INTERNATIONAL MONETARY FUND

Iraq: Macroeconomic Assessment

Prepared by the Middle Eastern Department
In Consultation with other Departments

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October 21, 2003

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A previous version of this staff paper was summarized as the macroeconomic framework section of the United Nations Development Group (UNDG)/World Bank Joint Iraq Needs Assessment report issued on October 8, 2003 for the International Conference on Reconstruction in Iraq..

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EXECUTIVE SUMMARY

Background

During the last three decades, Iraq has suffered from pervasive state intervention, costly militarization, three wars, and over a decade of international sanctions. As a result, despite proven oil reserves of about 112 billion barrels, second only to Saudi Arabia, Iraq's GDP per capita is estimated to have dropped from over $3,600 in the early 1980s to about $770–1,000 in 2001. In recent years, fiscal and monetary policies were completely subordinated to political objectives. Even before taking into account reparation claims, Iraq is among the most heavily externally indebted countries in the world.

More recently, economic activity has been further disrupted by the hostilities, looting and sabotage activities. Despite steps taken by the Coalition Provisional Authority (CPA) and Iraqi officials, security conditions have made it difficult for economic activity to resume freely. Overall, despite a recovery of oil production to a level of 1.3 million barrels per day (mbpd) in August, the decline in GDP in U.S. dollar terms for 2003 is likely to be close to 20 percent, similar to the decline estimated for 2002. Consumer price inflation is likely to be less than 15 percent by end-2003, helped by the fact that the prices of energy, water, and some other goods continue to be heavily subsidized. To remedy a severe shortage of banknotes and fear of counterfeiting, a banknote exchange program started on October 15, for a period of 3 months.

The budget for the second half of 2003 envisages expenditures of about $7.8 billion that are to be financed by oil export sales, grants by the United States government, and official Iraqi assets held abroad. The implementation of the budget for the second half of 2003 has not been without difficulties, reflecting disruptions in the payments system and infrastructure. Nevertheless, as of August 2003, wage and pension payments have been regularized, and rehabilitation work has started.

Macroeconomic framework for 2004

A reform agenda is being formulated to move to a market economy and liberalize prices. As part of this strategy, in September, 2003, the newly appointed economic ministers announced reforms in the areas of foreign investment, the financial system, and taxes to encourage private sector participation, including foreigners, in the reconstruction of Iraq.

The resumption of real GDP growth in 2004 will depend critically on the restoration of adequate security, the normal functioning of basic utilities, and the expansion of oil production and private investment. The inflation outcome in 2004 will be affected by the conduct of macroeconomic policies and by the extent to which price subsidies are phased out.

The draft 2004 budget assumes oil revenue of $12 billion, negligible non-oil revenue, operating (recurrent) expenditures of almost $20 billion, and minimal investment expenditures for rehabilitation of $1.4 billion. The resulting deficit is very large, $8.5 billion or 55 percent of GDP but should be fully financed by official Iraqi assets held abroad ($0.7 billion) and existing contracts under the UN-administered Oil-for-Food Program (OFFP) of about $7.8 billion. This projection of the fiscal deficit does not include the accruing interest bill on external debt. External debt data is still being collected; however, based on partial information, the external debt stock is projected at over 900 percent of GDP. Critical fiscal policy decisions for 2004 that still need to be taken include the possible transition from the existing OFFP to a uniform cash-based system (the draft budget contains resources for this), the amount of subsidies to state-owned enterprises (SOEs) (some assistance is budgeted), and the possible reduction of domestic oil price subsidies (not envisaged in the draft budget).

The draft 2004 budget does not include reconstruction projects identified in the needs assessment carried out by the staffs of the World Bank and the United Nations ($9 billion in reconstruction projects that could be initiated in 2004) and by officials of the CPA and Iraq ($8.2 billion in projects mostly in the energy and security sectors that could be initiated in 2004). Based on the experience of post-conflict environments, World Bank staff has estimated that disbursements on these projects identified for 2004 by the UN/World Bank staff would probably not exceed some $5 billion (about 35 percent of GDP). The fiscal deficit would widen further by the amount for which financing will be assured.

Assessment

The potential reform agenda to move to a market economy, open the economy to trade and foreign investment and liberalize prices is very ambitious. In other transition economies, the implementation of these reforms has typically been difficult and time consuming, reflecting the need to build political support for reforms to ensure that they are durable, and that adequate institutional capacity exists to ensure effective implementation.

There are uncertainties regarding fiscal revenues, including a non-negligible downside risk on oil export prices. Consideration therefore needs to be given to adopting a broader-based tax revenue effort. On the expenditure side, the recently introduced decompression of the wage scale is welcome, but a large wage bill increase is being budgeted; efforts will need to be taken to control the growth of the wage bill in the future. Reconstruction expenditures should be in line with the findings of the needs assessment work.

With respect to transfers, the reform strategy for SOEs should take into account the complexities of the existing environment, including the capacity of the economy to absorb the current high levels of unemployment. The removal of domestic oil price subsidies would need to be phased-out in stages to avoid undue social disruption. A gradual, carefully monitored transition from the in-kind social safety net under the OFFP to a cash-transfer system could be undertaken in 2004.

While Iraq's fiscal situation will improve over time as oil production increases and a stronger domestic tax effort is implemented, public finances will remain under strain in the coming years. Moreover, for Iraq to achieve sustainable debt service payments in the future, it will need generous restructuring of its external debt.

Monetary policy management in the coming months will likely prove challenging. The primary objective for monetary policy should be to maintain broad price stability, by targeting currency in circulation, and monitoring closely inflation and exchange rate developments. Nevertheless, a formal move to targeting currency in circulation may need to await the conclusion of the banknote exchange program to allow the central bank to establish a firmer handle on the stock of currency issued. A flexible exchange rate regime should be adopted as soon as the banknote exchange program is completed. In the interim, it would be advisable to manage policies to keep the exchange rate relatively stable to guide expectations and establish credibility for central bank polices and public confidence in the currency.

The Central Bank of Iraq (CBI) also needs to take steps to improve its banking supervision capacity to ensure that the banking sector plays its key role in the economy. Domestic banks will need to be strengthened at the same time as the financial system is opened to foreign investment.

I. ECONOMIC BACKGROUND

A. Economic Activity

1. During the last three decades, Iraq has suffered from political repression, pervasive state intervention, costly militarization, three wars, and over a decade of international sanctions. GDP per capita is reported to have dropped from over $3,600 in the early 1980s to as low as $200 in the early 1990s, before recovering to an estimated $770–1,000 in 2001 (Box 1).[1] The economic dislocation has led to a noticeable deterioration in Iraq's human development indicators, which had exceeded the average for the region only two decades ago. Moreover, unemployment is reported to have risen significantly,[2] and a large segment of the population now relies on commodities distributed through the United Nations' administered OFFP for basic consumption.

2. Growth of the Iraqi economy has historically been linked to developments in the oil sector. Iraq has proven oil reserves estimated at about 112 billion barrels, second only to Saudi Arabia. Oil resources, in turn, supported the development of related industries, including petroleum refining, chemicals, and fertilizers. However, the sector's infrastructure has been damaged by the factors mentioned above and, more recently, by sabotage. In 2002, oil production declined to about 2 mbpd from an average of 2.5 mbpd in 2000 and 2001. Similarly, other sectors of the economy were affected in recent years by a combination of the effects of international sanctions and external shocks. A substantial industrial sector, largely publicly owned, has lost competitiveness due to mismanagement, capital stock degradation, and sanctions. It is heavily dependent on budget support. The agricultural sector was also seriously affected by severe droughts in 1999 and 2000, while food prices were repressed by the imports of agricultural commodities under the OFFP.

B. Prices

3. Most prices were controlled until the onset of hostilities in the spring of 2003 when they were de facto liberalized except for the prices of energy, water, and some other goods which continue to be heavily subsidized. In particular, the market prices of goods in the consumption basket provided under the OFFP remain well below their international levels. As a result, inflation was relatively restrained prior to the 2003

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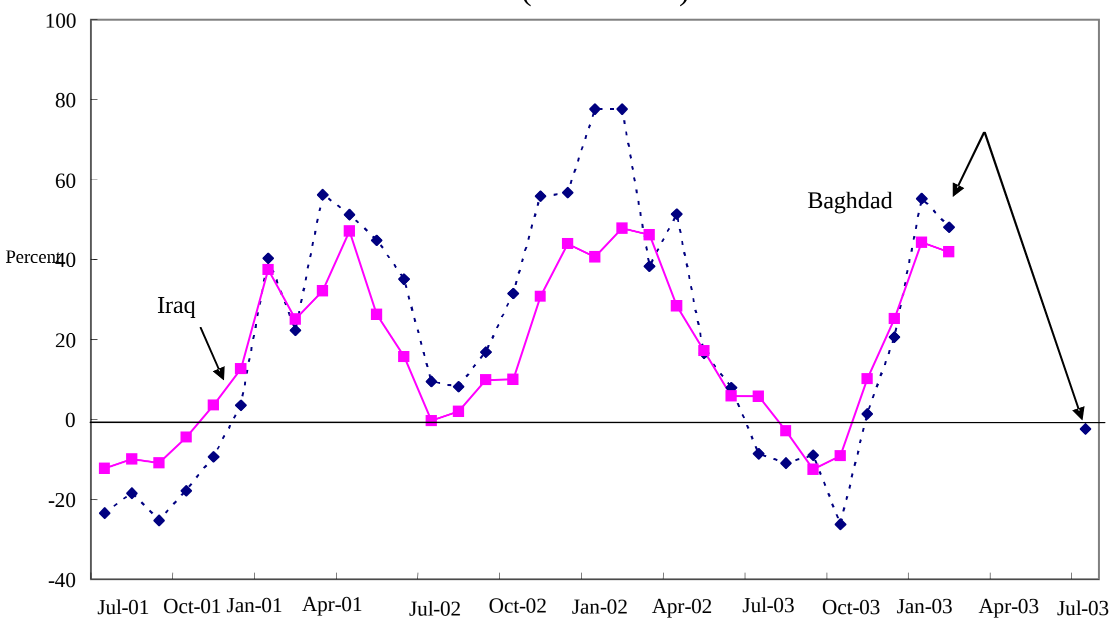
[1] Given the absence of reliable basic macroeconomic data, these estimates of economic activity must be taken with caution. Box 1 explains the adjustments that were made to official GDP sectoral data to arrive at the estimated GDP per capita value of $770. The $1,000 estimate is from the United Nations' Watching Brief on Macroeconomic Data.

[2] No reliable information is currently available on the size of the labor force. The last official unemployment figure available is from 1997, 17.5 percent, but unemployment is believed to have increased significantly recently.

conflict despite supply bottlenecks and strong monetary expansion. Inflation was about 29 percent and 15 percent in 2001 and 2002, respectively. Information for 2003 indicates that it continues to be moderate despite the effects of the war, with the 12-month rate to July estimated at 23 percent. Moreover, after a significant increase in December 2002, the consumer price index (CPI) (for Baghdad only) from end-January to end-July 2003 declined by close to 3 percent. Overall, in these conditions, consumer price inflation is unlikely to exceed 15 percent during 2003.[3]

Figure 1. Iraq: Six-Month Inflation Rates, July 2001–July 2003
(Annualized)



Source: Statistical Agency and CPA.

C. Fiscal Policy

4. Fiscal policy in the pre-war period operated under a soft budget constraint and a multiplicity of parallel budgets. There were distinct budgets for investment, operating expenditure, the three northern governorates, and expenditure under the OFFP. Budget appropriations included in the operating budget were increased on an almost daily basis at the request of the Presidential Office, resulting in a doubling or tripling of the original expenditure allocation on a cumulative basis by year-end. The budget was

[3] The projection for 2003 takes into account past seasonal patterns, in which most of the increase in the price level takes place in the very early part of the year.

revised in a supplemental budget at the end of the year, but both the revised budget and final accounts were kept secret. Thus, while the expenditure process conformed to generally accepted principles of separation of spending authority, and monthly accounts of the public sector operations were prepared by the ministry of finance, corruption of the system from above weakened controls and eroded scrutiny of budget execution. The deficit was financed through the issuance of treasury bills, which were mainly purchased by the large state-owned banks. Non-oil revenue amounted to $725 million (8 percent of GDP) in 2002, including $169 million in profit transfers from state-owned enterprises (SOEs) and $171 million in revenue from services provided by government agencies. About $260 million was collected in taxes, of which $70 million was from personal income taxes.[4]

D. Monetary Policy

5. The most salient feature of monetary policy in Iraq in recent years was its complete subordination to political and fiscal interests. The role of financial institutions—including the CBI—was restricted to the provision of cash to the government sector, including the SOEs. Financial transactions were largely conducted on a cash basis. Noncash payment systems were primitive and inefficient. Reflecting the loose fiscal policy, currency in circulation outside the northern provinces (i.e., Saddam dinar only) is estimated to have increased by 21 percent and 44 percent in 2001 and 2002, respectively.

6. Two types of banknotes were in circulation—the Saddam dinar (issued by the CBI from 1990 onwards and whose only effectively available denominations were ID 250 and ID 10,000 in recent years) and the Swiss dinar issued between 1979 and 1989, which circulated only in the northern Kurdish provinces.[5] Control over cash issuance was complicated by the existence of a printing press that remained outside the control of the CBI.

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[4] Civil servants wages are not taxed under Iraq's income tax law.

[5] Other denominations of Saddam dinars were legal tender but only small amounts circulated.

E. Balance of Payments

7. No reliable balance of payments data exist for Iraq. One problem is that multiple exchange rates were used to record balance of payments transactions. Box 2 contains preliminary estimates of the external current account balances in recent years. Developments in the current account balance have been driven by oil exports, which accounted for almost the totality of export earnings. While Box 2 estimates are approximate and incomplete, they suggest that the external current account balance swung from a surplus of about 3.3 percent of GDP in 2001 to a deficit of 2.5 percent of GDP in 2002.

8. Iraq's external debt to Paris Club creditors amounts to some $42 billion including penalty and late interest. Fund staff is currently gathering information on non-Paris Club debt, which should help provide a basis for debt relief in the future. There is also some debt in arrears to international financial institutions. In addition, there are war reparation claims on Iraq. Even before taking into account reparation claims, Iraq is among the most heavily externally indebted countries in the world in terms of GDP (about 900 percent of GDP) and in relation to its export earnings (about 1000 percent of export earnings).

II. Developments and Reconstruction Efforts in 2003

A. Steps to Reactivate the Economy and Strengthen Liquidity

9. Since May 2003, the CPA and Iraqi officials have been taking steps to restart economic activity, ensure price stability, and improve institutional and administrative capacity. Salaries of all public employees have been paid since May 2003, including those in SOEs.[6] About one-third of SOEs had resumed operation by end-August 2003 and was receiving modest transfers from the budget for working capital and other operational costs. An employment-generation program linked to irrigation infrastructure projects was started in June 2003. However, these efforts are only partially mitigating the significant negative effects on growth this year caused by the stoppage of economic activity during the hostilities and since then by looting, the limited supply of electricity, and the problems with restoring oil production to its 2002 level. Security conditions have presented difficulties for the normal resumption of economic activity. Overall, given the sharp decline in oil production (about 40 percent), [7] severe problems with electricity production (a 30 percent drop), and the closure—due to looting and war damage—of about 50 percent of SOEs in the industrial sector, the decline in GDP in U.S. dollar terms for 2003 is likely to be close to 22 percent.

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[6] There are about 1,000,000 civil servants, 496,000 SOE employees, and 996,000 pensioners.

[7] Because of sabotage and looting, the decline in production for domestic purposes (refinery inputs) is even larger, at more than 50 percent.

10. At the beginning of the 2003 conflict, close to $1 billion in foreign currency was taken out of the CBI vaults, but most of this was subsequently recovered and has been used to finance government operations. Some $1.7 billion in vested assets were in the United States, and reportedly, additional funds are vested in other countries. Gross international reserves of the CBI were reported to be about $500 million in July 2003. The looting of the main central bank building, combined with the destruction of several commercial bank branches exacerbated the shortage of bank notes in the immediate aftermath of the conflict. Moreover, a CBI printing press used for the production of ID 10,000 notes was stolen (and has not been retrieved) during the 2003 conflict, leading to a situation where these notes were traded at a discount of 20–30 percent because of the fear of counterfeiting.[8]

11. The central bank accelerated the printing of ID 250 notes in June to allow for free conversion of the ID 10,000 note. Also, in order to help address the illiquidity problem associated with the partial rejection by the population of the ID 10,000 notes, the central bank initiated in late July a program to allow individuals to exchange ID 10,000 notes into dollars up to a limit $2,000 per person, and with a global maximum of $0.5 million per day. These programs have been only partially successful in alleviating liquidity conditions, underlining the priority of proceeding with the banknote exchange program taking place during the period October 15, 2003–January 15, 2004. The announcement of the banknote exchange immediately reduced the demand for ID 250 notes, as the ID 10,000 notes would be redeemed at full value. Significant progress also has been made in restoring limited banking operations at state bank branches that had been closed during the conflict (except for a few that were destroyed by looting, all others have reopened, or their clients are being served by another branch).

B. Oil Production and the Balance of Payments

12. There is some uncertainty about near-term prospects for oil production. After halting completely in April and May 2003, oil production was renewed slowly in June and July, and reached 1.3 mbpd at end-August. It is expected to reach 1.6 mbpd by end-year 2003.[9] On balance, official projections suggest that oil exports in 2003 will drop to about 325 million barrels (an average of 0.9 mbpd) from somewhat under 500 million barrels in 2002 (an average of 1.3 mbpd), although buoyant oil prices may help to cushion the financial effect of this decline. Iraqi exports in 2003 are almost entirely crude oil; there is little prospect for the resumption of refined product exports this year, and other exports that flow through normal or recorded channels are likely to be very

[8] Recently, this discount has virtually disappeared, perhaps reflecting an adjustment in expectations triggered by the ongoing banknote exchange (where ID 10,000 notes will be exchanged at face value).

[9] About 0.4 mbpd of oil production is consumed locally; crude oil exports are therefore commensurately lower.

small until next year. Altogether, this scenario suggests total export receipts of $9.3 billion in 2003 and a trade surplus in 2003 of almost $2 billion. The current account balance for 2003 is expected to return to a sizeable surplus because the decline in oil exports will be more than offset by a reversal in net transfers from payments of over $3 billion to receipts exceeding $1 billion, and by the delay to 2004 of imports financed by existing OFFP contracts.

C. Budget Implementation in 2003

13. The 2003 conflict has made it difficult to evaluate fiscal policy for the year as a whole. Most government records have disappeared in the pervasive looting and destruction of ministries, and government services have only recently been resumed. In addition, in the immediate aftermath of the conflict, priority was given to restarting government expenditure, and several initiatives were launched by ministries outside the budget process. However, in late June, on the basis of submissions by line ministries, a budget for the second-half of 2003 was put together remarkably quickly covering both operating and investment expenditure. Because of the speed of the process, ministries were given another month to make modifications to their original submission and a revised budget was adopted for the second-half of 2003, which integrated the three northern governorates.

14. The revised budget for the second-half of 2003 included on the revenue side oil export receipts of about $2.5 billion, down from $3.5 billion in the original budget, $0.3 billion in transferred profit from SOEs on sales of items bought under the OFFP, and $2.7 billion in U.S. grants (Box 3). On the expenditure side, the revised budget includes $3.3 billion in operating expenditure (including imports of goods financed under the OFFP), and $4.5 billion in investment expenditure. The originally planned transition from the in-kind OFFP social safety net to a cash payments system (budgeted at $1.35 billion) was postponed, offsetting the loss in oil export sales revenue, while oil and gas investments have been accelerated, partly to repair the damage caused by recent sabotage. The budget deficit of $2.3 billion is to be financed by contracts under the OFFP ($0.8 billion), and Iraqi assets held abroad ($1.5 billion). These assets comprised Iraqi vested and seized assets held abroad,[10] and funds transferred from the OFFP account.

15. One major expenditure policy decision made by the CPA pertains to the introduction of a 4-tier wage scale in April 2003, which was replaced by a new 13-tier wage scale in September 2003. The decompression of wages included in the new 13-tier wage scale will be accompanied by a 35 percent increase in the wage bill.[11] Some

[10] This excludes assets reportedly held in countries other than the United States.

[11] This projection assumes that the dinar does not depreciate vis-à-vis the dollar (the salary scale has been set in dinars).

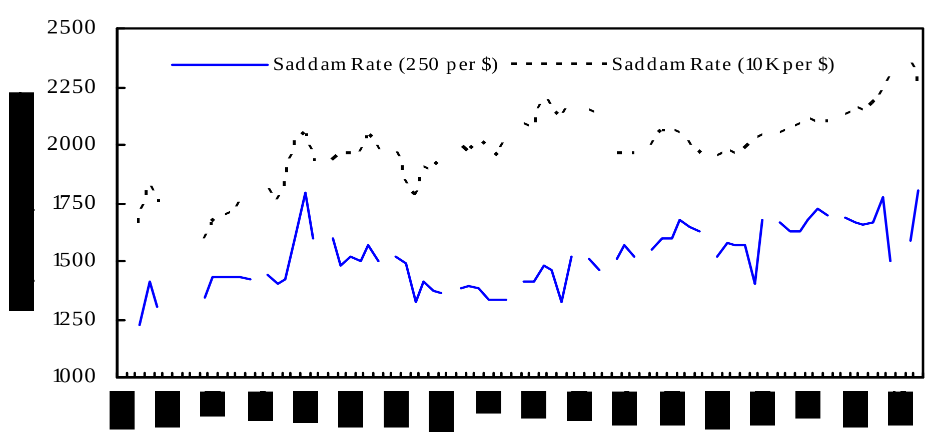
$460 million are projected to be transferred to SOEs to cover their wage bill and provide some working capital.

16. The implementation of the budget for the second-half of 2003 has been hampered by disruptions in the payments system, telecommunications, infrastructure, as well as by damage to government buildings. However, as of August 2003, wage and pension payments have been regularized, and ministries in Baghdad have started nonwage expenditures. Budget execution in the governorates was more difficult. The financial operations of some 4,000 accounting units have now been mostly centralized in ministries in Baghdad and in sub-treasury branches in governorates. While centralizing expenditures should improve cash management, it will also require a considerable strengthening of financial operations and accounting units in the ministries and sub-treasury branches. Fiscal reporting is also hampered by the lack of staff in these units and disruptions in communications.

D. Central Bank and Financial System

17. With the CBI yet to become fully operational, monetary policy has been passive since the start of hostilities. However, the lack of banknotes has led to tight monetary conditions. This is reflected in the aforementioned stability of the price level since February, as well as the broad stability of the exchange rate through August, notwithstanding the prevailing economic and political uncertainties. From July through end-August 2003, the value of ID 250 note fluctuated around an exchange rate of ID 1,500/US$, while in the case of the ID 10,000 note, the exchange rate was about ID 2,000/US$ (Figure 2). These rates implied some nominal appreciation relative to the average exchange rate of ID 2,000/US$ that prevailed in 2002. However, during September and in the first two weeks of October, the exchange rate for both types of notes fluctuated about ID 2,100/US$ on average.

Figure 2. Exchange Rates for the Iraqi Dinar



18. In a measure intended to enhance the operational independence of the CBI, the CPA announced in July 2003 the suspension of articles in the central bank law that allowed for the issuance of credit to the government, and that required ministry of finance approval for monetary and credit policy actions.[12] Nevertheless, the latitude for proper monetary and exchange rate policy actions is limited by a lack of appropriate instruments, the current low level of foreign exchange reserves, and constraints on institutional and physical infrastructure capacity.[13]

19. The two large state-owned banks, Rafidain and Al-Rasheed, which together account for about 90 percent of the total assets in the system, have liquidity and solvency problems associated with the fact that most of their assets are in treasury bills or in loans to SOEs. [14] In that regard, a request-for-information document was issued to try to gauge external interest in management or advisory contracts for these two banks. In reply, several offers from foreign banks and advisory groups were received and are being studied. As a first step, a thorough analysis of the financial condition of the state banks needs to be conducted in order to be able to develop a restructuring strategy. Also, the interim Iraqi Minister of Finance announced at the World Bank-IMF Annual Meetings that international banks will be allowed to invest in Iraq and that appropriate fit-and-proper criterion for bank ownership and new minimum capital requirements were being introduced.

E. Other Policy Initiatives

20. Among other policy initiatives, on July 17 the CPA issued an executive order creating the Trade Bank of Iraq (TBI). The TBI's purpose is to help Iraqi entities finance imports by acting as an intermediary between them and overseas suppliers. This institution is expected to work with a consortium of foreign banks, which was selected on August 30, and will be responsible for issuing letters of credit. $100 million of the Trade Bank's callable capital will be used as collateral for letters of credit. In addition, the CPA with assistance from International Finance Corporation is in the process of designing a micro-finance program for financing of small and medium enterprises. This program is intended to provide up to 6 months credit with a limit of $50,000 per enterprise. Finally, as part of the measures announced at the Annual Meetings by the interim minister of finance, the CPA issued an order in September introducing a new

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[12] A new central bank law has been prepared and is expected to be approved in the near future. IMF staff proposed a draft law based on best practices in developing countries.

[13] These are, currently, reserve requirements that apply to dinar liabilities. The existing rates are 20 percent for demand deposits, 5 percent for savings accounts, and 2 percent for term deposits.

[14] Given the degree of financial repression, total assets of the banking system are estimated to amount to about $2 billion, or only about 17 percent of GDP. Moreover, the loan portfolio accounts for only 8 percent of total assets.

foreign investment regime. The regime's main provisions include allowance for full foreign ownership in all sectors of the economy (except natural resources) and unrestricted profit remittances.

III. Macroeconomic Program for 2004 and Prospects

A. Macroeconomic Projections

21. A strong growth recovery is projected for 2004, keyed to the restoration of adequate security, the proper functioning of public services (particularly electricity), and the availability of external resources for reconstruction. The oil sector will continue to be the driving force behind economic growth in Iraq. At the same time, significant political, economic, and social changes are taking place that open up new opportunities for economic activity.

22. Concerning expected macroeconomic performance in 2004, post-conflict experience suggests that, once political stability is restored, relatively high rates of growth—in the range of 7–12 percent per annum—are usually observed in the two years immediately after the end of the conflict. Clearly, experiences vary widely, and mainly reflect recovery in the main productive sector. In the case of Iraq, with oil estimated to account for about three quarters of GDP, GDP growth will be even more closely linked to developments in this main sector; on the basis of projected oil output expansion, nominal oil GDP is projected to rise by one-third. Despite the positive effects of reconstruction efforts and an expected increase in both domestic and foreign private investment, growth in the non-oil sectors in 2004 will continue to be limited by the negative impact of the closure or restructuring of SOEs and hampered by lingering security problems. In these circumstances, non-oil GDP is expected to remain slightly below its estimated 2002 level. Unlike transition economies that suffered from output declines after market reforms were introduced, the projected economic recovery in Iraq should be made possible by the pick-up in oil production. To the extent that external reconstruction financing is directed towards the domestic goods sector, it will contribute to demand recovery.

23. The avoidance of monetary financing of the budget deficit and the adoption of a liberal trade regime should help maintain inflationary pressures under control. However, the price outcome in 2004 will also depend on the extent to which price subsidies are reduced for energy products, and on the monetization of social safety net transfers.

B. The 2004 Budget

24. With respect to the 2004 draft budget, a directive note was issued by the ministry of finance for the preparation of ministries' budget submissions under the guidance of the CPA. In early September, the CPA and the finance ministry held hearings with Iraqi ministries to discuss their budget submissions. Subsequently, at the

time of the Bank-Fund Annual Meetings discussions were held among representatives of Iraqi ministries and the CPA and staffs of the World Bank and the UN on reconstruction needs. The draft 2004 budget has then been reviewed by the Governing Council. Finally, after the donors' conference on October 23–24, the budget will be revised in light of donors' financing commitments.

25. For the first time in many years, the draft 2004 budget covers in a single document operating expenditure for the whole country, including the three northern governorates, with the sole exception of expenditure carried out in the context of contracts signed under the OFFP. For completeness, the fiscal table presented in Box 3 includes the projected OFFP expenditure for 2004. The figures on the OFFP were provided on a tentative basis by the UN Office of Iraq Program.

26. The draft 2004 budget has a realistic oil revenue assumption, reflecting a restoration of output capacity of 2.7 mbpd by end-2004. Iraq oil export prices are projected to follow the overall downward trend of oil prices, reflecting the effect of decreased uncertainty in oil markets brought about by the restoration of security, and Iraqi crude oil characteristics.

27. Non-oil revenues are budgeted at only $0.8 billion, reflecting the view that introducing low tax rates is essential to stimulate economic growth. In particular, an order was issued in September introducing a 5 percent uniform reconstruction levy on imports. However, because of wide-ranging exemptions, it would mostly be a levy on final consumption goods other than food, clothing, and medicines. Personal and corporate income tax rate have also been set at a uniform rate of 15 percent, but due to the economic disruptions in 2003, no significant income tax revenues is expected in 2004. In addition, all other taxes have been suspended with the exception of the hotel and the restaurant tax, the tax on the transfer of real property, the car sale fee, and gasoline excise duties until end-2003 (by then a thorough review of the tax system is expected to be completed).

28. In addition to reflecting the 35 percent increase in the wage bill associated with the introduction of the 13-tier wage scale, the wage bill in the 2004 budget is higher than originally expected because the number of registered civil servants on the payroll turned out to be 25 percent higher than originally estimated. Pensions continue to be paid at the existing levels. The $8.8 billion allocation for the acquisition of goods and services is financed largely under existing contracts under the OFFP.[15] The 2004 draft budget has $1.4 billion in investment expenditure (separately from reconstruction projects to be financed by donors).

[15] OFFP contracts are not included in the budget discussed by the Governing Council.

29. Abstracting from reconstruction requirements, the deficit of the draft 2004 budget of about $8.5 billion (55 percent of GDP) is expected to be financed with existing contracts under the OFFP of about $7.8 billion, and official Iraqi assets held abroad of $0.7 billion. This cash fiscal deficit projection excludes accruing interest on external debt in line with the Paris Club decision that suspended Iraq's debt servicing obligation until end-2004.

30. Reconstruction needs have been identified as a result of the needs assessment work carried out by the staff of the World Bank, the UN, Iraqi officials, and the CPA. The estimated needs are predicated on an overall objective of restoring social indicators and infrastructure capacity to the levels prevalent in the mid-1980s or early 1990s. The benchmarks for 2004 vary by sector depending on a number of factors, but generally aim, at a minimum, at rehabilitating existing capacities to pre-March 2003 levels. The assessment work done by the Bank and the UN identified reconstruction needs of about $9 billion for 2004, and $26 billion over the period of 2005–07.[16] Implementation of these expenditures—and therefore the level of aid disbursements—will depend on the security situation, the capacity of Iraqi institutions to plan and implement projects, and the state of infrastructure and energy services. In the absence of further detailed work in Iraq, it is not possible to estimate implementation capacity reliably. However, the World Bank has analyzed a sample portfolio of 19 rehabilitation projects implemented in post-conflict environments and, on that basis, estimates that actual disbursements in 2004 are not likely to exceed $5.2 billion (about 35 percent of GDP) even if donors were to make the upfront commitment of $36 billion for the sectors surveyed by the Bank and the UN.

31. Regarding debt and external obligations, the budget foresees the payment of interest on the domestic stock of treasury bills (about $1.5 billion),[17] and war reparations as specified in UN Security Council Resolution 1483. Other external debt payments are being postponed until end-2004, consistent with the announcement of Paris Club creditors. The payment of interest on treasury bills should help build the public confidence necessary for any future possible issue of domestic debt—not envisaged for the time being—and enhance the quality of the main asset of state-owned banks.

C. Structural Fiscal Issues

32. The large amount of budgetary transfers in the draft 2004 budget reflects the dominant role of the state in Iraq's economy, particularly the social safety net

[16] In addition, the CPA separately estimated needs for the oil, security, and other sectors not covered by the UN/Bank assessment work amounting to $8.2 billion in 2004 and $11.2 billion for the 2005–07 period.

[17] The payment of interest on treasury bills is part of a strategy to generate financial resources for the banks to restart lending activities.

($4.9 billion) and transfers to SOEs ($1 billion). In addition, there are some implicit domestic oil subsidies.

33. While the whole population receives OFFP assistance, it is estimated that more than 60 percent of the population rely mainly on goods provided under the OFFP for their subsistence. In these circumstances, avoiding disruption of the safety net program is of paramount importance. At the same time, the system also has clear drawbacks: the population cannot choose the goods, which are often of inferior quality; there is no targeting of resources towards the neediest; and the development of private initiatives is inhibited. Moving to a cash-based social safety net, targeted on the basis of means-testing, would overcome these problems, but this requires the collection and analysis of household income data, as well as careful planning to avoid any possible disruption in the delivery of goods, or the effects of an uncompensated price impact on income. It also requires the development of adequate infrastructure, notably in the financial sector.

34. The Governing Council and the CPA are currently considering the possible monetization of the social safety net program. One possibility being explored is to have a gradual transition from the existing OFFP to a uniform cash-based system, starting with the privatization of the distribution network, and limited cash-transfers to replace a few, less critical commodities such as soap and detergent. The transfers would be operated through the banking system, with each household opening a bank account. Under this option, the second step would be the distribution of a cash transfer covering the food basket in the second half of 2004. The government would constitute a strategic food reserve that could be distributed if market prices in Iraq should exceed some threshold level well above international prices (say 125 percent).

35. The draft 2004 budget assumes limited subsidies for a number of key SOEs. A decision on whether to start removing oil price subsidies has not yet been taken, but one option being considered is that any savings from the elimination of domestic oil subsidies would be given back to households in the form of transfers.

D. Balance of Payments

36. Preliminary staff projections show a current account deficit of about $6 billion in 2004 (excluding imports associated with reconstruction projects), most of which arises from a final bulge in OFFP imports and a recovery in private imports. Available information is not adequate to make financial accounts projections and assess the overall balance of payments situation for next year. However, several sources of financing can be envisaged for the $8.5 billion in projected private sector imports. The U.S. dollars that have been placed in circulation among the Iraqi population since April combined with trade credits, the drawdown of Iraqi external assets, and external borrowing by Iraq’s reviving banks and other financial institutions, could finance a substantial part of the projected current account deficit. The implementation of reconstruction projects would obviously increase the current account deficit but the imports associated with these projects would be financed by donors’ contributions.

37. The conclusions that can be derived about the macroeconomic flows in 2004, particularly the implied net domestic savings of the private sector, have to be taken with caution. Given that the projected fiscal deficit is significantly larger than the external current account deficit, it would appear that the private sector would have a large net saving position. It is possible that, as oil revenues are injected back into the economy, the private sector will save some of these resources. However, the private import projection should be only be taken as indicative and it will need to be reassessed as more information becomes available. If private sector savings were lower—for example, owing to higher consumption and imports—the current deficit account would be wider still; however, conservative import estimates have been used.

E. Monetary Policy

38. Monetary policy management in the coming months will likely prove challenging. During the period of the banknote exchange program it would perhaps be advisable for the central bank to try to limit movements in the exchange rate, this would allow for the central bank to guide expectations and establish public credibility on its policies and confidence in the currency. Once the banknote program is concluded, it would appear that the intermediate target for monetary policy will need to be currency in circulation, given that this is the only monetary variable for which information exists, and that monetary transmission channels are uncertain. Efforts in this area will be facilitated once the banknote exchange process is concluded and the CBI has better information on the stock of currency in circulation. However, the demand for currency is likely to be very unstable, complicating the conduct of monetary policy. With few monetary policy instruments at hand, particularly for withdrawing liquidity, adhering to targeted increases in monetary aggregates will be demanding. The design of a monetary program will need to take into account the expected economic recovery, inflation pressures, as well as the possible re-monetization of the economy. When the need to withdraw liquidity arises, the CBI may need to adjust reserve requirements and, if adequate reserves are available, carry out foreign exchange sales through auctions. Given the unusual degree of uncertainty, the monetary program will need to be kept under careful review and may need to be adjusted frequently to avoid unwanted deviations from the inflation target.

39. The Iraqi economy's heavy reliance on oil (a commodity that is subject to wide price variations), the near complete openness of the economy as well as the uncertainty surrounding the fiscal picture and limited availability of foreign exchange reserves suggest that, as a long term strategy, a flexible exchange rate regime is appropriate in these circumstances. The Central Bank of Iraq should follow a rules-based and transparent intervention policy. A system of foreign exchange auctions (sales/purchases) needs to be and has been instituted.

40. The projected use of large foreign resources in relation to the size of the economy in 2004 could have significant implications for the real exchange rate and care will need to be taken to avoid a deterioration in the competitiveness of the economy.

However, spending is likely to be to a large extent, for imported goods and services rather than on nontraded goods, mitigating these concerns somewhat.

IV. Assessment

41. The CPA and Iraqi officials are elaborating a strategy intended to help restore economic growth on the basis of market friendly policies, including price liberalization foreign investment, banking regulation, reduction of SOE subsidies, and domestic taxation. Changes introduced in the foreign investment code count on the role of the private sector, and in particular foreign investors, to resurrect non-oil economic activity. Measures announced in the areas of the financial system and foreign investment are intended to encourage private sector activity, strengthen the capital base of the banking system, and acquire internationally qualified expertise.

42. The potential reform agenda to move to a market economy and liberalize prices is ambitious, covering the reforms of SOEs, the price liberalization associated with the possible monetization of the OFFP social safety net and the reduction of the subsidies for domestic petroleum derivatives. This type of reform has been difficult in transition economies, where careful examination of the political and social impact has been required.

43. There are also challenges and risks ahead. First, the strategy to reactivate Iraq's economy relies heavily on oil revenue and foreign assistance. If oil export earnings and foreign financing turn out to be less than projected, the pace of recovery could be smaller. Second, a persistent lack of security could be disruptive to economic activity and significantly inhibit private investment and donors' involvement in Iraq's reconstruction. Third, as in other transition economies, inadequate sequencing of reforms or insufficient political ownership could jeopardize long term economic recovery. Fourth, there is a need to establish regulatory and legal frameworks as well as adequate enforcement capabilities (through the build up of the required institutional capacity) that will serve to support a market-based economy and a functional banking system. Fifth, the dearth of reliable economic data in Iraq complicates the design and evaluation of the macroeconomic strategy.

44. Due to the uncertainties about fiscal oil revenue, consideration could be given to adopting a broader-based tax revenue effort than is currently being implemented to support Iraq's economic reconstruction. [18] In particular, the recent introduction of a reconstruction levy of only 5 percent (with many exemptions) may be inadequate under the circumstances. Given the massive reconstruction needs, a more appropriate strategy could have been the introduction of a uniform 10 percent custom levy on a wider import

[18] An average price of $18 per barrel instead of $20.50 per barrel for Iraqi oil exports in 2004 would result in a revenue shortfall of about $2 billion.

base. Excise taxes could play a role and if the tax administration is up to the task a sales tax that could be charged on imports and domestic manufacturers could also be introduced.[19] These taxes should be relatively easy to collect, and would not introduce large distortions or prevent private sector activity. The adoption of such a package could raise tax revenues of several times the $0.4 billion contemplated in the present budget.

45. On the expenditure side, the implementation of reconstruction projects identified by the World Bank, the UN, the Iraqi officials, and the CPA, will depend on the level of external financing made available by donors and will be closely tied to the degree of domestic absorptive capacity. Regarding operating expenditure, the recent decompression of the wage scale is welcome, but the increase in the wage bill is large, and wage policy should be coordinated with the reform of price subsidies and the commodity distribution program under the OFFP.

46. While Iraq’s fiscal situation will improve over time as oil production increases and a stronger domestic tax effort is implemented, public finances will remain under strain in the coming years. Also, for Iraq to achieve a sustainable debt position in the future it will require generous external debt relief.

47. With respect to transfers to SOEs, the competitiveness of SOEs should be evaluated in the context of the overall desired structure of utility prices, the development of infrastructure, the trade regime, competition policy, options available for the involvement of private sector capital, and the capacity of the economy to absorb the current high levels of unemployment. Such broad analysis is likely to take several months. In the meantime, it may be unavoidable to continue to support for a while SOEs that are not likely to be closed in 2004, in addition to making redundancy payments.

48. The reduction of domestic oil price subsidies would be highly desirable to eliminate their distortionary effect, but in light of pervasive cost and price distortions in the economy, comprehensive approach to price liberalization is called for. In practice, this may imply that domestic oil price subsidies would need to be phased out in stages to avoid undue social disruptions. Oil revenues should be considered as an integral part of government resources, and all oil-funded expenditures, including all types of transfers, should be channeled through the budget to ensure adherence to spending priorities as determined in the budget process.

49. A gradual, carefully monitored, and a well-publicized transition from the in-kind social safety net under the OFFP to a cash-transfer system could be undertaken in 2004,

[19] In order to avoid tax cascading, the sales tax paid on inputs should be creditable against the sales tax levied at the production stage.

provided that the government constitutes a strategic food reserve to guarantee access to essential food commodities at international prices until alternative private import supply channels develop. Moving to targeted cash transfers will require the capacity to conduct means-testing, and should be postponed to the medium term.

50. A major challenge with respect to the 2004 budget will be its implementation, which will require a substantial strengthening of execution and control systems. Key measures in these areas include: the strengthening of payment and accounting functions; consolidation of all government cash balances (including donors financing) in a main treasury account to be set-up at the CBI; enhancement of accounting and procurement procedures; and strengthening of internal and external audit functions.

51. The conduct of monetary policy in the coming months will be difficult. The current success of the banknote exchange program is key as it has many repercussions for work in other policy areas, including the execution of the budget, functioning of the payments system (and thus the banking system), and the reactivation of economic activity. Moreover, the CBI will have to address these issues with limited monetary policy instruments. The proposed transfer of resources to the CBI to replenish its international reserves is welcome. This action will allow the CBI to have additional room for proper monetary policy actions. Steps are being taken to modernize the central bank law and this will facilitate the meeting of these challenges. There is also a need to enhance the CBI's technical and institutional capacity, in particular in the areas of monetary and foreign exchange operations. In this environment, the primary objective for monetary policy should be to maintain broad price stability.

52. On exchange rate management, it is encouraging that a consensus appears to have emerged in favor of a managed float arrangement. Although under the current institutional limitations a less discretionary policy framework, such as a currency board, has some appeal, its drawbacks outweigh its benefits. Nevertheless, there is merit in trying to limit exchange rate variability in the period up to the conclusion of the banknote exchange program.

53. Technical assistance from the IMF has so far focused on the banknote exchange, banking legislation, and public expenditure management. In the immediate period ahead, further assistance will be provided in the areas of banknote exchange implementation; central bank restructuring, accounting, and financial reporting; banking sector restructuring; tax policy and administration; public expenditure management; fiscal federalism; the development of a minimum set of economic indicators; and the strengthening of fiscal and monetary policy.

Box 1. Assumptions in the Estimation and Projection of Gross Domestic Product

Iraq's official national income accounts data need to be adjusted because of methodological problems related to price distortions and the effects of multiple exchange rate practices. Most prominently, these valuation problems have led to the undervaluation of oil output and the underestimation of value added in this sector. Also, since 1991 official data have not covered non-oil economic activity in the northern governorates. IMF staff have made an effort to properly value the historical net contribution of the oil sector to GDP by using externally available data on Iraq's oil extraction volumes and world market prices. Similarly, value added in the remaining sectors of the economy has been estimated by adjusting official figures to take into account the geographical coverage deficiencies; nevertheless, further adjustments may be warranted to reflect the effect of existing price distortions once more information becomes available. However, given that such distortions affect both the value of gross output and intermediate consumption, a priori it is hard to judge whether non-oil GDP will be higher or lower than the official figure. Based on these adjustments, staff estimates that GDP for 2001 was about $19.1 billion (about four times the official number).

When compared with other estimates from market participants and the one reported in the UN Watching Brief on macroeconomic data, the 2001 GDP estimate in this box is smaller. Estimates prepared by market participants specifically differ in that non-oil GDP is arrived at by using data on regional levels of non-oil GDP per capita and then multiplied by the estimated population level. These estimates tend to produce GDP estimates of around $25 billion for Iraq for 2001. However, given the shocks and degradation suffered by Iraq's economy during the last two decades, the size of its non-oil sector cannot be compared with the regional averages. For this reason, this alternative approach has not been followed.

Very preliminary estimates and projections of GDP have been made for 2002–04. These figures should only be taken as illustrative and will need to be revised once more information becomes available. In order to estimate 2002 GDP, an assumption was made that total GDP was essentially driven by developments in the oil sector, and that sectoral shares remained constant at their 2001 level. Under this assumption, GDP was estimated in2002 at $15.2 billion, a decline attributed to the sharp reduction in oil production of about 20 percent in volume terms. In 2003, GDP is expected to be linked to three key developments: oil levels (a 40 percent fall), shortages of electricity (a 30 percent drop in production) and the temporary or definite closure of most SOEs. Given these factors, it is expected that nominal GDP in $ terms will decline by about 22 percent.

As regards 2004 , in terms of oil production, the assumption is that productive capacity will be restored to previous levels and actual output would reach about 2.0 mbpd on average during the year (a 67 percent increase relative to 2003). Moreover, the recovery of non-oil GDP will be conditioned by the restructuring of state-owned enterprises and lingering security problems; nevertheless, it is expected that a significant increase in the provision of public services and a pick up in private investment would allow for a recovery in non-oil GDP of about 17 percent, still below its 2002 level of $4.7 billion. On this basis, total GDP would reach some $15 billion.

Table1. Iraq: Gross Domestic Product

	2001	2002	2003	2004
GDP (in millions of $)	19,105	15,192	11,813	15,346
Oil GDP (millions of $)	13,201	10,482	8,530	11,505
Non-oil GDP (millions of $)	5,904	4,709	3,283	3,841
Population (millions)	24.8	25.5	26.3	27.1
Nominal GDP growth rate (percent)	-12.3	-20.5	-22.2	29.9
GDP per capita ($)	770	596	449	566

Box 2. External Current Account Estimates and Projections, 2001–04

The table below shows estimates for the main entries in Iraq's external current account for 2001–02, and projections for 2000–04. Iraq's dominant export has been crude oil, whose proceeds in recent years have been under the administration of the UN's OFFP. Estimates shown here for 2001–02 include some allowance for oil smuggled outside the framework of that program. The value of oil exports is expected to drop to about $9.3 billion in 2003, owing to the disruptive effects on production of the April–May conflict and difficulties faced in restoring oil production, in addition to some losses due to pipeline sabotage.

While current projections anticipate a significant gain in production in 2004, oil export values increase only to about $12 billion, owing to an expected decline in prices. Iraq's exports in 2003 and 2004 are almost entirely crude oil, with only a marginal contribution from other sectors.

Humanitarian imports under the OFFP were authorized at 72 percent of the value of oil exports, but a large share arrives a year or two later, which is reflected in the time profile of current estimates. Notwithstanding the expiration of the OFFP in November 2003, it is expected that OFFP imports generated by outstanding contracts will bulge in 2004. Government imports of capital goods needed for the reconstruction of the economy have not been included but are likely to be very substantial. Import projections include provision for imports of some refined oil products, which will still be required into 2004. Private sector imports are projected to rise rapidly in 2004, financed in part by the large amounts of U.S. currency paid out to individuals as pensions and salaries.

Significant invisibles payments make up the balance of these current account estimates and projections. Up to 2003, services payments are mostly to the UN, at about 3 percent of oil exports, according to provisions of the OFFP; in 2003, there are also outlays for currency printing, and thereafter further services payments associated with reconstruction. As to net official transfers, reparations payments to Kuwait for the 1990 invasion are the principal continuing payments. Since 2000, these were 25 percent of oil exports under the OFFP, but under the UN resolution 1483 of May 2003, they were reduced to 5 percent of oil exports.

Balance of payments accounts prepared in dinars by CBI compilers, although available, are not easily compared with the results shown here. Taking the results for 2000–01, for instance, the trade surplus recorded by the CBI is somewhat lower and the current account shows a significant deficit. In part, these results reflect higher merchandise imports, which may indeed be missing, so far, from IMF staff estimates based on the OFFP. At the same time, CBI accounts show implausibly large "services" payments, the nature of which has not yet been determined. While the nature of the CBI exchange rate translation(s) of entries in the current account from Iraqi dinars to dollars is not clear (there were vast differences between the official rate and market rate), the official rate appears to have been used. This is suggested by the fact that both exports and net transfers—mainly payments to the Kuwait compensation fund under terms of the OFFP—are rather close in both sets of accounts.

Box 2. External Current Account Estimates and Projections, 2001–04 (Concluded)

(In millions of U.S. dollars)

	2001	2002	2003	2004
Trade balance	4,994	3,061	1,996	-5,659
Exports	15,825	12,487	9,273	12,100
Crude oil exports	15,275	12,487	9,273	12,000
Refined products	550	0	0	0
Other exports			0	100
Imports	-10,832	-9,427	-7,277	-17,759
Government imports	-10,832	-9,427	-3,645	-8,565
Refined oil products	...	...	-632	-644
Private sector imports	...	...	-3,000	-8,550
Income, net	0	0	2	0
Services, net	-410	-325	-718	-400
Receipts	0	0	0	0
Payments	-410	-325	-718	-400
UN costs and weapons inspection	-410	-325	-263	
Currency printing			-155	
Other			-300	-400
Transfers, net	-3,956	-3,122	1,182	12
Private, net	0	0	0	0
Official	-3,956	-3,122	1,182	12
Current account balance	627	-386	2,462	-6,047
(in percent of GDP)	3.3	-2.5	20.8	-39.4
Memorandum items:				
Oil exports (mbpd)	1.7	1.3	0.9	1.6
Oil Price ($ per barrel)	21.75	22.46	26.28	20.49

Sources: U.S. Energy Information Agency; Iraq official data; and IMF staff estimates.

1/ Imports related to reconstruction efforts are not included in 2004.

Box 3. Budget, July–December 2003–04 1/

(In millions of U.S. dollars)

	Jul.-Dec. 2003		2004
	Budget	Rev. proj.	Budget
Total revenues and grants	6,086	5,484	12,839
Revenues	3,888	2,801	12,839
Oil revenues	3,455	2,519	12,000
Tax revenues	0	0	400
Direct taxes	0	0	40
Indirect taxes	0	0	360
Nontax revenues	433	282	439
Grants	2198	2683	0
Expenditures	7,158	7,787	21,322
Operating expenditures	4,195	3,270	19,949
Salary and pension payments	661	967	2,700
Goods and services	729	1,115	8,750
Oil-for-food program (other than social safety net) 2/	326	326	6,402
Oil product imports	0	300	0
Others	403	489	2,348
Capital expenditures 3/	48	61	113
Transfers	2,580	1,012	7,646
Social safety net	1,801	451	4,921
Oil-for-food program 2/	451	451	1,421
Non-OFF	1,350	0	3,500
Transfers to SOEs	479	461	1,000
Banks refurbishing	0	100	100
Transfers to Kurdish governorates	300	0	0
Others	0	0	1,625
Interest payments	0	0	140
War reparations	177	115	600
Investment expenditures	2,963	4,517	1,374
Overall balance (including grants)	-1,072	-2,303	-8,483
Overall balance (excluding grants)	-3,270	-4,986	-8,483
Financing	1,072	2,303	8,483
External financing	1,072	2,303	8,483
Iraqi assets held abroad	295	1,526	660
Oil-for-food program contracts 2/	777	777	7,823
Domestic financing	0	0	0

1/ Based on draft Iraqi budget as of end-September 2003, which was to be reviewed by the Governing Council, and on estimates for oil-for-food contracts provided by the UN Office of the Iraq Program. This budget table excludes projects to be carried out to address the needs identified in the assessment work conducted by the UN and the World Bank. The execution of such reconstruction projects will depend on available financing and is also likely to extend beyond 2004.
2/ Funded contracts under the oil-for-food program for which letters of credit have been issued.
3/ Nonproject-related capital expenditure (i.e., refurbishing spending).

Box 3. Iraq: Budget, July–December 2003–04 1/ (Concluded)

Notes:

Under the OFFP, oil export sales proceeds were used to finance projects in the north of Iraq and import contracts in the center and south. A large number of these contracts have already been approved, and their financing secured through the issuance of letters of credit. Under the transitory arrangement leading to the end of the program in November 2003, Iraqi and CPA officials are reviewing these contracts, and will be in charge of monitoring their execution after November. Imports under contracts pursuant to UN Security Council resolution 1472 (2003) have to be delivered by November 21, 2003, but imports under other contracts are mostly expected to come in 2004, with the possible exception of some durables which may delivered beyond 2004. Funds for projects in the North remaining on November 21, 2003 will be made available to the CPA. These funds may be needed for the implementation of these or similar projects.

Funds remaining in the UN OFF account in November 2003 will be transferred to the Development Fund of Iraq. These funds, together with Iraqi seized and vested assets, constitute Iraqi assets held abroad that can be used for financing of the budget, and replenishing international reserves of the Central Bank of Iraq. These funds do not include possible Iraqi assets held in countries other than the US.

The distribution of food and other essential products under the OFF safety net is expected to continue in 2004, and will be supplied by existing stocks, already financed imports under the OFFP, and other funds set aside in the budget ($3.5 billion in 2004). If the monetization of the social safety net is carried out, these funds could be distributed in cash. As a transitory measure, to avoid disruptions in food supply, strategic food reserves might need to be constituted (generating nontax revenue when they are sold).

Transfers to state-owned enterprises consisted mostly of wage transfers in 2003, working capital, and other non-wage subsidies. In 2004, the draft budget envisages the continuation of limited subsidies on a case-by-case basis, and severance payments for employees of SOEs expected to be closed in 2004.

In the original budget for the second half of 2003, net transfers to Kurdish governorates were included as a separate line item, as expenditure and revenue from these governorates had not yet been integrated in the budget. This was corrected in the revision of the budget, which presents an integrated budget framework for the whole country.