

**Iraq: Use of Fund Resources—Request for Emergency Post-Conflict Assistance—
Staff Report; Press Release on the Executive Board Discussion; and Statement by the
Executive Director for Iraq**

In the context of the use of Fund resources—request for emergency post-conflict assistance with Iraq, the following documents have been released and are included in this package:

- the staff report for the use of Fund resources—request for emergency post-conflict assistance, prepared by a staff team of the IMF, following discussions that ended on **September 5, 2004**, with officials of Iraq on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 24, 2004.** 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 Press Release summarizing the **views of the Executive Board as expressed during its September 29, 2004 discussion** of the staff report that completed the request.
- a statement by the Executive Director for Iraq.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Iraq*
Memorandum of Economic and Financial Policies by the authorities of Iraq*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

IRAQ

Use of Fund Resources—Request for Emergency Post-Conflict Assistance

Prepared by Middle East and Central Asia Department
(In Consultation with Other Departments)

Approved by Mohsin S. Khan and G. Russell Kincaid

September 24, 2004

- Discussions with the Iraqi authorities on a program that could be supported by Emergency Post Conflict Assistance (EPCA) started in early 2004 and took place almost on a monthly basis thereafter. The staff met with the Governor of the Central Bank of Iraq (CBI), the minister of finance, other members of the Iraqi Interim Government, and representatives of the Coalition Provisional Authority (CPA).
- 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. The last (1979) Article IV Consultation with Iraq was concluded on February 29, 1980.
- In the attached letter of intent and memorandum of economic and financial policies, the Iraqi authorities request a purchase under the EPCA policy for SDR 297.1 million (25 percent of quota).
- Iraq cleared its arrears to the Fund (SDR 55.3 million) on September 22, 2004, and has consented to increase its quota in line with the Eleventh Review of Quotas.
- Relations with the Fund and the World Bank are summarized in Appendices II and III, respectively.

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EXECUTIVE SUMMARY

Policy efforts and recent developments

- A number of important policy reforms have been implemented in Iraq to facilitate progress toward a more market-oriented economy. These reforms included *inter alia* the completion of a banknote exchange, approval of new banking sector and central bank legislation, enactment of a new tax law, and the simplification of the trade regime.
- The authorities' policies have succeeded in promoting overall macroeconomic stability despite the difficult security environment. Inflationary pressures have remained relatively subdued, the exchange rate has remained largely unchanged and gross international reserves have increased by about US\$3 billion since end-2003.
- The 2003 conflict brought about an almost complete halt in economic activity. But by end-July 2004, oil production, which constitutes about three quarters of the economy, had recovered. Non-oil economic activity has also been recovering, driven by reconstruction and a (partial) revival in the agricultural sector, although many enterprises are not fully operational yet. Commercial activity at the retail level is brisk, but unemployment remains high.
- Despite efforts to bring opponents into the political mainstream, Iraq continues to suffer repeated attacks by insurgents against government officials and police officers, as well as sabotage of crucial infrastructure.

The Program for 2004–05

- The authorities' main goals under the EPCA-supported program are to improve the general welfare of the Iraqi people and address Iraq's external debt problem. The authorities' program is to be underpinned by a prudent fiscal policy that aims to limit spending to available government revenues and external resources, the use of the exchange rate to anchor inflationary expectations, and the planning and undertaking of key structural reforms to transform Iraq into a market economy.
- The proposed purchase under the Fund's EPCA policy is for SDR 297.1 million (25 percent of quota). EPCA should help catalyze additional international support (including debt relief) for the reconstruction of Iraq.
- Fund financing to Iraq under the present circumstances is subject to a considerable degree of risk. The security situation has not been brought under control and Iraq also has an unsustainable level of debt. Official creditors have yet to agree on how to resolve the debt burden. In this regard, the staff and management have sought to allay the risks of lending to Iraq under these circumstances by seeking assurances from Iraq's official creditors for the program period as well as the repayment period.

I. INTRODUCTION

- 1. Iraq was one of the founding members of the IMF, but Fund staff had little official contact with the government of Iraq between 1983 and 2003.** During this twenty-year period, Iraq suffered from severe economic mismanagement, and over a decade of international sanctions. GDP per capita is estimated to have dropped from over US\$3,000 in the early 1980s to as low as US\$200 in the early 1990s. Although GDP per capita recovered somewhat to an estimated US\$800 in 2001, it fell again to about US\$500 in 2003 as a result of the most recent conflict. Iraq's human development indicators, which had exceeded the regional average in the early 1980s, are now considered among the lowest in the region. Unemployment is running close to 30 percent and underemployment is pervasive. Furthermore, about 60 percent of the population is thought to depend exclusively on the government's food distribution system for subsistence.
- 2. In the attached letter of intent and memorandum of economic and financial policies (Appendix I), the Iraqi authorities request a purchase under the Fund's Emergency Post-Conflict Assistance (EPCA) policy to help begin the process of economic recovery from the most recent conflict and the many years of policy mismanagement by the previous regime.** Fund support would be a key part of a concerted international effort to provide financial and technical assistance to Iraq. Financial assistance from the Fund will help meet some of the urgent balance of payments needs arising from the reconstruction and recovery of the Iraqi economy. In addition, the approval of EPCA should facilitate negotiations on urgently needed debt relief. A large number of bilateral donors and multilateral agencies are participating in the reconstruction of Iraq.
- 3. The authorities have already demonstrated a capacity to plan and implement policies, despite the institutional damage wrought by conflict and past mismanagement and despite the serious security problems.** Several key macroeconomic policy measures have already been taken to help secure economic stability and facilitate progress toward a more market-oriented economy (see next section).
- 4. The proposed EPCA program will cover the remainder of 2004 through the end of 2005.** The authorities have indicated that they intend to seek further financial support from the Fund in the form of an upper credit tranche stand-by arrangement (SBA) in 2005, assuming that enough progress has been made in strengthening administrative and institutional capacity under the program supported by EPCA, and that there is a significant improvement in security.

II. BACKGROUND AND RECENT DEVELOPMENTS

A. The Political and Security Situation

5. **After the fall of Saddam Hussein's regime in May 2003, the Coalition Provisional Authority (CPA) began to initiate reforms to help stabilize the political and economic situation in post-war Iraq.** The CPA took steps to ensure early participation of Iraqi nationals in decision-making. In this connection, the CPA recognized the Governing Council (GC) as the principal body of an interim Iraqi administration. In early September 2003, the GC named the first post-war cabinet of ministers. They were charged with running the day-to-day work of the government and reporting to the Council, although final political and economic authority remained in the hands of the CPA.
6. **On November 15, 2003, an agreement on an accelerated transfer of power to an autonomous interim Iraqi government was reached between the GC and the CPA.** The interim government would act as a caretaker administration until direct elections could be held. A central element of the agreement was the commitment to draft and enact a law that would establish the basis for naming the interim Iraqi government. The agreement also set a specific date (end-June 2004) for transfer of power from the CPA to the interim Iraqi government.
7. **On March 8, 2004 the Governing Council agreed on the elements of a Law for the Transitional Administration of Iraq (TAL).** The TAL serves as Iraq's supreme law for the transitional period from June 28, 2004, when Iraq's interim government took over Iraq's administration from the CPA, until the formation of an Iraqi government pursuant to a permanent constitution. During this period, a Transitional National Assembly will be elected by direct elections expected to take place in early 2005. The Assembly will have responsibility for forming a Transitional Government and drafting a permanent constitution for Iraq. The new constitution is expected to be approved by a national referendum no later than October 15, 2005. Further elections would follow and take place by end-2005.
8. **On June 28, 2004, an interim Iraqi government formally took over the administration of Iraq from the CPA.** On August 18, 2004, delegates representing different political parties, tribes, and regions concluded discussions on naming representatives to a 100-member Interim National Council. The Interim National Council advises the Council of Ministers of the Interim Government and has the right to approve the 2005 Iraqi national budget proposed by the Council of Ministers.
9. **Despite efforts to bring opponents into the political mainstream, Iraq continues to suffer repeated attacks by insurgents against government officials and police officers, as well as sabotage of crucial infrastructure.** This has severely hampered the economic recovery and reconstruction of Iraq. The authorities hope that timely implementation of the political reform program articulated in the TAL will enhance support for the Iraqi government and thereby undermine support for the insurgents.

B. Policy Efforts During 2003–04

10. In May 2003, the CPA and Iraqi officials began taking steps to restart economic activity, ensure price stability, and improve institutional and administrative capacity.

Salaries of all public employees began to be paid in late May 2003, including those for employees in state-owned enterprises (SOEs). A number of SOEs had resumed operations by the second half of 2003 and began receiving modest transfers from the budget for working capital and other operational costs. In addition, in the immediate aftermath of the conflict, priority was given to resuming government operations and several initiatives were launched by ministries outside the budget process.

11. The GC established its economic ministries in early September 2003. A number of important policy reforms then began to be implemented to facilitate progress toward a more market-oriented economy. These reforms included the completion of a national currency exchange (Box 1), the approval of new central bank and commercial bank laws, the liberalization of interest rates, approval of a foreign direct investment law, the establishment of the Trade Bank of Iraq, the passage of the Financial Management Law and a new tax law, and the simplification of the trade regime. More recently, on July 18, 2004, the ministry of finance completed its first treasury bill auction. Auctions have since been conducted on a bi-weekly basis. The authorities also focused their attention on rebuilding the oil industry, which remains the foundation of the Iraqi economy (Box 2). Although gradually recovering, attempts to expand oil production beyond current levels are being hampered by the frequent attacks on oil installations by saboteurs.

Box 1. Currency Exchange

During the previous regime, the (old) Iraqi dinar was the legal tender in the country and comprised two types of co-circulating banknotes: the “Swiss” dinar, issued between 1979 and 1989, and circulated only in the northern Kurdish provinces after 1989, and the “Saddam” dinar, issued by the Central bank of Iraq (CBI) from 1990 onwards (with effective available denominations in recent years of only ID 250 and ID 10,000 banknotes). The printing of the Saddam dinar was not fully controlled by the CBI, and the result was soaring inflation.

As a result of this chaotic situation, the Iraqi government, with assistance from the Coalition Provisional Authority (CPA), USAID, and the U.S. Department of Treasury, conducted a three-month program (between October 15, 2003 and January 15, 2004) to exchange all denominations and types of existing Iraqi banknotes into new ones with better quality and security features. The operation involved shipping and distributing about ID 6.1 trillion of new dinars into Iraq, while also destroying the old currency.

The old currency which featured Saddam Hussein was replaced with a new design based on the features of the Iraqi nation and its history. While the Saddam dinar was printed on cheap paper and easily counterfeited, the new currency is much more secure as it has features built in that make it very difficult to counterfeit. The new dinar has six denominations of banknote (instead of two), and has improved the efficiency of transactions significantly.

The conversion to a new currency was a significant accomplishment in a very difficult security environment, and has facilitated the revival of commercial activity in the country.

Box 2. Oil Sector in Iraq

Iraq has one of the largest estimated petroleum reserves in the world. Based on old geological surveys, reserves are estimated at some 100–130 billion barrels (about 11% of the world total), second only to Saudi Arabia. However, there is widespread belief in the industry that reserves could be even higher. Iraq's oil is good quality and relatively inexpensive to produce; many fields are large, onshore, and have fairly simple geological structures.

The discovery of oil in Iran in 1908 stimulated interest in Iraq as a possible oil producer. In 1925 an oil concession was granted to the Turkish Petroleum Company (TPC), and exploratory drilling began soon afterwards. Oil was discovered in 1927 just north of Kirkuk. In 1929, TPC was renamed Iraqi Petroleum Company (IPC). The IPC was wholly owned by foreign interests, but paid royalties to the Iraqi government. By 1938, Iraq was exporting oil at an average of 80,000 barrels per day.

In 1961, the Iraqi government expropriated all of IPC's concessions in areas that were not in production. This was followed in 1964 by the establishment by the Iraqi government of the Iraq National Oil Company (INOC), which was to develop the concession areas taken over from IPC. In 1972, the Iraqi government nationalized all the remaining holdings of IPC in Iraq and transferred them to INOC. In 1976, the structure of the Iraqi oil sector was revamped. A ministry of oil was established in which all oil activities were concentrated. Under this new scheme, INOC was responsible for the production, transport, and sale of crude oil. In 1987, INOC was dissolved and merged with the ministry of oil. The minister of oil heads a board of three under-secretaries and the executive director of the State Oil Marketing Organization (SOMO). Marketing activities are under the responsibility of SOMO, whereas activities related to oil exploration, production, transportation, and refineries are managed by 14 operating companies reporting to the three under-secretaries.

At the eve of the first Gulf War, Iraq's petroleum sector accounted for more than one-third of its gross national product and 99 percent of merchandise exports. Oil production had reached 3.5 mbpd of which 3.2 mbpd were exported. After the interruption of production during the war, Iraqi oil output slowly recovered to reach 0.6 mbpd in 1996. With Iraq's acceptance in 1996 of UN Resolution 986, which allowed limited Iraqi oil exports in exchange for food, the country's oil output began increasing more rapidly, reaching about 2.5 mbpd by the end of 2002. However, following the second Gulf War last year, the oil production facilities were badly damaged. While production has recovered to its pre-war level in 2004, it is expected to reach 3.5 mbpd by 2009. With adequate investment and the use of modern technologies, crude oil production could reach over 5 mbpd in the long run.

Iraq has three large refineries—Baiji (constructed in 1982), Basra (constructed in 1972, and doubled in capacity in 1979), and Daura (constructed in 1955)—and several small refineries. All refineries suffered severe damage during the Persian Gulf War of 1991, and all are very inefficient. Substantial investment will be required to upgrade existing refineries and expand total capacity before Iraq can meet again the domestic demand for oil refined products. In the next few years, therefore, Iraq is expected to have to continue to import oil refined products worth over US\$2 billion annually.

C. The Role of the Fund to Date

12. **Since June 2003, Fund staff has been engaged in a dialogue on macroeconomic policy issues with Iraqi officials and the CPA.** Discussions were held with Iraqi officials (and with CPA representatives until June 2004 when the CPA was dissolved) to assist them in preparing a macroeconomic framework for 2004 and the medium term. These discussions focused mainly on the monetary and fiscal policy stance for 2004 and 2005, as well as on key structural policy reforms in the medium term, such as price liberalization, banking sector restructuring, state-owned enterprise reform, and social safety net issues. The staff also worked—in close consultation with Iraqi officials and CPA representatives—on the preparation of an external debt sustainability analysis (DSA). Finally, Fund management has been represented on the International Advisory and Monitoring Board (IAMB), an audit oversight body for the Development Fund for Iraq (DFI), which holds Iraqi external assets, including proceeds from oil export sales.

13. **In addition to providing policy advice, Fund staff has also provided Iraq with much needed technical assistance (TA).** In September 2003, donors to a special TA sub-account at the Fund approved a TA program for the period through June 2004. This program, which is being implemented through seminars outside Iraq owing to security concerns, includes training in the areas of public expenditure management, tax policy and administration; central bank organization, accounting procedures and financial reporting, banking supervision, support for the banknote exchange program, and payments system reform; joint training on macroeconomic policies by INS and the Arab Monetary Fund (AMF); and a series of statistics missions.

14. **Fund staff has also played a coordinating role in the TA efforts of other providers (at their request) in macroeconomic policy areas, in particular, with the World Bank, U.S. Treasury, USAID, DFID (UK), and the Bank of England.** The World Bank has implemented a capacity-building project, funded by the European Union, in diverse areas such as macroeconomic and financial management, procurement, social safety net issues, and investment regimes. In addition, a technical assistance center in the Middle East (METAC) has been established in Beirut and will officially start operations in late October 2004. The Center will provide technical assistance to Iraq and other countries and territories in the region. The principal objective of the Center is to provide technical assistance in the Fund's core areas to improve institutional capacity and facilitate regional integration. Iraq is expected to be one of the major beneficiaries of these activities.

D. The Role of the International Community

15. **An International Donors' Conference on the Reconstruction of Iraq was held in Madrid on October 23–24, 2003.** Representatives from 73 countries and 20 international organizations met to pledge their support for the reconstruction of Iraq. During the conference, pledges amounting to more than US\$33 billion in grants and loans were announced for the period 2003–2007. An International Reconstruction Fund Facility for Iraq

(IRFFI) was established into which contributions by the international community were to be paid. The IRFFI has two windows, administered respectively by the World Bank and the UN in close coordination with the Iraqi authorities and donors. Disbursements are on a grant basis. Contributions into the IRFFI have so far amounted to about US\$1 billion.

E. Recent Economic Developments

16. **The 2003 conflict brought about an almost complete halt in economic activity for a large part the year.** Nominal GDP is estimated to have fallen by about 35 percent in 2003, reflecting a contraction in oil production to an average 1.2 million barrels per day (mbpd) from a level of almost 2.0 mbpd in 2002, and a severe retrenchment in non-oil economic activity in the first half of the year. But by end-July 2004, oil production, which currently constitutes three quarters of the economy, had recovered to 2.0 mbpd and exports were up to 1.5 mbpd (Figure 1). Monthly production and export levels have fluctuated due to the effects of sabotage and unreliable infrastructure. Non-oil economic activity has also been recovering, driven by reconstruction and a (partial) revival in the agricultural sector, but many state-owned enterprises and private businesses are still not fully operational. Commercial activity at the retail level is brisk, but unemployment remains high.

17. **The authorities' policies have succeeded in promoting overall macroeconomic stability despite the difficult security environment.** Inflationary pressures have remained relatively subdued, with the CPI increasing by 5.7 percent in the first eight months of 2004 (Figure 1). The exchange rate has remained largely unchanged (at around ID 1,460 per US\$) since the end of the banknote exchange in mid-January 2004. Reflecting increased re-monetization of the economy, base money increased significantly in the first six months of 2004 (by about 60 percent). Finally, the international reserves position of the central bank has strengthened, as gross reserves amounted to about US\$4.4 billion at end-August 2004.

III. ELEMENTS OF THE ECONOMIC PROGRAM

A. Overview

18. **The authorities' main goals under the EPCA-supported program are to improve the general welfare of the Iraqi people, enhance social stability, and address Iraq's external debt problem.** Although some key economic and structural reforms have been already accomplished (notwithstanding the difficult security environment), the reconstruction process has only just begun and will require the continued support of the international community to succeed. Key challenges that the authorities must now address include restoring security, preparing for the elections, strengthening administrative capacity, stepping up reconstruction, and promoting the development of the private sector.

19. The Iraqi authorities have stated in the MEFP their intention to implement a sound macroeconomic program and to begin planning and undertaking structural reforms to transform Iraq into a market economy and establish the basis for sustainable growth.

But the authorities recognize that implementation of their program will be linked to a restoration of security, which in turn will depend on the successful conclusion of the political reform process. Success in achieving the goals of the program will also depend importantly on Iraq's ability to expand oil production and exports, and will be vulnerable to developments in oil prices.

20. EPCA should help catalyze additional international support, including debt relief, for the reconstruction of Iraq. Iraq's total external debt as of end-2002 is estimated at some US\$125 billion, or around six times GDP, and is clearly unsustainable. Adherence to the program specified in the MEFP should also serve as a track record to help justify the transition to a SBA. EPCA should help the authorities to undertake difficult but necessary reforms, including the restructuring of the public sector, the elimination of price subsidies, and the reform of the social safety net.

21. Building on the progress achieved so far, the authorities' program aims at achieving a growth in real GDP of 52 percent in 2004 (from a very low base in 2003) and 17 percent in 2005. Growth is expected to come mainly from the expansion of oil production capacity, which is expected to reach 2.1 mbpd in 2004 and 2.4 mbpd in 2005, respectively. The inflation rate could reach 7 percent per annum in 2004, while rising to about 15 percent in 2005, reflecting the assumption of rising economic activity and demand pressures in the context of a stable exchange rate, with consequent increases in prices of non-traded goods. Finally, the CBI will aim to build up its net international reserves to at least US\$5.0 billion by end-2004, and US\$6.0 billion by end-2005.

B. Macroeconomic Policies

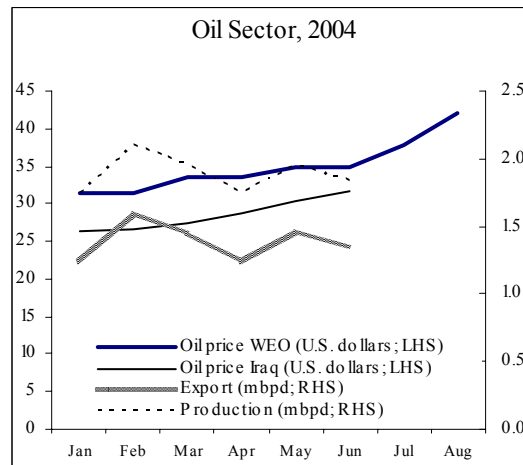
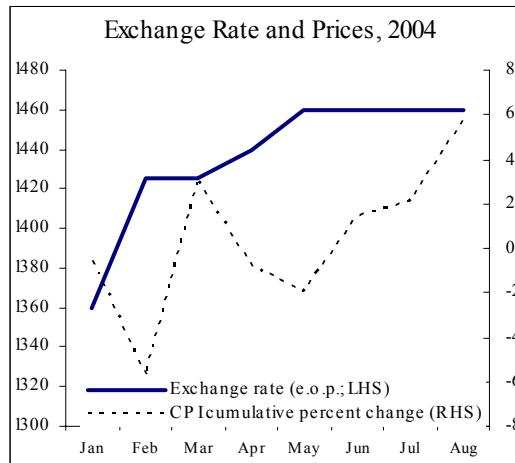
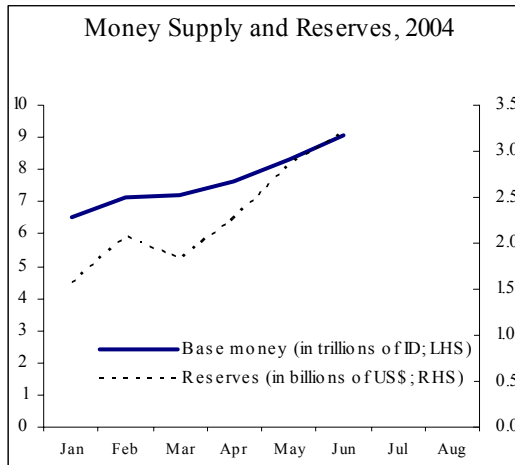
Fiscal policy

22. The authorities are committed to a prudent fiscal policy: they aim to limit spending to available government revenues and external resources, and avoid reliance on domestic financing of the budget.¹ The staff have projected a path to fiscal sustainability in the medium term with the primary fiscal deficit declining from 41.9 percent of GDP in 2004 to 27 percent in 2005, and turning into a primary fiscal surplus of 1.3 percent of GDP by 2007. The program assumes that creditors will grant Iraq a deferral on external debt service due through end-2005, based on financing assurances provided by the Paris Club and other non-Paris Club creditors in September 2004. On this basis, the overall government fiscal

¹ Under the new central bank law, the government cannot borrow directly from the CBI.

deficit is projected to reach US\$6.7 billion in 2005. The deficit should be fully financed from resources available from letters of credit issued by the UN under the oil-for-food program equivalent to US\$2.1 billion, assets accumulated abroad held in the Development Fund for Iraq of US\$4.2 billion, and project loans financed by donors of US\$0.3 billion (see Box 3 for an explanation of fiscal operations and financing).

Figure 1. Iraq: Economic and Financial Indicators



Sources: Iraqi authorities and Fund staff estimates.

23. The authorities have been cautious in projecting government revenues for 2005.

Revenues are budgeted to increase by 14 percent from US\$17.1 billion in 2004 to US\$19.5 billion in 2005 (including US\$0.9 billion of revenues from oil-related state-owned enterprises). They have agreed that the use of any revenue windfall would be prioritized in favor of reconstruction or the financing of budgets in future years. Off-budget expenditures will not be allowed, and any additional spending would need to be integrated into a revised budget, on the basis of the availability of additional resources.

24. Projections for 2005 are based on a very conservative oil export price assumption.

The export price of Iraqi oil is assumed to be US\$26, US\$6 lower than the 2005 Iraqi price implied by the oil futures market in September, and US\$4.5 lower than the average oil export price obtained in the first half of 2004. Oil exports are projected to increase from 1.5 mbpd to 1.8 mbpd in 2005.

Box 3: Government Fiscal Operations

Under the program-supported EPCA, government fiscal operations consist of:

(i) *government budget*; this covers all government recurrent and capital spending, except those directly financed by donors. The budget covers all general government expenditures in Baghdad and in Iraq's 18 governorates. Budget execution is the responsibility of ministries in Baghdad, and of sub-treasury branches in the governorates. However, the three northern governorates are relatively autonomous;

(ii) *letters of credit (LCs) issued under the oil-for-food program managed by the UN*; these are managed directly by ministries according to their area of responsibility. The ministry of trade manages LCs related to the food distribution system. LCs are fully financed by past oil exports, and cover the purchase of recurrent and capital imports mostly in 2004–05;

(iii) *expenditures financed by donors*; these are mostly limited to capital projects, except for some recurrent expenditure in the security and oil sectors financed by the US Supplemental Budget for Iraq. Some foreign donor grants are managed by the International Reconstruction Fund Facility for Iraq (a multilateral trust fund with two separate windows run by the World Bank and the UN). The U.S. Government, through its embassy in Baghdad, oversees the use of funds from the U.S. Supplemental Budget on Iraq. Some other bilateral donors are also active. The Iraqi Strategic Review Board, chaired by the minister of planning, has been assigned the responsibility of coordinating these programs with the Iraqi budget.

(iv) *operations of oil-related state-owned enterprises not included in the budget*; these cover mainly domestic oil sales, and some oil-related operating expenditure.

All Iraqi external assets are 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.

25. The authorities have decided to raise US\$1 billion in 2005 through a reduction in the price subsidy on domestic consumption of oil derivatives (starting by end-2004). The authorities acknowledge the very substantial revenue shortfall arising from the domestic price subsidy on oil derivative products (estimated at about US\$7 billion or 34 percent of GDP in 2004), and are committed to its full elimination by 2009 to help ensure government medium-term fiscal sustainability.²

26. Government recurrent expenditures will be contained at US\$21.4 billion (88 percent of GDP) in 2005, down from a projected US\$22.6 billion (107 percent of GDP) in 2004. Wages and pensions are expected to increase by 11 percent to US\$3.7 billion in 2005, mainly reflecting an adjustment to pensions (which had been very low throughout 2003–04). Goods and services, and transfers will decrease from US\$16.3 billion in 2004 to US\$14.5 billion in 2005, reflecting savings on one-off expenditures required in the immediate aftermath of the conflict. The level of oil-related spending (recurrent and capital) will increase from US\$3.1 billion in 2004 to US\$4.3 billion to generate the projected increase in oil production. Non-oil capital spending is projected to increase by 41 percent from US\$4.3 billion in 2004 to US\$6.1 billion in 2005, and assumes a substantial acceleration of disbursements of the pledges made at the Madrid Donors Conference in October 2003 (projected at US\$4.7 billion in 2005, including US\$3.7 billion from the U.S. supplemental Budget on Iraq).

27. During the course of 2005, the government intends to take steps to broaden the tax base, with revenue effects likely to show up in 2006. With external assistance, the government will develop by June 2005 a plan to overhaul the tax and customs administrations. Related tax measures, which could be adopted in 2006, include the introduction of a general sales tax which could serve as the precursor to a value added tax, in addition to the existing 5 percent import duty (or “reconstruction levy”) which would in turn be changed into a uniform import duty with reduced exemptions.

28. The authorities intend to implement reforms aimed at reducing the role of government in the economy over the medium term, while continuing to protect the poor. First, they will take steps aiming at reducing the wage and pension bill to 11 percent of GDP (from the current level of 16 percent). A payroll covering all civil servants and government workers has already been established, and an automated payroll system will be implemented in 2005. Second, a thorough analysis of state-owned enterprises will be completed by end-2005, with the aim of producing plans for restructuring or privatizing these enterprises over the medium term. And third, the authorities will prepare the ground for transforming the current food ration system into a cash distribution system targeted at the poor and the unemployed. This monetization of the food basket should help domestic

² The current price of gasoline is 1.4 US cents per liter, the price of diesel is 0.7 US cents per liter, and the price of kerosene is 0.3 US cents per liter.

agriculture, encourage private trade, and eliminate a pervasive sources of price distortions, while at the same time ensuring that families in need are properly supported within the social safety net.

29. The authorities recognize the importance of enhancing the effectiveness and transparency of budgetary management. To that effect, they have undertaken to improve the planning, tracking, and reporting of public expenditure (see Box 4).

Box 4: Government Fiscal Transparency

The authorities are committed to implementing the following measures toward enhancing the efficiency and transparency of fiscal operations in the coming months:

(a) *budget preparation and coverage*; adoption of regulations related to the financial management law by end-2004; adjustment of budget appropriation only through mid-year budget reviews (extra-budgetary expenditure will be forbidden); the financial management law was approved in June 2004 with technical advice from staffs of the World Bank and the IMF.

(b) *budget execution*; development of monthly fiscal accounts for the general government and the oil sector by end-2004; introduction of a treasury single account by September 2005; implementation in the entire country of the reporting and control modules of a financial management information system (FMIS) by June 2005; and,

(c) *budget control*; strengthening of the operations of the Supreme Board of Audit; implementation of the recommendations of the KPMG audit and of the International Advisory and Monitoring Board (IAMB), including ensuring that oil export sales are in line with international standards, and strengthening governance through the effective metering of oil production; and publishing the government's final consolidated fiscal accounts by June of the following fiscal year, starting in June 2005.

Monetary and exchange rate policy

30. The authorities have utilized exchange rate stability as a framework for monetary policy. With little data in the aftermath of the conflict, particularly on monetary aggregates and the real sector, the authorities had only the exchange rate to anchor inflationary expectations and establish confidence in the new currency. The framework has so far worked well in this regard. The authorities recognize, however, that as Iraq undergoes structural change and faces up to external shocks, the appropriateness of this framework may need to be reassessed. They intend to be vigilant regarding developments that may call for

greater flexibility of the exchange rate, including excessive downward pressure on the exchange rate or unfavorable inflation developments.³

31. **The CBI is broadening its set of monetary policy instruments to facilitate the conduct of monetary policy.** The CBI Board has approved the creation of a lender-of-last-resort (LOL) facility and an overnight standing credit/deposit facility, and issued new regulations on reserve requirements, making them uniform and setting a ceiling on the amount of vault cash that can be used to meet them. The LOL facility would provide short-term assistance to banks that face temporary liquidity shortages but that remain solvent. The implementation of the standing facilities should provide the banking system with the flexibility required to manage liquidity more efficiently. The use of domestic currency monetary policy instruments has also been greatly enhanced by the recent introduction of an auction for treasury bills, which should enable the CBI to conduct open market operations.

32. **The CBI has outlined an agenda for strengthening its regulatory and supervisory capacity.** The CBI is preparing regulations on loan classification, capital requirements, related party lending restrictions and risk management for commercial banks. The CBI is also in the process of strengthening its supervisory capacity by restructuring its banking supervision department and intensifying the training of its personnel. Moreover, given the role of the state banks in the financial system, the CBI and the government are preparing a plan for the restructuring of the operations of these banks with a view to improving their governance structure and enhancing their market value (see Box 5 for a description of the banking system). Also, the legal and monetary elements of a systemic safety net will be developed to ensure that any bank insolvencies do not impair confidence. Finally, the CBI will strengthen institutional capacity for payments, which will ensure that a weak payments system does not inhibit the recovery.

³ The authorities, with the assistance of the staff, have developed a monetary framework for 2004–05 to help assess the appropriateness of their current policy stance. The monetary program is designed to be consistent with the overall assumptions of the economic program relating to economic growth, inflation, and incorporates expectations of additional growth in money demand connected to further remonetization of the economy.

Box 5. Iraq: Banking System

The current structure and condition of the banking system in Iraq reflects years of government intervention. The banking system comprises six state-owned banks, the two largest being Rafidain and Rasheed (accounting for nearly 90 percent of banking sector assets), and 17 private banks. Although the two large state banks have extensive branch networks (together they own more than 400 branches, out of 550 in the system), the state banks effectively operate on a unit banking system. In the aggregate, the banking system as a whole has only about US\$2 billion in assets (less than 10 percent of 2004 GDP). Reflecting the limited extension of credit to the private sector, asset composition is heavily tilted toward treasury bills. Credit culture is limited and the payments system needs serious revamping.

33. **The government and the CBI are negotiating an agreement on the restructuring of the government obligations held by the central bank.** Staff has been advised that such an agreement should not negatively affect the capital of the CBI. As part of the agreement, the CBI law will be amended to require the CBI to transfer to the ministry of finance any excess realized profits, but only as long as the CBI's capital remains at or above its required regulatory minimum. Finally, the intention is to formally close the government overdraft facility at the CBI.

External sector

34. **The authorities are committed to developing an open trade and exchange system.** Under the program the government will avoid imposing restrictions on payments and transfers for international transactions, to introduce new or intensify trade restrictions for balance of payments purposes, or resort to multiple currency practices. Iraq has not yet accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement. Iraq has been granted observer status in the World Trade Organization.

35. **Paris Club and non-Paris Club creditors, have provided financing assurances for the period of the EPCA.** The authorities are committed to normalize their relations with external creditors and to finalize reconciliation of their debt as soon as possible. The authorities are keen to conclude discussions with Iraq's bilateral official creditors on a final solution to the countries' external debt problem, which they are aiming for by late 2004. As is clear from the staff's medium-term analysis (see Box 6), the current level of debt is unsustainable.⁴ While staff is of the view that Iraq will need substantial debt reduction to

⁴ At the request of the Paris Club, the staff undertook a debt sustainability analysis (DSA) and submitted it to the Paris Club in May 2004. This DSA indicated that Iraq needed substantial debt relief. The staff's medium-term scenario uses new information that has become available since the DSA was prepared (oil prices are higher, oil production is proceeding more slowly, and oil extraction costs have been revised down).

reach external and fiscal viability, the staff has not made any recommendation regarding the magnitude of debt reduction needed. This is a matter for Iraq and its creditors to decide. In order to accelerate the resolution of the debt problem, the authorities have already started contacts with official bilateral creditors to begin a data reconciliation process with them. In addition, several non-Paris Club bilateral creditors have already indicated a willingness to reduce substantially their claims on Iraq. The authorities are also taking steps to clear arrears with the World Bank and are expected to reach an agreement with the Arab Monetary Fund toward resolving outstanding obligations.

Structural reforms

36. The authorities are expected to implement a number of reform initiatives covering the financial and oil sectors during the remainder of 2004 and 2005. Steps will be taken to modernize the central bank and strengthen its supervisory capacity. CBI operations will be made more transparent, including through regular dissemination of monetary statistics. The CBI will undergo an external audit of the 2004 financial statements by mid-2005 according to international standards. Improvements will also be made to the payments system. Finally, toward improving governance in the oil sector, the authorities will review the fiscal regime for the sector and prepare an overall restructuring plan by end-2005. This plan will include the implementation of the recommendations of the IAMB as regards monitoring and control systems.

37. For the longer term, the authorities are close to finalizing an interim national development strategy for Iraq that will outline structural reforms expected to support the transition to a market economy. Key elements of the strategy are expected to address the rehabilitation of the oil sector, diversification of economic activity, improvement of social indicators, and regional development. A draft version of this strategy will be presented at the next donors' meeting scheduled for October 13–14 in Tokyo and will be put before the elected National Assembly early in 2005.

C. Donor Coordination, Technical Assistance, and Statistical Issues

38. The fulfillment of the pledges made at the Madrid Conference will be of critical importance for the reconstruction efforts in Iraq. So far, less than 3 percent of those pledges have been disbursed. The authorities hope that the smooth implementation of the political agenda will help restore political stability and improve the security environment sufficiently to facilitate the fulfillment of those pledges.

39. Despite the intensity of efforts by the international community so far, TA needs in Iraq are still significant. Key areas within the mandate of the Fund are fiscal policy (customs and tax administration, fiscal federalism, tax regime for the oil sector, and expenditure and treasury management), banking sector reform, statistics, and social safety net

Box 6. Iraq: Medium-Term Macro-Framework

Staff project GDP to recover rapidly, with a post conflict bounce in 2004 and robust growth in later years fed by a huge investment and reconstruction program (US\$68 billion over 2004–2009). Real GDP is expected to increase by 52 percent in 2004, by 17 percent in 2005 and by an average of 9 percent per annum over 2006–09. **Oil output** is projected to rise from 2.1 million barrels per day (mbpd) in 2004 to 3.5 mbpd by 2009. **Non-oil real GDP** is projected to grow at 34 percent in 2004, slowing to 10 percent by 2009. **Oil export prices** after 2005 are derived from the August World Economic Outlook (WEO), adjusted downward by one standard deviation (\$4.50 per barrel) reflecting a likely downward revision in the next WEO round, and an additional discount of \$4.0 per barrel (reflecting transportation costs and quality). Annual consumer price **inflation** is expected to rise from 7 percent in 2004 to 15 percent in 2005, and then fall gradually to 7 percent by 2009.

Fiscal consolidation is envisaged over the medium term. Oil export revenues rise from US\$16 billion in 2004 to US\$22 billion in 2009, reflecting a combination of rising oil exports and declining oil prices. Domestic **oil derivative price subsidies**, equivalent to some US\$7 billion in 2004, are expected to be eliminated between 2005 and 2009. The **tax effort** rises from 3 percent of non-oil GDP in 2004 to nearly 9 percent over 2006–09. Government **recurrent expenditures** (excluding interest payments and war reparations) are projected to decline from about 102 percent of GDP in 2004 to around 54 percent of GDP in 2009. **Public investment** is expected to rise from 26 percent of GDP to 37 percent of GDP in 2005, and then slowly decline to 27 percent of GDP by 2009. The **primary fiscal balance** improves from a deficit of 42 percent of GDP in 2004 to a small surplus over 2007–09.

In the **balance of payments**, exports are driven mainly by oil, but non-oil exports are also projected to grow rapidly from a low base. Imports are assumed to grow steadily. The trade balance is projected to remain in deficit through the medium term. The scenario assumes the disbursement of US\$22.2 billion in grants pledged at Madrid, and US\$6.4 billion in multilateral and bilateral loans. Iraq's external debt (estimated at US\$126 billion on a preliminary basis) is assumed to be rescheduled over 20 years, with a 10-year grace period, but no debt reduction (Houston terms). A deferral applies through 2005.

The medium-term scenario shows large financing gaps from 2006 through 2009, reflecting the clearly unsustainable level of external debt. **Excluding debt service, however, the scenario shows small financing surpluses.** This indicates that, subject to the Fund having assurances from creditors that debt relief would be sufficient to remove financing gaps arising from debt service, the Fund could expect to be repaid EPCA under this scenario, subject to the usual risks that derive from the assumptions (especially oil prices). The scenario's financial surpluses excluding debt service do not imply that any particular amount of debt reduction would be required to restore debt sustainability. They could be consistent either with a large debt reduction, with a range of smaller debt reductions and partial interest deferrals, or no debt reduction and a large interest deferral.

design. The work plan approved by donors last year to finance TA activities by Fund staff has been revised and extended to June 2005. Several other important activities are under preparation, which will enhance the government's capacity to implement the proposed program. For example the World Bank's second capacity building project is close to being approved (funded by the bilateral donors via the IRFFI). It will focus on market reforms, including the reform of the subsidy system, poverty assessment and alleviation, the design of a social safety net, private and financial sector development, public finance and governance, and financial management and procurement.

40. **The quality of Iraq's statistical base is limited after years of institutional isolation, and was substantially weakened as a result of the conflict and the looting of offices in its aftermath.** Fiscal and monetary data are only barely adequate for program monitoring purposes, but the authorities expect that this situation will improve in the context of the current TA program in statistics and the implementation of the authorities' program of expenditure management reforms. Staff now receive monthly data on the balance sheet of the central bank, price statistics, government exports and imports, and quarterly fiscal data although its coverage needs to be expanded to correspond to the fiscal coverage used in the program.

D. Program Issues

Access

41. **The proposed purchase under the Fund's EPCA policy is for SDR 297.1 million (25 percent of quota), or about ID 633 billion.** The authorities have expressed their intention to keep the total purchase in their SDR account at the Fund.

42. **Iraq cleared its arrears to the Fund (SDR 55.3 million) on September 22, 2004.** Iraq has also consented to increase in its quota under the Eleventh Review of Quotas, and is in the process of making the increase effective.

Financing and risks

43. **The provision of Fund financing to Iraq under the existing circumstances poses unusual risks to the Fund.** Perhaps most importantly, since official creditors have not reached an agreement on the debt reduction that would effectively address the unsustainability of Iraq's external indebtedness, serious doubts exist as to whether Iraq will have the capacity to repay to the Fund the amounts to be made available under EPCA. This raises issues regarding the adequacy of safeguards as required under the Fund's Articles.

44. **Against this background, staff and management have consulted—through the relevant Executive Directors—with the bulk of Iraq's official bilateral creditors to address the risks that are posed by the provision of Fund financing in these circumstances.** Based on these consultations, management has understood that these creditor members recognize the Fund's preferred creditor status in respect of drawing by Iraq under the EPCA and, similarly, that they are willing to make their best efforts—given Iraq's continuing cooperation with the Fund—to provide debt relief on appropriate terms to ensure timely repayment to the Fund of the amounts provided under the EPCA, in accordance with the Fund's preferred creditor status. Of course, this is consistent with the general understanding of the Fund's preferred creditor status, as has been confirmed in earlier

instances, including when the Systemic Transformation Facility was established in 1993.⁵ During the consultations with these creditors, they also confirmed that, during the period of the economic program being supported by the EPCA, a deferral will be in place with respect to those obligations of Iraq that are falling due to them.

45. Since the security situation has not been brought under control, there are significant political risks that may derail the program. The authorities' ability to implement reforms could also be compromised by political pressures in the run-up to legislative elections in January and the need to agree on the text for a new constitution later in the year. In addition, the program is subject to the usual risks that attend assumptions regarding external economic variables.

Monitoring

46. The MEFP includes structural and quantitative indicators through September 2005 (Appendix I, Table 1). The definitions for the financial indicators are described in the technical memorandum of understanding (Appendix I). Assuming that performance under the program is satisfactory, and that the authorities are able to strengthen their capacity to implement a more ambitious program, an upper credit tranche stand-by arrangement could be considered in the second half of 2005.

IV. STAFF APPRAISAL

47. After decades of war and economic mismanagement, Iraq is on the threshold of a new beginning. Whether this is the beginning of an era of peace and prosperity, of democracy and social inclusion, of the development of an efficient market economy, and of the reintegration of Iraq into the community of nations will depend not only on the efforts of the new Iraqi government, but also on the sustained engagement of the international community. Without the commitment of the international community, the opportunity for reform risks being lost, and Iraq could return to a regime of autocracy, renewed economic decline, and rising poverty. This downside scenario, bringing with it the likelihood of further conflict and political instability, has serious adverse implications not only for Iraq, but for the entire Middle East region.

48. The role of the Fund is to help Iraq rebuild its economy and institutions, and thereby release the country's considerable economic potential for the benefit of all its citizens. Following the collapse of the Saddam Hussein regime in April 2003 after the invasion by coalition forces, the Fund initially concentrated on providing technical assistance and on undertaking analysis of Iraq's economy as well as its capacity to service debt. But

⁵ See *Concluding Remarks by the Chairman on the Systemic Transformation Facility* (BUFF/93/19, 4/23/93).

with international recognition of the Interim Administration in July 2004, Iraq has been able to normalize its relations with the Fund. The Fund can now make its financial resources available to the country, and therefore materially support the economic and financial program outlined above and set out in the authorities' MEFP.

49. The Fund's financial support will, in the first instance, be in the form of Emergency Post Conflict Assistance (EPCA). Given the huge dislocation to the economy and damage to the country's institutions and administrative capacity brought about, inter alia, by the conflict, EPCA would seem the most appropriate vehicle for Fund financial support at this juncture. Despite the continuing violence and the very difficult security situation in key parts of the country, the Iraqi authorities appear to have the necessary capacity to proceed with a basic economic program of sufficient strength to warrant the support of EPCA. EPCA would also have the very important role of facilitating the process of bringing Iraq's external debt burden to a sustainable level. EPCA would most likely permit the start of negotiations between official creditors (Paris Club and non-Paris Club) and Iraq. The Iraqi authorities are expected to follow EPCA with a request for a SBA sometime in the second half of 2005.

50. The objective of the Iraqi economic and financial program described above is, first and foremost, to stabilize the economy and lay the groundwork for the development of a reform program that could be undertaken in the years to come. The budgets for both 2004 (revised) and 2005 have been devised to: (i) provide the minimum adequate level of social support to the people of Iraq, and (ii) begin the urgent reconstruction of the economy. The financial demands of these requirements—especially reconstruction—are very large. There should be sufficient resources available to meet basic demands, both from rising oil revenues and from balances accrued in the DFI. But donor support will also be crucial. The budgets are not without risks, including in the wage and pension bill, on other recurrent spending, and on possible financing shortfalls. But they have also been based on deliberately conservative assumptions regarding oil prices and production. The authorities have also committed to prioritize the use of higher than programmed oil revenues in favor of additional investment and/or to help defray future budgetary expenses in 2006 and beyond.

51. The 2005 budget will also incorporate an upward adjustment in the price of domestic petroleum products, both to help restore long run fiscal sustainability and to rationalize the use of Iraq's oil resources. This bold move toward reducing the enormous subsidy on domestic consumption of petroleum would demonstrate the firm resolve of the new government in Iraq to tackle the fundamental problems that beset the Iraqi economy today. The measure envisaged for 2005 would be only the first step of many that must be undertaken if the government is to reach its goal of eliminating the subsidy by 2009. The continued gradual removal of the subsidy should therefore be a key element of subsequent economic programs supported by successor arrangements with the Fund.

52. The Iraqi authorities' policy of maintaining exchange rate stability has served Iraq well so far, and the staff recommends that this policy be continued for the time being. It has helped secure a fairly stable price level, and also allowed the new currency to gain

acceptance inside Iraq. But the authorities will need to watch carefully the growth of the money supply, in case this threatens their inflation objective, and also monitor economic developments that might affect the appropriate level of the exchange rate. Depending on events, the authorities may need to find ways to sterilize the growth in the money supply (for example, through open market operations in treasury bills), or allow the exchange rate to be more flexible.

53. The economic and financial program for 2004 and 2005 contains a number of commitments to develop a reform program in key areas. These include reforms in the fiscal and monetary areas, as well as data compilation and reporting. It will be important for these reforms to get underway as soon as possible, especially those that relate to rebuilding administrative capacity and program monitoring, as progress in these areas will have a bearing on how quickly Iraq could move into an upper credit tranche arrangement (e.g., a SBA). These reforms are also only the beginning of what will need to be a comprehensive reform program over the coming years.

54. The key areas of reform on which progress must be made in 2005 are in the fiscal, public sector and financial areas. Tax reform, for example, will need to be an early item on the agenda of a successor program, as the tax effort in Iraq is currently minimal. A wide range of public sector reforms are needed, including towards enhancing the governance and transparency of the oil sector. Financial sector reform will be a key factor in promoting the recovery and growth of the private sector. A plan for the state banks will need to be developed. The CBI's own balance sheet will need to be restructured (taking into account the transformation of the government's overdraft accounts) in such a way as not to compromise its capital base.

55. Fund financing to Iraq under the present circumstances is subject to a considerable degree of risk. In addition to the usual risks that relate to program implementation and the influence of external factors, Iraq also has an unsustainable level of debt. Official creditors have yet to agree on how to resolve this debt burden. This raises questions about Iraq's capacity to repay the Fund. The staff and management have sought to allay the risks of lending to Iraq under these circumstances by seeking assurances from Iraq's official creditors that they will respect the Fund's preferred creditor status, specifically by committing to make their best efforts provide debt relief on appropriate terms to ensure timely repayment to the Fund of the amounts provided under EPCA.

56. The economic and financial program described in this report would represent an important step toward rebuilding the Iraqi economy, and this program merits financial support from the Fund, in the form of EPCA. There is no doubt that in providing resources under EPCA, the Fund would be lending into an extremely hazardous situation. But we believe that the criteria for EPCA have been met. The staff, therefore, recommends this program to the Board.

Table 1. Iraq: Selected Economic and Financial Indicators, 2004–2009

	2004	2005	2006	2007	2008	2009
Economic growth and prices						
Nominal GDP in US\$ (percentage change)	74.4	15.0	28.6	9.4	9.7	11.8
Real GDP in US\$ (percentage change)	51.7	16.7	14.6	5.9	5.5	10.0
Nominal non-oil GDP in US\$ (percentage change)	35.6	26.5	17.4	16.4	14.4	12.3
Nominal GDP per capita (In US\$)	780	870	1,087	1,156	1,234	1,343
Nominal GDP (In US\$ million)	21,132	24,295	31,252	34,203	37,518	41,941
Oil production (In mbpd)	2.1	2.4	2.8	2.9	3.0	3.3
Oil prices (US\$ pb)	30.4	26.0	26.8	26.0	25.3	24.8
Population growth	3.0	3.0	3.0	2.9	2.8	2.7
Domestic consumer Price Inflation (year-on-year)	7.0	15.0	12.0	10.0	8.0	7.0
Libor (In percent)	1.6	4.3	5.5	5.5	5.5	5.5
(In percent of GDP)						
National Accounts						
Gross domestic investment	34.9	44.8	38.5	34.0	32.8	31.6
<i>Of which: public</i>	26.4	37.4	33.8	29.7	27.9	26.7
Gross domestic consumption	91.2	90.7	78.3	79.1	78.5	76.6
<i>Of which: public</i>	50.5	45.2	35.3	30.6	27.5	26.7
Gross national savings	17.0	26.6	17.3	13.1	11.3	10.1
<i>Of which: public</i>	-16.4	9.7	10.5	11.2	9.7	8.4
(In percent of GDP, unless otherwise indicated)						
Public Finance						
Government revenue and grants	90.6	97.7	101.7	94.2	87.9	83.4
Government oil revenue	76.7	74.6	77.8	75.2	72.2	71.5
Government non oil revenue	1.4	2.1	3.4	3.7	3.9	4.0
Grants	9.7	17.5	17.4	12.3	8.9	5.5
Expenditure	133.5	125.4	124.9	112.6	106.1	101.7
Recurrent expenditure	107.1	88.0	91.1	82.9	78.2	75.0
Capital expenditure	26.4	37.4	33.8	29.7	27.9	26.7
Overall fiscal balance (including grants)	-42.9	-27.7	-23.2	-18.4	-18.2	-18.3
Gross borrowing/use of external assets	45.3	27.7	3.5	3.4	4.0	3.3
Amortization	2.4	0.0	0.0	3.6	6.7	9.7
<i>Of which: amortization to finance gap</i>	0.0	0.0	0.0	3.6	6.7	9.7
Financing gap (+)/Surplus (-)	0.0	0.0	19.7	18.6	20.9	24.6
Memorandum item:						
Tax revenue/non oil GDP (In percent)	3.0	3.7	8.8	8.8	8.8	8.9
Primary fiscal balance	-41.9	-27.3	-1.9	1.3	1.2	0.2
Non oil primary fiscal balance	-103.7	-80.5	-60.3	-54.2	-51.9	-51.6
(In millions of U.S. dollars, unless otherwise indicated)						
Balance of payments						
Current account	-3,768	-4,428	-6,637	-7,157	-8,071	-9,034
Trade balance	-5,137	-7,878	-4,327	-3,759	-3,673	-3,065
Exports of goods	16,543	17,597	21,390	21,239	21,096	22,866
Imports of goods	-21,680	-25,475	-25,716	-24,998	-24,768	-25,932
Income and services	-363	-747	-7,502	-7,380	-7,743	-8,171
<i>Of which: interest payment</i>	-1	-13	-6,572	-6,636	-7,185	-7,638
<i>Of which: oil profit remittances</i>	0	0	0	0	0	-161
Transfers	1,731	4,197	5,191	3,982	3,345	2,203
Financial account	8,973	7,026	1,502	431	-320	-1,809
Direct investment	200	300	400	500	679	861
Gross borrowing/use of external assets	9,565	6,726	1,102	1,161	1,504	1,401
Amortization	0	0	0	-1,230	-2,503	-4,071
Other flows	-792	0	0	0	0	0
Overall external balance	5,204	2,598	-5,135	-6,726	-8,391	-10,843
Financing	-5,204	-2,598	5,135	6,726	8,391	10,843
Central bank reserves (increase -)	-4,624	-2,598	-1,016	362	552	513
Change in arrears	-580	0	0	0	0	0
Financing gap (+)/Surplus (-)	0	0	6,151	6,364	7,839	10,330
Memorandum item:						
Trade balance (In percent of GDP)	-24.3	-32.4	-13.8	-11.0	-9.8	-7.3
Current account (In percent of GDP)	-17.8	-18.2	-21.2	-20.9	-21.5	-21.5
Total reserves (In US\$ million) 1/	5,691	8,289	9,305	8,944	8,392	7,879
In months of goods and services	2.6	3.7	4.3	4.2	3.8	3.6
As ratio of debt service	--	--	1.4	1.1	0.8	0.7
Debt Stock (In US\$ billion) 2/	124.3	131.5	138.8	145.5	152.2	159.9

Source: Program projections agreed with Iraqi authorities through 2005; Fund staff projections for the medium term.

1/ Central Bank and government.

2/ Excludes multilateral obligations.

Table 2. Iraq: Medium-Term Fiscal Projections, 2004–2009

(In millions of U.S. dollars)

	2004	2005	2006	2007	2008	2009
Revenues & Grants	19,153	23,745	31,777	32,216	32,967	34,998
Revenues	17,111	19,492	26,347	28,007	29,609	32,696
Crude oil export revenues	16,200	17,113	20,778	20,531	20,262	21,979
Oil products domestic revenues from reduction in price subsidy	0	1,000	3,539	5,185	6,813	8,002
Revenues of oil-related state owned enterprises	600	860	966	1,012	1,058	1,045
Tax revenues	169	262	743	865	989	1,122
Direct taxes	5	26	35	43	52	60
Indirect taxes	164	236	708	822	937	1,062
Nontax revenues	133	247	320	414	488	548
Interest on assets held abroad	10	10	0	0	0	0
Grants	2,041	4,253	5,430	4,208	3,358	2,301
Expenditures 1/	28,217	30,471	39,030	38,511	39,808	42,657
Operating expenditures 1/	22,632	21,384	28,483	28,358	29,326	31,476
Salary and pension payments	3,360	3,733	3,733	3,733	4,095	4,578
Goods and Services	5,454	5,085	4,785	4,034	3,336	3,363
Budgeted goods and services	4,501	4,133	4,785	4,034	3,336	3,363
Oil derivative imports	2,100	2,400	2,099	1,292	328	0
Other budgeted goods and services	2,401	1,733	2,685	2,742	3,008	3,363
Financed by oil-for-food program (other than social safety net)	952	952	0	0	0	0
Oil extraction expenditures (including refineries)	1,860	2,160	2,522	2,704	2,901	3,251
Transfers	10,935	9,450	9,744	10,134	10,701	11,444
Social safety net (incl. financed by OFFP)	4,056	4,000	4,084	4,170	4,377	4,589
Transfers to SOEs	1,020	1,020	850	700	550	400
Others	5,859	4,430	4,810	5,264	5,774	6,455
Interest payments 1/	213	100	6,661	6,727	7,281	7,742
Domestic interest payments	213	100	102	104	106	109
External interest payments	0	0	6,559	6,623	7,174	7,634
[Accrued (and deferred) interest] 2/	[6,217]	[6,217]	...	...	...	...
War reparations	810	856	1,039	1,027	1,013	1,099
Investment expenditures	5,585	9,087	10,548	10,152	10,482	11,181
Non-oil investment expenditures	4,325	6,087	7,025	6,120	6,212	6,159
Domestic financed reconstruction expenditure	2,579	1,367	1,000	1,000	1,600	2,707
OFFP financed reconstruction expenditure	527	713	0	0	0	0
Grant financed reconstruction expenditure	1,219	3,653	5,430	4,208	3,358	2,301
Loan financed reconstruction expenditure	0	354	595	911	1,254	1,151
Oil investment expenditures (including on refineries)	1,260	3,000	3,523	4,033	4,270	5,022
			0			
Balance (including grants but excluding accrued and deferred interest)	-9,065	-6,726	-7,253	-6,295	-6,841	-7,659
Balance (excluding grants and accrued and deferred interest)	-11,106	-10,979	-12,684	-10,503	-10,198	-9,961
[Balance (including grants and accrued and deferred interest)]	[-15,282]	[-12,943]	[-7,253]	[-6,295]	[-6,841]	[-7,659]
External financing	9,065	6,726	1,102	-69	-999	-2,670
Assets held abroad	5,943	4,206	507	0	0	0
Project financing	0	354	595	911	1,254	1,151
Other financing 3/	3,622	2,166	0	250	250	250
Amortization	500	0	0	1,230	2,503	4,071
[Deferred accrued interest]	[6,217]	[6,217]	...	...	...	...
Financing gap 4/	0	0	6,151	6,364	7,839	10,330
Memorandum items						
Primary fiscal balance	-8,852	-6,626	-593	432	440	83
Financing gap less debt service	...	...	-407	-1,489	-1,838	-1,375
GDP	21,132	24,295	31,252	34,203	37,518	41,941

Table 2. Iraq: Medium-Term Fiscal Projections, 2004–2009 (concluded)

(In percent of GDP)

	2004	2005	2006	2007	2008	2009
Revenues & Grants	90.6	97.7	101.7	94.2	87.9	83.4
Revenues	81.0	80.2	84.3	81.9	78.9	78.0
Crude oil export revenues	76.7	70.4	66.5	60.0	54.0	52.4
Oil products domestic revenues from reduction in price subsidy	0.0	4.1	11.3	15.2	18.2	19.1
Revenues of oil-related state owned enterprises	2.8	3.5	3.1	3.0	2.8	2.5
Tax revenues	0.8	1.1	2.4	2.5	2.6	2.7
Direct taxes	0.0	0.1	0.1	0.1	0.1	0.1
Indirect taxes	0.8	1.0	2.3	2.4	2.5	2.5
Non-tax revenues	0.6	1.0	1.0	1.2	1.3	1.3
Interest on assets held abroad	0.0	0.0	0.0	0.0	0.0	0.0
Grants	9.7	17.5	17.4	12.3	8.9	5.5
Expenditures 1/	133.5	125.4	124.9	112.6	106.1	101.7
Operating expenditures 1/	107.1	88.0	91.1	82.9	78.2	75.0
Salary and pension payments	15.9	15.4	11.9	10.9	10.9	10.9
Goods and Services	25.8	20.9	15.3	11.8	8.9	8.0
Budgeted goods and services	21.3	17.0	15.3	11.8	8.9	8.0
Oil derivative imports	9.9	9.9	6.7	3.8	0.9	0.0
Other budgeted goods and services	11.4	7.1	8.6	8.0	8.0	8.0
Financed by oil-for-food program (other than social safety net)	4.5	3.9	0.0	0.0	0.0	0.0
Oil extraction expenditures (including refineries)	8.8	8.9	8.1	7.9	7.7	7.8
Transfers	51.7	38.9	31.2	29.6	28.5	27.3
Social safety net (incl. financed by OFFP)	19.2	16.5	13.1	12.2	11.7	10.9
Transfers to SOEs	4.8	4.2	2.7	2.0	1.5	1.0
Others	27.7	18.2	15.4	15.4	15.4	15.4
Interest payments 1/	1.0	0.4	21.3	19.7	19.4	18.5
Domestic interest payments	1.0	0.4	0.3	0.3	0.3	0.3
External interest payments	0.0	0.0	21.0	19.4	19.1	18.2
[Accrued and deferred] interest] 2/	[29.4]	[25.6]	...	...	...	...
War reparations	3.8	3.5	3.3	3.0	2.7	2.6
Investment expenditures	26.4	37.4	33.8	29.7	27.9	26.7
Non-oil investment expenditures	20.5	25.1	22.5	17.9	16.6	14.7
Domestic financed reconstruction expenditure	12.2	5.6	3.2	2.9	4.3	6.5
OFFP financed reconstruction expenditure	2.5	2.9	0.0	0.0	0.0	0.0
Grant financed reconstruction expenditure	5.8	15.0	17.4	12.3	8.9	5.5
Loan financed reconstruction expenditure	0.0	1.5	1.9	2.7	3.3	2.7
Oil investment expenditures (including on refineries)	6.0	12.3	11.3	11.8	11.4	12.0
Balance (including grants but excluding accrued and deferred interest)	-42.9	-27.7	-23.2	-18.4	-18.2	-18.3
Balance (excluding grants and accrued and deferred interest)	-52.6	-45.2	-40.6	-30.7	-27.2	-23.7
[Balance (including grants and accrued and deferred interest)]	[-72.3]	[-53.3]	[-23.2]	[-18.4]	[-18.2]	[-18.3]
External financing	42.9	27.7	3.5	-0.2	-2.7	-6.4
Assets held abroad	28.1	17.3	1.6	0.0	0.0	0.0
Project financing	0.0	1.5	1.9	2.7	3.3	2.7
Other financing 3/	17.1	8.9	0.0	0.7	0.7	0.6
Amortization	0.0	0.0	0.0	3.6	6.7	9.7
[Deferred accrued interest]	[29.4]	[25.6]	...	...	...	...
Financing gap 4/	0.0	0.0	19.7	18.6	20.9	24.6
Memorandum items						
Primary fiscal balance	-41.9	-27.3	-1.9	1.3	1.2	0.2
Financing gap less debt service	....	....	-1.3	-4.4	-4.9	-3.3

Source: Program projections agreed with Iraqi authorities through 2005; Fund staff projections for the medium term.

1/ Does not include interest accrued and deferred in 2004 and 2005.

2/ The accrued interest for 2004 is notional because no agreement has been reached on whether to accumulate this amount in 2004.

3/ Includes OFFP letters of credit and budget support loans.

4/ Assumed to be financed by market borrowing.

Table 3. Iraq: Central Bank of Iraq's Balance Sheet, 2003–05 1/

	Actual	Actual						Program	Program
	2003	2004						2004	2005
	Dec.	Jan.	Feb.	March	April	May	June		
(In billions of Iraqi dinars, unless indicated otherwise)									
Net foreign exchange assets 2/	1,600	1,887	2,701	2,353	3,000	3,892	4,404	7,532	11,419
Foreign exchange assets	1,916	2,134	2,952	2,606	3,251	4,150	4,661	8,309	12,196
Gold 3/	114	88	91	91	92	94	94	94	94
Other	1,803	2,046	2,861	2,515	3,159	4,056	4,568	7,578	12,102
CBI Vaults	1,803	2,046	2,861	2,515	3,159	4,056	4,568	7,578	12,102
Foreign exchange liabilities 4/	-316	-247	-251	-253	-251	-258	-257	-777	-777
Net domestic assets	4,038	4,604	4,457	4,846	4,630	4,459	4,637	4,704	4,832
Domestic assets	3,698	3,808	4,388	3,417	4,390	4,655	3,111	3,919	4,048
Net claims on general government	3,492	3,204	3,748	2,761	3,709	3,959	2,385	3,119	3,119
Holdings of treasury bills	2,874	2,942	2,902	2,817	2,822	2,628	2,562	2,562	4,019
Overdrafts	909	860	1,216	1,263	1,597	1,513	1,458	1,458	0
Domestic currency deposits	15	3	19	37	30	122	157	300	300
Foreign currency deposits	276	595	351	1,283	681	59	1,477	600	600
Claims on nonbank public institutions	0	0	0	0	0	0	0	0	0
Claims on commercial banks	206	604	641	655	682	696	726	800	929
Other items net 5/	339	795	68	1,429	239	-197	1,526	784	784
Base money	5,638	6,547	7,158	7,199	7,630	8,351	9,042	12,235	16,252
Currency outside banks	2,606	3,803	4,965	5,461	5,778	5,976	6,512	9,522	12,648
Banknotes and coins issued 6/	4,586	5,676	5,927	6,282	6,414	6,674	7,003	10,014	13,301
less cash in vaults of commercial banks	1,980	1,873	962	821	635	698	492	492	653
Bank reserves	1,052	871	1,231	917	1,216	1,677	2,038	2,222	2,951
Required	717	658	713	1,029	808	1,461	1,816	2,000	2,657
Excess	335	212	519	-112	408	216	222	222	295
Memorandum items:									
Base money (annual growth, in percent)	...	16.1	27.0	27.7	35.3	48.1	60.4	117	33
Gross foreign exchange assets (millions of U.S. dollars)	1,134	1,569	2,072	1,829	2,258	2,843	3,193	5,691	8,354
Gold	67	65	64	64	64	64	64	64	64
CBI vaults	1,067	1,505	2,008	1,765	2,194	2,778	3,129	5,627	8,289
Deposits at state banks	0	0	0	0	0	0	0	0	0
Foreign exchange liabilities (IMF, in millions of U.S. dollars)	-187	-182	-176	-178	-174	-177	-176	-532	-532
Net foreign exchange assets (millions of U.S. dollars)	947	1,388	1,895	1,651	2,084	2,666	3,017	5,159	7,821
Exchange rate (program)	1,690	1,460	1,460	1,460	1,460	1,460	1,460	1,460	1,460
Inflation (12-month)	36.3	...	...	...	...	...	...	7.0	15.0
Non-oil real GDP growth (in percent)	-3.4	...	...	...	...	...	...	5.0	10.0
Gross foreign exchange assets/Base money (ratio)	0.34	0.33	0.41	0.36	0.43	0.50	0.52	0.68	0.75
Claims on banks/Base money (percent)	3.65	9.2	9.0	9.1	8.9	8.3	8.0	6.5	5.7
Bank Reserves	3032	2744	2193	1738	1852	2375	2530	2,713	3,604
Base money coverage (percent)	0.28	0.29	0.38	0.33	0.39	0.47	0.49	0.62	0.70
Currency in Circulation / Base Money (ratio)	0.46	0.58	0.69	0.76	0.76	0.72	0.72	0.78	0.78

Sources: CPA, CBI, and Fund staff estimates and projections.

1/ Program projections agreed with Iraqi authorities through 2005.

2/ Valued at market exchange rates.

3/ Valued at historic or market price, whichever is lower.

4/ Includes estimated arrears to the Fund.

5/ Includes the counterpart to the revaluation of Swiss dinar notes.

6/ Includes Swiss dinars with total value of ID900 billion using 150:1 conversion rate.

Table 4. Iraq: Balance of Payments, 2004–2009
(In millions of U.S. dollars; otherwise as indicated)

	2004	2005	2006	2007	2008	2009
Trade balance	-5,137	-7,878	-4,327	-3,759	-3,673	-3,065
(In percent of GDP)	-24.3	-32.4	-13.8	-11.0	-9.8	-7.3
Exports	16,543	17,597	21,390	21,239	21,096	22,866
Oil	16,200	17,113	20,778	20,531	20,262	21,979
Other exports	343	484	611	709	834	887
Imports	-21,680	-25,475	-25,716	-24,998	-24,768	-25,932
Government Imports	-14,790	-17,197	-16,707	-15,676	-14,950	-15,583
UN Oil for Food Program (OFFP)	-3,622	-2,166	0	0	0	0
Other consumption imports (non-OFFP)	-4,267	-5,301	-5,992	-5,963	-6,121	-6,444
Oil-related capital imports	-1,197	-2,850	-3,346	-3,831	-3,843	-4,520
Other non-oil related capital imports (non-OFFP)	-3,603	-4,480	-5,269	-4,590	-4,659	-4,619
Refined oil products	-2,100	-2,400	-2,099	-1,292	-328	0
Private sector imports	-6,890	-8,277	-9,009	-9,322	-9,818	-10,348
Income, net 1/	9	-3	-6,572	-6,636	-7,185	-7,799
[Accrued (and deferred) interest] 2/	[6,217]	[6,217]	...	...	...	...
Services, net	-372	-744	-930	-744	-558	-372
Transfers, net	1,731	4,197	5,191	3,982	3,345	2,203
Private, net (incl. NGOs)	500	800	800	800	1,000	1,000
Official	1,231	3,397	4,391	3,182	2,345	1,203
Receipts	2,041	4,253	5,430	4,208	3,358	2,301
Payments	-810	-856	-1,039	-1,027	-1,013	-1,099
Current Account 1/	-3,768	-4,428	-6,637	-7,157	-8,071	-9,034
(In percent of GDP)	-17.8	-18.2	-21.2	-20.9	-21.5	-21.5
[Current Account, including accrued (and deferred) interest] 1/	[-9,985]	[-10,645]	[-6,637]	[-7,157]	[-8,071]	[-9,034]
[In percent of GDP]	[-47.3]	[-43.8]	[-21.2]	[-20.9]	[-21.5]	[-21.5]
Capital Account	0	0	0	0	0	0
Financial Account, excl. CBI foreign position	8,973	7,026	1,502	431	-320	-1,809
Direct investment	200	300	400	500	679	861
Other capital, net	8,773	6,726	1,102	-69	-999	-2,670
Official, net	9,565	6,726	1,102	-69	-999	-2,670
Assets	9,565	6,372	507	0	0	0
Liabilities	0	354	595	-69	-999	-2,670
Loan disbursements	0	354	595	1,161	1,504	1,401
Amortization	0	0	0	-1,230	-2,503	-4,071
Private, net	-792	0	0	0	0	0
Errors and omissions	0	0	0	0	0	0
Overall Balance 1/	5,204	2,598	-5,135	-6,726	-8,391	-10,843
[Overall Balance including deferred accrued interest]	[-1,013]	[-3,619]	[-5,135]	[-6,726]	[-8,391]	[-10,843]
[In percent of GDP]	[-4.8]	[-14.9]	[-16.4]	[-19.7]	[-22.4]	[-25.9]
Financing 1/	-5,204	-2,598	-1,016	362	552	513
Central bank (increase -)	-4,624	-2,598	-1,016	362	552	513
Reserves (net; increase -)	-4,188	-2,598	-1,016	362	333	295
Liabilities (increase +)	436	0	0	0	-218	-218
Fund credit (net)	436	0	0	0	-218	-218
Disbursement	436	0	0	0	0	0
Repayments	0	0	0	0	-218	-218
Changes in arrears	-580	0	0	0	0	0
[Deferred accrued interest]	[6,217]	[6,217]	...	...	...	...
Financing gap	0	0	6,151	6,364	7,839	10,330
Memorandum item						
Central Bank Reserves	5,691	8,289	9,305	8,944	8,392	7,879
Central Bank Reserves (in months of imports of goods and services)	2.6	3.7	4.3	4.2	3.8	3.6
GDP	21,132	24,295	31,252	34,203	37,518	41,941
Non-oil GDP	4,173	5,661	7,161	8,408	9,787	11,191

Source: Program projections agreed with Iraqi authorities through 2005; Fund staff projections for the medium term.

1/ Does not include interest accrued and deferred in 2004 and 2005.

2/ The accrued interest for 2004 is notional because no agreement has been reached on whether to accumulate this amount in 2004.

Table 5. Iraq: Indicators of Fund Credit, 2004–2009 1/

(In millions of SDRs, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009
Clearance of arrears	55.3	0.0	0.0	0.0	0.0	0.0
Obligations from prospective drawings	0.4	9.2	9.2	9.2	155.9	151.2
EPCA repayments	0.0	0.0	0.0	0.0	148.6	148.6
Charges and interest	0.4	9.2	9.2	9.2	7.3	2.7
Total obligations	55.7	9.2	9.2	9.2	155.9	151.2
Outstanding Fund credit	297.1	297.1	297.1	297.1	148.6	0.0
In percent of:						
Exports of goods and nonfactor services	2.6	1.9	2.5	2.0	1.0	0.0
External public debt	0.3	0.3	0.3	0.3	0.2	0.0
Gross official reserves	8.3	6.6	5.5	4.9	2.6	0.0
GDP	2.1	1.3	1.8	1.4	0.6	0.0
Quota	25.0	25.0	25.0	25.0	12.5	0.0
Total obligations	55.7	9.2	9.2	9.2	155.9	151.2
In percent of:						
Exports of goods and nonfactor services	0.5	0.1	0.1	0.1	1.1	1.1
External public debt	0.1	0.0	0.0	0.0	0.2	0.2
Gross official reserves	1.6	0.2	0.2	0.2	2.7	2.8
GDP	0.4	0.0	0.1	0.0	0.7	0.6
Quota	4.7	0.8	0.8	0.8	13.1	12.7
Memorandum item:						
Projected disbursements	297.1	0.0	0.0	0.0	0.0	0.0

Source: Fund staff estimates and projections.

1/ Program projections agreed with Iraqi authorities through 2005; staff projections for the medium term.

Table 6. Iraq: Estimated External Debt Stock, End-December 2002 1/

(In billions of U.S. dollars)

Non-Paris Club official bilateral creditors 2/	67.4
Paris Club creditors	42.0
Private creditors (including commercial banks)	15.0
Multilateral obligations	0.5
Total external debt stock	124.9
Memorandum item 3/	
Unpaid awarded claims, UN Compensation Commission	29

1/ Based on Paris Club data at end-2003 and partial responses from potential non-Paris Club creditors for end-2002. Data have not been reconciled and may be incomplete. Includes late interest.

2/ For 2003, outstanding amounts due to Non-Paris Club creditors are increased by 5 percent to reflect late interest in 2003.

3/ War reparations related to the Iraq-Kuwait war, which are not included in total debt figures.

Baghdad, September 24, 2004

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

Dear Mr. de Rato:

1. Iraq's economy is suffering the aftermath of decades of conflict, state control over economic and political activity, lack of investment in critical social areas, and over a decade of international isolation. The end result of this era of economic mismanagement and political repression is that Iraq's human development indicators are now among the lowest in the region. Iraq has enormous economic potential, but we face huge challenges in the reconstruction and rehabilitation of our country.
2. Despite continuing security problems, we have begun to implement an ambitious policy agenda, including macroeconomic stabilization, which will eventually facilitate progress toward a more market-oriented economy. In the political area, we are in the process of preparing for legislative elections early next year. The elected National Assembly will be charged with preparing a new constitution, which in turn will lead us to the election of a constitutional government by the end of next year. The assistance of the international community in both political and economic reform efforts has been invaluable. Nevertheless, significant financial and technical assistance will be needed to meet Iraq's reconstruction needs.
3. The attached memorandum describes the government's economic and financial program for the remainder of 2004 and for 2005. The principal objectives of the program are to improve the welfare of the Iraqi people, enhance political and social stability, and to enable Iraq to achieve a sustainable external debt position. The government believes that the policies and measures described in the attached memorandum of economic and financial policies will make it possible to reach the economic objectives of its program. Nevertheless, we remain ready to take, in consultation with the IMF, any additional measures that may be necessary to ensure the success of the program.
4. In order to support the implementation and success of the program, the government of Iraq hereby requests access to the IMF's policy for emergency post-conflict assistance (EPCA) in the amount of SDR 297.1 million, or the equivalent of 25 percent of quota. In addition, the government of Iraq hereby commits to retaining the full amount of this assistance in the country's SDR account at the IMF.
5. Satisfactory implementation of the EPCA-supported program should allow the government to move next year to a more ambitious economic program of reform that would

address remaining structural impediments to long-term sustainable economic growth and fiscal and external sustainability. Such a program could be supported with a stand-by arrangement from the Fund, on the basis of a positive assessment that the government's capacity for planning and policy implementation is adequate.

6. The government of Iraq will provide the IMF with any information it may request on the progress made with program implementation.

Sincerely yours,

- /S/ -

Dr. Sinan Shabibi
Governor of the Central Bank of Iraq

- /S/ -

Mr. Adil A. Mahdi
Minister of Finance of Iraq

IRAQ

Memorandum of Economic and Financial Policies for 2004–05

September 24, 2004

I. INTRODUCTION

1. The liberation of Iraq from the Saddam Hussein regime has marked a critical opportunity to reverse more than two decades of economic decline. On June 28, 2004, Iraq's Interim Government undertook a task of economic and political rebuilding without historical parallel. Iraq has enormous economic potential, but we face huge challenges in the reconstruction and rehabilitation of our country. We have already made significant progress towards creating an open market economy, but require the assistance of the international community to support Iraq's substantial needs.
2. Iraq's needs stem primarily from the destructive actions of Saddam Hussein's regime and the impact of years of war and sanctions. Although Iraq has the world's second largest oil reserves, the previous regime squandered Iraq's oil wealth, neglecting investment in public infrastructure and failing to provide basic services. The policies of this highly centralized and corrupt authoritarian government led to major distortions of economic activity and the suppression of private sector development on an unprecedented scale. As a consequence, after attaining middle income status in the 1970s, Iraq's nominal GDP per capita had dropped to about US\$700 by 2002, and many of Iraq's human development indicators are now the lowest in the region.
3. Key economic and institutional reforms have already been undertaken. A new currency was successfully launched. Monetary policy has been conducted with a view to guarding against inflation and maintaining a broad degree of stability in the exchange rate. New financial sector legislation has given autonomy to the central bank and paved the way for the creation of a modern banking sector. In the fiscal sector, important tax and customs policy measures were implemented. Several key reforms in the areas of trade and foreign investment liberalization have also been taken.
4. Important steps have also been implemented with a view to reintegrate Iraq into the world economy. Following the international recognition of our government, we have taken all necessary steps to normalize our relations with the IMF, including nominating a governor for the IMF, payment of Iraq's arrears to the Fund (SDR 55.3 million, and consenting and payment of our quota increase (raising it from SDR 504.0 million to SDR1,188.4 million). We are also taking steps to clear our arrears to the World Bank and the Arab Monetary Fund. We have also begun working with our other external creditors towards the resolution of our unsustainable external debt burden.

5. The international community has played a vital role in providing assistance and support in Iraq's reconstruction. On October 23–24, 2003, Spain hosted a Ministerial-level Donors' Conference for Iraq. High level representatives from over 70 countries attended the conference, which succeeded in raising over US\$32 billion in support of Iraq's reconstruction. The World Bank and the United Nations subsequently established the International Reconstruction Fund Facility for Iraq (IRFFI) to channel donor resources in support of priority projects. The Facility encompasses two trust funds: the World Bank Iraq Trust Fund (ITF) and the UN Development Group Iraq Trust Fund. Follow-up donors' meetings took place in April and May 2004 in Washington, D.C. and Doha (Qatar), respectively, and another one will take place in Tokyo in mid-October 2004.

6. Establishing the institutions and mechanisms necessary for a peaceful political transition is also an essential part of our agenda. An interim national assembly was selected by members of a national conference in August 2004, and will serve as a consultative legislative body to our interim government. In line with the transitional administrative law, a permanent national assembly will be elected to office no later than January 31, 2005. The national assembly will prepare a new draft constitution, which will be submitted to a popular referendum for approval before October 15, 2005. Elections for a new government under the constitution will take place before December 31, 2005.

II. RECENT ECONOMIC AND POLICY DEVELOPMENTS

7. As a result of the conflict, real GDP is estimated to have plummeted by about 35 percent in 2003, reflecting a contraction in oil production to an average 1.2 million barrels per day (mbpd) from a level of almost 2.0 mbpd in 2002, and a severe retrenchment in non-oil economic activity, which lasted for several months beyond the end of major conflict last year.

8. Real GDP is projected to rebound sharply, by about 50 percent in 2004, thanks in part to a stable macroeconomic environment; this is less than originally anticipated, mainly because of the continuing security problems. By end-July, oil production, which constitutes more than 75 percent of total economic activity, had risen to 2.1 mbpd and exports were up to 1.6 mbpd. Actual production and export levels, however, have recently fluctuated due to sabotage and a deteriorated infrastructure. Oil production is expected to average 2.1 mbpd in 2004, and exports 1.5 mbpd.

9. Non-oil economic activity has also been recovering, driven essentially by commercial and reconstruction activities, but many state-owned enterprises and private businesses are still not fully operational. Retail commercial activity is brisk, and there appears to be a revival of agricultural activity. But the recovery has still a long way to go in reducing unemployment, which was estimated at about 28 percent in mid-October 2003. Moreover, more than 60 percent of the population continue to rely exclusively on a commodity-distribution system for their basic needs.

10. Our policies have contributed to overall macroeconomic stability despite the difficult security environment. Consumer prices have remained relatively stable so far this year. The exchange rate has remained largely unchanged (at around ID 1,460 per US\$) since the end of the banknote exchange in mid-January 2004. Furthermore, perhaps reflecting increased re-monetization of the economy, currency issued increased significantly in the first six months of 2004 (by about 53 percent since end-2003).

11. Fiscal policy has been geared towards restarting economic activity and public services, while limiting expenditures to available resources. In 2003, government spending was essentially limited to wage payments to civil servants and employees of state-owned enterprises, and towards guaranteeing the distribution of basic goods through the commodity-based safety net. In the first six months of 2004, budget execution began to be normalized with total spending amounting to US\$10.5 billion (100 percent of GDP) in line with the budget. The budget is nevertheless under considerable pressure from rising security costs and the enormous costs associated with the reconstruction of Iraq's infrastructure and restoration of basic services.

12. There is a need to diversify Iraq's revenue base and maintain a tax regime that is conducive to growth and revenue generation. A simplified tax regime was put in place involving: a 5 percent reconstruction levy on imports, which was introduced in April 2004; revising personal and corporate income taxes to include a maximum marginal tax rate of 15 percent, while increasing the personal income tax allowances significantly, thereby making the system progressive; and introducing a wage withholding tax on higher-income civil servants. Pension contributions have also been introduced for civil servants.

13. On the expenditure side, fiscal reforms have been limited to the wage structure. The previous regime had put in place a wage system which was essentially rewarding affiliation and loyalty to the Baath party. In April 2003, a new more transparent wage scale was introduced, which was further revised in early 2004 to include a new 13-tier scale; at the same time, the average wage level was increased significantly. Pensions have also been revised. However, given the political and security environment, the 2004 budget had to be drawn keeping in place costly subsidy policies, including subsidies on the domestic price of oil refined products, transfers to state-owned enterprises, and the commodity distribution system.

14. A more integrated budgetary framework has become operational. The adoption of the second half of 2003 budget and the 2004 budget represented a significant step in integrating operating and investment expenditure, and covering general government operations in northern, central, and southern governorates. Expenditure financed by letters of credit issued under the oil-for-food program are managed by each relevant ministry. Expenditures financed by donors are not yet incorporated into the budget, but the Iraqi Strategic Review Board was created to help ensure consistency and coherence between activities financed by donors and the overall Iraqi priorities and budget.

15. Important steps have been taken towards ensuring effective and transparent fiscal management. To date, the major achievements include: (i) the establishment of a fiscal policy unit that will ensure coordination between the various departments of the ministry of finance; (ii) the establishment of the Development Fund for Iraq (DFI), to ensure transparent accounting of all oil export sales and government assets held abroad, and their channeling through the budget; (iii) the establishment of the International Advisory and Monitoring Board (IAMB), as an audit oversight board to ensure transparency in oil export sales, and in the administration and use of the DFI; and (iv) the strengthening of external controls by Iraq's Supreme Board of Audit.

16. In the monetary area, a new currency has brought confidence and reunified the country. After decades during which monetary policy was reduced to financing extra-budgetary expenditure of the old regime, a new central bank law provides for the independence and accountability of the Central Bank of Iraq (CBI) and prohibits the CBI from extending credit to the government. In addition, the CBI law established a nine-member governing board, consisting of the governor, two deputy governors, three senior managers, and three full-time outside directors. The first meeting of the governing board took place on August 16, 2004.

17. Monetary policy has focused on maintaining price stability, in the context of a stable exchange rate. The CBI has been conducting daily foreign exchange auctions to limit the impact on base money growth of the sale of the government's oil export earnings. This strategy has led to a period of low inflation and a significant accumulation of gross international reserves, which amounted to about US\$4,273 billion at end-July 2004 (implying base money coverage of about 60 percent). In addition, the ministry of finance has started conducting bi-weekly treasury bill auctions to roll over bills outstanding with commercial banks. The intent is also to develop a secondary market that will facilitate open market operations by the CBI for the purpose of managing liquidity.

18. New financial sector legislation has paved the way for the creation of a modern financial sector. A new commercial banking law in line with international standards was adopted in October 2003. Since then, three foreign banks have already been licensed to begin operations, and more are slated to receive licenses this year. The CBI is now evaluating over 30 license applications and a number of foreign banks have shown interest in acquiring a minority ownership stake in private Iraqi banks. Commercial banks have also been required to strengthen their capital base.

19. In the external area, a liberal and open trade regime has been established. The current account deficit is estimated to have reached about US\$1.89 billion (18 percent of GDP) in the first six months of 2004, reflecting the rebound of the economy, and was financed mainly through the transfer of government assets held abroad and letters-of-credit issued under the UN oil-for-food program. The Trade Bank of Iraq was established in December 2003 to help facilitate international trade. Iraq also recently secured observer status at the World Trade Organization.

20. The government has begun working with Iraq's external creditors towards the resolution of its unsustainable external debt burden. Iraq's debt at end-2003 was preliminarily estimated by Fund staff at US\$125 billion (7 times Iraq's GDP), of which US\$42 billion are due to Paris Club sovereign creditors, US\$67.3 billion to non-Paris Club sovereign creditors, US\$0.5 billion to international financial institutions, and US\$15 billion to private creditors. IMF staff completed debt sustainability analysis (DSA) for Iraq in May which, in our opinion, shows that Iraq will need substantial debt reduction (in the neighborhood of 90% to 95%) to reach external and fiscal viability. Iraq's DSA has already been discussed with the Paris Club and Iraq's main non-Paris Club sovereign creditors. We are also making significant progress in reconciling our external debt and in improving data on total outstanding debt. A number of our major creditors have agreed to make efforts to reach agreement on restructuring Iraq's debt by the end of 2004.

21. In the area of structural reform, a new foreign direct investment law was enacted that allows ownership in most sectors of the economy (except natural resources, real estate, and insurance) providing national treatment for foreign firms. The legal and judicial systems have been revamped, and are independent from the executive branch of government.

22. Essential services and infrastructure are also being re-established. Improvements have been made to electricity generating capacity, though production still falls short of growing demand. Schools have been reopened despite shortages of educational materials. The public food distribution system has been continued in order to protect the most vulnerable groups in society. Hospitals and health services are being refurbished, though medicines and other supplies fall short of needs. Significant investment is being undertaken to improve water and sanitation standards. Measures to strengthen transparency and public governance—for example, improvements in the frequency with which economic and financial data are reported, as well as the amount of data that are reported—are also being implemented.

23. A comprehensive program of technical assistance (TA) agreed with the IMF and other donors has been implemented with a view to strengthening Iraq's administrative and institutional capacity. Workshops and seminars have been held since late 2003 on key aspects of fiscal and monetary policy, and in the area of statistics. In addition, technical advisors financed by USAID and other donors have been providing continuous support on the ground in Baghdad.

III. GOVERNMENT PROGRAM FOR 2004 AND 2005

A. Main Challenges

24. The overarching goals of the Iraqi economic and financial policies are to improve the welfare of the Iraqi people, enhance political and social stability, and achieve a sustainable external debt position. Notable economic and structural reforms have been accomplished in a short period of time under extremely difficult circumstances. Nevertheless, in the immediate future, Iraq faces daunting challenges, including restoring security, preparing the new

elections, strengthening administrative capacity, broadening the revenue base, stepping up reconstruction, developing an effective social safety net, and promoting the development of the private sector.

25. We are determined to confront these challenges by implementing a sound macroeconomic program and have begun planning and undertaking the structural reforms necessary to advance Iraq's transition to a market economy and establish the basis for sustainable growth. Iraq has great economic potential, but requires reforms to restructure the public sector, develop a sound banking system, modernize the central bank, establish a market-oriented legal framework conducive to private sector development, strengthen good governance and transparency, and continue efforts to increase domestic revenue and strengthen expenditure management. Notwithstanding our commitment to succeed, we recognize that the pace at which we will be able to implement our program may depend on a quick return to a more normal and secure environment. Furthermore, given the prominent role that oil will continue to have in the performance of the economy, success in achieving our program goals will be closely linked to developments in the international oil market and our ability to bring production and exports to their full potential.

B. Macroeconomic Objectives

26. Building on the progress achieved so far, the government aims at achieving a growth in real GDP of 52 percent in 2004, 17 percent in 2005, and 10 percent on average over 2006–2009. Growth is expected to come mainly from the expansion of oil production capacity, which is expected to reach 2.1 mbpd in 2004, 2.4 mbpd in 2005, and gradually increase to 3.3 mbpd by 2009. In non-oil sectors, economic expansion is expected to be mainly driven by reconstruction activities, particularly in the construction and utility sectors, a diversification in agriculture, trade, and a resumption of manufacturing activities related to the oil sector (including chemical industries). Significant levels of investment are expected to help meet these growth objectives, as the disbursement of donors' financial assistance accelerates, and the environment becomes more conducive to private investment in small and medium size enterprises.

27. The inflation rate is expected to be in the range of 4 to 7 percent per annum in 2004 and our program contemplates a rise in the inflation rate to about 15 percent in 2005, reflecting the assumption of rising economic activity and demand pressures in the context of a stable exchange rate, with consequent increases in prices of non-traded goods. This objective may need to be revised depending on the extent of the administered price adjustments that are eventually undertaken in 2005. Given the significant dollarization in the economy and the vulnerability of the economy to large oil price and production shocks, the CBI will aim to build up its net international reserves to at least US\$5 billion by end-2004, and US\$6 billion by end-2005.

C. Macroeconomic Policies

28. For the remainder of 2004 and 2005, our macroeconomic policy stance will remain guided by the following principles: fiscal policy will continue to be constrained by a resource envelope based on government revenues and available external resources. Monetary policy will be geared toward ensuring price stability, while avoiding unwarranted foreign exchange rate fluctuations.

Fiscal policy

29. The overall objective of fiscal policy for 2004 and 2005 is to accelerate Iraq's reconstruction and raise the level and quality of government services, while taking steps to ensure fiscal sustainability over the medium term. Cautious management of our oil export revenues and diversifying our revenue sources will be critical in this regard.

30. Consistent with the revised 2004 budget, the overall government fiscal deficit for 2004 is to be limited to US\$9.0 billion (or 43 percent of GDP), and will be fully financed by external financing, including resources available from letters of credit issued by the UN under the oil-for-food program almost US\$3.6 billion, and assets accumulated abroad held in the Development Fund for Iraq of US\$5.9 billion. Consistent with the understandings reached in principle at the Paris Club, which should enable similar understandings with non-Paris Club official creditors, a moratorium on debt payments to our international creditors has been incorporated into our fiscal projections for 2004 and 2005.

31. In 2005, we are committed to constraining current budget expenditures while laying the foundation for sustained revenue growth. The overall government deficit will be limited to US\$6.7 billion (or 28 percent of GDP), and will be fully financed through external sources, including about US\$350 million in new bilateral and multilateral assistance; as in 2004, the budget assumes a moratorium on debt service due to foreign creditors. For budgetary purposes, the oil export price level was conservatively assumed at around US\$26 per barrel, about US\$6 below the level currently implied by oil prices on the futures markets. A 2005 budget incorporating the parameters mentioned above will be submitted for approval to the National Assembly by October 10, 2004, as required by law. In case there are additional revenues, priority will be given to using these resources for capital spending and financing the budgets of future years.

32. Revenues in 2005 are projected to increase by 14 percent compared to 2004, to US\$19.5 billion (including oil export revenues of US\$17.1 billion). By end-2004 the government will increase the domestic prices of oil derivative products (including gasoline), a measure that is expected to bring US\$1 billion in revenue in 2005. This initial adjustment is part of a plan to bring domestic energy prices to cost recovery levels by end-2009. The government believes that this step will demonstrate the willingness of Iraqi people to implement fundamental reforms to put Iraq's public finances on a strong footing in the medium term. The government will continue to strengthen the capacity of the tax and

customs administrations through extensive seminars and courses, and, with the support of external technical assistance, will develop by June 2005, a plan to overhaul the tax and customs administration.

33. We also have plans to broaden the tax revenue base in the medium term. Additional tax measures to be adopted in 2006 may include: (i) reducing exemptions to the reconstruction levy, and turning it into a uniform import duty; (ii) introducing a general sales tax with a single rate of 10 percent to be collected at the border and on manufacturing goods, as a first step towards introducing a value added tax over the longer term; (iii) introducing a uniform excise tax on imported cars; (iv) imposing a tax on cellular phones; and (v) introducing a fee on foreign visitors.

34. On the expenditure side, overall public expenditure in 2005 will be limited to US\$36.7 billion, consistent with the overall resource envelope available from revenues, grants, and external financing. Off-budget expenditures will not be allowed, and any additional spending will need to be integrated into a revised budget, on the basis of the availability of additional resources.

35. The government considers the current level of wages, and salaries and pensions (which has already been increased several times in 2003 and 2004) as generally sufficient, and will limit the overall wage and pension bill to US\$ 3.7 billion in 2005–2006, with a view to keeping it at a level of about 11 percent of GDP in the medium term (2006–09). To support this objective, a payroll covering all civil servants and government workers has been established, and an automated payroll system will be implemented in 2005.

36. With respect to government transfers, we recognize that many state-owned enterprises are not viable as currently structured, but further analysis of these businesses is necessary to develop specific recommendations regarding their future. We are committed to complete this analysis by end-2005, with the aim of producing plans for reforming or restructuring these enterprises. In the meantime, and in light of the social and economic importance of these enterprises, operating transfers will be made to help pay wages and finance some working capital of those enterprises that are not yet fully operational and profitable.

37. The government is also committed to enhance the effectiveness of the social safety net by moving over the medium term from a food ration system to a cash distribution system targeted at the poor and unemployed. This monetization of the food basket should help domestic agriculture, encourage private trade, and eliminate one of the most pervasive sources of price distortions, while at the same time ensuring that families in need are properly compensated within the social safety net. To ensure a successful transition towards a monetized system, the government will put an efficient payment system in place, and allow state trade entities to take up commercial business (in import activities as well as wholesale trading). An effective public information campaign on the benefits of moving to a monetized

social safety net will also be mounted. Regions and local governments will also continue to receive significant transfers to carry out their responsibilities.

38. The government is continuing reforms to enhance the effectiveness and transparency of budgetary management. These reforms include (i) passing regulations related to the financial management law by end-2004; (ii) introducing a treasury single account by September 2005; (iii) adjusting budget appropriation through mid-year budget reviews; (iv) implementing in the whole country the reporting and control modules of a financial management information system (FMIS) by June 2005; (v) implementing the recommendations of the KPMG audit and of the IAMB, including ensuring that oil export sales are in line with international standards, and strengthening governance through the effective metering of oil production; (vi) publishing the government's final consolidated fiscal accounts by June of the following fiscal year, including expenditures financed by donors, starting in June 2005 and (vii) the introduction of a GFS-compatible budget classification.

Monetary and exchange rate policy

39. The current framework of broad exchange rate stability has worked well towards achieving price stability and we will preserve it for the time being. However, as the data situation improves and the CBI gains a better understanding of the transmission mechanism of monetary policy, the appropriateness of this policy regime as the best means in the medium term of delivering price stability will need to be reevaluated. The CBI would expect the exchange rate to be allowed to reflect the effects of structural changes in the economy and real shocks as needed. We will therefore be vigilant regarding developments that may call for greater flexibility of the exchange rate, including excessive downward pressure on the exchange rate that would threaten to reduce Iraq's foreign exchange reserves below a minimum acceptable level of \$4 billion, or signs that inflation could exceed our forecast (as specified above).

40. In order to facilitate the task of assessing the appropriateness of the current policy stance, we have formulated a monetary program for 2004 and 2005. A key element of the monetary program is the projection for the growth of money demand. This projection is related to assumptions and forecasts on economic growth, inflation, and any potential structural shifts in money demand relating to further remonetization of the economy. The projected growth in currency in circulation is consistent with the projected accumulation in net international reserves mentioned earlier and a policy of no lending to the government by the CBI.

41. During 2004, the CBI has relied on foreign exchange auctions as the principal instrument in the conduct of monetary policy. The CBI has utilized the foreign exchange auction to manage liquidity in the system, to absorb excess dinars, as well as to provide foreign exchange to private sector activity. To allow for more flexibility in managing monetary policy, the CBI is in the process of broadening its set of monetary policy

instruments. The CBI Board recently approved the creation of a lender-of-last-resort facility and an overnight standing credit/deposit facility, and has issued new regulations making the reserve requirement regime more flexible. The banking facilities should be in operation by October 1, 2004, and the reserve requirement regulation should be implemented by no later than December 1, 2004. Similarly, the newly introduced auction of treasury bills will help stimulate the development of a secondary market for these securities, which will enable the CBI to conduct open market operations. Moreover, in order to facilitate the formation of an appropriate benchmark interest rate, we will provide an adequate environment for the private sector's banks to increase their participation in the treasury bills auctions.

42. The CBI is developing a strategy for communicating its policies to the public. It is seeking to explain its monetary framework aimed at achieving price stability. To inform the public of its actions, the CBI has developed a website where it publishes the results of its daily currency auctions and its monthly balance sheet, and has begun to issue a policy statement after board meetings on monetary policy. The CBI is working diligently to expand and improve information on its operations.

43. In an effort to regularize the financial relations between the government and the CBI, the ministry of finance and the CBI are in the process of agreeing to restructure all government obligations held by the central bank. This agreement will be implemented in installments to facilitate the payments by the government, while minimizing any possible negative impact on the capital of the CBI, taking into consideration acceptable international accounting standards. The CBI also intends to return any excess realized profits (but only after the CBI's capital reaches its required regulatory minimum) to the ministry of finance. The government will be proposing an amendment to the CBI law that would facilitate the transfer of excess earnings to the ministry. The agreement also calls for a formal closure of the government overdraft facility at the CBI.

External sector policies

44. Data and information on the balance of payments is extremely limited, and a priority for the government will be to improve data collection so as to better evaluate external sector developments. Initial estimates indicate that despite a very large current account deficit (equivalent to 18 percent of GDP), there should be a balance of payments surplus in 2004, largely resulting from large public sector capital inflows. The outlook for 2005 for the balance of payments, however, is uncertain as it depends on the level of donor assistance that materializes. The projected current account deficit in 2005, equivalent to about 20 percent of GDP, is expected to be covered by donor assistance and public capital flows.

45. The government remains committed to an open trade and exchange system. In that regard, we are taking steps to become a full member of the World Trade Organization. Looking forward, the government will avoid imposing restrictions on payments and transfers for international transactions, to introduce new or intensify trade restrictions for balance of payments purposes, or resort to multiple currency practices. The government will also discuss

with IMF staff the possibility of accepting as early as possible the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

46. The success of Iraq's reconstruction and recovery effort, as well as our ability to attract the inflow of funds to develop the private sector, will depend on the reduction of Iraq's external debt burden to a sustainable level. The IMF staff's debt sustainability analysis makes it clear that deep debt reduction ranging from 90% to 95% is necessary to help restore debt sustainability. We have been encouraged by the reaction so far of the international community on this issue. Many countries have agreed to reduce substantially their claims on Iraq. We intend to reach agreement with the Paris Club on a substantial reduction in the value of Iraq's debt as soon as possible.

47. Recognizing that much of Iraq's debt is held by non-Paris Club creditors, our expectation is that those creditors will treat their claims comparably to any Paris Club treatment. In that regard, we are working with our legal advisors to develop a strategy for dealing with both non-Paris Club official bilateral and private sector creditors. We have already started contacting our non-Paris Club official bilateral creditors to begin a data reconciliation process with them. In addition, several non-Paris Club bilateral creditors have already indicated a willingness to reduce substantially their claims on Iraq.

D. Structural Reforms

48. The government has set up an interministerial committee to prepare an interim national development strategy for Iraq that will outline structural reforms expected to support the transition to a market economy, the development of the oil sector, the strategy for the diversification of economic activity, the improvement of social indicators, and the development of regions. A draft version of this strategy will be discussed at the next donors' meeting in Tokyo. The final draft of the strategy is expected to be discussed by the new national assembly in March 2005.

49. As regards the financial sector, we will take further steps towards the modernization of the central bank and the creation of a sound financial system. Problems in lending and payments mean that banks are unable to contribute to recovery and may impose fiscal costs, and, further, some small private banks may be nonviable. Reliable and regularly reported data for individual banks are the first step. The institutional capacity for bank resolution needs to be developed and a bank resolution strategy formulated. The legal and monetary elements of a systemic safety net should be developed to ensure that any bank insolvencies do not impair confidence. Finally, strengthening institutional capacity for payments and developing large value and retail payment systems would help ensure that a weak payments system does not inhibit the recovery. Specifically, we will focus our efforts on (i) enhancing the payments system through the establishment of an automatic clearing house and passing payments system law to regulate its activities; (ii) making CBI operations more transparent, particularly through the regular dissemination of monetary statistics and undergoing an external audit of the 2004 financial statements according to international standards by mid-2005 in accordance

with the IMF's safeguards policy; (iii) enhancing the CBI's supervisory capacity; and (iv) adopting by end-June 2005 of a plan for the restructuring state-owned banks.

50. The government will also review the fiscal regime for the oil sector, and prepare an overall restructuring plan by end-2005. The government will also take steps to address governance issues in the oil sector, along the lines of the recommendations of the IAMB.

E. Statistics

51. The government is conscious that the timely provision of comprehensive macroeconomic data is critical for improving the design and monitoring of its policies. It is determined to ensure regular reporting to the Fund of data on government budget execution, monetary aggregates, inflation, real sector activities, and the balance of payments. Efforts to improve the compilation and dissemination of macro-economic and financial statistics will be intensified, based on the recommendations of, and with assistance from, the IMF Statistics Department. The Central Statistical Office (CSO) currently publishes a monthly consumer price index (CPI) excluding northern Iraq, but it plans to begin publishing a CPI covering the entire territory, as well as subannual statistics on agricultural and industrial production. The CBI will start collecting information on the banking system to allow for the preparation of a monthly monetary survey. Based on a population census and household expenditure survey, for which field work should be completed by end-2004, the government plans to develop poverty and social indicators. It will also ensure greater transparency in the production and dissemination of statistics.

F. Technical Assistance

52. To improve Iraq's capacity to design and implement policies and monitor macroeconomic developments, a broad technical assistance program in monetary, fiscal and other statistical areas is envisaged by the IMF for end-2004 and 2005. This will be supplemented with the substantial assistance being provided by other donors. In the context of this economic program, the government will particularly require technical assistance in the following areas: (i) banking supervision, monetary operations, and payments system; (ii) budget execution and public expenditure management, tax policy and administration, fiscal federalism, tax regime for the oil sector, and customs administration; and (iii) the compilation and dissemination of economic statistics.

IV. PROGRAM MONITORING

53. The duration of the program supported by the Emergency Post-Conflict Assistance will be from November 1, 2004 through end-December 2005. Performance under the program will be monitored using quantitative indicative benchmarks, and structural indicative benchmarks. Indicative quantitative benchmarks for end-December 2004, end-March 2005, end-June 2005, and end-September 2005, as specified in Table 1 (attached), relate to currency in circulation (range), CBI international reserves (floor), CBI lending to the government (ceiling), government primary fiscal balance (floor), external arrears on new

disbursements (ceiling), and contracting and guaranteeing of nonconcessional external debt (ceiling).⁶ Quantitative benchmarks are defined in the attached Technical Memorandum of Understanding (TMU). The program's structural benchmarks are specified in Table 2 (attached).

54. To coordinate and monitor the implementation of the program, the government will set up an interministerial technical committee. Furthermore, in order to support our efforts to implement and monitor this program, we are asking the Fund to assign a resident representative for Iraq. The government believes that the policies described herein will further strengthen our macroeconomic stabilization and structural reform efforts, and that they are adequate to achieve the objectives of our economic program for 2004 and 2005. We intend to remain in close consultation with the IMF, in accordance with IMF policies on such consultation, and will provide the IMF with information it requests for monitoring economic developments and implementation of policies under the program. The government stands ready to take further measures, in consultation with the IMF staff, which might be necessary to ensure that the overall objectives of the program can be achieved.

⁶ The government will not contract any loans collateralized by future oil revenues.

Table 1. Iraq: Quantitative Indicators, 2004–2005,
Under Emergency Post-Conflict Assistance Policy

(In billions of Iraqi dinars, unless otherwise indicated)

	6/30/04	12/31/04	3/31/05	6/30/05	9/30/05
	4	Ind.	Ind.	Ind.	Ind.
Currency issued (range) ^{1/}	7,003	9,000-11,000	9,700-11,800	10,400-12,700	11,100-13,600
Net international reserves of the central bank (floor) ^{1/}	3,193	4,000	4,250	4,500	4,750
(in millions of U.S. dollars)					
Lending to the government by the CBI (ceiling) ^{1/2/}	3,986	3,986	3,100	3,100	3,100
Government primary fiscal deficit (in millions of US\$; ceiling) ^{3/}	...	8,852	1,800	3,500	4,750
New medium- and long-term nonconcessional external debt ^{3/} (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling)	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

^{1/} Stocks as of the end of test period.

^{2/} Consistent with legal prohibition on CBI lending to the government.

^{3/} Flows from January 1, 2004, for test date of end-2004; and from January 1, 2005, cumulative flows for test dates in 2005.

^{4/} This will be monitored on a continuous basis.

Table 2. Iraq: Structural Benchmarks,
Under Emergency Post-Conflict Assistance Policy

Policy Actions	
I. Structural Indicative Benchmarks	
Development of a monetary survey.	• March 2005
Establishment of an automatic payroll system for all government employees.	• June 2005
Development of monthly fiscal accounts for the central government and the oil sector.	• December 2004
Issuance of regulations regarding bank licensing and standard prudential ratios.	• December 2004
Enactment of payments systems law.	• December 2004
Adoption of a plan to overhaul the tax and customs administration.	• June 2005

IRAQ

Technical Memorandum of Understanding

September 24, 2004

1. This memorandum describes the quantitative and structural indicators for the program supported by the Fund's emergency post-conflict emergency assistance facility policy. It also specifies the periodicity and deadlines for transmission of data to the staff of the International Monetary Fund (IMF) for program monitoring purposes.

I. QUANTITATIVE INDICATORS

2. The quantitative indicators are the following:

- a range on currency in circulation;
- a floor on net international reserves of the Central Bank of Iraq (CBI);
- a ceiling on lending to the government by the CBI;
- a ceiling on the primary deficit of the government;
- a ceiling on external arrears on new borrowing; and
- a ceiling on contracting and guaranteeing of non-concessional external debt.

II. DEFINITIONS

3. For purposes of monitoring under the program, a program exchange rate will be used. This program exchange rate will be the U.S. dollar/Iraqi dinar exchange rate on or about August 31, 2004, as reported by the CBI (ID 1,460 per U.S. dollar). The program exchange rate will be used to convert into Iraqi dinars the U.S. dollar value of all CBI foreign assets and liabilities denominated in U.S. dollars, as required. For CBI assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted in U.S. dollars at their respective SDR-exchange rates prevailing as of August 31, 2004, as published on the IMF's website.

4. For the purpose of measuring fiscal operations, unless otherwise indicated, the government is defined as the central government of Iraq, expenditures related to oil extraction and oil-related investment activities not reflected in the central government's budget, and all donor-financed expenditures (including through the U.S. supplemental budget).

5. **Currency issued** is defined as currency holdings by the public plus cash in the vaults of commercial banks. As of June 30, 2004, currency in circulation amounted to ID 7,003 billion.

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

7. **Reserve liabilities** shall be defined as foreign currency denominated liabilities of the CBI to residents and nonresidents with original maturity of one year or less, and all liabilities to the Fund. They include: foreign currency reserves of commercial banks held at the CBI; commitments to sell foreign currency arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies. Excluded from reserve liabilities are the government's foreign currency deposits at the CBI. As of June 30, 2004, net international reserves amounted to US\$ 3,017 million (ID 4,407 billion).

8. **Lending by the CBI to the central government** comprises holdings by the CBI of treasury bills plus the outstanding balance in the government overdraft account at the CBI, but excluding accrued interest that has not fallen due. As of end-June, treasury bill holdings by the CBI amounted to ID 2,528 billion and the balance of the overdraft account at the CBI stood at ID 1,458 billion. This limit will be fully adjusted in the event of any write-off resulting from the rescheduling agreement between the ministry of finance and the CBI.

9. **The primary fiscal deficit** is calculated as the difference between primary government expenditure, which is total government expenditure (including oil sector-related extraction costs and investments outlays, and donor-financed expenditures) excluding interest payments, and government revenue valued on a cash basis. The indicative ceiling for end-2004 will be measured in a cumulative basis from January 1, 2004; the quarterly indicative ceilings for 2005 will be measured on a cumulative basis from January 1, 2005.

10. A continuous indicative ceiling applies to the non-accumulation of **external payments arrears** on new external debt contracted or guaranteed by the central government or the CBI. External payment arrears consist of external debt service obligations (principal and interest) falling due after September 30, 2004 and that have not been paid at the time they are due, as specified in the contractual agreements.

11. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) August 24, 2000), the term "debt" will be

understood to mean a current liability (i.e., not contingent), created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits), and temporary exchanges of assets that are equivalent to fully collateralized loans, under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement, excluding those payments that cover the operation, repair or maintenance of the property. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

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

13. The limits on **medium- and long-term external debt** apply to the contracting or guaranteeing by the government of new, nonconcessional external debt with an original maturity of more than one year, excluding obligations to the IMF. This limit applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. External debt will be considered to have been contracted at the point the loan agreement or guarantee is ratified by the Iraqi parliament. Excluded from this limit are leases of real property by Iraqi embassies or other foreign representations. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on August 31, 2004, as published on the IMF's website.

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

III. PROVISION OF INFORMATION TO THE FUND STAFF

Data

15. The Government of Iraq will establish an Inter-agency Technical Committee to coordinate and implement the EPCA and to provide data to the Fund. To monitor developments under the EPCA, the authorities agree to provide the Fund, the information specified below after EPCA approval. The program is designed with quarterly quantitative targets and the actual outcome should be provided within six weeks following the end of the quarter. However, in order to facilitate regular monitoring, many of the indicators should be provided with the frequencies indicated below.

- CBI gross foreign exchange reserves (weekly) and balances on the Development Fund for Iraq. This should be reported no longer than 2 weeks after the end of the reference week.
- The monthly balance sheet of the CBI, with a month lag.
- The balance sheets of Rafidain and Rasheed banks (quarterly).
- Weekly preliminary monetary and financial aggregates, including exchange rate data (daily), currency in circulation, demand and savings deposits held at commercial banks, balances on government accounts at the CBI, interest rates on savings deposits at commercial banks, holdings of government securities, and credit outstanding to the public and private sectors. The data, excluding exchange rates, should relate to no longer than three weeks after the end of the reference period.
- Consumer price index (CPI), including indices for main cities (monthly). These should be reported no longer than a month after the end of the relevant month.
- Detailed operational budget operations and their financing, including budgetary (wage and non-wage) support for state-owned enterprises, customs revenues collected, the amount of treasury securities outstanding, and interest rates on treasury securities. These data should

be reported on a monthly basis and reported no more than a month after the end of the reference month.

- Detailed data on disbursement of external assistance from the US Supplemental and other donor assistance, including by recipient sector; foreign debt amortization and interest payments made; and total outstanding domestic and external debt.
- List of short, medium, and long-term government or government-guaranteed external loans contracted during each quarter, identifying for each loan: the creditor, the borrower, the amount and currency, the maturity and grace period, and interest rate arrangements (quarterly).
- Foreign trade statistics (imports, exports, re-exports) (quarterly). This should be reported no longer than eight weeks after the end of the reference period.
- Indicators of real economic activity (quarterly). These data should be reported no longer than eight weeks after the end of the reference quarter.

Structural Reforms

16. **Review of the structural reforms.** The authorities will prepare and send to the IMF reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial planning, and specifying expected revised completion dates.

State-Owned Banks

17. The authorities will provide staff with relevant documents and information dealing with the restructuring of the commercial banks.

Other Information

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

Relations with the Fund

As of September 23, 2004

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

II. General Resources Account:	SDR Million	%Quota
Quota	504.00	100.00
Fund holdings of currency	504.01	100.00
Reserve Position	0.00	0.00
Holdings	0.00	0.00

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	68.46	100.00
Holdings	0.00	0.00

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. Projected Payments to Fund

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest	0.52	1.36	1.36	1.36	1.36
Total	0.52	1.36	1.36	1.36	1.36

VII. **Implementation of HIPC Initiative:** Not Applicable.

VIII. **Safeguards Assessments:** None.

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 broad exchange rate stability which has translated in a *de facto* peg of the exchange rate since early 2004. The existing exchange system may still contain several *de jure* restrictions on the making of payments and transfers for current international transactions, which the authorities are in process of assessing with a view to removing them in the near term..

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.

Recent Technical Assistance

Department	Date	Topic
FAD	July 15–31, 2003	Public expenditure management
	December 2003	Public expenditure management
	February 29–March 4, 2004	Fiscal seminar for high level officials
	April 4–8, 2004	Training course in budget preparation
	May 31–June 8, 2004	Tax Policy and Tax Administration Workshop
	June 2004	Expenditure management
LEG	July–October 2003	Wrote first draft of new Central Bank legislation
	July–October 2003	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
STA	July 8–14, 2003	Monetary and financial statistics (jointly with MFD)
	December 1–11, 2003	Multisector statistics
	January 17–22, 2004	National accounts statistics
	January 24–29, 2004	Consumer price statistics

Iraq: 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 has been in non-accrual status since 1990.

G. The Bank Group Strategy and Lending Operations

2. During the Madrid Conference in October 2003, the Bank indicated a possible range of lending of US\$3.0-5.0 billion over five fiscal years, including up to \$500 million for FY05-06, once “threshold issues” are resolved, including security, the legal status of Iraq’s government, and payment of arrears to the Bank. As of the transfer of authority to an Interim Iraqi Government on June 28, 2004, Iraq has a de jure government that can access Bank resources, pending clearance of arrears (about US\$100 million, which is included in Iraq’s 2004 budget). The IBRD lending envelope is predicated on an optimistic political scenario, rapid economic recovery, and generous debt relief. No formal request for accessing IDA/IBRD has been made to date.

3. In the meantime, the Bank’s Interim Strategy, discussed by the World Bank Board in January 2004, focuses on: (i) building Iraqi capacity; (ii) emergency operations to generate employment and restore essential infrastructure and services; and (iii) laying the foundation for the medium-term program, through studies and policy advice. The Interim Strategy relies on the World Bank Iraq Trust Fund (ITF) within the International Reconstruction Fund Facility for Iraq (IRFFI) to finance operations. Commitments to the World Bank ITF currently stand at US\$413 million, of which US\$360 million have been deposited into the ITF account. One project funded from the ITF (First Capacity Building) is completed and another project (Emergency Textbook Provision) is underway. Seven additional emergency operations amounting to about US\$320 million will be appraised and approved in the next few months, resulting in the commitment of nearly all ITF funds. These seven operations in the pipeline are:

- Emergency Community Infrastructure Project (US\$20 million);
- Emergency School Rehabilitation Project (US\$60 million);
- Emergency Baghdad Water Supply and Sanitation Project (US\$60 million);
- Emergency Water Supply and Sanitation and Urban Development Project (US\$90 million);
- Emergency Health and Rehabilitation Project (US\$25 million);
- Second Capacity Building Project (US\$10 million) as a follow-up to the successful First Capacity Building Project, to support the authorities in market reforms and strengthening social safety nets and public sector governance; and
- Emergency First Private Sector Development Project (US\$55 million).

4. The Bank is assisting to lay the groundwork for Iraq’s medium-term program through economic and sector work financed from the Bank’s own budget. 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 management. The Bank's economic and sector work includes short policy notes to provide timely advice, and reports that comprise building blocks for more comprehensive analytical assessments.

5. The Bank has encouraged and supported Iraq's elaboration of a **National Development Strategy**, which seeks to provide an overall vision for the Iraqi economy, identify reform drivers and sector needs, and place external finance requirements within a multi-year fiscal framework. The Interim Iraqi Government will share the NDS with donors at the Facility Donor Committee Meeting in Tokyo on October 13-14, 2004.

6. **The Bank has found ways to work in the current situation.** The Interim Iraq Office in Amman is playing a key role in facilitating meetings and workshops with Iraqi officials and coordination with the UN. The Bank videoconferencing facilities in Baghdad conference center, Ministry of Planning, and Central Bank are used constantly, and will soon extend to the Ministry of Finance. The Bank also has Iraqi staff and consultants in Baghdad.

7. **The World Bank is a member of the International Advisory Monitoring Board (IAMB)**, which commenced in December 2003.

8. **The International Finance Corporation is moving forward to implement its two initiatives approved by the Board in December 2003:** the Iraq Small Business Financing Facility and the Private Enterprise Partnership for the Middle East (PEP-ME). IFC has finalized a Financial Sector Review of private Iraqi banks, which identifies gaps and needs in banking institutions. IFC has worked with the first participating financial institution to upgrade its financial statements to international standards. There are some delays, however, in providing investments and technical assistance due to legal issues and security concerns. Earlier this month, PEP-ME conducted a three-day training session in Amman for commercial bankers. IFC has appointed a Head of Mission for Iraq, who is co-located with the World Bank Head of Mission in Amman.

H. 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 organized a number of policy workshops and training courses for Iraqi civil servants and academics, covering financial management, investment climate, payment system, banking supervision, social safety nets, macroeconomic and fiscal management, 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.

I. Table 1. Bank-Fund Collaboration

J. Area of Reform	Lead Institution
1. Market-focused reforms	
Reform of domestic subsidies	World Bank/IMF
Trade reform/WTO accession	World Bank
2. Monetary and credit policies	IMF
3. External sector	
Balance of Payments	IMF
Debt sustainability	IMF
4. Public Sector Governance	
Revenue management, incl. oil	IMF/World Bank
Tax administration	IMF
Public financial management	IMF/World Bank
Intergovernmental finance	IMF/World Bank
Civil service reform and governance	World Bank
5. Public Service delivery	
Agriculture, water and environment	World Bank
Urban infrastructure	World Bank
Telecommunications	World Bank
Education and health	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
7. Human development	
Pension and labor market reform	World Bank
Social development and poverty analysis	World Bank
Gender issues	World Bank
8. Other	
Oil and gas sector	World Bank
Statistical capacity building	IMF

K. 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, such as education (under implementation) and health systems, water supply and sanitation, urban infrastructure and telecommunications (projects are at the negotiation stage). 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 is undertaking a poverty analysis and social development report, and leads work on gender issues.

L. 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 in drafting Iraq's National Development Strategy (NDS). The NDS outlines the main pillars of economic reform, such as market-focused transition, strengthening social safety nets and public sector governance, and private and financial sector development. Specific Bank inputs are provided in the form of policy notes on key reform areas and sectors, such as pension and labor market reforms, SOE reform and investment climate, agriculture, and trade reform with the view of eventual WTO accession. The World Bank is working with the World Food Program on the food market issues. Work is also under way on policy notes on oil and gas sector governance, public finance and civil service reform.

12. The IMF has a strong interest in the areas listed above from the macroeconomic perspective (economic growth and fiscal sustainability, including the phasing out of non-transparent quasi-fiscal operations). The IMF has also a strong interest in the governance issues, in particular with regards to oil revenue management.

M. Areas of Shared Responsibility

13. The World Bank and IMF are working together on macroeconomic and fiscal sustainability agendas, including revenue management, the reform of domestic subsidies, financial sector development (comprising the payment system and banking supervision and regulation) and statistical capacity building. The World Bank and IMF are developing the dialogue with the Interim Iraqi Government on the intergovernmental finance agenda. The Bank and the Fund closely coordinate their capacity building activities in macroeconomic management, public sector governance, private sector development, and social safety nets.

N. Areas in Which the Fund Leads and its Analysis Serves as Input into the World Bank-Supported Programs

14. The IMF leads the dialogue on core macroeconomic policies and has taken the lead on Debt Sustainability Analysis, monetary policy, and the management of aggregate expenditures. The Bank is working with the IMF to ensure consistency of its support to the formulation of Iraq's National Development Strategy and its project work with the overall macroeconomic and fiscal framework.

O. Areas in Which the IMF Leads and There is no Direct World Bank Involvement

15. The IMF 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.

Iraq: Statistical Issues
(As of September 20, 2004)

A. Background

Iraq's macroeconomic statistics, which once were among the most developed in the region, have suffered from years of repression and neglect. Statistics were mostly confidential and had limited use. There were little or no incentives 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. Seen against all these setbacks, the extent to which statistical data are available is remarkable.

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 Statistical Office (CSO) 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 staff need training.

STA has provided 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, CSO, 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 Iraqi statisticians, also in Amman, one workshop on national accounts and one workshop on consumer price indices. The FY 2005 RAP includes terms for follow-up missions in all statistical areas. STA will deliver this 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

The CSO compiles national accounts statistics mainly for government use and the existing Statistical Act has the CSO reporting to the Minister of Planning who has to agree on the data before release. This procedure affects the CSO's statistical independence. CSO 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. Constant price estimates

are a State secret and the penalties for releasing these are severe. Only the Minister of Planning gets data in some detail.

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 well as the surveys used are out-of-date. Also, they miss a significant portion of the building industry for political reasons. Further, there are many gaps in the coverage of business, community, social, and personal services. The CSO uses out-of-date classifications, which do not follow standard international best practice.

The data collections are reasonably comprehensive for current price data in the formal sector. Under present 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.

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.

There are several statistical techniques which need improving. For instance, estimates on total manufacturing use extrapolation with the total industrial production index. There is frequent use of the overall CPI as a deflator when it is not fitting to the implicit prices in the industry. The deflation techniques often involve deflating value added with a single deflator which can give misleading results.

Consumer price index

The number of staff is inadequate in numbers and in need of training. There is not enough computer hardware and software. The adverse economic circumstances in Iraq during the last decade caused serious problems for all data collection. For instance, price collectors had to pay for their transport during data collection from the field. These problems had a negative effect on data quality. In addition, the 1993 weights are outdated and might possibly be updated using the 2002 household budget survey. The CSO needs to document the procedures and methods used in compiling the CPI.

Monetary and financial statistics

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

The monetary survey for Iraq does not include banking activity data from the northern region of the country (Kurdistan). The survey presents claims on government gross and include claims on central government, claims on local government, and claims on state enterprises; liabilities to government include central and local government deposits. In addition, the monetary survey compiled by the CBI does not provide a sufficiently detailed breakdown of financial instruments by resident economic sectors. There is a need for further clarifications to ensure the proper classification of economic units in the government sector and the public nonfinancial corporations subsector.

CBI values its monetary gold at historic cost or market price, whichever is lower. The CBI adjusts the value of loans for expected losses from anticipated defaults by borrowers. This value does not include the accrued interest, which is included in the capital account. End-of-month positions in foreign currency denominated assets and liabilities in the monetary survey are valued using various exchange rates.

There is no cross-checking of information between the relevant monetary data and the matching balance of payments information.

Balance of payments statistics

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 *BPM4* time series. For 1990 and for 2002, the balance of payments statistics are also in the IMF's *Balance of Payments Manual, fifth edition (BPM5)* format. However, this presentation is limited and has the same deviations as those data in *BPM4* format.

On major coverage issue is the balance of payments statistics do not include the northern region of the country (Kurdistan). Further, it is not clear whether the CBI applies the residency criteria consistently, which may also affect coverage.

The data from sources other than the banking system are unreliable because of shortages in the collection methods. The CBI relies on reporting of the Banking Sector to capture a large part of the transactions related to services, income, and the transactions in the Capital and Financial accounts. Transactions in the Financial Account, for which the CBI is using other sources than the banking accounts, are on a cash rather than accrual basis. For government transactions, the Balance of Payments Division applies accrual accounting as they base their information on government administrative records.

While most of the goods and services components are on a gross basis, transfers and most Financial Account transactions are net. The Balance of Payments Division records the financial account on a net basis, with no breakdown available for any component.

Data collection is not comprehensive and most shortages in the coverage and classification of the balance of payments statistics reflect gaps in the data sources. The major areas where the existing data sources are deficient are service transactions, income transactions, transfers, capital, and financial account transactions.

There are no data breakdowns available for foreign direct investment, portfolio investment, and other investment transactions such as trade credits. Further, there are almost no data available for the Services Account except for travel, and the freight and insurance components of imports. The Balance of Payments Statistics Division does not record transactions of nongovernmental organizations (NGOs), foreign embassies, and international organizations.

Current data compilation procedures are error prone. Most importantly, the Balance of Payments Division receives trade data and reporting data from the banks and other institutions in hard copy form. In addition, there is no procedures manual. In general, data adjustments and transformations are large.

The Balance of Payments Statistics Division makes classification and coverage adjustments to the trade statistics to include smuggled, bartered, and free trade. In addition, the Division converts imports recorded on a c.i.f. basis to a f.o.b. basis using a constant factor.

The monetary data are source data for the balance of payments statistics compilers. However, no there is no further cross-checking of information between the relevant monetary data and the matching balance of payments information.

There is no consistency between the external trade data from the CSO, and the data compiled by the CBI. The Balance of Payments Division receives data on the CBI's and the commercial banks' transactions directly from the internal departments.

External trade statistics

There is not enough staff in the section within the CSO that is 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.

The customs declaration forms reflect an outdated declaration method. The Customs Department declaration forms are old and often they are unreadable and miss important information.

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 CSO to reclassify. As a result, there is a large margin of error in the final product.

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.

There is no consistency between the external trade data from the CSO and the data compiled by the CBI. The Balance of Payments Division of the CBI uses external trade data from the CSO only to a limited extent.

Government finance

Iraq does not report government finance statistics for publication in the *Government Finance Statistics (GFS) Yearbook* or *International Financial Statistics (IFS)*. STA has not been able to assess properly the quality of fiscal data because of a lack of appropriate counterparts.



Press Release No. 04/206
FOR IMMEDIATE RELEASE
September 29, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US\$436.3 Million In Emergency Post-Conflict Assistance to Iraq

The Executive Board of the International Monetary Fund (IMF) approved today SDR 297.1 million (about US\$436.3 million) in Emergency Post-Conflict Assistance¹ to Iraq as a sign of support for Iraq's economic reconstruction efforts through 2005 and to help catalyze additional international support, including debt relief.

Emergency Post-Conflict Assistance (EPCA) is designed to promote a strengthening of administrative and institutional capacity, which will be necessary to sustain economic recovery and a higher level of financial assistance. To assist in this capacity building, the IMF has been providing extensive technical assistance and training to Iraqi officials in a number of areas, including tax policy, budget preparation and execution, central banking, the creation of a treasury bill market, and statistics.

Following the Executive Board's discussion of Iraq, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"The Fund's Emergency Post-Conflict Assistance to Iraq is a crucial step toward putting Iraq back on the path to economic stability and strong, sustainable growth. The Fund is making these resources available to Iraq at a difficult time in terms of security, but also at a critical time as Iraq strives to rebuild its economy and prepare for elections early next year. The approval of EPCA will hopefully serve to catalyze much needed financial and technical assistance from the international community and will facilitate the process of reducing Iraq's external debt to a sustainable level.

"The authorities' main goals under the EPCA-supported program are to stabilize the economy, lay the groundwork for the development of a reform program that could be undertaken in years to come, and to begin the process of restoring Iraq's external debt sustainability. The authorities' program is to be underpinned by a prudent fiscal policy that aims to limit spending to available government revenues and external resources, the use of the exchange rate to anchor inflationary

¹ <http://www.imf.org/external/np/exr/facts/conflict.htm>

expectations, and the implementation of key structural reforms to transform Iraq into a market economy.

“The Iraqi authorities have already taken some important steps to facilitate progress toward a more market-oriented economy. The authorities’ policies have succeeded in promoting a degree of macroeconomic stability despite the difficult security environment. The authorities’ continued commitment to their reform agenda, and the assistance of the international community, will play critical roles in advancing the rehabilitation of Iraq’s economy.

“The authorities’ commitment to an economic program geared toward stabilizing the economy and laying the groundwork for adopting policies to support economic growth is particularly welcome. In that regard, the authorities’ approach in preparing their 2004 and 2005 budgets—focusing on providing the minimum adequate level of social support and carrying out urgent reconstruction projects—seems the most appropriate under the current circumstances. Similarly, the authorities’ strategy of caution in projecting oil revenues in 2005 is welcome, particularly when accompanied by their commitment to use any windfall oil revenues for additional reconstruction investment and/or to help meet budgetary needs in 2006 and beyond.

“The authorities have succeeded in managing monetary policy in a manner consistent with price stability. The authorities should nevertheless remain vigilant and closely monitor developments that may threaten their inflation objective, and also take steps to strengthen monetary policy by developing and implementing a wider menu of instruments for managing liquidity conditions.

“The authorities will be focusing, as early as possible, on implementing key structural reforms, particularly in the areas relating to rebuilding administrative capacity and improving program monitoring. The authorities will also be working on developing a reform program in areas in which progress must be made in 2005 to set the economy on a sustainable path, including tax reform, financial sector reform, restructuring of state-owned enterprises, and enhancing the governance and transparency of the oil sector, all of which will be key in promoting the recovery and growth of the private sector.

“In addition to risks related to program implementation, external developments, such as lower oil prices, and the hazardous security situation, Iraq has an unsustainable level of external debt. In order to allay the risks to the Fund from lending to Iraq under these circumstances, the bulk of Iraq’s official bilateral creditors—through the relevant Executive Directors—have reaffirmed their recognition of the Fund’s preferred creditor status in respect of the drawing by Iraq under the EPCA and, similarly, have indicated that they are willing to make their best efforts—given Iraq’s continuing cooperation with the Fund—to provide debt relief on appropriate terms to ensure the timely repayment to the Fund of the amounts provided under the EPCA, in accordance with the Fund’s preferred creditor status. They have also confirmed that during the period of the economic program supported by the EPCA, a deferral will be in place with respect to those obligations of Iraq that are falling due to them,” Mr. Kato said.

Iraq's access to emergency assistance was possible following Iraq's settlement on September 22, 2004 of its overdue financial obligations to the IMF. With the settlement of these arrears, which totaled SDR 55.3 million (about US\$81 million), Iraq is now current on its financial obligations to the IMF.

The Iraqi government has also consented to and paid its quota increase under the IMF's Eleventh General Review of Quotas, which brings its current quota in the IMF to SDR 1.19 billion (about US\$1.75 billion), up from SDR 504 million (about US\$740.1 million). The amounts provided under the EPCA to Iraq represent 25 percent of its current quota.

**Statement by A. Shakour Shaalan, Executive Director for Iraq
September 29, 2004**

Today marks a new beginning in the relationship between Iraq and the International Monetary Fund. It has been some two decades since the Executive Board has formally met to consider economic developments in the country. The Iraqi authorities are very appreciative of the Fund staff and management's tireless work and their commitment to helping the country in its efforts to establish economic stability and reverse the sharply deteriorating situation that has characterized the past two decades. They would also like to express their gratitude in particular for the substantial technical assistance they have been receiving from the Fund, which has proven indispensable for the rehabilitation of the economic Institutions in the country.

Recent Developments

Years of wars, sanctions, and mismanagement, coupled with the recent conflict have exacted a heavy toll—both human and material—on the Iraqi economy. Given the well-known economic degradation that has taken place throughout these years, I will refrain from detailing it here. Suffice it to say that after enjoying relatively high standards of living in the 1970s, the per-capita income of the Iraqi people experienced a precipitous decline from over \$3000 in the early 1980s to \$500 in 2003, a level comparable to or even below that prevailing in many of our low-income/HIPC member countries.

The challenges facing the Iraqi authorities today to reverse this deterioration are by any standard daunting. Developments since mid-2003 however have shown a high degree of resolve to take the necessary actions to address these challenges under most difficult circumstances. The ongoing economic rebound and reforms, including in the monetary and fiscal areas, introduced to transform Iraq into a market-oriented economy, have to be viewed against the starting point of the reform process when the economy came to a virtual standstill in the wake of the conflict that started in early 2003. In addition to the decaying institutions and infrastructure, the oil sector, which is the backbone of the Iraqi economy, has suffered serious damage and production was completely halted. Since then, among other positive developments, oil production resumed, a functioning payment system has been put in place, new bank notes were introduced, the trade regime was reformed, a new tax law came to light, and new banking sector legislations were approved. Along with the continuous recovery in the non-oil economic activity, the increase in oil production is likely to lead to a sharp rebound in overall activity in 2004. Underlying this recovery has been a relatively stable macroeconomic environment with inflation kept under control and a stable exchange rate. The accompanying increase in base money is a testimony to the improving confidence in the economy, notwithstanding the security concerns.

As we all know, Iraq continues to suffer from virtually daily attacks within the country which complicate the ongoing reform effort as well as the task of increasing oil production. As they have demonstrated however, the authorities are strongly committed to continue with their reforms in spite of these difficulties. In fact, the recent completion of the

first treasury-bill auction and its bi-weekly recurrence since July 2004 is worth noting given its importance for the conduct of both fiscal and monetary policies.

Emergency Post Conflict Assistance

Based on their demonstrated ability to implement difficult reforms and after clearing all Iraq's arrears to the Fund and consenting to increase the country's quota under the Eleventh Review of Quotas, the authorities are requesting Emergency Post Conflict Assistance (EPCA). They consider the EPCA to be critical to support their efforts to build on the reforms introduced in recent months and to catalyze and pave the way for additional international support, including in particular debt relief, without which no meaningful reconstruction and rehabilitation can take place. They look forward for prospective negotiations with all their creditors to alleviate the tremendous debt burden accumulated in the period leading to the last conflict. In this regard, they are taking steps to clear arrears with the World Bank and the Arab Monetary Fund. The authorities are grateful to their creditors for agreeing to a moratorium on debt service and for the financing assurances they have provided to facilitate the move to an EPCA. They intend to adhere to the program agreed with the staff with a view to building the necessary track record to move to an upper credit tranche stand-by arrangement in 2005 to support a more ambitious reform agenda.

Economic Program

The authorities' economic program to be supported by the EPCA aims at maintaining a stable macroeconomic environment while laying the ground for implementing a comprehensive structural reform agenda to transform Iraq into a market-based economy with a larger role for the private sector. The main macro targets include enhancing growth performance while keeping inflation under control, and maintaining a sound fiscal policy.

Fiscal Policy

The conduct of fiscal policy will be shaped by the drive toward prudence on the one hand and meeting the large basic and social needs of the Iraqi people and the reconstruction requirements on the other. Spending will be constrained by the available domestic and external resources. With the primary fiscal deficit projected to decline to around 42 percent of GDP in 2004 and 27 percent in 2005, the authorities would likely be able to finance it with resources available through the United Nations oil-for-food program resources, assets held in the Development Fund for Iraq, and donors' project financing. The authorities are committed not to borrow directly from the central bank in accordance with the new central bank law. Meeting these objectives hinges to a large extent on a substantially faster disbursements of aid pledges made at the Madrid Donors Conference in October 2003 than has been the case since commitments were made about a year ago. The authorities very much look forward to continuing cooperation of the donor community.

A tremendous effort is being made to keep spending under control. The 2005 budget aims at reducing recurrent spending from 107 percent of GDP this year to 88 percent of GDP. This will be achieved by limiting wage and pension increases to 11 percent and

decreasing outlays on goods, services, and transfers. Oil-related spending will be directed at rehabilitating oil production in line with projections.

The authorities are very well aware of the large burden that the price subsidy on domestic consumption of oil derivatives imposes on the budget. Given the high social sensitivity of this issue, they intend to move in a deliberate and gradual manner to avoid a possible detrimental public reaction. They are committed to begin the process of reducing the subsidy by end 2004 with a view to full elimination by 2009.

On the revenue side of the budget, the authorities have put in place a simplified tax regime that includes a 5 percent reconstruction levy, as well as a revised personal and corporate income tax with a maximum marginal tax rate of 15 percent and a higher personal income allowances that introduces progressivity into the system. Moving forward, the plan is to take further measures starting in 2005 to broaden the tax base. A reform of the tax and customs administration will be undertaken and a general sales tax will be introduced most likely in 2006.

More broadly, ensuring fiscal sustainability over the long term will require that the role of the government in the economy be curtailed. The authorities are intent on taking the necessary steps to reduce the wage and pension bill, reforming the state owned enterprises, and replacing the current food ration system with a cash-based distribution system that better targets the needy.

Monetary and Exchange Rate Policy

The introduction of a new currency and a new central bank law that endows the Central Bank of Iraq with independence and accountability are key building blocks for ensuring a prudent monetary policy conduct, with the main objective of price stability. While the exchange rate system for Iraq is still under consideration, the authorities had no means other than the exchange rate to anchor inflationary expectations which has proven to be rather effective in maintaining stability.

Further reforms to modernize the central bank and the financial sector are being pursued. The central bank has introduced a lender of last resort and overnight standing credit/deposit facilities to better manage liquidity. With regard to the supervisory and regulatory function of the central bank, work is underway to implement regulations on loan classification, capital requirements and risk management. The dominance of state banks in the economy clearly suggests that a restructuring plan is warranted to improve their efficiency and governance structure.

Structural Reforms and Capacity Building

In addition to the structural reforms in the monetary and financial areas, the authorities plan during the program period to work towards improving governance in the oil sector, review its financial operation, and prepare a restructuring plan for it which will

include the recommendations of the International Advisory and Monitoring Board regarding monitoring and control systems.

On capacity building, I would like to reiterate the Iraqi authorities' deep appreciation for the ongoing technical assistance provided by donors and the Fund, which is critical for the reform program. They recognize the very difficult conditions under which Fund staff is working to help Iraq build its capacity in the statistical, fiscal, monetary, and financial areas. While substantial assistance has been provided over the past year, the needs of the country are still great. As the First Progress Report on Technical Assistance Subaccount for Iraq clearly shows, weaknesses remain widespread even in those areas where TA has been provided. This underscores the importance of continuity and follow-up training to ensure that initial TA is disseminated throughout the concerned ministries and departments and thus properly implemented. The authorities look forward for continued training and assistance including through the Middle East Technical Assistance Center.

Conclusion

In spite of all the progress made over the past year in reforming the economy and the ongoing economic rebound, the authorities are very well aware of the difficult situation Iraq finds itself in and the many obstacles and risks facing them. They also recognize that in addition to the wide ranging fiscal, monetary, and financial sector reforms planned for the period ahead, placing the economy on the path of sustainable recovery requires the implementation of a far reaching reform agenda to enhance the role of the private sector in Iraq which has been suppressed for many years. In this regard, the preparation of a national development strategy which entails plans to rehabilitate the oil sector, diversify the economy, improve social conditions, and for regional development is nearing completion. The authorities are confident that with the generous support of the international community, their commitment to political, economic, and social reform, and the Iraqi people's well known resilience, entrepreneurship, and human capital endowment, peace and prosperity will return to Iraq.