down to 1.4 mbpd on average (from 1.8 mbpd under the program). This shortfall in exports is expected to be offset by higher than programmed oil export prices—oil prices are projected to be \$36 per barrel (close to the average actually observed in the first five months of 2005). But fiscal revenues in 2005 have also been adversely affected by the delay in raising official domestic prices of petroleum products. This measure was supposed to have raised the equivalent of \$1.0 billion in the EPCA program, and \$1.5 billion in the approved Iraqi budget. If oil export prices turn out higher than programmed (because for example, the Iraqi oil price differential returns to a more normal level), it is possible that this gap could be closed without additional measures. But the authorities were persuaded that some corrective action may be needed, including in the context of a supplementary budget.
- 45. The authorities are contemplating a possible supplementary budget for 2005, although the details remain to be worked out. The minister of finance is giving serious consideration to including some significant upward adjustments to the prices of oil products

as part of this budget in order, inter alia, to raise revenue.<sup>17</sup> The staff pressed the authorities to raise prices of domestic oil products, both to remove a damaging economic distortion and restore fiscal viability. The authorities concurred, while noting that this was a politically difficult step to take and would require a well crafted public education campaign. However, the budget is also likely to incorporate a number of additional spending commitments. This additional spending could offset or even exceed the budget's revenue measures for 2005. The authorities may have to reallocate spending within the existing budget allocation. The authorities agreed with the staff that it was important that any additional spending commitments be fully funded by government revenues or from liquidation of government assets held abroad (including from seized or frozen assets). The minister of finance affirmed his intention to respect the "no-overdraft" rule and avoid recourse to financing from the CBI.

- 46. The authorities shared the staff's concerns about exchange rate pressures that have emerged since late April. Following the large increase in net international reserves achieved in 2004, the accumulation of reserves has been much smaller so far in 2005. The monetary projection for 2005 that was discussed with the authorities suggests that reserves might increase by an additional \$1.7 billion in 2005, but the increase in the five months through end-May is only about \$0.5 billion. The full year projections might be hard to achieve if the daily sales of dollars at auction stay as high as \$50 million (compared to the more usual \$25 million recorded during 2004 and early 2005). 18
- 47. The CBI has sought to reduce dollar sales by screening out bids on grounds of their origination from crime or money laundering, and have occasionally rationed the supply of dollars at the cut-off price. The CBI regretted the rationing, observing that it had occurred on only a few occasions. They noted staff concerns that rationing could undermine market confidence, as well as constitute an exchange restriction. The staff also cautioned against misusing screening for criminal activity as an exchange control device. The staff urged the authorities to satisfy the demand for dollars in full, since reserves were at comfortable levels. The authorities agreed with the staff that the defense of the exchange rate could be bolstered by raising dinar interest rates in addition to selling dollars.
- 48. The authorities wondered whether the increase in demand for dollars might emanate from increasing dollarization in certain regions. Dollarization is believed to be extensive in Iraq (though it is hard to measure), and has been exacerbated by the practice of key donors (the United States) of paying local contractors and employees in U.S. dollars

<sup>17</sup> The details of the adjustment of domestic petroleum product prices remain to be worked out, but such a plan could include substantial upward adjustments for regular and premium gasoline. Private importation of the latter could also be liberalized, enabling the government to gradually withdraw from supplying this segment of the market (there is no domestic production of premium gasoline, which the government must currently import and sell at a loss). The authorities recognize that efforts to compensate consumers for higher petroleum prices would be hard to implement or target effectively and could potentially be very costly.

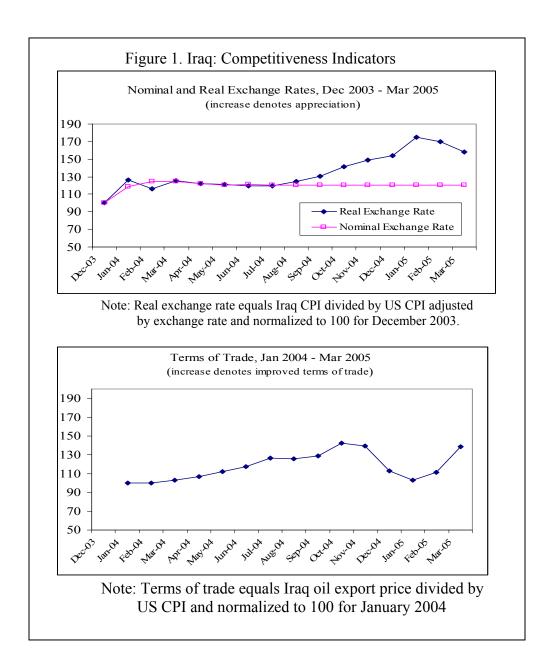
<sup>&</sup>lt;sup>18</sup> The government is expected to sell (from its oil revenues) an average of around \$35 million per day to the CBI to finance its domestic spending in 2005.

rather than Iraqi dinars. Efforts are underway to reorient the denomination of donor spending toward the Iraq dinar.

49. The CBI has been considering the advantages and disadvantages of moving to a more flexible exchange rate system. It was noted that the fixed exchange has not ensured price stability, though it was accepted that some real appreciation of the exchange rate may be the inevitable consequence of reconstruction spending and economic recovery (Figure 1). The staff cautioned the authorities against premature abandonment of the peg, and noted that if the authorities were to decide to depart from the existing de facto peg, they would need to develop an alternative nominal anchor to guide monetary policy, so as to maintain price stability. A flexible exchange rate regime would also imply a need for (i) an appropriate intervention and reserve management policy, (ii) the development of a true foreign exchange market, and (iii) a strengthened capacity of commercial banks and companies to manage exchange risk.

#### **B.** Structural Reforms

- 50. The authorities agreed on the need to strengthen budget management. They expressed their intention to prepare consolidated government accounts (including donors' operations) toward improving understanding of the impact of fiscal operations in Iraq. The staff advised that budget appropriations should be set close to the expected outcome to limit the need for supplementary budgets, and to cast the budget in a medium-term framework.
- 51. The authorities expressed their determination to combat corruption and improve governance. In particular, the authorities indicated their intention to make substantial savings by scrutinizing procurement processes. They also planned to operate oil-related state-owned enterprises on a commercial basis. The staff underscored the need to ensure transparency in accounting for oil revenues by continuing to have an international accounting firm audit proceeds of oil export sales and DFI operations. Regarding the recommendations of the IAMB, the authorities commented that Iraqi inspectors now routinely checked the quantities of oil loaded at each of the seven export points and that leakages were mostly the result of saboteurs. They agreed that oil metering would be an important aid to oil accounting, but said that efforts to install meters were being hampered by the ongoing security situation.
- 52. The authorities agreed with the staff that there was a need to press forward with improving public financial management. The staff encouraged the authorities to adopt a chart of accounts compliant with international (GFSM) standards for the preparation and execution of the 2007 budget, and to introduce a new FMIS and automated payroll system in due course. The authorities shared staff concerns about "ghost workers" and the need for a payroll survey (for which the World Bank has offered technical assistance).



53. The authorities are determined to improve the functioning of the financial system, with a strong focus on capacity building. A detailed plan to implement a real time gross settlement (RTGS) system and an automated clearing house (ACH) by early 2006 has been developed. The CBI also intends to implement a check-clearing system and is drafting rules and regulations to form the basis for a modern regulatory framework. As regards financial data, progress has been made in compiling monetary data for the depository corporations in accordance with the methodology of the 2001 Monetary and Financial Statistics Manual (MFSM). The CBI intends to implement a revised reporting form for the commercial banks with sectorization and classification consistent with the MFSM and to compile a preliminary depository corporations survey by September 2005.

- 54. The authorities are looking at ways to develop the banking sector and allowing greater competition, but are cautious about the scope and speed of the restructuring of state-owned banks. Proposals being considered include the restructuring of the Trade Bank of Iraq to undertake commercial and possibly investment banking functions, inviting foreign participation in Rafidain and Rasheed banks, amalgamating the four smaller and specialized banks into two regional development banks, and setting up Islamic banks.
- 55. The authorities are keen to implement a deposit insurance scheme to foster financial stability. However, they agreed with the staff that they should not proceed too quickly in implementing an insurance scheme, bearing in mind the need to improve regulation and supervision and to improving the condition of the state-owned banks (before restructuring or privatization) prior to implementation. Modalities relating to the funding for the scheme, membership, and the level of coverage are being discussed.
- 56. Over the medium term, the authorities intend to implement international accounting and auditing standards, and improve disclosure requirements. The authorities expressed an interest in completing the AML/CFT questionnaire, but noted that this may have to wait until the operational instructions of the AML law are finalized.
- 57. The CBI has requested tenders from international auditors to audit its accounts in line with International Standards on Auditing. The deadline for tenders (originally set for end-June) has been extended to end-July and the audit could be underway shortly thereafter. Completion of this audit should contribute toward the IMF safeguards assessment process. The authorities are also in the process of providing other materials requested by staff in connection with the safeguards assessment, and have appointed one of the deputy governors as a liaison officer for this exercise. Progress in this area would be a key consideration for Iraq's possible use of Fund resources under a future stand-by arrangement.

#### C. External Debt

- 58. The authorities indicated that they are making progress in reconciling external debt claims and reaching tentative bilateral agreements in line with the Paris Club agreement. The staff acknowledged that progress with Paris Club creditors was generally good, but urged the authorities to press ahead in reconciling non-Paris Club claims, especially with Gulf countries, as these were much larger in total than those of the Paris Club. The staff suggested that the Iraqi authorities approach these creditors directly, as well as via their legal and financial advisers.
- 59. The authorities said that their advisers had followed up on the Dubai meeting with private creditors with further meetings with private creditors and creditor representatives. They noted that they were looking at the possibility of offering a menu of options to private creditors with a view to providing flexibility while at the same time adhering to the principle of comparability of treatment with the Paris Club. The authorities recognized the importance of complying with the Fund's policy on lending into arrears should the country enter into a stand-by arrangement with the Fund. They understood the

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importance for Iraq to be acting in "good faith" in its discussions with private creditors, even though it may take time for their claims to be resolved.

# D. Medium-term Prospects and Vulnerabilities

- 60. Iraq's medium term economic outlook appears satisfactory as long as the expansion in oil production proceeds without undue interruption and world oil prices remain at favorable levels (Tables 2–4, and 6). Such a prognosis also assumes that Iraq's reconstruction is undertaken relatively smoothly, that security is progressively restored, and that the political transition goes forward as planned. The medium term scenario was discussed with the authorities. They accepted, however, that there are considerable downside risks to the scenario, particularly as oil prices are subject to a great deal of uncertainty, the insurgency could continue unabated for some time, and the political transformation of Iraq is still ongoing.
- 61. Overall GDP growth is expected to reach 17 percent in 2006 and then decline **slowly to 7 percent by 2010.** The recovery in economic growth is predicated upon a resumption in the expansion of oil production to 2.4 mbpd in 2006 (following stagnation in 2005), and to 3.5 mbpd by 2010. Non-oil real GDP growth is projected to remain strong throughout the period, sustained by high levels of (mostly public) investment. Inflation is expected to fall to single digits over the medium term as shortages end and upward pressure on prices from reconstruction slowly eases.
- 62. The fiscal position over the medium term should be sustainable provided the authorities contain the growth of recurrent expenditures and revenues do not fall. While financing gaps exist for both 2005 and 2006, thereafter they largely disappear. However, the scenario reveals little room for maneuver, and no space for slippages in fiscal discipline or a deterioration in oil prices.
- 63. The fiscal revenue forecast depends crucially on oil price projections. Iraqi oil prices have been based on WEO oil price projections, adjusted downward by \$7 per barrel on average to reflect transportation costs and quality factors specific to Iraqi oil, and by an additional discount of \$4.5 per barrel to account for the uncertainty related to the WEO projections. 19 The scenario assumes that the existing subsidy of domestic petroleum prices is maintained. This is not, however, a policy recommendation. The absence of any buffer to protect the scenario from adverse developments and shocks highlights the importance of taking action to raise domestic petroleum prices in order to establish the necessary fiscal margin to make this scenario robust. The EPCA program envisaged a phased elimination of the subsidy over a five year period ending in 2009. By way of illustration, under this plan,

<sup>&</sup>lt;sup>19</sup> The adjustment factor of \$4.5 dollars per barrel is equivalent to one standard deviation in the variation of monthly oil prices over the past 20 years. This downward adjustment to allow for uncertainty was also made to staff projections for the medium term scenario prepared in conjunction with the staff report for the Iraqi request for EPCA (IMF Country Report 04/325) in September 2004.

revenues would have been \$1 billion higher in 2005 and \$3.5 billion higher in 2006. 20 This would have covered a large part of the financing gap that has since emerged for 2005, and more than covered it for 2006 (although this does not take account of additional spending that may be included in a supplemental budget). The scenario does not assume any additional tax measures. However, the authorities are considering converting the temporary 5 percent reconstruction levy on imports into a permanent import duty of 10 percent, and strengthening customs collection by the creation of bonded zones with neighboring countries.<sup>21</sup> Other new taxes and duties could also be introduced starting in 2006.<sup>22</sup>

- 64. The scenario assumes that efforts are made to contain recurrent spending, while allowing sufficient room for investment and reconstruction. The staff stressed the need to keep the wage and pension bill at around 12 percent of GDP from 2006, and to reduce the share of transfers over the medium-term. The authorities noted that they were considering reducing the number of non-essential commodities in the commodity distribution system as an expenditure saving measure. They also stressed that Iraq needed to develop an adequate safety net system over the medium term, preferably cash-based. The staff cautioned that a safety net should be targeted. The authorities noted that there may be pressures to increase transfers to regions and provinces if spending responsibilities are devolved in the forthcoming constitution.<sup>23</sup> They also indicated their plan to restructure and privatize some of the state-owned enterprises over the medium term but noted that this might require some additional financial support in the next couple of years. If oil revenues prove in the end to stronger than projected in this scenario, the staff would encourage the authorities to prioritize these additional resources in favor of reconstruction investment, and/or to help meet budgetary needs in future years (per their commitment in the EPCA program).
- 65. The balance of payments is projected to improve over the medium term as oil exports grow and imports related to reconstruction stabilize. The balance of trade, in substantial deficit in 2005, is expected to move into comfortable surplus by 2007. The projection for the current account presumes only the first stage of debt relief (per the Paris Club agreement), so that accrued interest remains a large item throughout the medium term and keeps the current account in deficit.<sup>24</sup> If the second and third stages of debt relief were to

<sup>&</sup>lt;sup>20</sup> See IMF Country Report 04/325.

<sup>&</sup>lt;sup>21</sup> Although the reconstruction levy allows a number of product exemptions (e.g., food, medicine, and clothing) which should be rationalized, other reasons for the relatively low revenue take from this levy include (i) poor enforcement and administration, and (ii) the exemption of imports by donors and coalition forces.

<sup>&</sup>lt;sup>22</sup> The minister of finance is considering the adoption of a surcharge on trucks entering Iraq, a 10 percent additional tax on profits of cell phone companies, license fees for cars and weapons and charges for work permits for foreign workers, and special visas for visitors of shrines.

<sup>&</sup>lt;sup>23</sup> There are a number of different federal models that could emerge in the constitution, including a unitary state, a state with a semi-autonomous Kurdish sector, and a federal system with regional or provincial autonomy. Within these models there are overlapping issues of revenue sharing or grant allocation.

<sup>&</sup>lt;sup>24</sup> The scenario assumes treatment for all creditors (including private) comparable to the Paris Club.

go forward as scheduled, then the current account position would improve significantly (and would be approximately balanced by 2010).

#### IV. STAFF APPRAISAL

- degree of macroeconomic stability, and initiated some structural reforms, despite extremely difficult circumstances. But there is still much to be done, and plenty of scope for the economy to derail before it has really started its recovery and transformation into a growing market-based economy. The authorities will need to remain vigilant to protect the economy from macroeconomic imbalances, whether from spending pressures, revenue shortfalls, or monetary developments. The authorities should also be encouraged to accelerate the momentum of reform, and to ensure continuity in policy (to the extent possible) despite the transitional nature of the government.
- 67. **Iraq faces enormous challenges in reconstructing its economy over the medium term.** Iraq's social indicators have deteriorated significantly over the past quarter century, reflecting the decline in its infrastructure, persistent economic mismanagement, and three devastating wars. Rebuilding Iraq's economy and restoring the health and welfare of its people will place significant demands upon the country's resources. The authorities will therefore need to ensure that these resources are prioritized appropriately, and that recurrent spending, particularly on wages, pensions, transfers, and non-essential projects, are kept under control.
- 68. The staff is concerned that pressures are mounting for additional (mainly recurrent) spending without sufficient identified funding. The authorities are urged to pursue a cautious fiscal stance by continuing to observe the no overdraft rule, to aim at a spending level in 2005 that can be financed within the available resource envelope (including expected oil revenues, domestic revenues, (liquid) funds held abroad, and external grant resources), and to avoid the accumulation of arrears. In this context, any agreements between the central government and governorates regarding revenue sharing and assumption of spending responsibilities should pay close attention to safeguarding macroeconomic stability and should establish a comprehensive fiscal reporting system to permit adequate fiscal monitoring.
- 69. The staff urges the authorities to quickly reduce government subsidies for petroleum products. Such action will not only alleviate damaging market distortions but will also generate additional resources for the budget—resources which currently accrue to black market dealers and smugglers. A substantial reduction of the petroleum subsidy will be critical both to help close the emerging financing gap under existing policies, and also help finance such additional spending as may be included in the supplementary budget.
- 70. The authorities' reliance on exchange rate stability as a framework for monetary policy has served them well. Although there has been an appreciation of the real exchange rate—reflecting Iraq's relatively high inflation rate—some of this will be unwound

by the recent fall in the price of commodities earlier subject to shortages. However, the recent significant increase in the amount of dollars demanded at the CBI's daily dollar auction over the past two months—which the CBI has not always satisfied in full—may signal a weakening of demand for the dinar. It is too early to say whether these pressures will be sustained or warrant a reconsideration of the monetary policy framework. The staff recommend that the authorities continue to support the exchange rate peg to the dollar.

- 71. The staff urges the CBI to fully satisfy dollar demand at the auction cut-off rate, and avoid resort to administrative measures to limit the amount of dollars sold. The CBI's external reserves are more than adequate at present levels (and well above the net international reserves objective specified in the EPCA program). The CBI therefore has plenty of room to deploy its reserves in defense of the exchange rate. Use of reserves in this way will automatically tighten the dinar money supply. Screening and rationing will quickly result in the development of a parallel exchange rate more depreciated than the official rate, and this in turn will compound the market's demand for dollars. Staff are seeking additional information related to the foreign exchange auctions to determine whether they give rise to exchange restrictions or multiple currency practices subject to Fund jurisdiction.
- 72. The staff recommends that the CBI raise dinar interest rates to bolster the defense of the exchange rate. If the CBI is reluctant to use its dollars to reduce the dinar money supply, then it must drain liquidity using the dinar deposit facility (the only domestic monetary instrument presently at its disposal). The CBI has guidance from the recent treasury bill auction, where interest rates have risen to 9.9 percent, by comparison to a dinar deposit rate of 5 percent (increased from 4 percent on July 3, 2005).
- 73. The staff urges the authorities to push ahead with their reform program. The reforms identified in the program supported by EPCA have been extensively delayed, partly because of the continuing security problems. There is a good deal of catching up to do. Looking ahead, the authorities' reform agenda should focus on: developing a strategy for restructuring the state banks and other state—owned enterprises (including those in the oil sector); preparing an overall restructuring plan for the oil sector, including by reviewing the fiscal framework governing the sector; formulating a strategy for the reform and monetization of the in-kind social safety net (public distribution system (PDS)) in parallel with the reform of the payments system; and modernizing prudential banking regulations and the supervisory framework.
- 74. The staff encourages the authorities to bolster the budget execution process and financial management efforts. In this regard, the staff urge the authorities to fully account for the operations of the Development Fund for Iraq (DFI) and to publish the DFI accounts on a monthly basis. The staff underscores the need to ensure that the Financial Management Information System (FMIS), which is being developed with foreign assistance, addresses properly the financial management needs of Iraq and is done in line with the GFSM compliant chart of accounts. In addition, the staff encourages the authorities to adopt implementing regulations for the financial management law in the area of budget preparation. The staff also encourages the authorities to take steps to establish a roster of government

employees, and eventually develop an automated government payroll and human resource management system; and to strengthen other key areas of public financial management including debt management.

- 75. The staff urges the authorities to strengthen governance and the management of oil sector operations. The staff underscores the need to implement without delay the recommendations of the IAMB, particularly the metering of oil production and strengthening of internal controls and audit in ministries.
- 76. The staff welcomes the authorities' intention to establish a liberal foreign trade and exchange regime. At the present time, it is not possible to make a determination whether or not any restrictions exist that might fall under Fund jurisdiction. As a result, it is not possible to determine whether a decision under Article XIV is required, though Iraq continues to avail itself of the transitional arrangements under Article XIV, Section 2. The authorities should review and overhaul their legislation and regulations to remove any such restrictions. As and when they are confident that all such restrictions have been removed, they can move forward toward acceptance of Article VIII, Sections 2, 3, and 4.
- 77. The staff welcomes the recent steps taken by the CBI towards seeking the appointment of an international auditor to conduct an audit of its operations. Such an audit will help facilitate the IMF's safeguards assessment process, without which it would not be possible for Iraq to enter into a stand-by arrangement with the Fund. This audit will also be useful for the CBI's assessment of its balance sheet, and help guide consideration of the restructuring of CBI claims on the government.
- 78. The staff underscores the need to agree debt rescheduling terms for non-Paris Club and private creditors comparable to those recently agreed with Paris Club creditors in order to reach bilateral agreements as soon as possible. The staff welcomes the intentions of the authorities to proceed in good faith toward the resolution of its external debt arrears, including by taking all necessary steps to enter into a constructive dialogue with all creditors, and consulting with the Paris Club with respect to comparability of treatment.
- 79. The staff believes that the medium term economic outlook for Iraq is satisfactory provided the expansion in oil production goes according to plan and world oil prices remain favorable. There are, however, significant downside risks to this favorable medium-term outlook, particularly as oil prices are subject to a great deal of uncertainty and the political transformation of Iraq has not reached its conclusion. The staff therefore believe that it would be important to bolster this scenario with additional revenue measures, particularly by raising the prices of domestic petroleum products.
- 80. The staff notes the authorities' desire for Iraq to enter into a stand-by arrangement by the end of 2005. Progression to a stand-by arrangement would help underpin a sound macroeconomic framework for the continuation of Iraq's reconstruction and recovery, as well as pave the way for Iraq to move forward to a sustainable external debt situation under the terms of the Paris Club. The staff urges the authorities to build on their

track record of policy implementation by continuing to follow the program supported by EPCA, with an urgent focus on improving the flow of timely and reliable data (especially the fiscal accounts), auditing the CBI according to International Standards on Auditing, and implementing a plan to significantly increase domestic petroleum prices.

81. The staff recommends the next consultation to be held on the standard 12 month cycle.

Table 1. Iraq: Social Indicators (Most recent estimate-latest year available, 1998–2004)

	Iraq	Middle East and North Africa	Lower middle income
Life expectancy at birth (years)	61	69	69
Infant mortality (per 1,000 live births)	102	37	30
Child malnutrition (in percent of children under 5)	12		11
Access to an improved water source (in percent of population)	81	88	81
Literacy (in percent of population age +15)	65	35	13
Gross primary enrollment (in percent of school-age population)	99	95	111
Male	109	98	111
Female	89	90	110
Population, mid-year (in millions)	27.1	306	2,411
Urban population (in percent of total population)	67	58	49
Population (average annual growth in percent, (1998–2004)	2.8	1.9	1.0
Labor force (average annual growth in percent, 1998–2004)	2.4	2.9	1.2

Sources: UNDP and World Bank estimates.

Table 2. Iraq: Selected Economic and Financial Indicators, 2004–10

	200-	4	200	)5	2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev.Proj.			ed projection		
Economic growth and prices									
Nominal GDP (In millions of US\$)	21,132	25,539	24,295	29,341	39,003	45,203	51,389	55,318	60,306
Nominal GDP per capita (In US\$)	780	942	870	1,051	1,357	1,528	1,690	1,771	1,882
Nominal GDP (In billions of ID)	31,698	37,287	36,442	44,011	64,177	80,135	96,365	108,711	121,879
Real GDP (percentage change)	51.7	46.5	16.7	3.7	16.8	13.6	12.5	7.8	7.2
Oil production (In mbpd)	2.1	2.0	2.4	2.0	2.4	2.8	3.1	3.3	3.5
Iraq oil export prices (US\$/bbl)	30.4	31.6	26.0	36.0	40.5	39.8	38.8	38.5	38.5
Differential between Iraq export prices and WEO prices (US\$/bbl) 1/	6.8	6.1	11.3	12.7	8.0	7.5	7.0	6.5	6.0
Domestic consumer price inflation (year-on-year)	7.0	32.0	15.0	20.0	12.0	10.0	8.0	7.0	5.0
GDP deflator	15.0	3.2	-1.5	13.8	24.8	9.9	6.9	4.7	4.6
Libor (In percent)	1.6 1,500	1.6	4.3 1,500	4.3	5.5	5.5	5.5	5.5	5.5
Exchange rate (ID/US\$)  Population growth	3.0	1,460 3.0	3.0	3.0	3.0	2.9	2.8	2.7	2.6
National Accounts Gross domestic investment	34.9	26.6	44.8	(In pe 37.1	rcent of GDP 30.8	') 30.7	30.5	31.1	29.1
Of which: public	26.4	22.3	37.4	31.8	26.0	25.8	24.5	24.2	22.1
Gross domestic consumption	91.2	97.0	90.7	99.6	85.5	75.9	72.3	68.3	69.6
Of which: public	50.5	56.8	45.2	61.5	49.2	41.1	37.6	33.8	33.0
Gross national savings	17.0	-10.4	26.6	6.9	18.6	21.9	21.5	22.1	21.8
Of which: public	-16.4	-42.2	9.7	-0.7	1.6	4.7	2.9	2.1	0.4
Public Finance			(In n	ercent of GDP,	unless other	wise indicate	d)		
Government revenue and grants	90.6	80.5	97.7	87.7	88.0	81.9	76.3	72.4	70.9
Government oil revenue	79.5	70.1	78.0	65.1	70.3	71.4	71.1	70.1	68.6
Government non-oil revenue	1.4	1.3	2.1	2.5	2.0	2.0	2.1	2.2	2.3
Grants	9.7	9.2	17.5	20.1	15.7	8.5	3.1	0.1	0.0
Expenditure	133.5	121.3	125.4	115.4	92.3	82.5	77.4	74.0	72.5
Recurrent expenditure	107.1	99.0	88.0	83.6	66.3	56.7	52.9	49.8	50.5
Capital expenditure	26.4	22.3	37.4	31.8	26.0	25.8	24.5	24.2	22.1
Overall fiscal balance (including grants)	-42.9	-40.8	-27.7	-27.7	-4.3	-0.6	-1.1	-1.6	-1.7
Gross borrowing/use of external assets	45.3	43.4	27.7	23.0	0.4	0.6	1.0	1.4	1.4
Amortization	2.4	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	0.0	-1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual or Financing gap [+]/surplus[-] 2/	0.0	0.7	0.0	4.7	3.9	0.0	0.1	0.2	0.3
Memorandum items:									
Tax revenue/non-oil GDP (In percent)	3.0	1.3	3.7	1.9	2.0	2.6	2.8	3.1	3.4
Primary fiscal balance Non-oil primary fiscal balance	-41.9 -96.7	-39.8 -89.0	-27.3 -74.2	-27.4 -69.5	-3.8 -60.4	-0.2 -61.2	0.1 -60.8	1.1 -57.5	3.0 -54.1
Non-on primary fiscal balance	-70.7	-07.0	-/4.2	-07.5	-00.4	-01.2	-00.8	-57.5	-54.1
Monetary Indicators					n percent)				
Gross central bank foreign exchange assets/Base money	68.0	94.4	75.0	104.6					
Claims on banks/Base money	6.5	0.1	5.7	0.1					
Base money (annual growth) Currency issued (annual growth)	117.0 118.4	116.9 74.9	32.8 32.8	12.6 30.7					
currency issued (united growth)	110.4	74.7	52.0	50.7					
Balance of payments	0.005	0.445		ons of U.S. dol				4.055	4 412
Current account Trade balance	-9,985 -5,137	-9,447	-10,645	-8,847	-4,729 -817	-3,972	-4,602	-4,975	-4,412
	16,543	-1,788 17,782	-7,878 17,597	-5,127 19,016	27,273	1,743 31,892	2,860 36,094	4,087 38,125	4,751 40,600
Exports of goods Imports of goods	-21,680	-19.569	-25.475	-24.143	-28,090	-30.149	-33,234	-34,038	-35,849
Income and services	-6,580	-9,638	-6,964	-9,510	-9,609	-9,015	-8,804	-9,222	-9,696
Transfers	1,731	1,979	4,197	5,790	5,698	3,300	1,342	160	533
Financial account	8,973	10,842	7,026	9,158	4,597	5,012	5,740	6,101	5,350
Direct investment	200	200	300	300	400	500	1,062	1,768	2,128
Gross borrowing/use of external assets	9,565	10,642	6,726	8,858	4,197	4,512	4,678	4,333	3,222
Amortization	0	0	0	0	0	0	0	0	0
Other flows	-792	-193	0	-1,750	0	0	0	0	0
Errors and omissions	0	178	0	1,388	1,525	10	36	101	190
Overall external balance	-1,013	1,573	-3,619	1,700	1,393	1,050	1,174	1,226	1,128
Financing	1,013	-1,573	3,619	-1,700	-1,393	-1,050	-1,174	-1,226	-1,128
Central bank reserves (increase -)	-4,624	-6,768	-2,598	-1,700	-1,393	-1,050	-1,174	-1,226	-1,128
Change in arrears	-580	-35,858	0	0	0	0	0	0	0
Accrued but deferred interest	6,217	5,380	6,217	0	0	0	0	0	0
Debt forgiveness		35,673		0	0	0	0	0	0
Memorandum items:									_
Trade balance (In percent of GDP)	-24.3	-7.0	-32.4	-17.5	-2.1	3.9	5.6	7.4	7.9
Current account (In percent of GDP)	-47.3	-37.0	-43.8	-30.2	-12.1	-8.8	-9.0	-9.0	-7.3
Reserves (In US\$ million)	5,691	7,902	8,289	9,602	10,995	12,045	13,218	14,445	15,573
In months of goods and services	2.6	3.2	3.7	3.4	3.8	3.9	4.2	4.4	4.2
Debt Stock (In US\$ billion)	124.3	78.2	131.5	82.1	86.3	90.8	95.2	99.4	102.6
Debt service in percent of exports 3/	0.0	0.0	0.1	0.1	0.1	0.1	2.0	4.2	6.7

Sources: Iraqi authorities and staff estimates and projections.

<sup>1/</sup> In the EPCA, differential to WEO oil export prices were calculated to reflect assumed budget prices.
2/ Residual in 2004 could be explained advances currently classified as expenditure.
3/ Debt service paid (not accrued), excluding repayment of arrears.

Table 3. Iraq: Fiscal and Oil Sector Accounts, 2004-10

(In billions of ID; unless otherwise indicated)

	200		200		2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev. Proj.1/		Revise	ed projection	ıs 2/	
Revenues and Grants	28,730	30,018	35,618	38,585	56,484	65,661	73,491	78,696	86,381
Revenues	25,668	26,595	29,238	29,719	46,401	58,818	70,473	78,627	86,321
Crude oil export revenues 3/	24,300	25,326	25,670	27,614	43,783	55,299	66,306	73,691	80,717
Of which: budgeted crude oil export revenues	24,300	24,300	25,670	25,623	30,846	38,866	46,527	51,485	56,369
Revenues from reduction in price subsidy on petroleum products 4/	0	0	1,500	0	0	0	0	0	0
Revenues of oil-related state owned enterprises	900	799	1,290	1,020	1,364	1,896	2,185	2,569	2,840
Tax revenues	254	160	393	315	418	643	856	1,108	1,395
Direct taxes	8	78	39	90	135	170	210	252	294
Indirect taxes	246	81	354	225	282	348	421	495	567
Non-tax revenues	215	310	386	770	837	980	1,126	1,259	1,369
Grants	3,062	3,424	6,380	8,865	10,083	6,843	3,019	69	61
Expenditures	42,324	45,244	45,707	50,782	59,220	66,122	74,559	80,459	88,419
Operating expenditures	33,947	36,921	32,076	36,782	42,520	45,442	50,939	54,190	61,489
Salary and pension 5/	5,040	4,532	5,600	7,031	8,056	10,003	12,166	13,119	13,907
Goods and Services (non-oil sector)	5,030	11,017	4,028	15,404	19,159	21,001	21,927	21,020	23,491
Budgeted goods and services 6/	3,602	6,985	2,600	8,051	12,558	16,259	19,817	21,020	23,491
Financed by oil-for-food program (OFFP) (other than social safety net)	1,428	1,623	1,428	1,429	0	0	0	0	23,471
Overhead costs for donors' financed projects 7/	0	864	0	2,315	2,580	1,853	824	0	0
Other goods and services financed by donors 8/	0	1,546	0	3,609	4,022	2,889	1,285	0	0
Goods and Services (oil sector)	5,940	5,612	6,840	4,620	4,364	1,896	2,185	2,569	2,840
Oil derivative imports 9/	3,940	4,823	3,600	3,600	3,000	0	2,163	2,309	2,840
Operating expenditures of oil-related state-owned enterprises (including refineries)	2,790	790	3,240	1,020		1,896	2,185	2,569	2,840
Transfers  Transfers	16,403		14,175	8,294	1,364	9,479	10,150	10,867	
		14,085			8,474				11,473
Social safety net (excluding OFFP)	3,908	3,829	6,000	6,000	6,180	6,995	7,766	8,534	9,194
Social safety net (financed by OFFP)	2,177	2,126	1.520	0	0	0	0	0	700
Transfers to SOEs	1,530	1,237	1,530	1,273	1,273	1,273	1,000	850	700
Other transfers 10/	8,789	6,893	6,645	0	0	0	0	0	0
Interest payments	320	369	150	150	279	297	1,196	2,930	5,741
Domestic interest payments	320	369	150	150	270	270	270	270	270
External interest payments	0	0	0	0	9	27	926	2,660	5,471
War reparations 11/	1,215	1,304	1,284	1,283	2,189	2,765	3,315	3,685	4,036
Investment expenditures	8,378	8,323	13,631	13,999	16,700	20,680	23,620	26,268	26,930
Non-oil investment expenditures	6,488	6,135	9,131	8,509	12,200	14,261	16,034	16,305	15,897
Domestic financed reconstruction expenditure 12/	3,869	4,087	2,051	4,739	8,759	11,909	14,460	14,922	14,433
OFFP financed reconstruction expenditure	791	1,084	1,070	1,070	0	0	0	0	0
Grant financed reconstruction expenditure	1,829	964	5,480	2,701	3,214	1,909	823	69	61
U.S. grant financed reconstruction expenditure		814		2,075	2,312	1,661	739	0	0
Non U.S. grant financed reconstruction expenditure		150		626	902	248	84	69	61
Loan financed reconstruction expenditure	0	0	531	0	226	443	751	1,314	1,403
Oil investment expenditures (including on refineries)	1,890	2,188	4,500	5,490	4,500	6,419	7,586	9,963	11,033
Balance (including grants)	-13,595	-15,225	-10,089	-12,197	-2,736	-461	-1,068	-1,763	-2,038
Balance (excluding grants)	-16,656	-18,649	-16,469	-21,062	-12,819	-7,304	-4,086	-1,832	-2,098
External financing	13,598	15,498	10,089	10,114	226	443	1,001	1,564	1,653
Assets held abroad 13/	8,915	10,177	6,309	6,866	0	0	0	0	0
Project financing	0	0	531	0	226	443	751	1,314	1,403
Other financing 14/	5,433	5,992	3,249	3,249	0	0	250	250	250
Amortization	750	670	0	0	0	0	0	0	0
Domestic financing	0	-533	0	0	0	0	0	0	0
Bank financing	0	-333	0	0	0	0	0	0	0
Non bank financing	0	-200	0	0	0	0	0	0	0
Residual or Financing gap[+]/surplus [-] 15/	0	260	0	2,082	2,509	18	67	199	384
Memorandum items:									
Primary fiscal balance	-13,275	-14,856	-9,939	-12,047	-2,457	-164	129	1,167	3,704
Non-oil primary fiscal balance	-30,645	-33,181	-27,059	-30,571	-38,740	-49,044	-58,592	-62,561	-65,980
Tax revenue in percent of non-oil GDP	3.2	1.3	2.4	1.9	2.0	2.6	2.8	3.1	3.4
Nominal GDP	31,698	37,287	36,443	44,011	64,177	80,135	96,365	108,711	121,879

Sources: Iraqi authorities, and staff estimates and projections.

- 1/ Revised projections for 2005 are based on the 2005 budget, expenditures committed by the Coalition Provisional Authorities, information on revenues and expenditures of oil-related state-owned, enterprises, indicative information on donors' activities, and information on oil-for-food program, but excludes possible spending or revenues from a supplementary budget.
- 2/ Medium-term projections do not include possible revenue measures or additional spending (e.g. on transfers) to be discussed by the cabinet.
- 3/ Projections for 2005 are based on average oil price (\$36 per barrel) and volume (1.4 mbpd) for the first five months of 2005.
- 4/ Projections are based on the fact that no formal agreement has yet been reached on increasing domestic price of light petroleum products, but do not represent the staff's recommendations.
- 5/ EPCA (2004 and 2005) data, and estimates for 2004, do not include wages and salaries for the Kurdish area, which are included in other transfers. 2004 estimates for wages include ID2.2 trillion in advances to be reclassified.
- 6/ Includes spending by the U.S. from seized and vested assets in 2004.
- 7/Overhead costs associated with donor-financed reconstruction are believed to be spent mostly outside of Iraq. No firm figures were received from donors to date.
- 8/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.
- 9/2005 figures are from the budget. It is assumed that the private sector will import an increasing share of light petroleum products starting in 2005.
- 10/2004 and 2005 EPCA data and estimates for 2004 include wages and goods for the Kurdish area.
- 11/ Calculated as 5 percent of oil exports as per UN Security Council Resolution 1483 to finance war reparations to Kuwait. The 2005 data is from the budget. 5 percent of any additional revenue recorded in 2005 should be paid as war reparation.
- 12/ Projections for 2005 include ID1.4 trillion reportedly committed by the Coalition Provisional Authorities, to be paid by the U.S. out of a special subaccount of the DFI, and unrecorded in the budget, projects in the north previously classified as transfers, and ID1.9 trillion in maintenance expenditure previously classified as goods.
- 13/ Estimates for 2005 are based on reported balances of Development Fund for Iraq (DFI) managed by the Iraqi authorities, and balances on the DFI subaccount managed by the U.S.
- 14/ Includes financing from letters of credit previously issued under the UN oil-for-food program.
- 15/ Residual in 2004 could be explained advances currently classified as expenditure.

Table 4. Iraq: Fiscal and Oil Sector Accounts, 2004–10 (In percent of GDP)

	2004		2005		2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev.	2000		l projections		2010
Revenues and Grants	90.6	80.5	97.7	87.7	88.0	81.9	76.3	72.4	70.9
Revenues	81.0	71.3	80.2	67.5	72.3	73.4	73.1	72.4	70.9
Crude oil export revenues 3/	76.7	67.9	70.4	62.7	68.2	69.0	68.8	67.8	66.2
Of which: budgeted crude oil export revenues	76.7	65.2	70.4	58.2	48.1	48.5	48.3	47.4	46.2
Revenues from reduction in price subsidy on petroleum products 4/	0.0	0.0	4.1	0.0	0.0	0.0	0.0	0.0	0.0
Revenues of oil-related state-owned enterprises	2.8	2.1	3.5	2.3	2.1	2.4	2.3	2.4	2.3
Fuel oil and gas exports	0.0	1.4	0.0	1.6	1.3	1.1	1.0	0.7	0.7
Domestic petroleum revenues (excluding those from reduction of subsidy)	0.0	0.6	0.0	1.2	0.8	0.8	0.9	0.9	2.7
Tax revenues Direct taxes	0.8 0.0	0.4	1.1 0.1	0.7 0.2	0.7 0.2	0.8 0.2	0.9 0.2	1.0 0.2	1.1 0.2
Indirect taxes	0.8	0.2	1.0	0.2	0.2	0.2	0.2	0.2	0.2
Non-tax revenues	0.7	0.8	1.1	1.7	1.3	1.2	1.2	1.2	1.1
Grants	9.7	9.2	17.5	20.1	15.7	8.5	3.1	0.1	0.0
U.S.	0.0	8.8	0.0	18.7	14.3	8.2	3.0	0.0	0.0
Non U.S.	0.0	0.4	0.0	1.4	1.4	0.3	0.1	0.1	0.0
Expenditures	133.5	121.3	125.4	115.4	92.3	82.5	77.4	74.0	72.5
Operating expenditures	107.1	99.0	88.0	83.6	66.3	56.7	52.9	49.8	50.5
Salary and pension 5/	15.9	12.2	15.4	16.0	12.6	12.5	12.6	12.1	11.4
Goods and services (non-oil sector)	15.9	29.5	11.1	35.0	29.9	26.2	22.8	19.3	19.3
Budgeted goods and services 6/	11.4	18.7	7.1	18.3	19.6	20.3	20.6	19.3	19.3
Financed by oil-for-food program (OFFP) (other than social safety net)	4.5	4.4	3.9	3.2	0.0	0.0	0.0	0.0	0.0
Overhead costs for donors' financed projects 7/	0.0	2.3	0.0	5.3	4.0	2.3	0.9	0.0	0.0
Other goods and services financed by donors 8/	0.0	4.1	0.0	8.2	6.3	3.6	1.3	0.0 2.4	0.0
Goods and services (oil sector) Oil derivative imports 9/	18.7 9.9	15.1 12.9	18.8 9.9	10.5 8.2	6.8 4.7	2.4 0.0	2.3 0.0	0.0	2.3
Operating expenditures of oil-related state-owned enterprises (including refineries)	8.8	2.1	8.9	2.3	2.1	2.4	2.3	2.4	2.3
Transfers	51.7	37.8	38.9	18.8	13.2	11.8	10.5	10.0	9.4
Social safety net (excl. OFFP)	12.3	10.3	16.5	13.6	9.6	8.7	8.1	7.9	7.5
Social safety net (financed by OFFP)	6.9	5.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers to SOEs	4.8	3.3	4.2	2.9	2.0	1.6	1.0	0.8	0.6
Other transfers 10/	27.7	18.2	18.2	0.0	0.0	0.0	0.0	0.0	0.0
Interest payments	1.0	1.0	0.4	0.3	0.4	0.4	1.2	2.7	4.7
Domestic interest payments	1.0	1.0	0.4	0.3	0.4	0.3	0.3	0.2	0.2
External interest payments	0.0	0.0	0.0	0.0	0.0	0.0	1.0	2.4	4.5
External interest payments on loans other than to finance the financing gap	0.0	0.0	0.0	0.0	0.0	0.0	1.0	2.4	4.5
External interest payments on loans to finance the financing gap War reparations 11/	0.0 3.8	0.0 3.5	0.0 3.5	0.0 2.9	0.0 3.4	0.0 3.5	0.0 3.4	0.0 3.4	0.0 3.3
Investment expenditures	26.4	22.3	37.4	31.8	26.0	25.8	24.5	24.2	22.1
Non-oil investment expenditures	20.5	16.5	25.1	19.3	19.0	17.8	16.6	15.0	13.0
Domestic financed reconstruction expenditure 12/	12.2	11.0	5.6	10.8	13.6	14.9	15.0	13.7	11.8
OFFP financed reconstruction expenditure	2.5	2.9	2.9	2.4	0.0	0.0	0.0	0.0	0.0
Grant financed reconstruction expenditure	5.8	2.6	15.0	6.1	5.0	2.4	0.9	0.1	0.0
U.S. grant financed reconstruction expenditure	0.0	2.2	0.0	4.7	3.6	2.1	0.8	0.0	0.0
Non U.S. grant financed reconstruction expenditure	0.0	0.4	0.0	1.4	1.4	0.3	0.1	0.1	0.0
Loan financed reconstruction expenditure	0.0	0.0	1.5	0.0	0.4	0.6	0.8	1.2	1.2
Oil investment expenditures (including on refineries)	6.0	5.9	12.3	12.5	7.0	8.0	7.9	9.2	9.1
Unidentified expenditure/savings 13/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance (including grants)	-42.9	-40.8	-27.7	-27.7	-4.3	-0.6	-1.1	-1.6	-1.7
Balance (excluding grants)	-52.5	-50.0	-45.2	-47.9	-20.0	-9.1	-4.2	-1.7	-1.7
External financing	42.9	41.6	27.7	23.0	0.4	0.6	1.0	1.4	1.4
Assets held abroad 13/	28.1	27.3	17.3	15.6	0.0	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	1.5	0.0	0.4	0.6	0.8	1.2	1.2
Other financing 14/	17.1	16.1	8.9	7.4	0.0	0.0	0.3	0.2	0.2
Amortization  Amortization on loans other than to finance the financing gap	2.4 2.4	1.8 1.3	0.0 2.1	0.0	0.0	0.0	0.0	0.0	0.0
Amortization on loans other than to finance the financing gap  Amortization on loans to finance the financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
						0.0			
Domestic financing Bank financing	0.0 0.0	-1.4 -0.9	0.0 0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non bank financing	0.0	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
•									
Residual or Financing gap[+]/surplus [-] 15/	0.0	0.7	0.0	4.7	3.9	0.0	0.1	0.2	0.3
Memorandum items:	41.0	20.0	27.2	27.4	2.0	0.2	0.1		2.0
Primary fiscal balance	-41.9 96.7	-39.8	-27.3 74.2	-27.4 60.5	-3.8 60.4	-0.2	0.1	1.1	3.0
Non-oil primary fiscal balance Sources: Iraqi authorities and staff estimates and projections.	-96.7	-89.0	-74.2	-69.5	-60.4	-61.2	-60.8	-57.5	-54.1

- 1/ Revised projections for 2005 are based on the 2005 budget, expenditures committed by the Coalition Provisional Authorities, information on revenues and expenditures of oil-related state-owned, enterprises, indicative information on donors' activities, and information on oil-for-food program, but exclude possible spending or revenues from a supplementary budget.
- 2/ Medium-term projections do not include possible revenue measures or additional spending (e.g. on transfers) to be discussed by the cabinet.
- 3/ Projections for 2005 are based on average oil price (\$36 per barrel) and volume (1.4 mbpd) for the first five months of 2005.
- 4/ Projections are based on the fact that no formal agreement has yet been reached on increasing domestic price of light petroleum products, but do not represent the staff's recommendations.
- 5/ EPCA (2004 and 2005) data, and estimates for 2004, do not include wages and salaries for the Kurdish area, which are included in other transfers. 2004 estimates for wages include ID2.2 trillion in advances to be reclassified.
- 6/ Includes spending by the US from seized and vested assets in 2004.
- 7/ Overhead costs associated with donor-financed reconstruction are believed to be spent mostly outside of Iraq. No firm figures were received from donors to date.
- 8/Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.
- 9/2005 figures are from the budget. It is assumed that the private sector will import an increasing share of light petroleum products starting in 2005.
- 10/2004 and 2005 EPCA data and estimates for 2004 include wages and goods for the Kurdish area.
- 11/ Calculated as 5 percent of oil exports as per UN Security Council Resolution 1483 to finance war reparations to Kuwait. The 2005 data is from the budget. 5 percent of any additional revenue recorded in 2005 should be paid as war reparation.
- 12/ Projections for 2005 include ID1.4 trillion reportedly committed by the Coalition Provisional Authorities, to be paid by the US out of a special subaccount of the DFI, and unrecorded in the budget, projects in the North previously classified as transfers, and ID1.9 trillion in maintenance expenditure previously classified as goods.
- 13/ Estimates for 2005 are based on reported balances of Development Fund for Iraq (DFI) managed by the Iraqi authorities, and balances on the DFI subaccount managed by the U.S.
- 14/ Includes financing from letters of credit previously issued under the UN oil-for-food program.
- 15/ Residual in 2004 could be explained advances currently classified as expenditure.

Table 5. Iraq: Central Bank Survey, 2003–05 (In billions of Iraqi dinars, unless otherwise indicated)

	2003	200							
_	Actual	Actual	EPCA		Actua			Proj.	EPCA
	Dec.	Dec.		Jan.	Feb.	Mar.	Apr	Dec.	
Net foreign exchange assets 1/	1,600	10,743	7,532	12,176	12,966	11,247	11,428	13,558	11,419
Foreign exchange assets	1,916	11,538	8,309	12,967	13,765	12,045	12,225	14,356	12,196
Gold 2/	114	115	94	117	119	117	118	117	94
Other	1,803	11,422	7,578	12,851	13,645	11,928	12,107	14,239	12,102
CBI Vaults	1,803	10,361	7,578	11,809	12,601	10,886	11,067	13,194	12,102
SDR Account	0	1,061	637	1,042	1,044	1,042	1,039	1,044	0
Foreign exchange liabilities	-316	-795	-777	-792	-799	-798	-798	-798	-777
of which IMF liabilities		-637	637	-637	-637	-637	-637	-637	
Net domestic assets	4,038	1,296	4,703	729	1,098	1,675	644	207	4,833
Domestic assets	3,698	4,156	3,919	2,681	2,916	3,494	4,451	3,720	4,048
Net claims on general government	3,698	4,147	3,119	2,672	2,907	3,338	4,296	3,711	3,119
Holdings of treasury bills	2,874	2,589	2,562	2,589	2,589	2,528	2,528	2,460	4,019
Holdings of discounted treasury bills	206	709	0	709	709	707	707	673	0,019
Overdrafts	909	1,637	1,458	1,851	1,821	1,821	1,821	1,528	0
Domestic currency deposits	-15	-596	-300	-849	-443	-715	-413	-450	-300
Foreign currency deposits	-276	-192	-600	-1,628	-1,769	-1,003	-346	-500	-600
Claims on nonbank public institutions	0	0	000	0	0	-1,003	-540	0	-000
Claims on commercial banks	0.0	8.7	800	8.8	8.9	155.6	155.1	8.7	929
Monetary policy instruments 3/	0.0	0.0		0.0	0.0	-1,639	-1,834	-2,053	
Other items net	339	-2,859	 784	-1,952	-1,818	-1,039	-1,834	-1,459	 784
_									
Base money	5,638	12,228	12,235	12,904	14,064	12,922	12,070	13,765	16,252
Currency outside banks	2,606	7,163	9,522	7,578	8,278	8,561	8,333	9,360	12,648
Currency issued	4,586	8,021	10,014	8,361	9,122	9,463	9,392	10,481	13,301
less cash in vaults of commercial banks	1,980	858	492	784	844	903	1,059	1,121	653
Banks reserves	1,052	4,208	2,222	4,543	4,942	3,459	2,679	3,285	2,951
Required	717	2,287	2,000	2,287	2,285	1,390	1,137	2,250	2,657
Excess	335	1,921	222	2,256	2,657	2,069	1,541	1,035	295
Memorandum items:									
Base money (annual growth, in percent)		116.9	117.0	5.5	15.0	5.7	-1.3	12.6	32.8
Currency issued (annual growth, in percent)		74.9	118.4	4.3	13.7	18.0	17.1	30.7	32.8
Gross foreign exchange assets (millions of U.S. dollars)	1,134	7,902	5,691	8,882	9,421	8,239	8,356	9,602	8,353
Gold	67	79	64	80	82	80	81	93	64
CBI vaults	1,067	7,097	5,191	8,088	8,625	7,446	7,565	8,796	8,289
Deposits at state banks	0	0	0	0	0	0	0	0	0
IMF disbursement	0	727	436	713	715	713	710	713	0
Foreign exchange liabilities (IMF, in millions of US dolla	-187	-544	-532	-542	-547	-547	-546	-532	-532
Net foreign exchange assets (millions of U.S. dollars)	947	7,358	5,159	8,339	8,874	7,692	7,809	9,070	7,821
Exchange rate (end-of-period)	1,690	1,460	1,460	1,460	1,461	1,462	1,463	1,500	1,460
Exchange rate (program)	1,690	1,460	1,460	1,460	1,460	1,460	1,460	1,500	1,460
Inflation (12-month)	36.3	32.0	7.0	20.0	12.0	10.0	8.0	20.0	15.0
Non-oil real GDP growth (in percent)	-3.4	14.9	5.0	12.0	12.0	12.0	12.0	12.0	10.0
Gross foreign exchange assets/Base money (in percent)	34.0	94.4	67.9	100.5	97.9	93.2	101.3	104.6	75.0
Claims on banks/Base money (percent)	0.0	0.1	6.5	0.1	0.1	1.2	1.3	0.1	5.7
Bank reserves	3,032	5,065	2,713	5,327	5,786	4,362	3,737	4,405	3,604
Base money coverage (in percent)	28.4	87.9	61.6	94.4	92.2	87.0	94.7	98.8	70.3
Currency in circulation /Base money (in percent)	46.2	58.6	77.8	58.7	58.9	66.2	69.0	68.0	77.8

Sources: Iraqi authorities; staff estimates and projections; CPA; CBI; and CSO.

<sup>1/</sup> Valued at market exchange rates.

<sup>2/</sup> Valued at historic or market price, whichever is lower.

<sup>3/</sup> This mainly represents the ID and US  $\$  overnight standing deposit facilities.

Table 6. Iraq: Balance of Payments, 2004–10 1/ (In millions of U.S. dollars, unless otherwise indicated)

	2004	4	200	05	2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev. Proj.		Revi	sed Projectio	ns	
Trade balance	-5,137	-1,788	-7,878	-5,127	-817	1,743	2,860	4,087	4,751
(In percent of GDP)	-24.3	-7.0	-32.4	-17.5	-2.1	3.9	5.6	7.4	7.9
Exports	16,543	17,782	17,597	19,016	27,273	31,892	36,094	38,125	40,600
Crude oil	16,200	17,329	17,113	18,410	26,609	31,194	35,359	37,498	39,939
Other exports	343	452	484	606	665	698	735	627	662
Imports 2/	-21,680	-19,569	-25,475	-24,143	-28,090	-30,149	-33,234	-34,038	-35,849
Government imports	-14,790	-13,761	-17,197	-15,199	-14,653	-15,105	-16,240	-17,087	-17,676
UN Oil for Food Program (OFFP)	-3,622	-3,488	-2,166	-1,884	0	0	0	0	0
Other consumption imports (non-OFFP)	-4,267	-3,843	-5,301	-5,181	-6,099	-6,941	-7,577	-7,753	-8,299
Other non-oil related capital imports (non-OFFP)	-3,603	-2,352	-4,480	-3,020	-4,619	-5,068	-5,387	-5,227	-4,955
Oil-related capital imports	-1,197	-1,429	-2,850	-3,025	-2,312	-3,096	-3,277	-4,106	-4,422
Refined oil products	-2,100	-2,648	-2,400	-2,088	-1,623	0	0	0	0
Private sector imports	-6,890	-5,809	-8,277	-8,944	-13,437	-15,044	-16,994	-16,952	-18,172
Of which: refined oil products	•••	0		-2,069	-3,805	-4,015	-4,455	-3,503	-3,620
Income, net 3/	-6,208	-5,381	-6,220	-3,878	-4,081	-4,294	-4,534	-5,440	-5,713
Services, net 2/	-372	-4,257	-744	-5,632	-5,529	-4,721	-4,269	-3,782	-3,983
Transfers, net	1,731	1,979	4,197	5,790	5,698	3,300	1,342	160	533
Private, net (incl. NGOs)	500	500	800	800	900	1,000	1,500	2,000	2,500
Official	1,231	1,479	3,397	4,990	4,798	2,300	-158	-1,840	-1,967
Receipts	2,041	2,345	4,253	5,910	6,128	3,860	1,610	35	30
Payments	-810	-866	-856	-920	-1,330	-1,560	-1,768	-1,875	-1,997
Current Account	-9,985	-9,447	-10,645	-8,847	-4,729	-3,972	-4,602	-4,975	-4,412
(In percent of GDP)	-47.3	-37.0	-43.8	-30.2	-12.1	-8.8	-9.0	-9.0	-7.3
Capital Account	0	0	0	0	0	0	0	0	0
Financial Account	8,973	10,842	7,026	9,158	4,597	5,012	5,740	6,101	5,350
Direct investment	200	200	300	300	400	500	1,062	1,768	2,128
Other capital, net	8,773	10,642	6,726	8,858	4,197	4,512	4,678	4,333	3,222
Official, net	9,565	10,835	6,726	10,609	4,197	4,512	4,678	4,333	3,222
Assets	9,565	10,835	6,372	6,743	0	0	0	0	0
Liabilities	0	0	354	3,866	4,197	4,512	4,678	4,333	3,222
Loan disbursements	0	0	354	0	138	250	651	919	944
Amortization 4/	0	0	0	2 966	0	0	0	2.414	2 279
Capitalized interest payment 4/ Private, net	-792	-193	0	3,866 -1,750	4,059 0	4,262 0	4,028 0	3,414 0	2,278 0
Errors and omissions 5/	0	178	0	1,388		10	36	101	190
				•	1,525				
Overall balance	-1,013	1,573	-3,619	1,700	1,393	1,050	1,174	1,226	1,128
(In percent of GDP)	-4.8	6.2	-14.9	5.8	3.6	2.3	2.3	2.2	1.9
Financing	1,013	-1,573	3,619	-1,700	-1,393	-1,050	-1,174	-1,226	-1,128
Central bank (increase -)	-4,624	-6,768	-2,598	-1,700	-1,393	-1,050	-1,174	-1,226	-1,128
Reserves (net; increase -) Liabilities (increase +)	-4,188 436	-6,332 436	-2,598 0	-1,700 0	-1,393 0	-1,050 0	-1,400 -226	-1,452 -226	-1,128 0
Fund credit (net)	436	436	0	0	0	0	-226	-226	0
Disbursement	436	436	0	0	0	0	0	0	0
Repayments	0	0	0	0	0	0	-226	-226	0
Deferred accrued interest 6/	6,217	5,380	6,217	0	0	0	0	0	0
Change in arrears (net, decrease -) 7/	-580	-35,858	0	0	0	0	0	0	0
Debt forgiveness 8/		35,673		0	0	0	0	0	0
Memorandum items:									
Central Bank reserves	5,691	7,902	8,289	9,602	10,995	12,045	13,218	14,445	15,573
Central Bank reserves (in months of imports of goods and services)	2.6	3.2	3.7	3.4	3.8	3.9	4.2	4.4	4.2
GDP	21,132	25,539	24,295	29,341	39,003	45,203	51,389	55,318	60,306
Non-oil GDP	4,173	8,297	5,661	10,854	12,411	14,193	16,230	18,228	20,285

Sources: Iraqi authorities and staff estimates and projections.

 $<sup>1/</sup>Excludes\ U.S.\ military\ spending\ in\ Iraq.$ 

<sup>2/</sup>Goods imports exclude freight and insurance, which are included in services. Goods imports in the EPCA include freight and insurance.

<sup>3/</sup>Includes interest accrued, deferred, and capitalized.

<sup>4/</sup>Based on Paris Club agreement, the payments of principal and most interest during 2005–10 are deferred and capitalized.

<sup>5/</sup>Reflects fiscal financing gap or residual.

<sup>6/</sup>Estimates accrued interest on existing stock of debt prior to Paris Club agreement.

<sup>7/</sup>Includes debt forgiveness and clearance of arrears on multilateral debt.

<sup>8/</sup>Reflects the first tranche of debt reduction (30 percent) at end 2004 as per Paris Club agreement of November 21, 2004, and assumes comparable debt reduction to all external debt.

Table 7. Iraq: Quantitative Indicators, 2004–05, Under Emergency Post-Conflict Assistance Policy

(In billions of Iraqi dinars, unless otherwise indicated)

	06/30/04	12/31/04	12/31/04	03/31/05	06/30/05	09/30/05
	Stock	Actual	Indic.	Ind. (Act)	Indic.	Indic.
Currency issued (range) 1/	7,003	8,021	9,000– 11,000	9,700– 11,800 (9,463)	10,400– 12,700	11,100– 13,600
Net international reserves of the central bank (floor) (in millions of U.S. dollars) 1/	3,193	7,358	4,000	4,250 (7,692)	4,500	4,750
Lending to the government by the CBI (ceiling) 1/2/	3,986	4,165	3,986	3,100 (4,349)	3,100	3,100
Government primary fiscal deficit (in millions of US\$; ceiling) 3/		10,175	8,850	1,800	3,500	4,750
New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 3/	0	0	0	500	750	1,000
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 3/4/	0	0	0	0	0	0

Sources: Iraqi authorities and staff estimates and projections.

<sup>1/</sup> Stocks as of the end-of-test period.

<sup>2/</sup> Consistent with legal prohibition on CBI lending to the government.

<sup>3/</sup> Flows from January 1, 2004, for test date of end-2004; and cumulative flows from January 1, 2005 for test dates in 2005.

<sup>4/</sup> This will be monitored on a continuous basis.

Table 8. Iraq: Structural Benchmarks and Key Policy Measures Under Emergency Post-Conflict Assistance

Policy Actions	Target Date	Status
I. Structu	ral Indicative	Benchmarks
Development of a monetary survey.	Mar-05	Preparatory work ongoing.
Establishment of an automatic payroll system for all government employees.	Jun-05	Pending; government to establish a census of all employees and take measures to control changes in position.
Development of monthly fiscal accounts for the central government and the oil sector.	Dec-04	Data is being generated with a long lag and the ministry of finance is establishing committees to accelerate the process and gather missing information.
Issuance of regulations regarding bank licensing and standard prudential ratios.	Dec-04	Pending, but authorities believe that the existing regulations are adequate.
Enactment of payments systems law.	Dec-04	Draft law is being prepared with the help of MFD.
Adoption of a plan to overhaul the tax and customs administration.	Jun-05	Tax policy unit in charge of preparing the plan to be established.
II. 1	Key Policy Me	asures
Increase of domestic prices of oil refined products.	Dec-04	Pending; political decision has been postponed.
External audit of Central Bank of Iraq (CBI).	Jun-05	Iraqi Supreme Board of Audit conducted audit of end–2003 balance. Request for tender from international audit firms issued.
Adopting implementing regulations for the Financial Management Law.	Dec-04	Pending.

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# Iraq: Relations with the Fund

As of May 31, 2005

I. Membership Status: Joined: December 27, 1945; Article XIV

II.	<b>General Resources Account:</b>	<b>SDR Million</b>	%Quota
	Quota	1,188.40	100.00
	Fund holdings of currency	1,314.41	110.60
	Reserve Position	171.10	14.40
	Holdings	0.00	0.00

III.	SDR Department: Net cumulative allocation Holdings	<b>SDR Million</b> 68.46 295.49	<b>%Allocation</b> 100.00 431.59
IV.	Outstanding Purchases and Loans: Post-Conflict Emergency Assistance	SDR Million 297.10	%Quota 25.00

# V. Latest Financial Arrangements: None

# VI. Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

		Fo	orthcoming		
	2005	2006	2007	2008	2009
Principal				148.55	148.55
Charges/Interest	5.52	10.97	10.97	8.48	2.97
Total	5.52	10.97	10.97	157.03	151.52

# VII. Implementation of HIPC Initiative: Not Applicable.

# VIII. Safeguards Assessments:

Iraq is considering an IMF financial arrangement, and the Central Bank of Iraq (CBI) would then be subject to a safeguards assessment under the Fund's safeguards assessment policy. Documentation has been requested from the CBI.

# IX. Exchange Rate Arrangement

The Central Bank of Iraq has been conducting foreign exchange auction on a daily basis since October 4, 2003. The central bank has followed a policy of exchange rate stability

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which has translated in a de facto peg of the exchange rate since early 2004. Additional information on Iraq's foreign exchange laws, regulations and practices is being sought to determine whether Iraq maintains any exchange restrictions subject to Fund jurisdiction.

# X. Article IV Consultations

A report for the 1983 Article IV consultation was issued to the Executive Board on August 5, 1983; however no Board meeting was convened. The last Article IV consultation took place in November 1979.

# **XI. Recent Technical Assistance**

Department	Date	Topic
FAD	July 15–31, 2003	Public expenditure management
	December 2003	Public expenditure management
	February–March 2004	Fiscal seminar for high level officials
	April 2004	Training course in budget preparation
	May–June 2004	Tax Policy and Tax Administration Workshop
	June 2004	Expenditure management
	July 2004	Customs Administration Workshop
	December 2004	Fiscal decentralization
	January 2005	Petroleum Sector Policies
	February 2005	Public financial management
	April 2005	Budget classification reform
LEG		Wrote first draft of new Central Bank legislation
		Wrote first draft of new Commercial Banking
		legislation
MFD	July 2003	Monetary and financial systems areas
	November 2003	Market policy and operations
	December 2003	Accounting and financial reporting
	January 2004	Central bank reform
	June 2004	Banking supervision
	June 2004	Market policy and operations
	June 2004	Payment and settlement systems
	March 2005	Payment and settlement systems
OT A	1.1.2002	M ( 16 :1 (C) (C) d (A) (A) (ED)
STA	July 2003	Monetary and financial statistics (jointly with MFD)
	December 2003	Multisector statistics
	January 2004	National accounts statistics
	January 2004	Consumer price statistics
	October 2004	Price statistics
	November 2004	National accounts
	April 2005	Balance of Payment Statistics
	April 2005	National Accounts
	April 2005	Consumer Price statistics
	May 2005	General Data Dissemination Standard
DIC	4 12005	
INS	April 2005	External sector policies

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#### Irag: Relations with the World Bank Group

1. Iraq, a founding member of the International Bank for Reconstruction and Development (IBRD), received six loans from the IBRD between 1950 and 1973 for agriculture, education, flood control, telecommunications, and transport. The last loan closed in 1979. Iraq was in non-accrual status from 1990 to December 2004, when it paid its arrears to IBRD (about US\$108 million).

# A. The Bank Group Strategy and Operations

- 2. On January 29, 2004, the World Bank's Board of Executive Directors discussed a first Interim Strategy Note (ISN) of the World Bank Group for Iraq and authorized the Bank to act as Administrator of the World Bank Iraq Trust Fund (ITF) within the International Reconstruction Fund Facility for Iraq.
- 3. The first ISN was designed to rely on the ITF to finance emergency operations and on the Bank's own budget to finance analytical and advisory services. It initiated activity on three tracks: (i) **build Iraqi institutional capacity**, especially to establish a mechanism of transparency and accountability urgently needed for utilizing external funding for Iraq's reconstruction; (ii) **prepare and start implementing emergency operations to address urgent needs**, especially to generate employment and kick-start economic activity and to restore essential infrastructure and services; and (iii) **lay the groundwork for Iraq's medium-term reconstruction and development program** and begin assisting in the transition from central planning to a market-driven economy, through policy advice and analytical work. To this end, it presented a range of potential interventions, aiming to provide as much support as possible for Iraq's reconstruction and development under difficult and evolving circumstances.
- 4. Over the past 16 months, the Bank has worked within the framework of the first ISN. Between March and December 2004, the Bank approved and launched nine emergency projects at a total value of about US\$366 million, thereby committing nearly all donor deposits in the ITF:
- First Capacity Building Project (US\$3.6 million)
- Second Capacity Building Project (US\$7 million)
- Emergency Textbook Project (US\$40 million)
- Emergency School Rehabilitation and Construction Project (US\$60 million)
- Emergency Private Sector Development Project (US\$55 million)
- Emergency Baghdad Water Supply and Sanitation Project (US\$65 million)

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- Emergency Urban Water and Sanitation and Urban Reconstruction Project (US\$90 million)
- Emergency Community Infrastructure Project (US\$25 million)
- Emergency Health Rehabilitation Project (US\$20 million)
- 5. The Bank has used it own budget to provide policy advice on core reform issues, and to undertake diagnostic and analytical sector work. To fully exploit cross-sectoral synergies, the economic and sector work program has been grouped into three clusters: (i) economic reform and transition; (ii) poverty, safety nets, and social development; and (iii) public sector reform and governance. The Bank's economic and sector work includes short notes to provide timely policy advice, and detailed reports that offer more comprehensive analytical assessments. The Bank also supported Iraq's elaboration of a National Development Strategy (NDS), which was presented to donors in October 2004. The Bank is in the process of finalizing a Country Economic Memorandum (CEM) that draws on sectoral studies of Iraq's economy and policy discussions with Iraqi officials over 2003–05.
- 6. The World Bank is a member of the International Advisory Monitoring Board (IAMB), which commenced in December 2003.
- 7. The International Finance Corporation (IFC) has focused on supporting the financial sector and small and medium enterprises (SME) through both investment and technical assistance. On the investment side, IFC signed an agreement in March 2005 to acquire a minority stake in the Credit Bank of Iraq, in partnership with the National Bank of Kuwait (NBK). IFC and NBK plan to increase the capital of the Credit Bank of Iraq in stages to put it in a strong position within the domestic financial market. This investment will have a demonstration effect and pave the way for other international banks to invest in and transfer knowledge to the Iraqi market. The Iraq Small Business Financing Facility (SBFF) combines investment and technical assistance to support the financing of the SME sector. Partially funded by donors and partly funded by IFC, the SBFF will provide financing, including a first loss component, and technical partners to the nascent local banking sector. The first participating bank has been identified, a joint venture partner bank has invested to increase the bank's capital, and an agreement with a technical assistance provider is about to be signed. The first commitment is expected this fiscal year, following challenges in registering the shares of the joint venture partner and delays caused by security concerns. IFC has also been active in technical assistance in Iraq through the Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA), which carried out a five-month bank training program for Iraq from September 2004 to February 2005 to discuss strategic options for the development of the Iraqi banking sector going forward.
- 8. The Government of Iraq requested resources from IDA in December 2004 and met with the Bank in February 2005 to begin discussing a possible lending program and to provide inputs into a Second Interim Strategy Note, which is expected to provide a framework for up to US\$500 million of IDA lending as well as additional ITF resources.

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# B. IMF-World Bank Collaboration in Specific Areas

9. The Bank is working closely with the Fund on the reform program in Iraq. The two institutions have conducted a number of joint missions and organized policy workshops and training courses for Iraqi civil servants and academics, covering public financial management, oil revenue management, intergovernmental finance, investment climate, payment system, banking supervision, social safety nets, and the like. There are no major differences of views between the two institutions on policy issues. The staffs are in broad agreement on the core reform program in Iraq, namely: (i) reinforcing public governance and institutions, including management of oil revenues; (ii) ensuring coherent and well-sequenced market-focused reforms; (iii) strengthening social safety nets; and (iv) improving the delivery of essential services, including education and health.

#### C. Areas in Which the World Bank Leads and There is No Direct IMF Involvement

10. Through ITF-funded projects, the Bank is providing emergency support to rehabilitate vital public services—education, health, water supply and sanitation, urban infrastructure, and telecommunications (all under implementation). The Bank anchors its project work in focused analysis of sector issues, and supports Iraqi capacity-building via policy workshops and training courses. The Bank leads work on gender issues; and it plans to support Iraq to undertake a Household Socio-Economic Survey and a Poverty Assessment.

# D. Areas in Which the World Bank Leads and Its Analysis Serves as Input Into the IMF-Supported Program

- 11. The Bank has provided policy advice and inputs to the Prime Minister's Supreme Economic Committee and to key ministries. Specific Bank inputs are provided in the form of just-in-time policy notes on key reform areas and sectors, such as subsidy reforms, pension system, SOE restructuring and investment climate, trade policy and trade facilitation, and telecommunications. The World Bank is working with the World Food Program on food market issues. Work is underway on social safety nets, state bank restructuring, agriculture reform, intergovernmental finance, and civil service reform.
- 12. The Fund has a strong interest in the areas listed above from the macroeconomic perspective (economic growth and fiscal sustainability, including the phasing out of nontransparent quasi-fiscal operations). The Fund has also a strong interest in governance issues, in particular with regards to oil revenue management.

#### E. Areas of Shared Responsibility

13. The World Bank and the IMF are working together on macroeconomic and fiscal sustainability, revenue management, the reform of domestic subsidies, financial sector reform (comprising state bank restructuring, system and banking supervision and regulation), public finance, public debt management, and statistical capacity building. The Bank and the Fund closely coordinate their capacity building activities in macroeconomic management,

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public sector governance, private sector development, and social safety nets. The Bank also coordinates with the Fund its macro-modeling work (which includes the formulation of an aggregate CGE model to evaluate the impact of major reforms). The design of the Bank's Household Socio-Economic Survey benefited from comments provided by the Fund team.

# F. Areas in Which the Fund Leads and Its Analysis Serves as Input Into the World Bank-Supported Programs

14. The Fund leads the dialogue on core macroeconomic policies and has taken the lead on debt sustainability analysis, monetary policy, the management of aggregate expenditures, and public expenditure management. The Bank is working with the Fund to ensure consistency of the overall macroeconomic and fiscal framework.

#### G. Areas in Which the IMF Leads and There is No Direct World Bank Involvement

15. The Fund leads the dialogue on monetary and credit policies, exchange rate management, tax administration, and balance of payments issues.

Iraq Country Director: Mr. Joseph P. Saba, contact number (202) 473-2992.

Table 1. Iraq: Bank-Fund Collaboration

Area of Reform	Lead Institution
1. Market-focused reforms	
Reform of domestic subsidies	World Bank/IMF
Trade policy and facilitation/WTO accession	World Bank
2. Monetary and credit policies	IMF
3. External sector	
Balance of Payments	IMF
Debt sustainability	IMF
4. Public sector governance	
Public financial management	IMF/World Bank
Oil revenue management	IMF/World Bank
Civil service reform	World Bank
Tax administration	IMF
Public debt management	World Bank/IMF
Intergovernmental finance	IMF/World Bank
Governance and anticorruption	World Bank
5. Public service delivery	
Education and health	World Bank
Power, water and infrastructure	World Bank
Agriculture, and environment	World Bank
Telecommunications	World Bank
6. Private sector development	
Investment climate	World Bank
SOE reform	World Bank
Financial sector development, incl. payment system and bank supervision	IMF/World Bank
Bank restructuring	World Bank
Housing Finance	World Bank
7. Human development	
Pension reform	World Bank
Social safety nets and poverty analysis	World Bank
Labor market issues	World Bank
Gender issues	World Bank
8. Other	
Oil and gas sector	World Bank/IMF
Statistical capacity building	IMF

# **Iraq: Statistical Issues**

# A. Background

- 16. Iraq's macroeconomic statistics, which were once among the most developed in the region, have suffered from years of neglect. Statistics were mostly confidential and had limited use. There was little or no incentive to improve or even preserve quality. There was not much contact with the outside world, and only a few Iraqi statisticians were able to gain knowledge of the latest statistical manuals. Recent turmoil has added to the difficulties. Given all these setbacks, the extent to which statistical data are available is remarkable.
- 17. The long period of neglect of government institutions under the previous regime has had devastating effects in many respects and has reduced statistical capacity. Although the Central Organization for Statistics and Information Technology (COSIT) remained in place, its technical expertise was at best obsolete. For instance, national accounts experience was solely with *System of National Accounts*, 1968 (1968 SNA). The CBI's statistical capacity is slightly better, although the staff needs training.
- 18. The Statistics Department (STA) has provided technical assistance (TA) in statistics since 2003. After the June 2003 Fund assessment mission in which STA also took part, a first monetary statistics mission visited Baghdad in July as part of an MFD-led mission. In December 2003, a multisector statistics mission met with Iraqi representatives from the CBI, COSIT, and the ministry of planning (MoP) in Amman, Jordan. The mission covered money and financial statistics, balance of payments and foreign trade statistics, national accounts, and consumer price statistics. In January 2004, STA hosted two workshops for Iragi statisticians, also in Amman, one workshop on national accounts and one workshop on consumer price indices. During FY 2005, follow-up missions, held in Amman, were conducted in national accounts, price statistics, and balance of payments statistics. In May 2005, STA, the IMF's Middle East Technical Assistance Center, and the World Bank jointly hosted a workshop for Iraqi statisticians and statisticians from the West Bank and Gaza, again in Amman, on General Data Dissemination System (GDDS) metadata development. The objective of the workshop was to assist the authorities in drafting GDDS metadata in a view of their participation in the GDDS. STA continues to deliver its TA mission program taking due account of the absorptive capacity of the statistical agencies involved, and the contributions of other donors.

# **B.** Shortcomings with Statistical Framework

#### National accounts

19. The COSIT compiles national accounts statistics mainly for government use and the existing Statistical Act has the COSIT reporting to the minister of planning who has to agree on the data before its release. This procedure affects the COSIT's statistical independence. COSIT releases national accounts statistics to the public only in a limited form. It publishes

current price estimates in the Statistical Yearbook, but this has limited circulation. It is available but only after application to, and the approval of, the minister of planning.

- 20. The national accounts follow the *1968 SNA* but there are gaps and flaws in its implementation. There are deficiencies in the scope of the accounts, both in the geographical and industrial coverage. The accounts do not—since 1991—include the northern region of the country (Kurdistan). The national accounts do not cover the informal sector and the surveys used are out of date. Also, they miss a significant portion of the building industry. Further, there are many gaps in the coverage of business, community, social, and personal services. The COSIT uses out-of-date classifications, which do not follow standard international best practice.
- 21. The data collections are reasonably comprehensive for current price data in the formal sector. Under current procedures, businesses employing more than 10 people should report calendar year data by the following October, and small businesses need to report by the following June. Because there are sizable penalties for noncompliance, respondents usually meet these deadlines. However, with recent changes in the country, one can expect the timeliness of this data reporting to worsen.
- 22. There is a shortage of quarterly and monthly indicators of economic activity and a lack of timely data for services. For several industries, extrapolating from out-of-date benchmarks adversely affects data quality.
- 23. Technical assistance by STA consultants is continuing. Areas in need of improvement include the implementation of 1993 SNA, improvement of data on external trade and capital formation, the compilation of the accounts by institutional sectors, and updating of surveys.

# **Consumer price index**

24. The staff is inadequate in number and has only recently received training during STA technical assistance missions. There is not enough computer hardware and software to process the CPI efficiently. Recent technical assistance missions have focused on providing hands-on training on methodologies for compiling the consumer price index (CPI) and on methods for making adjustments in the CPI for changes in the quality of goods and seasonality. Improvements in the CPI are limited by outdated weights, which date to 1993, but these cannot be updated until the next household budget survey is conducted in 2005/2006. Limited training has also been provided on methods for constructing the producer price index (PPI) and the wholesale price index (WPI) and on documenting the procedures and methods used to compile the CPI (metadata); work in this area is continuing.

#### Monetary and financial statistics

25. CBI staff compiling monetary statistics seem sufficient in number, but they need training on methods of the *Monetary and Financial Statistics Manual (MFSM)*. Availability of computers is far from satisfactory.

- 26. The monetary data for Iraq does not include banking activity data from the northern region of the country (Kurdistan). Staff have provided the CBI with the standardized reporting forms for the CBI and the other depository corporations and explained the concepts, linkages, and presentation formats of the Central Bank Survey (CBS), the Other Depository Corporations Survey (ODCS), and the Depository Corporations Survey (DCS). The CBI staff have begun to compile the CBS, in parallel with their current reporting format. Problems of classification, inadequate sectorization, and valuation are being reviewed.
- 27. Commercial bank balance sheet data are patchy. Inadequate reporting from branches have hampered proper coverage and sectorization, classification, and valuation problems exist. In that regard, Bearing Point/USAID consultants are providing technical assistance in Baghdad. A monetary and financial statistics mission is scheduled to take place during July 23–28, 2005.

# **Balance of payments statistics**

- 28. There are time series available from 1988 to 2002 presented according to the IMF's *Balance of Payments Manual, fourth edition (BPM4)* format. However, there are deviations in definitions, data coverage, classification, valuation, and sectorization for the *BPM4* time series. For 2002 to 2004, the balance of payments statistics are also in the IMF's *Balance of Payments Manual, fifth edition (BPM5)* format. Although the quality of the information for the past three years has improved, the presentation is still limited with deviations from the internationally acceptable methodologies.
- 29. A balance of payments technical assistance mission met with Iraqi counterparts of Balance of Payments Statistics Division's (BOPSD) of the CBI in Jordan from April 9-21, 2005. The mission provided assistance in improving collection and compilation methods for the balance of payments components, applied hands-on training on several aspects of external sector statistics methodology, and guided CBI staff in preparing a methodological note describing current statistical production and dissemination practices of external sector statistics.
- 30. The mission found that some progress has been made since the multisector mission in December 2003 in the following areas: (a) the new CBI Law and the Banking Law make reference to the compulsory reporting of information of banks and any other entities for publication, among others, of balance of payments statistics; (b) the exchange rate problems have been largely eliminated as most transactions are currently reported and compiled in U.S. dollars; (c) the stock data have been removed from the historical transactions series; and (d) new reporting forms for the commercial banks have been designed.
- 31. The mission noted that the quality of information has been seriously hampered because of the incorrect interpretation of key balance of payments concepts; the lack of human and technological resources; lack of internal cooperation within the CBI; nonresponse to surveys and reporting forms by external sources; difficulties in collecting information due

to the current security situation; and the exclusion of the Kurdish areas in most of the balance of payments statistics components.

- 32. These problems have made the balance of payments largely dependent on the BOPSD's ad-hoc observations and estimates. The lack of information is affecting the quality of the data in various components, notably in services, income, and transfers in the current account, and for all components in the capital and financial account.
- 33. The mission's main recommendations were to:
- improve human and technological resources for the BOPSD;
- improve the legal framework for collecting and compiling balance of payments statistics;
- align the concept of residence with the fifth edition of the *Balance of Payments Manual (BPM5)* in order to be consistent with international methodologies;
- present the balance of payments with the required *BPM5* components and breakdown by sector;
- reintroduce customs forms for compiling goods data;
- improve coverage of services, income and current transfers account, by introducing the new surveys developed by the mission;
- use the results of the exploratory survey by the ministry of planning conducted in 2003 to create a business directory register and participate in the review of the forthcoming FDI survey to be implemented by the ministry of planning in 2005;
- compile financial account data, within the current limitations of the compilers, with more reliable data sources; and
- compile and disseminate data on external debt consistent with the international guidelines.

#### **External trade statistics**

34. The COSIT does not have enough staff in the section responsible for compiling external trade data. The software for data entry is out of date. There is only one computer available, which is also out of date. The staff's main responsibility is checking the customs declaration forms for consistency and keypunching relevant data into computer files. In addition, gaps in the customs data occur in 2003 and 2004 because there were no customs inspections at the borders.

- 35. The customs declaration forms reflect an outdated declaration method. The Customs Department declaration forms are old, often unreadable, and miss important information. There is currently a customs form for exports; however, it is not used by the CBI as the primary source for compiling trade data. Furthermore, customs forms for imports ceased to be used from 2003.
- 36. The coverage of the external trade statistics does not include the northern region of the country (Kurdistan). The Customs Department classifies items often by customs duties, which makes it difficult for the COSIT to reclassify. As a result, there is a large margin of error in the final product.
- 37. The foreign trade data are monthly but there are serious problems of timeliness. Sometimes, release of the data may take up to one year. There are no legal requirements on the timeliness of source data.
- 38. The external trade data from the COSIT and the data compiled by the CBI are not consistent. The Balance of Payments Division of the CBI does not use external trade data from the COSIT.

#### Government finance

39. Iraq does not report government finance statistics for publication in the Government Finance Statistics Yearbook (GFSY) or International Financial Statistics (IFS). Currently there are no fiscal statistics published by the government beyond the summary central government budgetary estimates and outturn. The February 2005 government finance statistics (GFS) mission—held jointly with a parallel FAD and World Bank mission discussed a work plan aimed at building up GFS reporting as an integral part within the overall objective of major rehabilitation of the budgetary, accounting, and fiscal management information system. The mission identified institutional, technical, resource, and coordination issues that would need to be addressed prior to developing GFS for Iraq and recommended the creation of a GFS unit. Key first steps of this unit will be to implement the GFS classification for mapping the chart of accounts and budget classification onto the format of the Government Finance Statistics Manual (GFSM) 2001, initiate a General Data Dissemination System (GDDS) project to draw up plans for GFS development and dissemination, and create preliminary estimates of GFS-compliant data for general government on a best effort basis.

Table 1. Iraq: Table of Common Indicators Required For Surveillance (As of June 20, 2005)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	06/20/05	06/20/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	03/05	05/05	M	M	M
Reserve/Base Money	04/05	06/23/05	M	M	M
Broad Money	N/A	N/A	N/A	N/A	N/A
Central Bank Balance Sheet	04/05	06/23/05	M	M	M
Consolidated Balance Sheet of the Banking System	N/A	N/A	N/A	N/A	N/A
Interest Rates 2/	06/05	06/1/05	W	W	W
Consumer Price Index	05/05	06/20/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/– General Government 4/	2004	06/6/05	A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	2004	06/6/05	A	N/A	N/A
Stocks of Central Government and Central Government-Guaranteed Debt	N/A	N/A	N/A	N/A	N/A
External Current Account Balance 5/	2004	04/09/05	A	A	A
Exports and Imports of Goods and Services	2004	04/09/05	A	A	A
GDP/GNP	N/A	N/A	N/A	N/A	N/A
Gross External Debt	N/A	N/A	N/A	N/A	N/A

<sup>1/</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2/</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3/</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4/</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5/</sup> Including currency and maturity composition.

<sup>6/</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not available.

# **Iraq: External Debt Outlook**

- 40. On November 21, 2004, the Paris Club agreed to a reduction of Iraq's outstanding debt at end-December 2004 in three stages: 30 percent debt reduction upon the signing the agreement, combined with interest deferral on the outstanding balance; 30 percent additional debt reduction upon approval of an upper credit tranche arrangement with the IMF (expected by end-2005), and a further 20 percent debt reduction following completion of the IMF's Executive Board's final review of three years of one (or more) upper credit tranche arrangement(s). The agreement also entails a rescheduling of the remaining debt stock with repayments of the debt stock starting in July 2011 and ending in January 2038. In addition, interest payments accrued during 2005–07 are fully capitalized, and those accrued during 2008–10 are partially capitalized.
- 41. The first stage of debt reduction significantly reduces Iraq's debt burden. If all creditors (Paris Club, Non Paris Club, and private creditors) provide debt reduction comparable to that agreed by the Paris Club, debt forgiveness in 2004 would amount to some \$36 billion. The United States has already granted 100 percent debt cancellation, while other countries are assumed to provide 30 percent. Japan and Russia have indicated that they would opt for debt service reduction (rather than debt reduction) comparable to the agreed amount of debt reduction in net present value terms. The Paris Club agreement also reduces debt service over the medium term because it defers the principal and most interest payments until 2011.<sup>25</sup>
- 42. The first stage of debt reduction is nonetheless insufficient to bring the debt stock to a sustainable level. With the first stage of debt reduction, the stock of external debt outstanding at end 2004 is estimated to be about \$78 billion, or about three times of Iraq's GDP. Without additional debt reduction, the external debt stock would increase to about \$103 billion by 2010 (about 170 percent of GDP), partly because the capitalization of the majority of the interest payments during 2005–10. With the second and third stage of debt reduction, on the other hand, the external debt stock would decline to about \$34 billion (57 percent of GDP) by 2010 (see Appendix IV, Table 1).
- 43. Because of the deferral of most interest payments until 2010, Iraq would have limited liquidity needs after the first stage of debt reduction, notwithstanding the very high level of the stock of debt. Iraq would nonetheless be very vulnerable to a negative oil shock. With the implementation of the first stage of the debt reduction, Iraq's external debt service would be relatively small through 2010 (Appendix IV, Table 1). However, simulations for two oil shocks—a production shock which limits oil production to 3.0 mbpd

<sup>25</sup> The deferral of the payments is formally linked to the second stage of debt reduction. Although the projection in the baseline scenario assumes only the first stage of debt reduction, the assumption of deferred payment is maintained.

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in 2008–10, and a price shock which lowers oil export price by \$4.5 per barrel (equivalent to one standard-deviation) in 2006–10—show that Iraq's liquidity needs would increase substantially, requiring significant borrowing on international markets to close the (ex ante) financing gaps (Appendix IV, Table 2). Iraq's already unsustainable debt stock would also increase under these two scenarios.

Table 1. Iraq: Estimated External Debt Stock, 2004–10 (In billions of US\$ unless otherwise indicated)

	2004	2004	2005	2006	2007	2008	2009	2010
	before debt reduction 1/	after debt reduction 2/						
Without the second and third stage of debt reduction 3/								
Paris Club creditors	36.6	23.8	25.0	26.3	27.6	28.8	29.9	30.6
Non Paris Club creditors	76.4	53.5	56.2	59.0	61.9	64.7	67.1	68.6
Of which: official creditors	61.4	43.0	45.1	47.4	49.8	52.0	53.9	55.2
Multilateral creditors 4/	0.6	0.9	0.9	1.0	1.3	1.7	2.4	3.4
Total debt	113.6	78.2	82.1	86.3	90.8	95.2	99.4	102.6
Total debt (in percent of GDP)	444.9	306.2	279.8	221.2	200.9	185.3	179.6	170.1
Total debt service 5/		0.0	0.0	0.0	0.0	0.7	1.6	2.7
With the second and third stage of d	ebt reduction 6/							
Total debt	113.6	78.2	51.1	53.5	56.3	31.0	32.9	34.1
Total debt (in percent of GDP)	444.9	306.2	174.3	137.2	124.6	60.3	59.4	56.6
Total debt service 5/		0.0	0.0	0.0	0.0	0.6	0.8	1.1

Sources: The Paris Club and staff estimates.

<sup>1/</sup>Some debt has been reconciled, and the amount of reconciled debt is less than the initial claim. As a result, the estimates of debt outstanding prior to debt reduction are lower than those in the 2004 EPCA staff report (IMF Country Report 04/325).

<sup>2/</sup>Assumes comparable debt reduction to all external debt.

<sup>3/</sup>The projection assumes the deferral of payments of principal and most interests until 2011.

<sup>4/</sup>The projection includes new debt. Iraq cleared its arrears to the Fund and the Bank in 2004.

<sup>5/</sup>Debt service is actual amount paid (not accrued), excluding repayment of arrears.

<sup>6/</sup>Assumes no additional debt other than a larger disbursement of Fund credit.

Table 2. Iraq: External Debt Sustainability Framework, 2004–10 (In percent of GDP, unless otherwise indicated)

	Est.		P	rojections			
	2004	2005	2006	2007	2008	2009	2010
External debt	306.2	279.8	221.2	200.9	185.3	179.6	170.1
Change in external debt (1)	-528.1	-26.4	-58.5	-20.4	-15.5	-5.7	-9.5
Identified external debt-creating flows (2)	-395.6	-32.3	-62.1	-22.7	-17.4	-7.5	-11.4
Current account deficit, excluding interest payments	14.7	16.9	1.7	-0.7	0.1	0.4	-1.0
Deficit in balance of goods and services	22.5	36.7	16.3	6.6	2.7	-0.6	-1.3
Exports	69.6	64.8	69.9	70.6	70.2	68.9	67.3
Imports	92.1	101.5	86.2	77.1	73.0	68.4	66.1
Net non-debt creating capital inflows (negative) 1/	-41.9	-22.8	-4.9	-1.1	-2.1	-3.4	-3.8
Automatic debt dynamics 2/	-368.4	-26.5	-58.8	-20.8	-15.4	-4.5	-6.6
Contribution from nominal interest rate	21.1	13.2	10.5	9.5	8.8	8.6	8.3
Contribution from real GDP growth	-207.0	-9.9	-35.4	-26.0	-22.0	-13.4	-11.8
Contribution from price and exchange rate changes 3/	-182.4	-29.8	-33.9	-4.4	-2.2	0.2	-3.0
Residual, incl. change in gross foreign assets (1-2)	-132.5	5.8	3.6	2.3	1.8	1.8	1.9
Of which: change in official reserves (increase = positive)	26.5	5.8	3.6	2.3	2.3	2.2	1.9
External debt-to-exports ratio (in percent)	439.8	431.7	316.4	284.7	263.9	260.6	252.6
Gross external financing need (in billions of US dollars) 4/	8.7	7.5	3.2	4.0	4.6	4.9	4.2
in percent of GDP	34.1	25.4	8.2	8.8	8.9	8.8	7.0
External debt service in percent of exports 5/	30.3	20.4	15.0	13.5	12.6	12.5	12.3
Debt-stabilizing non-interest current account (positive = surplus) 6/	-542.8	-43.4	-60.2	-19.7	-15.6	-6.1	-8.6
Key Macroeconomic Assumptions							
Real GDP growth (in percent)	46.5	3.7	16.8	13.6	12.5	7.8	7.2
GDP deflator in US dollars (change in percent)	28.0	10.8	13.8	2.0	1.1	-0.1	1.7
Nominal external interest rate (in percent)	4.7	5.0	5.0	5.0	5.0	5.0	5.0
Growth of exports (US dollar terms, in percent)	91.7	6.9	43.4	16.9	13.2	5.6	6.5
Growth of imports (US dollar terms, in percent)	194.1	26.6	12.9	3.7	7.6	0.8	5.3
		Str	ess Tests for	r External D	ebt Ratio		
Limited oil production 7/		279.8	221.2	200.9	192.8	200.7	203.2
Lower oil price in 2005–06 8/		279.8	243.9	227.8	213.2	206.8	194.4
	Str	ess Tests fo	or External l	Debt Service	-to-Exports	s Ratio 5/	
Limited oil production 7/		20.4	15.0	13.5	13.1	14.3	15.6
Lower oil price in 2005–06 8/		20.4	16.8	15.6	15.2	15.4	15.1
Memorandum items:							
Real GDP growth under stress scenarios (in percent)							_
Limited oil production 7/		3.7	16.8	13.6	10.2	3.8	3.6
Lower oil price in 2005–06 8/		3.7	16.8	13.6	12.5	7.8	7.2
Non-interest current account deficit under stress scenarios (in percent of GDP)							
Limited oil production 7/		16.9	1.7	-0.7	2.4	5.6	6.9
Lower oil price in 2005–06 8/		16.9	5.6	4.0	5.0	5.4	3.8

<sup>1/</sup> Includes net FDI, other net private sector inflows (all assumed to be equity), and use of official assets held abroad.

<sup>2/</sup> Derived as  $[r - g - \rho(1+g) + ea(1+r)]/(1+g+\rho+g\rho)$  times previous period debt stock, with r = nominal effective interest rate on external debt;  $\rho =$  change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

<sup>3/</sup> The contribution from price and exchange rate changes is defined as  $[-\rho(1+g) + ea(1+r)]/(1+g+\rho+g\rho)$  times previous period debt stock.  $\rho$  increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

<sup>4/</sup> Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

<sup>5/</sup> Debt service is total accrued amount.

<sup>6/</sup> Balance that stabilizes the debt ratio at its previous year's level, given assumptions on real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP.

<sup>7/</sup> Assumes that oil production reaches its peak by 2008 at 3.0 mbpd.

<sup>8/</sup> Assumes that oil price in 2005-10 is US\$4.5 lower than in the baseline, equivalent to one standard-deviation shock.

#### INTERNATIONAL MONETARY FUND

#### **IRAQ**

# Staff Report for the 2005 Article IV Consultation Supplementary Information

Prepared by the Middle East and Central Asia Department

Approved by Lorenzo Pérez and Carlos Muñiz

July 25, 2005

- 1. This statement provides an update on developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged.
- 2. A donors' conference on Iraq was held in Jordan (Dead Sea) during July 18–19. Donors reiterated their support for the government's reconstruction program and welcomed the introduction of an Iraqi led donor coordination mechanism. 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. Other donors also announced and reaffirmed pledges. The World Bank announced a lending program of \$500 million over the next two years. Iran subsequently announced (outside the context of the donors' conference) that it would grant Iraq a \$1 billion credit line.
- 3. The overall Consumer Price Index (CPI) index increased by 1.0 percent in June. The CPI increased by a cumulative 5.7 percent in the first six months of 2005, or by 37.2 percent in the year to June 2005. Fuel prices, which rose by 237 percent during July through December 2004, fell by 48 percent during January through June 2005.
- 4. The cumulative increase in reserve money in the five months to May 2005, was 1.2 percent, while the increase in currency in circulation for the same period was 18.8 percent. The difference in the growth of the two monetary measures mainly reflects the impact of the recently introduced overnight deposit facility, which by end-May had attracted about ID 1,753 billion (the equivalent of 14.2 percent of reserve money) from the banks' free reserves and thereby reduced the growth of reserve money.
- 5. External reserves of the CBI continue to grow during the first five months of 2005, though at a slower pace than in 2004. Reserves increased to \$8.8 billion in May, compared with \$7.7 billion in March, and \$7.4 billion in December, 2004.
- 6. The CBI adopted the following measures effective July 3, 2005: (i) an increase in the interest rate on the overnight dinar deposit facility from 4 to 5 percent per annum; and (ii) the

introduction of a 14-day and a 30-day deposit facilities yielding 6 percent and 7 percent, respectively. The interest rate rose to 9.9 percent in the July 4 treasury bill auction.

- 7. The exchange rate has continued to be under some pressure. The exchange rate in the first three weeks of July has ranged between ID1,476 to ID1,470 per dollar, from an average of ID1,460 in June.
- 8. Oil export volume in June was 1.5 million barrels per day (mbpd), compared with an average of 1.4 mbpd in the first five months of 2005. Average oil export prices in June were \$39 per barrel compared with an average of \$36.4 in the first five months of 2005. The Northern Oil pipeline resumed operation in mid-July, allowing the shipment of about 250,000 barrels per day.

# Statement by A. Shakour Shaalan, Executive Director for Iraq August 1, 2005

1. Today marks another defining moment in the relationship between Iraq and the Fund: the resumption, after a quarter century of interruption of the Board's review of an Article IV consultation for Iraq. The authorities would like to thank the Fund's board, management and particularly the staff, for their ongoing commitment in assisting Iraq through a long and arduous road and in furthering the normalization of the country's standing in the international community. Moreover, I would like to convey the authorities' continued commitment to sound policies and to needed structural reforms, that will contribute to rebuilding the economy and its institutions, and recover the prosperous position it once held in the not too distant past.

#### **Background**

- 2. The economic situation—particularly in Iraq—needs to be assessed in its larger social and political context, given its tremendous bearing on economic developments. It is easy to overlook that the establishment and maintenance of relative macroeconomic stability in the midst of violence and a security chaos is an achievement in itself. It required strong and continuous efforts on the part of the authorities, along with firm assistance from the international community and in particular the Fund. Indeed, the staff's advice and technical assistance have strongly contributed to the identification of priorities, the assessment of capabilities and the formulation of desired policies in this difficult context.
- The implementation of policies in Iraq, and especially their pace, is severely constrained by the new and fragile institutional setting in which it is formulated, the limited administrative capacity and the precarious social, political and security situation. Large segments of the Iraqi population continue to live in hardship, with an unemployment rate estimated by the Ministry of Planning to be around 28 percent, probably an underestimate. The recent UNDP survey portrays some of the daunting social challenges, including widespread chronic children malnutrition and endemic diseases. Moreover, basic household needs, such as reliable access to water, sewage services and electricity are poorly provided for, and further underscore the urgency of assisting the population to cope with the ongoing conflict. In light of these large social needs, the politically charged atmosphere and the security breakdown, the timing of the introduction of major reforms such as that of the petroleum subsidy—to which the authorities are firmly committed—is critical. Tangible improvements in daily life and compensatory measures to alleviate the burden on the population would be crucial to ensure the feasibility of introducing politically contentious reforms. An acceleration of disbursements of the donor's commitments to Iraq—which has received only a small fraction of the pledges made so far—would go a long way in creating a policy space for the authorities and allow a more vigorous pace of economic restructuring.

# **Recent Developments**

- 4. Political reforms have advanced substantially even if the process appeared protracted at some junctures. Successful parliamentary elections were held in January 2005 for the Transitional National Assembly, which was followed by the election of the president of the republic followed by the formation of a new cabinet in April of this year. Moreover, a committee from the Assembly has been set up and has started its deliberations to draft a new constitution for the country. A public referendum on the constitution will follow shortly after.
- 5. In parallel with this active and eventful political dynamics, the economic process also moved along with resolve, even if in an uneven way. The rebuilding of the economic institutions has been pursued relentlessly in order to create a vibrant market based economy and increase the efficiency of the use of its natural resources. GDP growth in 2004 has been close to 50 percent (albeit from a low level), reflecting increases in oil production to about 2 mbpd—as a result of public investment in the oil sector—and sustained growth in the non-oil sector. While violence and insecurity have limited the further expansion of oil production this year so far, it is expected that it would rebound in 2006 with a strong prospect for real GDP growth to be in the double digits again. Iraq's proven oil reserves, estimated at around 115 billion barrels, are the world's third largest. The potential development of the oil sector is considerable given that a large portion of the country remains unexplored. Oil production could expand to 2.4 mbpd in 2006 and to a further 3.5 mbpd by 2010, pending improvements in general security as well as decreased sabotage to northern pipelines.

# **Monetary Policy**

- 6. High inflation has accompanied the high growth rate in 2004, essentially due to violence-related shortages of essential goods. Prices have, however, stabilized relatively in 2005, but will nonetheless imply a higher than expected rate for the year, requiring an adjustment of the EPCA target to 20 percent for end-2005. The Central Bank of Iraq (CBI) has recently introduced separate dinar and dollar deposit facilities in an effort to reduce liquidity and help stem price pressures. In early July, the CBI increased the remuneration on the dinar's overnight rate from 4 to 5 percent annually, and introduced 14 and 30-day deposit facilities, with a 6 and 7 percent interest rate respectively, signaling a tightening of monetary conditions. These facilities widened the range of monetary policy instruments of the CBI and additional instrument are under consideration. The monetary tightening was reflected in the CBI treasury bills' rates which have increased from 4 percent in 2004 to 7 percent in June 2005.
- 7. The rate increases should help ease some of the pressures on the exchange rate that were witnessed earlier this year. The authorities note that only on few occasions was the supply of dollars rationed and they understand the importance of satisfying the demand for foreign exchange. While the authorities have considered moving to a flexible exchange regime to alleviate the pressure on reserves in trying to achieve price stability, they recognize the need for a nominal anchor for monetary policy and agree that the peg to the dollar has been relatively effective in this respect. The rapid buildup of international reserves at the CBI

beyond the EPCA target, almost reaching US\$9 billion in May provides a safety cushion for the continued support of the peg. The authorities fully recognize that prudent monetary and fiscal policies are needed to support the peg.

#### **Fiscal Sector**

- 8. The fiscal deficit in 2004 was slightly higher than the EPCA's target. Higher oil revenues and lower than expected wage and pension outlays helped contain the net effect of an increase in spending in goods and services, the latter being, to a large degree, due to unbudgeted commitments by the Coalition Provisional Authority the year before. Investment spending was also lower, reflecting a weak disbursement in donor-financed non-oil reconstruction projects. On the other hand, the Iraqi investment spending on the oil sector was close to target.
- 9. While further oil price increases are keeping oil revenue targets in line with the program so far in 2005, thus compensating for the lower-than-programmed oil export volumes, the authorities are aware of the volatility of oil prices and the risk it entails for the fiscal outlook. Moreover, with a doubling of the differential between the price of Iraqi oil exports and world prices this year, Iraq is not reaping the full benefits of stronger prices. The authorities are looking into the matter to explain the origin of the differential and hope to be able to take any measure they can to narrow this differential, and thus increase revenues. The major fiscal issue, however, as staff points out, remains the foregone revenues of the petroleum product subsidy. The authorities are aware of the importance of this measure for the medium and long term sustainability of the fiscal stance. As we noted earlier, they are subject to stringent political constraints in this regard, but are committed to start reducing significantly the subsidy as soon as feasible. They, moreover, emphasize the need for a good communication and education strategy to be developed in this regard.
- 10. The authorities agree that in view of the delay in implementing the reduction of subsidies and the pressures to increase spending including on security, a financing gap might emerge for 2005 and 2006. They further agree that in the event that the gap is not closed by higher oil revenues, additional measures may have to be undertaken in the context of a supplementary budget and that any additional spending commitment would have to be funded from government revenues and the sale of assets held abroad. The accumulation of arrears will continue to be avoided as has been the case so far.

#### **Structural Reforms**

11. Budgetary management has improved in 2005 with the reporting on budget outturns in line ministries, albeit with a significant delay. To deal with the fragmentation of fiscal operations and off budget operations, the MOF is committed to approve additional spending only in the context of a supplementary budget. The authorities will work on strengthening further governance and budget management, including through the preparation of consolidated government accounts. They intend to follow up on the recommendation of the International Advisory and Monitoring Board regarding the Development Fund for Iraq and

the audit of the oil sector, and inspections and verification of oil exports is already taking place. Further measures to increase savings and enhance revenue will be undertaken, including scrutinizing procurement practices while strengthening and diversifying the sources of revenues. The authorities are considering the conversion of the levy on imports into a permanent import duty and the strengthening of customs collection and administration in order to increase the relatively low levels of revenues from this source. Other taxes and surcharges, including on profits in the cell phone sector, are also being contemplated.

12. The CBI is intent on the reform and modernization of the financial sector in general and the banking sector in particular, especially in view of the low financial sector intermediation and the prevalence of cash transactions in the economy. Modern central bank, commercial bank, and AML laws are being adopted. Moreover, a modern payment system, including a real time gross settlement system and an automated check-clearing system, and its accompanying regulation, is being developed. With a modernized payment infrastructure and regulation the promotion of a competitive financial sector will be sought next. This will include the restructuring of existing banks and inviting foreign participation in the commercial banks. It is important to note in this regard that the security situation has slowed the development of the banking sector as none of the international banks granted a license to operate in Iraq has established a presence there yet. In due time, the authorities will consider the creation of a deposit insurance scheme after the supervisory framework has been well established, and intend to apply international auditing and accounting standards in the sector. The CBI has proceeded with the request for tenders for an international auditor to audit its own operations according to the International Standards on Auditing, which the authorities understand is a requirement for its safeguard assessment process, a pre-condition for an SBA with the Fund. The audit could take place shortly after the end-July deadline for the tender. Other material necessary for the safeguard assessment is being provided as well.

#### **Debt Restructuring**

13. The Paris Club agreement in November 2004 paved the way for a major restructuring of Iraqi's external debt towards a sustainable position. Iraq has made good progress with official Paris Club creditors in reconciling debt claims, and has engaged non-Paris Club creditors, including the Gulf countries, in discussions with the aim of securing similar debt restructuring terms. Iraq is also engaging in good faith commercial creditors while clarifying the essential principle of Paris Club comparability in settling claims. The Iraqi authorities have met with the private creditors in Dubai in May of this year, and have subsequently made an offer to settle such claims in a press release on July 26. Further details on this offer will be communicated to the Board shortly. Given the structure of the Paris-Club agreement and the conditioning of further debt relief on an arrangement with the Fund, the authorities are seeking to enter into a stand-by arrangement with the Fund towards the end of the year.

#### Conclusion

14. The authorities are very well aware of the daunting challenges facing Iraq and of the major risks to the economic outlook looking forward, given the many political and security

obstacles facing the country. They also understand the necessity of sweeping reforms in the fiscal, monetary, and oil sectors as well as the importance to attend to the large social and humanitarian needs of the population. The authorities remain confident that with the continuous support of the international community, their commitment to political, economic, and social reforms will allow the resumption of a sustainable growth and an improvement in living standards commensurate with the aspirations of the Iraqi citizens.

# INTERNATIONAL MONETARY FUND

# Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/117 FOR IMMEDIATE RELEASE August 16, 2005

International Monetary Fund 700 19<sup>th</sup> Street, NW Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2005 Article IV Consultation with Iraq

On August 1, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iraq.<sup>1</sup>

# Background

The last Article IV consultation with Iraq was concluded by the Executive Board 25 years ago, on February 29, 1980. Following the resumption of normal relations with Iraq, the Executive Board approved a request by the government of Iraq for a purchase in an amount equivalent to SDR 297.1 million (about US\$436.3 million; 25 percent of quota) under the Fund's policy on Emergency Post Conflict Assistance (see <a href="Press Release No. 04/206">Press Release No. 04/206</a>). The EPCA-supported program, which runs through the end of 2005, underscored the authorities' commitment to a comprehensive economic and financial program. However, the implementation of the EPCA program has been hampered by the difficult security situation, a slow-moving process of reconstruction, the protracted electoral process, and slower-than-expected progress in strengthening administrative and institutional capacity. As a result, performance under the EPCA program has been mixed.

Economic activity rebounded in 2004, with real GDP estimated to have increased by nearly 50 percent, mainly reflecting the recovery of the oil sector. After an upsurge in consumer prices in late 2004 and January 2005—mostly due to supply shocks—inflationary pressures have subsequently subsided, but the 12-month inflation rate through June (at 37 percent) still exceeds by a wide margin the original EPCA-supported program projection for end-2005 of 15 percent.

The Central Bank of Iraq (CBI) reports net international reserves of US\$7.4 billion at end-December 2004, well above the program floor of US\$4 billion. After appreciating in early 2004

<sup>&</sup>lt;sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

following the introduction of the new currency, the exchange rate of the dinar has remained broadly stable since May 2004. More recently the exchange rate has been under pressure, with dollar sales volumes at the daily CBI foreign exchange auctions having almost doubled. Recently, the CBI broadened its menu of monetary policy instruments by activating separate dinar and dollar overnight deposit facilities to better manage overall liquidity in the banking system.

The fiscal deficit for 2004 was somewhat larger than targeted under the EPCA program. Spending on goods and services was higher than under the budget, with larger outlays for defense and security. Grant-financed reconstruction expenditure in 2004 fell significantly short of expectations. Although donors to the International Reconstruction Fund Facility for Iraq deposited about US\$1 billion into this facility, only about US\$103 million were disbursed to finance projects in 2004.

The implementation of all structural benchmarks under the EPCA program has been delayed, including the commitment to increase domestic prices of refined oil products, the development of payment systems, the full implementation of a financial management information system, and the establishment of an automated payroll system. This is due to the continuing lack of security, communications problems, and the need to tailor the required systems to the circumstances of Iraq. Nevertheless, progress has been made in developing a monetary survey, in drafting a new payments system legislation, and improving the banking regulatory framework.

On November 21, 2004, the Paris Club creditors agreed to debt reduction terms for Iraq to be implemented in three stages and amounting to a total of 80 percent debt reduction. The Iraqi government has begun to reconcile external claims and move toward concluding bilateral agreements with Paris Club and most non-Paris Club official creditors. The Iraqi authorities also held a meeting for private creditors in Dubai on May 4.

#### **Executive Board Assessment**

Executive Directors welcomed the resumption of Article IV consultations with Iraq, which represents a further important milestone in Iraq's relations with the Fund, and in its reintegration into the global economy. Directors commended the authorities for having established and maintained a degree of macroeconomic stability under extremely difficult circumstances, and for having initiated structural reforms. However, the economy remains fragile, and much work remains to be done to transform Iraq into a market economy, firmly based on a path of sustained growth. Directors stressed that, in the near term, the authorities will need to be ready to act resolutely to contain potential macroeconomic imbalances, most importantly, those that may arise from spending pressures, fluctuations in oil revenue, or adverse monetary developments. While recognizing that the pace of reconstruction and recovery will to a large extent depend on how the political and security situation evolves, they also urged the authorities to proceed with the most urgent structural reforms, and to maintain the policy momentum overall.

Directors noted that rebuilding Iraq's economy and infrastructure, while at the same time improving the standard of living of its people, will place significant demands on the country's limited resources. While the long-run prospects are well supported by its substantial resource base, Iraq still faces daunting challenges and downside risks in reconstructing its economy. To speed up investment in essential infrastructure, social services, and poverty reduction,

Directors underscored the importance of strong action on fiscal and oil sector reforms, along with the timely disbursement of aid commitments.

Directors stressed the critical importance of putting in place a coherent fiscal strategy aimed at prioritizing the use of available resources, while containing recurrent expenditures, particularly on wages, pensions, transfers, and non-essential projects. In this connection, Directors encouraged the authorities to maintain a cautious fiscal stance by strengthening public expenditure management, continuing to adhere to the "no overdraft" rule, and avoiding the accumulation of arrears. Directors noted that a key challenge facing the authorities is the elimination of existing price distortions, with a view to alleviating market distortions and sources of corruption, and generating additional budget resources to support priority sectors, such as education, health, and security. While recognizing the politically and socially difficult context, they urged the authorities to start phasing out the significant government subsidies on petroleum products as quickly as feasible. Directors underscored that the successful implementation of this measure will require careful preparation and supportive policies, including an effective communication and public education strategy, consideration of a pre-announced schedule, and careful social impact assessment. The role for technical assistance from the Fund and World Bank in helping the authorities in these areas was emphasized.

Directors welcomed the recent steps to enhance transparency and accountability in government activities, particularly the intention to appoint an international auditor to conduct an audit of the operations of the central bank, and the steps being taken to modernize the payments system and tackle corruption. They considered that these efforts will need to be broadened with additional measures to support budget execution and financial management, as well as with action to strengthen governance and the management of oil sector operations. In this context, Directors urged the full implementation of the Financial Management Law. They underscored, in particular, the need to implement without delay the recommendations of the International Advisory and Monitoring Board, specifically those regarding the metering of oil production and exports, and strengthening of internal controls and audit in ministries. The authorities were also encouraged to subscribe to the Extractive Industries Transparency Initiative (EITI) to help ensure improved transparency of oil revenues.

Directors agreed that the authorities' reliance on exchange rate stability as the pillar of their framework for monetary policy has served the economy well. They advised continuation of the exchange rate peg to the dollar in view of the relative stability achieved thus far and the absence of a suitable alternative nominal anchor. Directors stressed however that, in order for the peg to be credible, the central bank should refrain from resorting to administrative measures to limit the amount of dollars sold in the foreign exchange auctions and should satisfy the total amount demanded at the cutoff rate. Persistent pressures on the exchange rate should instead be met with a tightening of monetary policy, including by raising interest rates on the central bank's overnight deposit facility, and Directors welcomed the recent move in this direction. They encouraged the authorities to remain vigilant and closely monitor developments that may threaten their inflation objective, including by actively using their monetary policy instruments to adjust liquidity conditions as needed. Going forward, the development of additional monetary instruments would also facilitate the implementation of monetary policy.

Directors urged the authorities to take steps to advance their structural reform efforts. While recognizing that continuing security problems have contributed to delaying the reforms identified in the program supported by the 2004 EPCA, Directors stressed that steady progress

on a well-focused reform agenda will be key to creating the conditions for sustainable, broad-based growth. This should include: the development of a strategy for restructuring the state banks and other state-owned enterprises as part of a strategy toward reducing the role of the state over the medium term; the preparation of an overall restructuring plan for the oil sector, including by reviewing the fiscal framework governing the sector; the formulation of a strategy for the reform and monetization of the in-kind social safety net in parallel with the ongoing reform of the payments system; the phasing out of price distortions; and the modernization of prudential banking regulations and the supervisory framework. Further steps to strengthen financial management in the public sector, diversify revenues and the economy more generally, and enhance governance will also be important. Directors noted that the international community will have a continued role to play in supporting the authorities' reform and institution-building efforts.

Directors underscored the need for Iraq to reach agreement on debt rescheduling terms for non–Paris Club and private creditors comparable to those agreed last year with Paris Club creditors. They urged the authorities to accelerate the process of debt reconciliation with official creditors, so as to facilitate progress toward securing bilateral agreements as soon as possible. Directors welcomed the authorities' commitment to proceed in good faith toward the resolution of Iraq's external debt arrears. They were encouraged by the steps being taken, and called on the authorities to pursue a constructive dialogue with all creditors, and to consult with the Paris Club with respect to comparability of treatment.

Directors welcomed the authorities' intention to establish a liberal foreign trade and exchange regime and looked forward to Iraq's acceptance of the relevant Article VIII obligations. In order to facilitate the process of acceptance, the authorities should move expeditiously to review and overhaul their legislation and regulations in order to remove any possible exchange restrictions that may fall under Fund jurisdiction. Directors noted the progress made on putting in place a legal framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) matters, and looked forward to its implementation.

Notwithstanding some progress in the preparation and dissemination of statistics, Directors noted that the statistical information that the Iraqi authorities are able to provide to the Fund is just adequate for surveillance purposes. They urged the authorities to make further efforts to strengthen their statistical framework, in particular in the fiscal area.

Directors took note of the authorities' desire to enter into a Stand-By Arrangement by the end of 2005. They pointed out that progression to a Stand-By Arrangement would help underpin a sound macroeconomic framework for the continuation of Iraq's reconstruction and recovery, as well as pave the way for Iraq to move forward to a sustainable external debt situation under the terms of the Paris Club. They urged the authorities to continue to build on their track record of policy implementation by continuing to implement the program supported by EPCA, focusing on a reinvigoration of structural reforms and further steps to improve governance and the country's institutional and administrative capacity. A strengthening of the quality and timeliness of basic economic data that are essential for program monitoring will also be needed.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Iraq: Selected Economic and Financial Indicators

	2004		
	EPCA Projections	Estimated Outturn	
Production and Prices	(Percent chan	ige)	
Real GDP	51.7	46.5	
Consumer price inflation (year to December)	7.0	32.0	
Public Finance	(In percent of GDP)		
Government revenue and grants	90.6	80.5	
Expenditure	133.5	121.4	
Overall fiscal balance (including grants)	-42.9	-40.9	
Monetary Indicators	(Percent change)		
Reserve money (year to December)	117.0	116.9	
Currency issued (year to December)	118.4	74.9	
Balance of payments	(In US\$ billion	)	
Exports of goods	16.5	17.8	
Imports of goods	-21.7	-19.3	
Trade balance	-5.1	-1.5	
International reserves (stock at end-December)	5.7	7.9	

Sources: Iraqi authorities and IMF staff estimates.