January 2006
IMF Country Report No. 06/15

Iraq: Request for Stand-By Arrangement—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iraq

In the context of Iraq's Request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the request for Stand-By Arrangement was prepared by a staff team of the IMF. The staff report was completed on December 7, 2005**.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of December 21, 2005 updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its December 23, 2005 discussion of the staff report that completed the request.
- a statement by the Executive Director for Iraq.

The document(s) 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 the staff report

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

IRAQ

Request for Stand-By Arrangement

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

Approved by Lorenzo Pérez and Juha Kähkönen

December 7, 2005

- In the attached letter to the Managing Director, the Iraqi authorities request a Stand-By Arrangement (SBA) in support of a program outlined in the accompanying Memorandum of Economic and Financial Policies. Access is proposed at SDR 475.4 million (40 percent of quota), and the arrangement would cover a fifteen month period through March 2007. The authorities intend to treat the arrangement as precautionary.

- A key program objective would be to maintain macroeconomic and financial stability, while aiming for sustainable growth over the medium term. Approval of the SBA would also trigger the second stage of (30 percent) debt reduction under the Paris Club agreement.

- Iraq received Emergency Post Conflict Assistance (EPCA) amounting to SDR 297.1 million (25 percent of quota) on September 29, 2004.

- The 2005 Article IV consultation was concluded on August 1, 2005.

- This report is based on discussions with Iraqi authorities beginning in September, 2005. The staff conducted these discussions with the Minister of Finance, the Governor of the Central Bank of Iraq (CBI), and other representatives of the Iraqi Transitional Government.

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Executive Summary

The authorities have requested a Stand-By Arrangement (SBA) for 15 months from December 2005 through March 2007, which they intend to treat as precautionary. Access for the proposed arrangement is SDR 475.4 million (40 percent of quota). The SBA is intended to support the program for 2006, following the program for 2005 that was supported by Emergency Post Conflict Assistance (EPCA).

Policy efforts and developments in 2005

- The authorities' policies have succeeded in promoting overall macroeconomic stability despite the extremely difficult security environment. Economic growth in 2005 is estimated at 2.6 percent, following the rebound of almost 50 percent recorded in 2004. Inflationary pressures have moderated in 2005, though prices remain volatile.

- The projected fiscal deficit in 2005 is much lower than expected under the EPCA-supported program, mainly due to higher than projected export prices for crude oil. The exchange rate has remained stable, and the central bank's international reserves have continued to increase.

- The implementation of structural benchmarks specified in the EPCA-supported program was slower than scheduled. The commitment to increase domestic fuel prices of refined oil products was not implemented.

The Program for 2006

- The authorities' program for 2006 aims to strengthen administrative capacity, allocate resources towards the planned expansion of the oil sector, and to redirect expenditures away from general subsidies towards providing improved public services. The program seeks an acceleration in the growth rate of GDP to 10 percent in 2006, a reduction of inflation from 20 percent in 2005 to 15 percent in 2006, and an increase in net international reserves by $1.7 billion.

- The authorities plan to increase prices of all refined oil products as a prior action for the SBA. In addition, the audit of the Central Bank of Iraq needs to be at an advanced stage by the time of Executive Board consideration of the SBA.

- The medium term outlook for Iraq is favorable, but subject to many risks. Program implementation may suffer if there are continued security problems. Moreover, Iraq would remain vulnerable to external shocks, particularly if oil production does not expand as projected, or oil export prices decline substantially.

- Approval of the SBA should trigger the second stage (30 percent) of debt reduction, according to the terms of the Paris Club arrangement.

I. Introduction

1. **On September 29, 2004, the Executive Board approved a purchase by Iraq of SDR 297.1 million (25 percent of quota) under the Fund's policy on Emergency Post Conflict Assistance (EPCA).** The main objectives of the EPCA-supported program were to (i) begin the process of improving economic conditions in Iraq, and (ii) facilitate debt relief negotiations with Iraq's Paris Club creditors. The program included a quantified policy framework for 2005 and was designed, inter alia, to help build Iraq's capacity to implement a follow-up program of sufficient strength to merit support through an upper credit tranche arrangement.

2. **Following the approval of EPCA, Paris Club creditors (plus Korea) agreed on November 21, 2004, to reduce their claims on Iraq by 80 percent in net present value terms.** Under this agreement, debt reduction would take place in three stages: (i) 30 percent upon signing the debt agreement; (ii) 30 percent upon approval by the IMF Executive Board of an upper-credit tranche arrangement (expected by December 31, 2005); and (iii) 20 percent upon the successful conclusion of the last review under the third year of (one or more successive) upper credit tranche arrangements, expected by December 31, 2008.

3. **In their request for EPCA, the Iraqi authorities noted their intention to seek further financial support from the Fund in the form of a Stand-By Arrangement (SBA).** In the summing up of the 2005 Article IV Consultation with Iraq, Directors noted that progression to a SBA would help underpin a sound macroeconomic framework for the continuation of Iraq's reconstruction and recovery, as well as pave the way for Iraq to move forward to a sustainable external debt situation under the terms of the Paris Club agreement. To prepare the ground for a SBA, Directors urged the authorities to build on their track record of policy implementation under the EPCA-supported program, and to strengthen the quality and timeliness of economic data needed for program monitoring.[1]

4. **Despite serious security problems, which hindered implementation, and institutional limitations, the authorities have demonstrated a clear ability to execute policies during 2005, and made good progress in improving data compilation.** The EPCA-supported program has achieved a surprising degree of macroeconomic stability in very difficult circumstances. Progress was initially slow in pushing forward reforms. However, a number of important measures have recently been implemented, and more such actions are planned in the coming weeks. Data quality and timeliness has meanwhile been brought to a standard that would enable program monitoring under an upper credit tranche arrangement. The authorities now propose to follow the 2005 EPCA-supported program with a more ambitious program for 2006.

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[1] Iraq—2005 Article IV Consultation and Summing Up.

5. **In the attached letter to the Managing Director, the Iraqi authorities request a SBA in support of their program outlined in the accompanying Memorandum of Economic and Financial Policies (MEFP - Appendix I).** The arrangement is intended to cover the program for calendar year 2006, and is therefore expected to run for fifteen months through March 2007. The Iraqi authorities intend to treat the arrangement as precautionary.

II. Political and Economic Developments

A. The Political and Security Situation

6. **A profound transformation of Iraq's political landscape is underway.** Following the installation of the Iraqi interim government on June 28, 2004, parliamentary elections for a new Transitional National Assembly (TNA) were held on January 30, 2005. A new Iraqi transitional government (ITG) was sworn in on May 3, and began working on a permanent constitution (to replace the Transitional Administrative Law put in place by the Governing Council in March 2004). The draft constitution was approved by public referendum on October 15, 2005. The approved constitution envisages the possibility that changes could be made to it by the first Assembly elected under it. Elections for the first Assembly under the constitution are scheduled to take place on December 15, 2005. A constitutional government with a four-year term will then be formed.

7. **The security situation remains dangerous, and continues to hamper economic recovery and program implementation.** The lack of a secure environment has impeded reconstruction, and sharply increased security and insurance costs. In addition, there have been allegations of large misappropriations of funds in the security area by officials of the (former) interim government.

B. Developments under the EPCA-supported Program

8. **Reflecting, in part, the difficult security situation and the long political transition process, performance in 2005 was mixed when compared to expectations under the EPCA program**:

- **Gross domestic product** is estimated to have increased by only 2.6 percent in 2005, below the EPCA projection of 16.7 percent, though this followed a rebound of nearly 50 percent in 2004 (Table 1). Oil production expanded by 74 percent to 2.0 million barrels per day (mbpd) in 2004, but is projected to have stabilized at this level during 2005 due to delays in implementing oil investment projects and continued sabotage to Northern oil export pipelines. Non-oil GDP is estimated to have expanded only moderately in 2005, as continuing security problems, electricity shortages, and political uncertainties have hampered the recovery of private sector activity.

- **Inflation** in the year to December 2004 reached 31.7 percent, compared with a projected 7 percent under the EPCA program. A surge in prices in late 2004 and early 2005 appears to have been related primarily to supply shortages of key goods (gasoline and food) because of the intensification of violence in the run-up to the elections in January 2005. Inflationary pressures have since moderated, though prices remain volatile, reflecting periodic shortages of certain goods in the market and strong seasonal effects and Ramadan. Cumulative inflation for the first 9 months of 2005 was 15.5 percent, in line with a revised program objective of 20 percent for end 2005.[2]

- **The exchange rate of the dinar** has been relatively stable throughout 2005 at about ID 1460–1480 to the U.S. dollar. Foreign exchange sales volumes at the daily CBI auctions increased from around \$30–35 million in the first half of the year to around \$45–55 million in the second half. However, government sales of dollars to the Central Bank of Iraq (CBI) also rose, reflecting higher government spending in dinars (and higher oil revenues). **Foreign exchange reserves** are estimated to have reached around \$8.5 billion at end-September 2005, well above the EPCA projected floor for end–September of \$4.75 billion (Table 2).

- **Currency** issued, which grew rapidly during 2004, decelerated sharply during the first 8 months of 2005 to 13.9 percent (below program projections). **Reserve money** increased only by 6.9 percent for the same period (as a result of the introduction of CBI deposit facilities which reduced banks' free reserves).[3] **Interest rates** increased at recent treasury bill auctions, reaching 9.5 percent in early September and staying around this level through November. The CBI increased the interest rate on the overnight dinar deposit facility from 4 to 5 percent per annum in early July, and introduced 14-day and 30-day deposit facilities paying 6 percent and 7 percent, respectively. In October, the CBI also introduced two (30- and 90-day) term facilities for dollars, alongside the existing overnight dollar facility. As of end-September, banks had outstanding dinar deposits with the CBI of ID 2.4 trillion and dollar deposits of \$646 million.

- While the **fiscal deficit** for 2004 was somewhat larger (in dinars) than envisaged under the EPCA-supported program, the fiscal position in 2005 has turned out to be more comfortable than expected because of higher oil prices, as well as lower expenditures in certain areas (partly reflecting implementation difficulties associated with the lack of security). The overall fiscal deficit in 2005 is expected to be around ID 5.3 trillion, well below the ID 10.1 trillion deficit projected under the EPCA-supported program. As a result, the year should end with a positive balance in the Development Fund for Iraq (DFI) of some ID 5.8 trillion (\$3.9 billion) compared to ID 0.8 trillion envisaged under the EPCA-supported program and a balance of zero projected at the time of the Article IV Consultation. Disbursements of grants have also accelerated, and are now projected at ID 11.3 trillion (\$7.7 billion) in 2005, compared to ID 6.4 trillion (\$4.2 billion) projected under the EPCA-supported program.

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[2] The inflation projection for end-2005 was originally 15 percent, but was revised up to 20 percent during the 2005 Article IV Consultation.

[3] Deposits in CBI deposit facilities do not count toward bank's reserves.

9. **Implementation of structural reforms and key policy measures was much slower than expected in the EPCA-supported program** (Table 3). This reflected both the difficult security situation, and overestimation of the government's administrative and institutional capacity. However, progress was made in a number of areas. Some of the implementing regulations for the financial management law were issued on September 1, 2005, and agreements were negotiated with neighboring countries to facilitate the collection of customs revenues. In the financial area, draft payment system regulations were prepared (with technical assistance from MFD), and a contract was signed with Ernst and Young to conduct an audit of the CBI. In September, the government initiated the reform of domestic petroleum product subsidies by unifying the official price of regular gasoline in Baghdad (from ID 20 per liter) with the official price of premium gasoline (ID 50 per liter), and began selling premium gasoline in Baghdad from government-owned gas tankers for ID 100 per liter.

10. **The government has stepped up efforts to improve governance.** It has established (i) a cabinet-level committee for the purpose of reviewing all tenders greater than $3 million, and (ii) an integrity commission to investigate alleged corruption practices throughout the government. Finally, the ministry of finance has taken steps to ensure that the disbursement of all funds are made strictly on the basis of budget appropriations.

11. **Data reporting has also improved substantially.** Monthly fiscal data is now being reported with a lag of 9–10 weeks, monthly data on the CBI's balance sheet is reported with a lag of about seven weeks, and a preliminary depository corporations survey (monetary survey) for 2005 (through August) has just been compiled. STA has also conducted a number of technical assistance missions, aimed at improving national accounts and price statistics and balance of payments data.

12. **Following the Paris Club agreement, progress has been made towards securing bilateral debt agreements with official creditors.** So far five bilateral agreements on Paris Club terms have been signed with **Paris Club** creditors (U.S.A., Belgium, Canada, Italy, and Japan), and the authorities are optimistic that they will have nearly all 18 Paris Club bilateral agreements signed by end-2005.[4] The process of debt reconciliation with the 26 **non-Paris Club** official creditors has been slower.[5] Firm progress is yet to be made toward reconciling claims of Gulf country creditors, but there are indications that these creditors would be willing to provide debt relief on terms at least as favorable as those of the Paris Club.

13. **Progress has also been made toward resolving claims of small private creditors.** On July 26, 2005, Iraq announced a program to settle commercial claims. The program has two components: a cash buy-back of 10.25 cents on the dollar for small creditors with claims

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[4] The Paris Club agreed to extend the deadline for completion of bilateral agreements to December 2005.

[5] The authorities have signed agreements with Malta and Romania. Discussions with Brazil, Bulgaria, Czech Republic, Cyprus, Greece, Hungary, Indonesia, Pakistan, Poland, and Slovakia are well advanced. This would represent nearly 50 percent of non-Paris Club/non-Gulf claims by value.

of $35 million or less, and a debt-for-debt exchange for larger creditors.[6] The Paris Club has concluded that the offers made to Iraq's private creditors, both large and small, are on broadly comparable terms to the Paris Club agreement. Iraq successfully concluded the first two cash offers that were launched on August 8, and September 26, 2005. Of approximately $1.6 billion commercial claims eligible for settlement in the first two cash offers, the holders of 72.5 percent of claims accepted the offer, holders of 20.8 percent of claims deferred decision, and holders of 6.7 percent rejected it (or failed to respond in time).

14. **The process of dealing with large private creditors is proceeding.** Contacts between financial and legal advisors of the Iraqi authorities and large private financial and suppliers creditors took place in the period leading to the Annual Meetings. This followed correspondence between the Iraqi authorities and some of the larger creditors, raising issues regarding the terms of settlement and requesting more frequent face-to-face meetings. The minister of finance also met with the largest financial creditor of Iraq during the Annual Meetings. On October 21, the Iraqi advisors met with a group of large financial creditors to hear their suggestions for making the planned debt-to-debt exchange offer more attractive to creditors. Some of these suggestions were incorporated in the debt-to-debt exchange offer made on November 16, 2005.[7, 8] Korean supplier creditors have indicated, however, that they are not willing to accept settlement on the terms of the Paris Club. The Iraqi authorities, with their advisers, will be holding a meeting with private creditors in Singapore on December 7 for a presentation on Iraq's economic and political conditions.

III. THE ECONOMIC PROGRAM FOR 2006

15. **The main objective of the authorities' program for 2006 is to maintain macroeconomic and financial stability, while undertaking sufficient investment to secure the basis for sustainable growth over the medium term.** The program seeks, inter alia, to strengthen administrative capacity, and to prioritize resources toward regenerating the oil sector and rebuilding Iraq's infrastructure, and away from general subsidies (especially for domestic petroleum products) toward more targeted social support. Providing social services (including in health, education, security and the provision of reliable electricity) is an important objective of the program.

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[6] The total amount of claims eligible for cash-exchange offers is estimated at $2.2 billion (principal only) out of a total principal amount in arrears to private creditors of $10.1 billion. Of the arrears not eligible for the cash exchange offers, $3.9 billion is owed to financial institutions and $ 4.0 billion to suppliers.

[7] In response to suggestions made by creditors, for example, the authorities agreed to (i) release creditors from their obligations under performance bonds or guarantees given to Iraqi counterparts, (ii) to deal directly with assignees of part of the claims of the original creditors, and (iii) to waive Iraq's right to recognize the validity of claims held by assignees not approved by the Rafidain and Rasheed banks.

[8] The debt-for-debt exchange will have a choice of two debt instruments: a syndicated loan and a privately placed bond. The closing date for submission of tenders is December 21, 2005, but the exchange would only occur following IMF approval of the SBA. If the latter does not occur by July 15, 2006, the offer would be cancelled.

A. Overview of the Macroframework

16. **The program envisages an increase in economic growth in 2006, while maintaining the deceleration of inflation.** After stalling at 2.0 mbpd in 2005, oil production is projected to resume its expansion in 2006 to around 2.3 mbpd (Table 1). With non-oil economic growth assumed to be around 8 percent, overall GDP growth is projected to rise from 2.6 percent in 2005 to 10.4 percent in 2006. The inflation rate is expected to fall to 15 percent by end-2006.

17. **The fiscal stance in the near term will be driven by the reconstruction program, subject to a financing constraint**. The primary fiscal deficit in 2006 is projected to be 8.2 percent of GDP, following a deficit of 10.8 percent of GDP in 2005.[9] Over the medium term, as reconstruction needs subside, the government's fiscal deficit should gradually decline to zero.

18. **The monetary program is based on the continuation of the de facto peg of the Iraqi dinar to the U.S. dollar.** With no net domestic credit creation, net international reserves of the CBI should continue to increase by some $1.7 billion to $10.6 billion by end-2006.

B. Fiscal Policy in 2006

19. **The 2006 budget combines the government's competing expenditure requirements with revenues and available financing, with little room for slippage.** The government is seeking to contain recurrent (non-military) spending pressures, while allowing room for growing security responsibilities, and at the same time providing for investment in both the oil and non-oil sectors. The government's oil revenues—which comprise almost 90 percent of its total revenue (excluding grants)—are based on an assumed recovery in oil production and thereby oil exports. This in turn depends on the government's program of investment. The fiscal deficit for 2006 will be financed from remaining resources in the DFI and some modest amounts of project financing (Tables 4 and 5). Off-budget expenditures will not be allowed, and any additional spending will be integrated into a supplementary budget. Spending allocations from the contingency allowance will only be made after consulting with IMF staff and in light of a review of spending and revenue developments. In the event of revenue shortfalls, cuts in non-priority spending may also need to be made. The 2006 budget was passed by the TNA on December 4, 2005, in line with the program understandings.

20. **Oil revenues in 2006 assume continued stability in oil prices, as well as rising production.** The budgeted oil price projection for 2006 is based on WEO (futures market) benchmark price projections, less a $4.5 discount (to build in some downside risk to the oil

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[9] At the time of the Article IV Consultation, Iraq's fiscal deficit for 2005 was projected at 27.7 percent of GDP, fully exhausting the DFI, and the deficit for 2006 therefore had to be constrained to be much smaller at 0.6 percent of GDP.

market), and a further additional quality differential of $10.6 per barrel.[10] These assumptions generate an average assumed export price for Iraqi oil of $46.6 per barrel in 2006. Oil exports are projected to increase from 1.4 mbpd in 2005 to 1.65 mbpd in 2006. This assumes some limited restoration (of about 50,000 barrels per day on average) of oil exports through the North (this route has been badly affected in the past by the insurgency).

21. **The authorities are looking to raise ID 1.5 trillion in 2006 by reducing the subsidy on domestic consumption of oil derivatives.** The staff urged the authorities to seek the alignment of petroleum product prices to at least the average prices of similar products in other Gulf countries by 2007, according to an announced format. The authorities agreed to establish a schedule of price changes, but were reluctant to link this to a formula or automatic adjustment mechanism ahead of the formation of the new government at the end of the year. Under the authorities' strategy—and as a prior action to the SBA in December 2005—there would be sharp nationwide increases in prices of petroleum products. Premium gasoline would be raised from ID 50 to ID 250 per liter, while regular gasoline would go up from ID 20 per liter (ID 50 per liter in Baghdad) to ID 100 per liter nationwide. Diesel would go up from ID 10 to ID 90 per liter, and kerosene would go up from ID 5 to ID 25 per liter. Liquefied petroleum gas (LPG) would be increased from ID 250 to ID 600 per cylinder. Prices for all oil products would be raised again in (quarterly) stages during 2006. The cabinet has approved this path for price increases through September 2006. The private sector will be permitted to import premium gasoline in 2006 (according to a law submitted to the TNA in November 2005). Progress in adjusting petroleum product prices will be assessed in the context of the program's (quarterly) reviews, while the resulting revenues will be subject to a performance criterion. Revenues of state-owned oil related enterprises, which derive from domestic sales of oil and oil products (and which are used to finance domestic recurrent operations) will be subject to a floor. Part of these revenues will be remitted to the budget.[11]

22. **Total non-oil revenues in 2006 are projected to increase from 2.7 percent of GDP in 2005 to 3.0 percent of GDP.** Tax revenue rises from 2.4 percent of non-oil GDP in 2005 to 4.2 percent of non-oil GDP in 2006. This mainly reflects the expected conversion of the reconstruction levy (5 percent) into a uniform import duty of 10 percent (effective in April 2006), as well as enhanced customs revenue collection through arrangements with neighboring countries, customs revenues on (new) private imports of premium gasoline, and the introduction of a tax on mobile phone companies. The introduction of new levies should also help achieve an increase of 21 percent in non-tax revenues in 2006.

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[10] The risk discount of $4.5 represents one standard deviation in the variance of oil prices observed over the past twenty years. The quality differential (arising mainly because Iraqi crude oil is heavier and contains more sulfur (and so is less valuable) than the benchmark oils used in the WEO projection) is the average differential observed in the first 9 months of 2005.

[11] Revenues from foreign sales of crude oil go direct to the DFI, and are available to the ministry of finance.

23. **External grants are expected to remain at a high level in 2006, before winding down sharply in 2007.** Most of these grants (including $8 billion from the U.S.) are directly linked to donor projects and therefore have a neutral net effect on the overall budget balance.

24. **Government operating expenditures in 2006 are projected to increase by over 24 percent compared to 2005, reflecting upward pressure from wages and pensions (mostly in the security and defense sector), and from increasing security spending on goods and services.** The wage and pension bill increase from 17.7 percent of GDP in 2005 to 20.6 percent in 2006 includes an increase (equivalent to 1.5 percent of GDP) in the security and defense wage bill and a one-off compensation payment (worth 2.4 percent of GDP) for military personnel retired in 2003. Non-security/defense wages and pensions increase more modestly and actually fall as a ratio to GDP in 2006, after increasing sharply in 2005. Nevertheless, it remains important for the government to keep non-security/defense wages and pensions under firm control hereon. In an effort to contain the growth of civil service wages, the authorities have therefore agreed to put a ceiling (as a performance criterion under the SBA) on the non-security/defense wage bill. Potential future spending pressures arising from increases in pensions have been averted (for the moment) by the decision to withdraw from the National Assembly a proposal to set pensions at 80 percent of final salary. Security-related spending is now projected at ID 8 trillion (about $5.3 billion) in 2006, compared with ID 3.4 trillion in 2005, reflecting the rising cost of security and the transfer of responsibility for security from the US to the Iraqi budget. In 2007, it is expected that spending on goods and services, excluding security, will fall sharply, as donor disbursements (a large part of which are spent outside Iraq) decline, and government imports of refined petroleum come to an end.

25. **The program includes some new initiatives on the social safety net.** The authorities are determined to seek savings on the public distribution system (PDS), mainly through tighter control over procurement and efforts to reduce waste and corruption without sacrificing the quantity or quality of the distributed goods. With this in mind, the PDS budget for 2006 is set at the same amount as the estimated outturn for 2005, itself 25 percent below the budgeted amount in 2005.[12] However, the budget also makes provision for an additional ID 500 billion to improve on a new targeted social safety net for the poor, which should help mitigate some of the effects of the proposed increase in oil product prices. This program will be implemented in the course of 2006 and will benefit around 1 million of the poorest households in Iraq.[13] In addition, a voucher scheme has been introduced in Baghdad ensuring that residents get at least one liter of kerosene and one canister of LPG per month.

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[12] The authorities intend to reform the PDS over the medium term (with assistance from the World Bank), building on the implementation of a modern payments system and the results of a comprehensive household survey.

[13] This program will be administered by the Ministry of Labor and Social Affairs.

26. **The program allows for a significant increase in public investment in 2006.** Overall public investment is projected to increase by ID 3.4 trillion to ID 15.9 trillion in 2006 (25 percent of GDP). However, half of this increase reflects an increase in the budget allocation for the oil sector. Some of this oil investment will be reflected in physical investment in 2006, and some in investment which will materialize in later years and underpin the continued recovery in oil production over the medium term. Non-oil investment is projected to increase more moderately, reflecting higher disbursement of donor financing. Although security-related investment is budgeted to increase sharply, overall domestically financed non-oil investment (reconstruction) in 2006 is projected to be similar to 2005 (including investment financed by the oil-for-food-program), and in line with projected non-oil GDP growth.

27. **The overall budget deficit in 2006 is projected at ID 5.6 trillion.** With an estimated ID 5.8 trillion expected to be outstanding in the DFI at end-2005, and a possible World Bank IDA loan disbursement equivalent to ID 0.4 trillion, the deficit should be covered (although it will largely exhaust the DFI). The budget includes a contingency allowance of ID 2.4 trillion.[14]

C. Monetary and Exchange Rate Policy

28. **Monetary policy will continue to be based on the framework of a de facto exchange rate peg.** The exchange rate peg has proved a valuable anchor of stability for Iraq. Although inflation has been volatile (mainly reflecting periodic supply shortages), it has been on a downward trend. Apart from temporary pressures in the spring and early summer of 2005, moreover, the peg has not been seriously tested, and the CBI has been able to maintain it while still accumulating international reserves. In part, this is because of the prohibition on net lending to the government, which ensures that the money supply can only increase through increases in international reserves. The program includes a ceiling (performance criterion) in 2006 of zero new claims by the CBI on either the government or private sector.[15]

29. **Demand for dinars should pick up during 2006 as the economy resumes its expansion.** Demand for currency issued (and thereby supply) is projected to expand by about 24 percent during 2006, in line with nominal (non-oil) GDP and consistent with a modest increase in NIR of $1.7 billion (Table 7). The demand for dinars should be additionally supported by a recent decision of coalition forces in Iraq to switch payment to local contractors to dinars from dollars, in a move designed to help arrest dollarization in Iraq.

30. **The authorities have committed to supply dollars at the daily auction at the de facto pegged rate without applying any administrative limitations unrelated to anti-money laundering or counter-terrorism measures.** This commitment is intended to ensure

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[14] This contingency allowance is within the upper limit set by the Financial Management Law of 5 percent of total budgeted expenditure.

[15] Rolling over treasury bills would not be deemed to constitute new lending. In the event of a genuine need for the CBI to act as lender of last resort for a bank (or banks), the authorities could request a waiver for non-observance of this performance criterion.

the proper functioning of the foreign exchange market and avoid the emergence of a parallel market rate, and will constitute a performance criterion under the SBA. The program also includes a floor on NIR (performance criterion), derived from the above projection, less a margin rising from $1 billion to $3.0 billion over the program period. The large margin is designed to permit the CBI to be able to honor its commitment to sell dollars as needed to defend the exchange rate should the rate come under pressure again. Net sales of dollars by the CBI should serve to immediately tighten monetary conditions and rapidly correct any monetary disequilibrium that might have led to this pressure. Should such pressure persist, however, the authorities have committed to tighten monetary policy, including by raising interest rates on dinar deposit facilities. Staff noted that inflation continues to be quite high and that interest rates are still negative in real terms, and that the CBI should be prepared to raise interest rates as needed.

D. Institutional and Structural Reform

31. **The authorities recognize the importance of enhancing the effectiveness and transparency of budgetary management.** They have agreed to an agenda, with technical assistance from Fund and World Bank staff, incorporating: (i) the continuation in 2006 of the existing manual system for financial reporting to avoid disruption and changes in existing systems and procedures; (ii) the adoption of fully detailed budget classification and chart of accounts in line with the IMF's Government Financial Statistics Manual (*GFS*M) 2001, within a cash accounting framework by end-June 2006 (structural performance criterion), and initiation of an extensive training program to ensure successful implementation of the new classification for the 2007 budget;[16] (iii) the completion by end-March 2006 of an assessment of the FreeBalance software installed by USAID contractors, and by end-September 2006 a report on a plan to implement any changes necessitated by the assessment; (iv) the preparation of monthly government cash-flow projections by the recently established cash-flow unit; (v) the adoption of implementing regulations for the financial management law in the area of budget preparation by end-March 2006; (vi) the initiation of a training program to strengthen external audit; (vii) the review by end-June 2006 of existing procurement rules to bring them in line with international standards; (viii) the establishment by June 2006 of an audit oversight committee, to become effective on or before December 31, 2006, including the participation of independent international audit experts, to continue the work of the International Advisory and Monitoring Board upon its dissolution in overseeing and making public audits of the Development Fund for Iraq and oil export sales (structural benchmark);[17] and (ix) completion of a census of all public service employees (including military) by June 30, 2006 (structural benchmark).

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

[17] The continued operation of the DFI, and the mandate of the IAMB, was extended to end-2006, subject to review in June 2006 by the Iraqi government, under U.N. Security Council Resolution 1637, November 9, 2005.

32. **The authorities see the need to make progress in reorganizing, and improving the governance of the oil sector.** They intend to: (i) implement, with US technical assistance, a metering system for oil production; (ii) restructure oil sector operations into fully commercialized enterprises, with regulatory oversight by the Ministry of Oil; and (iii) draft a new petroleum law in line with the new constitution and international best practices, thereby defining the fiscal regime for oil and establishing the contractual framework for private investment in the sector. Progress in the drafting of this law will be discussed with staff in the program reviews.

33. **The CBI has undertaken to ensure that the Ernst and Young audit will be at an advanced stage by the time of Executive Board consideration of the SBA.** This will constitute a prior action for the SBA. Specifically, Ernst and Young will have completed (i) an assessment of the audit of the CBI 2004 accounts conducted by the Iraqi Supreme Board of Audit, (ii) a special audit of the external reserve position of the CBI (including of reserve composition and location) as of end-June, 2005, and will have (iii) established a timetable for the remaining work, including the audit of the CBI's 2005 accounts.

34. **The CBI is broadening its set of monetary policy instruments to facilitate the conduct of monetary policy.** The CBI intends ultimately to be able to influence monetary conditions by means of open market operations. Towards this end, and to facilitate the formation of a secondary market for treasury bills, the authorities intend to implement a securities depository, clearing and settlement system, supported by the relevant regulatory framework. The authorities also plan to negotiate a restructuring of the outstanding CBI claims on the government (estimated approximately at ID 5.1 trillion) so as to leave the CBI with enough marketable instruments (treasury bills) to be able to conduct open market operations.

35. **The program includes a commitment to install a modern payments system.** A functioning payments system will be crucial for enhancing financial sector operations, improving government financial management, and facilitating fiscal reforms such as the monetization of the in-kind social safety net. In line with donor assistance, the authorities have established a timetable to: (i) implement payment system regulations by end-June 2006 (structural benchmark); (ii) commence operations of the Real Time Gross Settlement system by end-August 2006 (structural benchmark); and (iii) commence operation of the Automated Clearing House by November 30, 2006 (structural benchmark).

36. **The banking system in Iraq is largely inert.** The authorities aim to work out a preliminary strategy for the reform and restructuring of the two main state-owned banks (Rasheed and Rafidain), based on a report to be submitted by foreign advisors in December 2005. A comprehensive financial and operational audit of these two banks (possibly by end-2006) will also feed into the development of a full-fledged restructuring strategy. Some of the other smaller banks could be considered for joint-venture operations, or for the development of Islamic banking in Iraq. Eight foreign banks have been granted licenses to operate in Iraq. The government hopes that some or all of these banks will begin operation during 2006, as security conditions permit. The CBI is meanwhile in the process of adopting modern prudential banking regulations and supervisory frameworks, in line with international standards.

37. **The authorities are seeking a comprehensive and orderly restructuring of Iraq's external debt.** Negotiations with Paris Club creditors should result in a large number of bilateral agreements being completed soon. However, negotiations with non-Paris Club creditors are likely to spill over to next year. As regards private commercial creditors, as long as arrears to these creditors are outstanding, the Iraqi authorities will continue to proceed with good faith efforts to reach collaborative restructuring agreements consistent with eliminating financing gaps and achieving medium-term sustainability. They will take all necessary steps to maintain a constructive dialogue with all Iraq's private creditors, in a manner consistent with the Fund's lending into arrears policy. This dialogue should enable the Iraqi authorities to explain the consistency of the debt restructuring with the government's macroeconomic and social policies, as well as provide an opportunity to respond to the concerns of private creditors. Progress toward reaching agreement with Iraq's private creditors will be reviewed in the context of (quarterly) financing assurances reviews.[18]

38. **The authorities intend to maintain an open trade and exchange system.** Under the program the government will avoid imposing restrictions on payments and transfers for international transactions, or introducing new or intensifying trade restrictions for balance of payments purposes, or resorting to multiple currency practices, or restricting moderate amortizations of external loans. A review of existing regulations is being undertaken by staff of the IMF. Iraq has not yet accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

39. **The program aims to further enhance the accuracy and timeliness of macroeconomic statistics.** A preliminary depository corporations survey (monetary survey) for 2005 (through August) has just been compiled, and this will be published on a monthly basis hereon (Table 8). Iraq will participate in the GDDS. The authorities also aim to complete a comprehensive household income and expenditure survey by the end of 2006.

IV. Medium Term Sustainability and Capacity to Repay the Fund

40. **The medium term outlook for Iraq appears broadly favorable, but subject to a substantial element of risk** (Tables 4, 5 and 9). Oil production and oil exports are projected to expand to 3.6 mbpd and 2.9 mbpd by 2010, respectively, but this would depend upon Iraq's ability to undertake sufficient investment in the sector. This in turn assumes some normalization of security conditions, as well as sufficient resources (chiefly oil revenues) to finance the investment program over the medium term. Oil prices in the medium term scenario are projected to be in line with WEO forecasts, allowing for some downward risk (one standard deviation of historic price variations), and adjusting for quality differentials in the price of Iraqi oil. The scenario assumes continued growth in private sector non-oil activity.

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[18] A debt management unit has been established in the Ministry of Finance, and should be operational by early 2006. The legal basis for government borrowing is defined in the Financial Management Law and Public Debt Law adopted in June 2004.

41. **Fiscal restraint will be required throughout the period to generate this favorable scenario.** The government will need to maintain control over the wage and pension bill, while steadily reducing government subsidies (including through the reform of the PDS), and increasing the tax effort in line with the growing share of private sector activity in the economy. This should enable the government to spend ID 33.8 trillion (roughly $21 billion) to expand its oil production over 2006-10, ID 59 trillion (about $36.8 billion) on (non-defense) reconstruction, and yet at the same time also shoulder an increasing responsibility for security and defense. If these projections hold up, the government should be running a primary fiscal surplus by 2009.

42. **Iraq received substantial debt forgiveness from the first stage of debt reduction (30 percent) in 2004, but without additional debt reduction, Iraq's external debt would remain unsustainable**. With the approval of the SBA, the second stage of debt reduction agreed by Paris Club creditors (including Korea) would provide Iraq with a further 30 percent debt reduction (in terms of the original stock outstanding at end-2004), reducing the stock of debt to about $51 billion (154 percent of GDP) at end-2005, assuming parri passu treatment for all of Iraq's other creditors too. While the stock of debt would then remain broadly stable in this scenario, and would indeed decline in relation to GDP, it would still be sufficiently high to render Iraq extremely vulnerable to shocks and adverse developments (see Appendix V, Table 1). This points to the need for the third and final stage of debt reduction (20 percent of the initial end-2004 stock) to restore Iraq's external debt to a sustainable level. This third and final stage would (under the Paris Club agreement) depend upon Iraq completing three successful years of IMF upper credit tranche arrangements.

43. **Although Iraq intends to treat the arrangement as precautionary, it should have the capacity to repay the Fund if, in the event, it were to make any purchases under the SBA.** The balance of payments is projected to be in surplus throughout the scenario, and CBI reserves steadily increase. The government's primary balance should also move into surplus toward the end of the scenario, with the government projected to begin accumulating assets during this period. If all purchases were to be made, debt service to the Fund would reach only 1 percent of exports of goods and services during 2009–10 (Table 10). As noted in Appendix V, however, Iraq's medium term prospects are vulnerable to shocks (absent the final debt reduction under the Paris Club agreement), especially if oil production does not expand as projected, or oil export prices decline substantially.

V. The Proposed Arrangement

44. **The arrangement is designed to cover 15 months, starting in December 2005 and running through late-March 2007.** Access is proposed at 40 percent of quota, or SDR 475.4 million. Implementation of the program will be monitored through prior actions, quantitative and structural performance criteria, and benchmarks, as specified in the MEFP and in Tables 11–13. In addition, the program will be monitored through (five) quarterly reviews, to be combined with financing assurances reviews.[19] Quantitative performance criteria for end-September and end-December 2006 will be set at the time of the second review. There will be six potential purchases during the arrangement period (Table 14).

45. **The use of Fund resources requires the completion of a safeguards assessment of the CBI.** Current conditions preclude an on-site assessment, but the ongoing off-site assessment (which will rely on the external audit of the CBI being conducted by Ernst and Young, and also on an examination of the CBI's legal and financial reporting framework), should be in process by the time of the first review.

VI. Staff Appraisal

46. **The authorities have had some success in implementing policies under the program supported by EPCA, despite serious security problems.** Although economic growth slowed sharply in 2005, this followed a near 50 percent rebound in GDP in 2004. The exchange rate has been stable and while inflation has been higher than expected, this was mainly due to supply shortages of certain commodities (partly reflecting the continuing violence). The fiscal position has been improving: while the deficit for 2004 was higher than envisaged, the overall fiscal position for 2005 is projected to be much more comfortable than envisaged under the EPCA program (mainly due to higher crude oil prices). The implementation of the structural benchmarks in the EPCA program was slower than scheduled, mainly because of the difficult security situation.

47. **The proposed program will provide the incoming government with a framework for economic policies and reforms during 2006.** Just as the transitional government formed in May 2005 continued the reform program initiated by the interim government that preceded it, so we expect that the new incoming government (following the elections in December) will honor the commitments made by the transitional government in their MEFP. Building on the progress made in the preceding EPCA-supported program, the new SBA-supported program for 2006 will pursue the objective of macroeconomic and financial stability that would be key to sustaining economic growth over the medium term, while improving governance and advancing Iraq's transition to a market economy.

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[19] Each review will focus on progress in adjusting domestic petroleum product prices, in addition to overall program implementation. Furthermore, the second review will assess the completion of Ernst and Young's audit of the CBI, and implementation of the law liberalizing private imports of premium gasoline, while the third review will assess progress in drafting a petroleum law.

48. **The program is nonetheless subject to a significant degree of risk.** Although the medium term outlook is favorable, Iraq has enormous reconstruction needs and faces considerable risks in program implementation, including a continuing very dangerous security situation, political uncertainties associated with the implementation of the new constitution, a possible decline in export prices, and a lower than projected expansion in oil production.

49. **The authorities' decision to prioritize resources toward regenerating the oil sector and to move away from general subsidies toward providing better social and public services is welcome.** In that regard, the staff strongly supports the proposed price increases on the domestic sales of petroleum products over the medium term, with a view to substantially reducing subsidies on these products, reducing price distortions, smuggling, and corruption, and providing support to the budget. Staff also support the authorities' intention to reform the public distribution system (PDS), while stressing the need to protect the poor. The government will need to ensure that the projected expenditures on wages and pensions are not exceeded, and the completion of a census of all public sector workers will help in this regard.

50. **The staff underscore the need to press ahead with structural fiscal reforms.** These include, most urgently, measures to enhance the efficiency and transparency of public financial management, the move forward toward the commercialization of oil-related state enterprises, and the drafting of a new petroleum law.

51. **The current framework for monetary policy has worked well, and there is no immediate need for a change from the de facto peg to the dollar.** The staff stresses the importance of fully satisfying the demand for dollars at the CBI's daily auction, and of the CBI being ready to tighten monetary conditions if necessary. The authorities will consult with staff prior to making any fundamental change to the current monetary policy framework.

52. **The authorities' focus on strengthening the financial system is important.** The establishment of a modern payments system is critical to enhancing financial sector operations, improving government financial management, and facilitating fiscal reforms such as the monetization of the in-kind social safety net. The staff therefore views the timely implementation of the payment systems regulation, the RTGS, and the ACH as paramount. The staff also welcomes the proposal to develop a restructuring plan for the state-owned banks, in view of the need to improve financial intermediation in Iraq. The Ernst and Young audit of the CBI will provide the authorities with a valuable assessment of the state of the CBI's balance sheet. The staff has advised the authorities to delay finalization of the agreement between the CBI and the Ministry of Finance on restructuring CBI claims on the government until this audit has been completed.

53. **The staff recommends the authorities' request for a Stand-by Arrangement in the amount of SDR 475.4 million for a period of 15 months.** While the implementation of the program is subject to higher than usual risk because of the security situation, the authorities remain committed to the reconstruction of Iraq and its transition to a market economy through fiscal discipline, a stable exchange rate, a sound financial system, and improved governance. The staff believes their program merits the support of the Fund.

Table 1. Iraq: Selected Economic and Financial Indicators, 2004–10

	2004		2005		2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev.Proj.	Revised Projections				
Economic growth and prices									
Nominal GDP (in millions of US$)	21,132	25,724	24,295	33,182	41,741	52,750	61,468	68,571	74,293
Nominal GDP per capita (in US$)	780	949	870	1,189	1,452	1,783	2,021	2,195	2,318
Nominal GDP (in billions of ID)	31,698	37,556	36,442	48,611	62,611	79,126	97,530	114,021	127,046
Real GDP (percentage change)	51.7	46.5	16.7	2.6	10.4	15.5	13.1	9.6	7.1
Oil production (in mbpd)	2.1	2.0	2.4	2.0	2.3	2.7	3.1	3.4	3.6
Iraq oil export prices (US$/bbl)	30	32	26	43	47	46	46	45	45
Differential between Iraq export prices and WEO prices (US$/bbl) 1/	7	6	11	11	11	9	8	8	8
Domestic consumer price inflation (year-on-year)	7	32	15	20	15	10	8	7	5
GDP deflator	15	4	-2	26	17	9	9	7	4
Libor (in percent)	1.6	1.6	4.3	4.3	5.5	5.5	5.5	5.5	5.5
Exchange rate (ID/US$)	1,500	1,460	1,500	...	...	...	...	...	...
Population growth	3.0	3.0	3.0	3.0	3.0	2.9	2.8	2.7	2.6
National accounts				(In percent of GDP)					
Gross domestic investment	34.9	26.5	44.8	29.1	29.0	27.0	27.6	28.5	27.5
Of which: public	26.4	22.3	37.4	25.6	26.6	24.2	23.6	23.3	21.9
Gross domestic consumption	91.2	97.1	90.7	95.4	87.1	73.3	70.1	68.7	69.4
Of which: public	50.5	56.3	45.2	59.6	57.2	36.7	36.0	36.0	35.7
Gross national savings	17.0	-10.2	26.6	14.7	26.1	23.2	24.4	25.3	24.9
Of which: public	-16.4	-39.1	9.7	14.6	17.6	23.3	22.4	22.3	21.4
Public finance				(In percent of GDP, unless otherwise indicated)					
Government revenue and grants	90.6	80.0	97.7	93.6	96.3	80.3	78.2	78.0	76.8
Government oil revenue	76.7	69.6	74.6	67.8	72.9	74.2	75.1	75.2	73.8
Government non-oil revenue	1.4	1.2	2.1	2.6	3.0	3.2	3.0	2.8	3.0
Grants	9.7	9.2	17.5	23.2	20.4	2.8	0.1	0.1	0.0
Expenditure	133.5	120.6	125.4	104.5	105.3	81.2	79.3	79.1	77.3
Recurrent expenditure	107.1	98.3	88.0	78.9	76.2	55.0	54.1	54.4	54.2
Capital expenditure	26.4	22.3	37.4	25.6	25.3	23.3	22.8	22.6	21.3
Contingency	0.0	0.0	0.0	0.0	3.8	2.9	2.4	2.0	1.8
Overall fiscal balance (including grants)	-42.9	-40.5	-27.7	-10.9	-9.0	-0.9	-1.1	-1.0	-0.5
Gross borrowing/use of external assets	45.3	43.1	27.7	11.9	9.3	0.9	1.4	1.6	1.5
Amortization	2.4	1.8	0.0	0.6	0.3	0.0	0.0	0.0	0.0
Domestic financing	0.0	-1.4	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Residual or financing gap [+]/surplus[-]	0.0	0.7	0.0	0.0	0.0	0.0	-0.3	-0.5	-1.0
Memorandum items:									
Tax revenue/non-oil GDP (In percent)	3.0	1.3	3.7	2.4	4.2	5.6	5.5	5.1	5.1
Primary fiscal balance	-41.9	-39.6	-27.3	-10.8	-8.2	-0.3	-0.2	0.5	1.9
Non-oil primary fiscal balance	-103.7	-88.4	-80.5	-57.1	-62.8	-64.1	-65.5	-64.2	-61.7
Monetary indicators				(In percent)					
Gross central bank foreign exchange assets/base money	68.0	94.4	75.0	98.8	99.2	...	...	...	...
Claims on banks/base money	6.5	0.1	5.7	0.1	0.1	...	...	...	...
Base money (annual growth)	117.0	116.9	32.8	12.9	20.6	...	...	...	...
Currency issued (annual growth)	118.4	74.9	32.8	20.7	24.2	...	...	...	...
Balance of payments				(In millions of U.S. dollars, unless otherwise indicated)					
Current account 2/	-3,768	-9,460	-4,428	-4,763	-1,133	-1,916	-2,002	-2,204	-1,941
Trade balance	-5,137	-1,808	-7,878	-1,636	476	3,710	5,338	6,238	6,778
Exports of goods	16,543	17,782	17,597	22,781	28,745	36,180	42,304	46,430	48,566
Imports of goods	-21,680	-19,590	-25,475	-24,416	-28,269	-32,470	-36,966	-40,192	-41,788
Income and services 2/	-363	-9,656	-747	-10,218	-9,330	-6,135	-6,412	-7,493	-7,861
Transfers	1,731	2,004	4,197	7,090	7,721	510	-928	-949	-857
Financial account	8,973	10,840	7,026	6,172	2,821	3,407	3,766	3,913	3,306
Direct investment	200	200	300	300	300	738	1,000	1,450	1,758
Gross borrowing/use of external assets	9,565	10,640	6,726	7,704	5,976	2,669	2,766	2,463	1,548
Amortization	0	0	0	-200	-136	0	0	0	0
Other flows	-792	-195	0	-1,632	-3,318	0	0	0	0
Errors and omissions	0	178	0	0	0	0	0	0	0
Overall external balance 2/	5,204	1,559	2,598	1,409	1,688	1,491	1,764	1,709	1,365
Financing 2/	-5,204	-1,559	-2,598	-1,409	-1,688	-1,491	-1,764	-1,709	-1,365
Central bank reserves (increase -)	-4,624	-6,768	-2,598	-1,409	-1,688	-1,491	-1,764	-1,709	-1,365
Change in arrears	-580	-34,959	0	-27,987	-1,195	0	0	0	0
Accrued but deferred interest	...	5,394	...	0	0	0	0	0	0
Debt forgiveness	...	34,774	...	27,987	1,195	0	0	0	0
Memorandum items:									
Trade balance (in percent of GDP)	-24.3	-7.0	-32.4	-4.9	1.1	7.0	8.7	9.1	9.1
Current account (in percent of GDP)	-17.8	-36.8	-18.2	-14.4	-2.7	-3.6	-3.3	-3.2	-2.6
Reserves (in US$ million)	5,691	7,902	8,353	9,311	11,013	12,505	14,268	15,978	17,343
In months of goods and services	2.6	3.2	3.7	3.1	3.6	3.7	3.8	4.1	4.1
Debt Stock (in US$ billion)	124.3	79.4	131.5	51.2	52.2	54.9	57.6	60.2	62.5
Debt service in percent of exports 3/	0.0	0.0	0.1	0.9	1.1	0.5	1.6	2.4	3.4

Sources: Iraqi authorities and staff estimates and projections.

1/ In the EPCA, differential to WEO oil export prices reflect assumed budget prices.

2/ In the EPCA columns, data for income net, current account, and the overall balance do not include interest accrued and deferred in 2004 and 2005. Consistent with the BOP table in this report, corresponding data for the 2005 outcome include interest accrued and deferred in 2004 and 2005. Consequently, the EPCA data are not directly comparable.

3/ Debt service paid (not accrued), excluding repayment of arrears.

Table 2. Iraq: Quantitative Indicators, 2004–05, Under Emergency Post-Conflict Assistance Policy
(In billions of Iraqi dinars, unless otherwise indicated)

	6/30/2004	12/31/2004		3/31/2005		6/30/2005		9/30/2005	
	Stock	Ind. Target	Actual	Ind. Target	Actual	Ind. Target	Actual	Ind. Target	Actual (Estimated)
Currency issued (range) 1/	7,003	9,000–11,000	8,021	9,700–11,800	9,463	10,400–12,700	9,017	11,100–13,600	...
Net international reserves of the central bank (floor) (in millions of U.S. dollars) 1/	3,193	4,000	7,358 /2 (6,061) /3	4,250	7,692 /2 (6,708) /3	4,500	8,312 /2 (7,183) /3	4,750	8,500 /2 (...)
Lending to the government by the CBI (ceiling) 1/	3,986	3,986	4,165 /4	3,100	4,349 /5	3,100	4,349	3,100	...
Government primary fiscal deficit (in millions of US$; ceiling; deficit [+]/surplus[-]) 6/	...	8,850	10,175	1,800	-904	3,500	-1,657	4,750	...
New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 6/	0	0	0	500	0	750	0	1,000	...
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 6/ 7/	0	0	0	0	0	0	0	0	...

Sources: Iraqi authorities and staff estimates and projections.

1/ Stocks at end-of-test period.
2/ Net foreign assets. See Appendix I (technical Memorandum of Understanding) for definition.
3/ Net reserve assets, defined as net foreign assets less CBI foreign currency liabilities to resident banks (comprising US dollar required reserve deposits and other US dollar deposits).
4/ Target exceeded due to an overdraft to cover a timing discrepancy in late-December 2004. Amount overdrawn was repaid in early January 2005.
5/ Reflects interest due on CBI claims on the Ministry of Finance (MoF) for 2004 and capitalized in January 2005, pending the restructuring agreement between the CBI and the MoF.
6/ Flows from January 1, 2004, for test date of end-2004; and cumulative flows from January 1, 2005 for test dates in 2005.
7/ This will be monitored on a continuous basis.

Table 3. Iraq: Structural Benchmarks and Key Policy Measures
Under Emergency Post Conflict Assistance

Policy Actions	Target Date	Status
I. Structural Indicative Benchmarks		
Development of a monetary survey.	Mar-05	A draft depository corporations (monetary) survey through August 2005 has been compiled, consistent with the Monetary and Financial Statistics Manual. Improvements to the call report form are ongoing and expected to be completed by end-December 2005.
Establishment of an automatic payroll system for all government employees.	Jun-05	Was not met.
Development of monthly fiscal accounts for the central government and the oil sector.	Dec-04	Monthly fiscal accounts are now reported with a lag of 9–10 weeks.
Issuance of regulations regarding bank licensing and standard prudential ratios.	Dec-04	Ongoing. Authorities expect to have them ready by end-2005/early 2006.
Enactment of payments systems law.	Dec-04	Draft regulations of an article in the CBI law that will serve this purpose has been prepared with the help of MFD and is pending approval.
Adoption of a plan to overhaul the tax and customs administration.	Jun-05	Considerable progress has been achieved towards improving custom collections through negotiating agreements with neighboring countries.
II. Key Policy Measures		
Increase of domestic prices of oil refined products.	Dec-04	Official price of regular gasoline in Baghdad was unified with the official price of premium gasoline from ID 20 per liter to ID 50 per liter on September 18, 2005. Premium gasoline is sold at a number of mobile gas stations in Baghdad at ID 100 per liter.
External audit of Central Bank of Iraq (CBI).	Jun-05	Iraqi Supreme Board of Audit (SBA) conducted audit of 2004 accounts. The audit firm Ernst and Young has been selected to review the SBA 2004 audited accounts.
Adopting implementing regulations for the Financial Management Law.	Dec-04	Regulations in the area of budget execution were adopted on September 1, 2005.

Table 4. Iraq: Fiscal and Oil Sector Accounts, 2004–10
(In billions of ID; unless otherwise indicated)

	2004		2005		2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev. Proj.	Revised projections				
Revenues and Grants	28,730	30,056	35,618	45,490	60,316	63,501	76,224	88,965	97,614
Revenues	25,668	26,595	29,238	34,211	47,529	61,278	76,148	88,903	97,560
Crude oil export revenues	24,300	25,326	25,670	31,919	42,109	53,176	65,877	76,031	81,719
Revenues of oil-related state owned enterprises	900	799	2,790	1,020	3,513	5,573	7,362	9,681	12,091
Of which: revenues from reduction in price subsidy on petroleum products transferred to the budget	0	0	1,500	0	1,513	2,816	4,066	5,773	7,852
Tax revenues	254	160	393	372	821	1,303	1,524	1,651	1,890
Direct taxes	8	78	39	119	222	271	331	412	502
Indirect taxes 1/	246	81	354	252	599	1,032	1,193	1,239	1,388
Non-tax revenues	215	310	386	900	1,087	1,226	1,384	1,541	1,860
Grants	3,062	3,461	6,380	11,279	12,787	2,223	76	62	55
Expenditures	42,324	45,281	45,707	50,797	65,935	64,213	77,326	90,145	98,263
Operating expenditures	33,947	36,921	32,076	38,368	47,698	43,497	52,794	62,049	68,880
Salary and pension 2/	5,040	4,532	5,600	8,591	12,899	14,156	17,061	19,647	21,412
Goods and Services (non-oil sector) 3/	5,030	11,017	4,028	13,600	15,265	10,589	13,182	16,012	18,139
Budgeted goods and services 4/	3,602	6,985	2,600	4,094	6,802	9,651	13,182	16,012	18,139
Financed by oil-for-food program (OFFP) (other than social safety net)	1,428	1,623	1,428	1,429	0	0	0	0	0
Overhead costs for donors' financed projects 5/	0	864	0	2,867	3,539	392	0	0	0
Other goods and services financed by donors 6/	0	1,546	0	5,210	4,925	546	0	0	0
Goods and Services (oil sector)	5,940	5,612	6,840	6,788	6,090	2,757	3,296	3,908	4,239
Oil derivative imports	3,150	4,823	3,600	5,768	4,090	0	0	0	0
Operating expenditures of oil-related state-owned enterprises (including refineries)	2,790	790	3,240	1,020	2,000	2,757	3,296	3,908	4,239
Transfers	16,403	14,085	14,175	7,724	10,858	12,827	15,013	16,916	17,953
Social safety net (excluding OFFP)	3,908	3,829	6,000	4,500	5,000	5,660	6,472	7,254	7,659
Social safety net (financed by OFFP)	2,177	2,126	0	0	0	0	0	0	0
Transfers to SOEs	1,530	1,237	1,530	1,160	1,260	1,260	1,260	1,150	1,000
Other transfers 7/	8,789	6,893	6,645	2,064	4,597	5,907	7,281	8,512	9,294
Interest payments	320	369	150	69	481	510	947	1,765	3,051
Domestic interest payments	320	369	150	69	244	244	244	244	244
External interest payments	0	0	0	0	237	266	703	1,521	2,807
War reparations 8/	1,215	1,304	1,284	1,596	2,105	2,659	3,294	3,802	4,086
Investment expenditures	8,378	8,361	13,631	12,430	15,862	18,416	22,232	25,795	27,083
Non-oil investment expenditures	6,488	6,172	9,131	8,800	10,530	12,965	16,020	17,761	18,315
Domestic financed reconstruction expenditure 9/	3,869	4,087	2,051	4,738	6,050	10,996	14,992	16,317	16,796
OFFP financed reconstruction expenditure	791	1,084	1,070	1,070	0	0	0	0	0
Grant financed reconstruction expenditure	1,829	1,002	5,480	2,992	4,068	1,256	76	62	55
Loan financed reconstruction expenditure	0	0	531	0	413	713	952	1,382	1,464
Oil investment expenditures (including on refineries)	1,890	2,188	4,500	3,630	5,331	5,451	6,212	8,034	8,768
Of which: advance payments for letters of credit to be executed in future years 10/	0	0	0	0	1,871	0	0	0	0
Contingency	0	0	0	0	2,375	2,300	2,300	2,300	2,300
Balance (including grants)	-13,595	-15,225	-10,089	-5,308	-5,619	-712	-1,103	-1,180	-649
Balance (excluding grants)	-16,656	-18,687	-16,469	-16,587	-18,406	-2,935	-1,179	-1,242	-703
External financing	13,598	15,498	10,089	5,484	5,619	713	1,349	1,798	1,892
Assets held abroad	8,915	10,177	6,309	2,528	5,411	0	0	0	0
Project financing	0	0	531	0	413	713	952	1,382	1,464
Other financing 11/	5,433	5,992	3,249	3,249	0	0	397	416	428
Amortization	750	670	0	293	205	0	0	0	0
Domestic financing	0	-533	0	-176	0	0	0	0	0
Bank lending	0	-333	0	0	0	0	0	0	0
Treasury bills	0	-200	0	-176	0	0	0	0	0
Residual or Financing gap[+]/surplus [-]	0	260	0	0	0	0	-246	-618	-1,243
Memorandum items:									
Security-related expenditure	...	...	...	3,360	8,018	11,246	12,654	13,820	14,593
Primary fiscal balance	-13,275	-14,856	-9,939	-5,239	-5,138	-203	-155	585	2,402
Non-oil primary fiscal balance	-32,866	-33,181	-29,333	-27,759	-39,338	-50,743	-63,886	-73,185	-78,401
Tax revenue in percent of non-oil GDP	3.0	1.3	3.7	2.4	4.2	5.6	5.5	5.1	5.1
Nominal GDP	31,698	37,556	36,443	48,611	62,611	79,126	97,530	114,021	127,046

Sources: Iraqi authorities, and staff estimates and projections.

1/ Projections for 2006-2010 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.
2/ EPCA (2004 and 2005) data, and estimates for 2004, do not include wages and salaries for the Kurdish area, which are included in other transfers. Projections for 2006 include a one-off compensation for military personnel who retired in 2003 (of ID1,484 billion).
3/ Include goods and services financed by donors, including overhead costs for reconstruction projects which are believed to be spent mostly outside of Iraq.
4/ Includes spending by the U.S. from seized and vested assets in 2004.
5/ Overhead costs associated with donor-financed reconstruction are believed to be spent mostly outside of Iraq. No firm figures were received from donors to date.
6/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.
7/ 2004 and 2005 EPCA data and estimates for 2004 include wages and goods for the Kurdish area.
8/ Calculated as 5 percent of oil exports as per UN Security Council Resolution 1483 to finance war reparations to Kuwait.
9/ Projections for 2005 include ID1.4 trillion reportedly committed by the Coalition Provisional Authorities, to be paid by the U.S. out of a special subaccount of the DFI, and unrecorded in the budget, projects in the north previously classified as transfers, and ID1.9 trillion in maintenance expenditure previously classified as goods.
10/ The amount in 2006 relates to transfers to banks for the procurement of capital goods to be received in future years.
11/ Includes financing from letters of credit previously issued under the UN oil-for-food program.

Table 5. Iraq: Fiscal and Oil Sector Accounts, 2004–10

(In percent of GDP)

	2004		2005		2006	2007	2008	2009	2010
	EPCA	Est.	EPCA	Rev. Proj.	Revised projections				
Revenues and Grants	90.6	80.0	97.7	93.6	96.3	80.3	78.2	78.0	76.8
Revenues	81.0	70.8	80.2	70.4	75.9	77.4	78.1	78.0	76.8
Crude oil export revenues	76.7	67.4	70.4	65.7	67.3	67.2	67.5	66.7	64.3
Revenues of oil-related state owned enterprises	2.8	2.1	7.7	2.1	5.6	7.0	7.5	8.5	9.5
Of which: revenues from reduction in price subsidy on petroleum products transferred to the budget	0.0	0.0	4.1	0.0	2.4	3.6	4.2	5.1	6.2
Tax revenues	0.8	0.4	1.1	0.8	1.3	1.6	1.6	1.4	1.5
Direct taxes	0.0	0.2	0.1	0.2	0.4	0.3	0.3	0.4	0.4
Indirect taxes 1/	0.8	0.2	1.0	0.5	1.0	1.3	1.2	1.1	1.1
Non-tax revenues	0.7	0.8	1.1	1.9	1.7	1.5	1.4	1.4	1.5
Grants	9.7	9.2	17.5	23.2	20.4	2.8	0.1	0.1	0.0
Expenditures	133.5	120.6	125.4	104.5	105.3	81.2	79.3	79.1	77.3
Operating expenditures	107.1	98.3	88.0	78.9	76.2	55.0	54.1	54.4	54.2
Salary and pension 2/	15.9	12.1	15.4	17.7	20.6	17.9	17.5	17.2	16.9
Goods and services (non-oil sector) 3/	15.9	29.3	11.1	28.0	24.4	13.4	13.5	14.0	14.3
Budgeted goods and services 4/	11.4	18.6	7.1	8.4	10.9	12.2	13.5	14.0	14.3
Financed by oil-for-food program (OFFP) (other than social safety net)	4.5	4.3	3.9	2.9	0.0	0.0	0.0	0.0	0.0
Overhead costs for donors' financed projects 5/	0.0	2.3	0.0	5.9	5.7	0.5	0.0	0.0	0.0
Other goods and services financed by donors 6/	0.0	4.1	0.0	10.7	7.9	0.7	0.0	0.0	0.0
Security cost related to implementation of oil capital projects	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Goods and services (oil sector)	18.7	14.9	18.8	14.0	9.7	3.5	3.4	3.4	3.3
Oil derivative imports	9.9	12.8	9.9	11.9	6.5	0.0	0.0	0.0	0.0
Operating expenditures of oil-related state-owned enterprises (including refineries)	8.8	2.1	8.9	2.1	3.2	3.5	3.4	3.4	3.3
Transfers	51.7	37.5	38.9	15.9	17.3	16.2	15.4	14.8	14.1
Social safety net (excl. OFFP)	12.3	10.2	16.5	9.3	8.0	7.2	6.6	6.4	6.0
Social safety net (financed by OFFP)	6.9	5.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers to SOEs	4.8	3.3	4.2	2.4	2.0	1.6	1.3	1.0	0.8
Other transfers 7/	27.7	18.4	18.2	4.2	7.3	7.5	7.5	7.5	7.3
Interest payments	1.0	1.0	0.4	0.1	0.8	0.6	1.0	1.5	2.4
Domestic interest payments	1.0	1.0	0.4	0.1	0.4	0.3	0.3	0.2	0.2
External interest payments	0.0	0.0	0.0	0.0	0.4	0.3	0.7	1.3	2.2
War reparations 8/	3.8	3.5	3.5	3.3	3.4	3.4	3.4	3.3	3.2
Investment expenditures	26.4	22.3	37.4	25.6	25.3	23.3	22.8	22.6	21.3
Non-oil investment expenditures	20.5	16.4	25.1	18.1	16.8	16.4	16.4	15.6	14.4
Domestic financed reconstruction expenditure 9/	12.2	10.9	5.6	9.7	9.7	13.9	15.4	14.3	13.2
OFFP financed reconstruction expenditure	2.5	2.9	2.9	2.2	0.0	0.0	0.0	0.0	0.0
Grant financed reconstruction expenditure	5.8	2.7	15.0	6.2	6.5	1.6	0.1	0.1	0.0
Loan financed reconstruction expenditure	0.0	0.0	1.5	0.0	0.7	0.9	1.0	1.2	1.2
Oil investment expenditures (including on refineries)	6.0	5.8	12.3	7.5	8.5	6.9	6.4	7.0	6.9
Of which: advance payments for letters of credit to be executed in future years 10/	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0
Contingency	0.0	0.0	0.0	0.0	3.8	2.9	2.4	2.0	1.8
Balance (including grants)	-42.9	-40.5	-27.7	-10.9	-9.0	-0.9	-1.1	-1.0	-0.5
Balance (excluding grants)	-52.5	-49.8	-45.2	-34.1	-29.4	-3.7	-1.2	-1.1	-0.6
External financing	42.9	41.3	27.7	11.3	9.0	0.9	1.4	1.6	1.5
Assets held abroad	28.1	27.1	17.3	5.2	8.6	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	1.5	0.0	0.7	0.9	1.0	1.2	1.2
Other financing 11/	17.1	16.0	8.9	6.7	0.0	0.0	0.4	0.4	0.3
Amortization	2.4	1.8	0.0	0.6	0.3	0.0	0.0	0.0	0.0
Domestic financing	0.0	-1.4	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Bank lending	0.0	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Treasury bills	0.0	-0.5	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Residual or financing gap[+]/surplus [-]	0.0	0.7	0.0	0.0	0.0	0.0	-0.3	-0.5	-1.0
Memorandum items:									
Security-related expenditure				6.9	12.8	14.2	13.0	12.1	11.5
Primary fiscal balance	-41.9	-39.6	-27.3	-10.8	-8.2	-0.3	-0.2	0.5	1.9
Non-oil primary fiscal balance	-103.7	-88.4	-80.5	-57.1	-62.8	-64.1	-65.5	-64.2	-61.7

Sources: Iraqi authorities and staff estimates and projections.

1/ Projections for 2006-2010 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.

2/ EPCA (2004 and 2005) data, and estimates for 2004, do not include wages and salaries for the Kurdish area, which are included in other transfers. Projections for 2006 include a one-off compensation for military personnel who retired in 2003 (of ID1,484 billion).

3/ Include goods and services financed by donors, including overhead costs for reconstruction projects which are believed to be spent mostly outside of Iraq.

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5/ Overhead costs associated with donor-financed reconstruction are believed to be spent mostly outside of Iraq. No firm figures were received from donors to date.

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7/ 2004 and 2005 EPCA data and estimates for 2004 include wages and goods for the Kurdish area.

8/ Calculated as 5 percent of oil exports as per UN Security Council Resolution 1483 to finance war reparations to Kuwait.

9/ Projections for 2005 include ID1.4 trillion reportedly committed by the Coalition Provisional Authorities, to be paid by the U.S. out of a special subaccount of the DFI, and unrecorded in the budget, projects in the north previously classified as transfers, and ID1.9 trillion in maintenance expenditure previously classified as goods.

10/ The amount in 2006 relates to transfers to banks for the procurement of capital goods to be received in future years.

11/ Includes financing from letters of credit previously issued under the UN oil-for-food program.

Table 6. Iraq: Oil Product Prices

	LPG 1/	Gasoline		Kerosene	Diesel
		Regular	Premium		
Official price, ID per liter/cylinder					
September 2005	250	20 2/	50	5	10
Proposed price increases:					
December 2005 (prior action) 3/	600	100	250	25	90
Average price for Gulf countries in US$ 4/	...	0.24	0.27	0.17	0.18

Sources: Iraqi authorities and MCD database.

1/ Priced at ID per 12 kg cylinder.
2/ ID 50 in Baghdad.
3/ Approved by cabinet decree.
4/ As of June 2005, average prices for Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Prices for regular gasoline in the Gulf are typically for octane levels of at least 87, whereas current octane for regular gasoline sold in Iraq is about 82, and it is of significantly lower quality.

Table 7. Iraq: Central Bank Survey, 2003–06
(In billions of Iraqi dinars, unless otherwise indicated)

	2003	2004		2005						2006
	Actual	Actual	EPCA	Actual			Latest Proj.	EPCA	Art. IV	Projection
	Dec.	Dec.		Mar.	Jun.	Aug	Dec.			
Net foreign exchange assets 1/	1,600	10,743	7,532	11,247	12,179	12,698	12,993	11,419	13,558	15,869
Foreign exchange assets	1,916	11,538	8,309	12,045	12,825	13,344	13,639	12,196	14,356	16,515
Gold 2/	114	115	94	117	118	120	119	94	117	119
Other	1,803	11,422	7,578	11,928	12,707	13,224	13,520	12,102	14,239	16,396
CBI vault + DFI sub-account	1,803	10,361	7,578	10,886	11,711	12,219	12,521	12,102	13,194	15,352
Fx claims on state banks	0	0	0	0	0	0	0	0	0	0
SDR Account	0	1,061	637	1,042	996	1,005	999	0	1,044	1,044
Foreign exchange liabilities	-316	-795	-777	-798	-646	-646	-646	-777	-798	-646
Of which : IMF liabilities	...	-637	637	-637	-637	-637	-637	...	-637	-637
Net domestic assets	4,038	1,485	4,703	1,675	953	379	811	4,833	207	777
Domestic assets	3,698	4,345	3,919	3,494	2,040	2,980	3,161	4,048	3,720	3,161
Net claims on general government	3,698	4,336	3,119	3,338	1,865	2,946	3,152	3,119	3,711	3,152
Holdings of treasury bills	2,874	2,589	2,562	2,528	2,528	2,528	2,528	4,019	2,460	2,528
Holdings of discounted treasury bills	206	709	0	707	707	707	707	0	673	707
Overdrafts	909	1,637	1,458	1,821	1,821	1,821	1,821	0	1,528	1,821
Domestic currency deposits	-15	-596	-300	-715	-1,689	-784	-596	-300	-450	-596
Foreign currency deposits	-276	-3	-600	-1,003	-1,501	-1,326	-1,307	-600	-500	-1,307
Claims on nonbank public institutions	0	0	0	0	0	0	0	0	0	0
Claims on commercial banks	0	8.7	800	155.6	174.9	33.2	8.7	929	8.7	8.7
Monetary policy instruments 3/	0	0	...	-1,639	-2,688	-3,106	-3,316	...	-2,053	-3,350
Other items net	339	-2,859	784	-180	1,601	506	966	784	-1,459	966
Reserve money	5,638	12,228	12,235	12,922	13,132	13,077	13,804	16,252	13,765	16,646
Currency outside banks	2,606	7,163	9,522	8,561	8,331	8,422	8,815	12,648	9,360	10,949
Currency issued	4,586	8,021	10,014	9,463	9,017	9,132	9,680	13,301	10,481	12,022
less cash in vaults of commercial banks	1,980	858	492	903	686	710	864	653	1,121	1,073
Banks reserves	1,052	4,208	2,222	3,459	4,115	3,945	4,124	2,951	3,285	4,624
Required	717	2,287	2,000	1,390	2,752	3,329	3,329	2,657	2,250	3,829
Excess	335	1,921	222	2,069	1,363	616	795	295	1,035	795
Memorandum items:										
Reserve money (annual growth, in percent)	...	116.9	117.0	5.7	7.4	6.9	12.9	32.8	12.6	20.6
Currency issued (annual growth, in percent)	...	74.9	118.4	18.0	12.4	13.9	20.7	32.8	30.7	24.2
Gross foreign exchange assets (in millions of U.S. dollars)	1,134	7,902	5,691	8,239	8,755	9,102	9,311	8,353	9,602	11013
Gold	67	79	64	80	81	82	82	64	93	82
CBI vault + DFI sub-account	1,067	7,097	5,191	7,446	7,994	8,335	8,547	8,289	8,796	10,235
Deposits at state banks	0	0	0	0	0	0	0	0	0	0
IMF disbursement	0	727	436	713	680	685	682	0	713	696
Foreign exchange liabilities (IMF, in millions of U.S. dolla	-187	-544	-532	-547	-443	-443	-441	-532	-532	-431
Net foreign exchange assets (in millions of U.S. dollars)	947	7,358	5,159	7,692	8,312	8,660	8,870	7,821	9,070	10582
Exchange rate (end-of-period)	1,690	1,460	1,460	1,462	1,465	1,466	1,465	1,460	1,500	1500
Exchange rate (program)	1,690	1,460	1,460	1,460	1,460	1,460	1,465	1,460	1,500	1500
Inflation (12-month)	36.3	32.0	7.0	20.0	20.0	20.0	20.0	15.0	20.0	15.0
Non-oil real GDP growth (in percent)	-3.4	14.9	5.0	8.0	8.0	8.0	8.0	10.0	12.0	8.0
Gross foreign exchange assets/reserve money (in percent)	34.0	94.4	67.9	93.2	97.7	102.0	98.8	75.0	104.6	99.2
Claims on banks/reserve money (in percent)	0.0	0.1	6.5	1.2	1.3	0.3	0.1	5.7	0.1	0.1
Reserve money coverage (in percent)	28.4	87.9	61.6	87.0	92.7	97.1	94.1	70.3	98.8	95.4
Currency in circulation /reserve money (in percent)	46.2	58.6	77.8	66.2	63.4	64.4	63.9	77.8	68.0	65.8

Sources: Iraqi authorities, and staff estimates and projections.

1/ Valued at market exchange rates.
2/ For 2005, valued at market prices.
3/ This mainly represents the ID and US$ overnight standing deposit facilities.

Table 8. Iraq: Depository Corporations (Monetary) Survey, 2004–05 1/
(In billions of Iraqi dinars)

	2004	2005							
	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.
Nonresident claims	4,043	6,541	8,118	-1,493	-4,427	14,737	13,490	20,387	20,328
Net foreign assets of depository corporations 2/	-5,944	-4,958	-3,819	-4,640	-6,182	-5,358	-4,001	-3,631	-4,483
Government claims on nonresidents on CBI balance sheet (DFI/OFF) 3/	9,987	11,498	11,937	3,147	1,754	20,095	17,490	24,018	24,810
Domestic claims	1,680	-2,039	-3,279	6,618	9,341	-9,550	-7,821	-15,049	-14,581
Net claims on central government	886	-2,901	-4,092	5,735	8,451	-10,476	-8,823	-16,025	-15,622
CBI liabilities to government (DFI/OFF)	-294	-1,796	-2,226	6,442	7,971	-10,369	-7,448	-13,246	-13,559
Other net claims on central government	1,180	-1,105	-1,865	-707	480	-107	-1,375	-2,779	-2,063
Claims on other sectors	794	862	813	883	890	925	1,002	976	1,041
Public nonfinancial corporations	120	146	142	159	161	150	153	156	154
Other nonfinancial corporations	63	117	93	121	110	116	140	138	156
Other resident sectors	611	599	578	604	619	660	709	682	731
Broad money liabilities	14,351	14,407	15,109	14,392	14,154	14,239	13,856	13,962	13,922
Currency outside depository corporations	6,730	7,154	8,051	8,330	8,204	8,330	8,260	8,316	8,369
Transferable deposits	6,287	5,793	5,520	4,472	4,346	4,254	3,934	3,951	3,860
Other financial corporations	252	189	273	332	313	471	504	422	405
Public nonfinancial corporations	1,426	1,278	1,280	1,132	1,123	1,092	1,048	1,016	921
Other nonfinancial corporations	2,958	3,043	2,876	1,834	1,813	1,095	967	1,077	1,021
Other resident sectors	1,650	1,283	1,093	1,174	1,096	1,596	1,414	1,437	1,513
Other deposits	1,334	1,460	1,537	1,590	1,604	1,656	1,663	1,695	1,693
Other financial corporations	20	24	24	25	26	27	25	24	23
Public nonfinancial corporations	43	47	47	47	47	47	47	48	47
Other nonfinancial corporations	69	55	42	38	31	19	20	17	16
Other resident sectors	1,202	1,334	1,424	1,479	1,501	1,562	1,571	1,607	1,607
Deposits excluded from broad money	17	31	34	43	42	64	67	77	90
Loans	150	150	150	151	151	151	151	151	151
Shares and other equity	-9,865	-10,906	-10,861	-7,651	-10,178	-9,589	-8,874	-8,879	-8,260
Other items (net)	1,069	819	407	-1,808	745	321	469	28	-157

Source: Central Bank of Iraq.

1/ The Depository Corporations Survey is a consolidation of the asset and liability positions of the depository corporations relative to all other economic sectors, both domestic and nonresident. In the *Monetary and Financial Statistics Manual* , depository corporations comprise all institutions that issue liabilities included in the national definition of money. These include the Central Bank of Iraq (CBI) and commercial banks resident in Iraq. Data is preliminary.

2/ Includes part of the external debt of Iraq nominally attributed to Rafidain and Rasheed banks.

3/ Claims relating to Development Fund for Iraq and Oil-for-Food program accounts. These refer to deposits, including at the Federal Reserve Bank of New York, held on account for the government and which appear in the official balance sheet of the CBI. Counterpart domestic liabilities are included in CBI liabilities to government (DFI/OFF), with some elements in other net claims on central government. These items are stripped out of the presentation of the CBI balance sheet in Table 7.

Table 9. Iraq: Balance of Payments, 2004–10 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2004		2005		2006	2007	2008	2009	2010
	EPCA 2/	Est.	EPCA 2/	Rev. Proj.			Projections		
Trade balance	-5,137	-1,808	-7,878	-1,636	476	3,710	5,338	6,238	6,778
(In percent of GDP)	-24.3	-7.0	-32.4	-4.9	1.1	7.0	8.7	9.1	9.1
Exports	16,543	17,782	17,597	22,781	28,745	36,180	42,304	46,430	48,566
Crude oil	16,200	17,329	17,113	22,176	28,073	35,451	41,519	45,724	47,787
Other exports	343	452	484	605	672	729	785	706	778
Imports 3/	-21,680	-19,590	-25,475	-24,416	-28,269	-32,470	-36,966	-40,192	-41,788
Government imports	-14,790	-13,781	-17,197	-14,596	-14,456	-14,901	-16,749	-18,732	-19,561
UN Oil for Food Program (OFFP)	-3,622	-3,488	-2,166	-1,929	0	0	0	0	0
Other consumption imports (non-OFFP)	-4,267	-3,843	-5,301	-3,528	-5,089	-6,398	-7,254	-7,943	-8,378
Other non-oil related capital imports (non-OFFP)	-3,603	-2,370	-4,480	-3,450	-4,882	-5,800	-6,665	-7,020	-7,030
Oil-related capital imports	-1,197	-1,429	-2,850	-2,261	-2,113	-2,703	-2,830	-3,769	-4,153
Refined oil products	-2,100	-2,651	-2,400	-3,428	-2,372	0	0	0	0
Private sector imports	-6,890	-5,809	-8,277	-9,820	-13,813	-17,569	-20,217	-21,460	-22,227
Of which: refined oil products	...	0	...	0	-2,429	-4,217	-4,524	-4,051	-4,158
Income, net 4/	-6,208	-5,395	-6,220	-3,741	-2,237	-2,348	-2,467	-3,197	-3,397
Services, net 3/	-372	-4,260	-744	-6,477	-7,093	-3,788	-3,945	-4,296	-4,464
Transfers, net	1,731	2,004	4,197	7,090	7,721	510	-928	-949	-857
Private, net (incl. NGOs)	500	500	800	500	600	800	1,100	1,300	1,500
Official	1,231	1,504	3,397	6,590	7,121	-290	-2,028	-2,249	-2,357
Receipts	2,041	2,371	4,253	7,699	8,525	1,482	48	37	32
Payments	-810	-866	-856	-1,109	-1,404	-1,773	-2,076	-2,286	-2,389
Current Account	-9,985	-9,460	-10,645	-4,763	-1,133	-1,916	-2,002	-2,204	-1,941
(In percent of GDP)	-47.3	-36.8	-43.8	-14.4	-2.7	-3.6	-3.3	-3.2	-2.6
Capital Account	0	0	0	0	0	0	0	0	0
Financial Account	8,973	10,840	7,026	6,172	2,821	3,407	3,766	3,913	3,306
Direct investment	200	200	300	300	300	738	1,000	1,450	1,758
Other capital, net	8,773	10,640	6,726	5,872	2,521	2,669	2,766	2,463	1,548
Official, net	9,565	10,835	6,726	7,504	5,839	2,669	2,766	2,463	1,548
Assets	9,565	10,835	6,372	3,943	3,607	0	-155	-372	-727
Liabilities	0	0	354	3,561	2,232	2,670	2,921	2,834	2,275
Loan disbursements	0	0	354	0	275	475	850	1,081	1,106
Amortization 5/ 6/	0	0	0	-200	-136	0	0	0	0
Capitalized interest payment 6/	0	0	0	3,761	2,093	2,195	2,071	1,753	1,169
Financial corporations, net 7/	...	0	...	0	-1,247	0	0	0	0
Private, net	-792	-195	0	-1,632	-2,071	0	0	0	0
Errors and omissions	0	178	0	0	0	0	0	0	0
Overall balance	-1,013	1,559	-3,619	1,409	1,688	1,491	1,764	1,709	1,365
(In percent of GDP)	-4.8	6.1	-14.9	4.2	4.0	2.8	2.9	2.5	1.8
Financing	1,013	-1,559	3,619	-1,409	-1,688	-1,491	-1,764	-1,709	-1,365
Central bank (increase -)	-4,624	-6,768	-2,598	-1,409	-1,688	-1,491	-1,764	-1,709	-1,365
Reserves (net; increase -)	-4,188	-6,332	-2,598	-1,409	-1,688	-1,491	-1,985	-1,931	-1,365
Liabilities (increase +)	436	436	0	0	0	0	-222	-222	0
Fund credit (net)	436	436	0	0	0	0	-222	-222	0
Disbursement	436	436	0	0	0	0	0	0	0
Repayments	0	0	0	0	0	0	-222	-222	0
Deferred accrued interest 8/	6,217	5,394	6,217	0	0	0	0	0	0
Change in arrears (net, decrease -) 9/	-580	-34,959	0	-27,987	-1,195	0	0	0	0
Debt forgiveness 10/	...	34,774	...	27,987	1,195	0	0	0	0
Memorandum items:									
Central bank reserves	5,691	7,902	8,353	9,311	11,013	12,505	14,268	15,978	17,343
Central bank reserves (in months of imports of goods and services)	2.6	3.2	3.7	3.1	3.6	3.7	3.8	4.1	4.1
GDP	21,132	25,724	24,295	33,182	41,741	52,750	61,468	68,571	74,293
Non-oil GDP	4,173	8,297	5,661	10,716	12,999	15,443	17,344	19,390	21,678

Sources: Iraqi authorities and staff estimates and projections.

1/Excludes U.S. military spending in Iraq.

2/ The BOP table in the EPCA shows the current account and overall balance both with and without the interest of ID 6,217 billion accrued and deferred in 2004 and 2005. For consistency of presentation, the BOP table in this Staff Report shows income (net), current account, pverall balance, and financing for the EPCA columns of 2004 and 2005 as including interest accrued, deferred, and capitalized.

3/ EPCA figures for imports of do not fully account for the cost of freight and insurance, which have been added under services for other estimates and projections.

4/Includes interest accrued, deferred, and capitalized.

5/Reflects the estimates of cash payments to settle the debt owed to small private creditors through cash exchange offer in 2005 and 2006.

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

7/Reflects advance transfers for the execution of letter of credit (L/C) in subsequent years.

8/Estimates of accrued interest on existing stock of debt prior to Paris Club agreement.

9/Includes debt forgiveness and clearance of arrears on multilateral debt.

10/The notional debt forgiveness reflects: (i) the first stage of debt reduction (30 percent) at end 2004; (ii) the second stage reduction (30 percent) at end-2005 upon approval of an upper credit tranche arrangement with the IMF; and (iii) the settlement of private debt owed to small creditors through a cash exchange offer (89.75 percent debt reduction) in 2005 and 2006. Assumes debt reduction comparable to the Paris Club agreement to other external debt (see Appendix V).

Table 10. Iraq: Indicators of Fund Credit, 2004–10 1/
(In millions of SDRs, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010
Disbursements of Fund credit							
EPCA	297.1	0.0	0.0	0.0	0.0	0.0	0.0
Prospective SBA 1/	0.0	79.2	316.9	79.2	0.0	0.0	0.0
In percent of IMF quota	0.0	6.7	26.7	6.7	0.0	0.0	0.0
Obligations							
Clearance of arrears	55.3	0.0	0.0	0.0	0.0	0.0	0.0
Repayments of EPCA	0.0	0.0	0.0	0.0	148.6	148.6	0.0
Repayments of prospective SBA	0.0	0.0	0.0	0.0	0.0	99.0	227.8
Total charges and interest	0.7	3.3	20.2	29.6	27.6	20.9	12.0
Total obligations	56.0	3.3	20.2	29.6	176.1	268.5	239.7
Total obligations, in percent of:							
Exports of goods and services	0.5	0.0	0.1	0.1	0.6	0.9	0.7
External public debt	0.1	0.0	0.1	0.1	0.5	0.7	0.6
Gross reserves	1.0	0.1	0.3	0.3	1.8	2.4	2.0
GDP	0.3	0.0	0.1	0.1	0.4	0.6	0.5
IMF Quota	4.7	0.3	1.7	2.5	14.8	22.6	20.2
Outstanding Fund credit							
EPCA	297.1	297.1	297.1	297.1	148.6	0.0	0.0
Prospective SBA	0.0	79.2	396.1	475.4	475.4	376.3	148.6
Total outstanding Fund credit	297.1	376.3	693.2	772.5	623.9	376.3	148.6
Total outstanding Fund credit, in percent of:							
Exports of goods and services	2.6	2.4	3.5	3.2	2.2	1.2	0.4
External public debt	0.6	1.1	2.0	2.1	1.6	0.9	0.4
Gross reserves	5.6	6.1	9.3	9.1	6.4	3.4	1.2
GDP	1.7	1.7	2.5	2.2	1.5	0.8	0.3
IMF Quota	25.0	31.7	58.3	65.0	52.5	31.7	12.5

Source: Staff estimates and projections.

1/Including the hypothetical purchases under the precautionary SBA, not shown in the balance of payments projections.

Table 11. Iraq: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement (SBA), 2005–06 1/
(In billions of Iraqi dinars, unless otherwise indicated)

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

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

Table 12. Iraq: Oil Product Prices: Prior Action Under the Stand-By Arrangement (SBA)
(In Iraqi dinars per liter, unless otherwise indicated)

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

Table 13. Iraq: Prior Actions, Structural Performance Criteria, and Structural Benchmarks Under the Stand-By Arrangement

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

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

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

Table 14. Iraq: Proposed Availability of Purchases Under the Stand-By Arrangement, 2005–07

Availability date	Amount of Purchase		Condition
	SDR	% quota	
December 23, 2005	79,226,667	6.67	Program approval
February 28, 2006	79,226,667	6.67	Completion of first review and observance of end-December 2005 performance criteria
May 15, 2006	79,226,667	6.67	Completion of second review and observance of end-March 2006 performance criteria
August 15, 2006	79,226,667	6.67	Completion of third review and observance of end-June 2006 performance criteria
November 15, 2006	79,226,667	6.67	Completion of fourth review and observance of end-September 2006 performance criteria
February 15, 2007	79,226,665	6.67	Completion of fifth review and observance of end-December 2006 performance criteria
Total access	475,360,000	40.00	

Source: Staff estimates and projections.

Baghdad, December 6, 2005

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

Dear Mr. de Rato:

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

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

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

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

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

Sincerely yours,

/s/	/s/
Dr. Sinan Shabibi	Dr. Ali Allawi
Governor of the Central Bank of Iraq	Minister of Finance of Iraq

IRAQ

Memorandum of Economic and Financial Policies for 2005–06

December 6, 2005

I. Introduction

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

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

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

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

II. Developments Under the EPCA–Supported Program

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

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

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

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

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

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

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

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

III. Government Program for 2005/6

A. Macroeconomic Objectives

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

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

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

B. Macroeconomic Policies

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

Fiscal policy

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

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

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

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

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

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

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

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

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

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

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

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

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

Monetary and exchange rate policy

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

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

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

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

External sector policies

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

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

C. Structural Reforms

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

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

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

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

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

D. Statistics

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

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

E. Medium-term Prospects

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

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

IV. Program Monitoring

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

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

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

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

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

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

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

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

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

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

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

IRAQ

Technical Memorandum of Understanding

December 6, 2005

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

I. Quantitative Performance Criteria and Indicators

2. The quantitative performance criteria are the following:

- a floor on net international reserves of the Central Bank of Iraq (CBI);
- a ceiling on lending to the government and the private sector by the CBI;
- a ceiling on the primary deficit of the government;
- a ceiling on the government wage and pension bill
- a floor on the revenue of oil-related state-owned enterprises, including those remitted to the budget
- a ceiling on external arrears on new borrowing; and
- a ceiling on contracting and guaranteeing of new medium- and long-term non-concessional external debt.

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

II. Definitions

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Provision of Information to the Fund Staff

Data

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

- CBI gross foreign exchange reserves (weekly) and balances of the DFI held at the FRBNY. This should be reported no longer than 2 weeks after the end of the reference week.
- The monthly balance sheet of the CBI, with a month lag.
- The monthly consolidated balance sheet of the other depository corporations (commercial banks), with an eight week lag.
- The depository corporations (monetary) survey of all commercial banks and the CBI (quarterly), with eight weeks lag.
- Weekly preliminary monetary and financial aggregates, including exchange rate data (daily), currency in circulation, transferable and other deposits held at commercial banks, balances on government accounts at the CBI, interest rates on loans and on deposits at commercial banks, holdings of government securities, and credit outstanding to the public and private sectors. The data, excluding exchange rates, should be reported no longer than three weeks after the end of the reference period.
- Consumer price index (CPI), including indices for main cities (monthly)**.** These should be reported no longer than a month after the end of the relevant month.
- Detailed revenues, operating and capital expenditure, and financing items of consolidated fiscal and oil operations, and overall fiscal balance. These data should include the execution of the Iraqi budget, operations of the oil-related state-owned enterprises, disbursements of external assistance and loans, execution of letters of credit financed under the UN oil-for-food program, all operations of the DFI, balances of all government accounts held at the CBI and the commercial banks, and outstanding stock of government securities (including treasury bills). These data should be reported on a monthly basis and reported no more than eight weeks after the end of the reference month.
- Detailed data on disbursement of external assistance from the US Supplemental and other donor assistance, including by recipient sector; foreign debt amortization and interest payments made; and total outstanding domestic and external debt. These data should be reported on a monthly basis and reported no more than eight weeks after the end of the reference month.

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

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

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

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

STRUCTURAL REFORMS

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

OTHER INFORMATION

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

Iraq: Relations with the Fund
As of October 31, 2005

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

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

III. **SDR Department:**	**SDR Million**	**%Allocation**
Net cumulative allocation	68.46	100.00
Holdings	295.04	430.94

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**%Quota**
Post-Conflict Emergency Assistance	297.10	25.00

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund:**
(SDR Million; based on existing use of resources and present holdings of SDRs):

		Forthcoming			
	2005	2006	2007	2008	2009
Principal				148.55	148.55
Charges/Interest	2.95	12.28	12.28	9.49	3.32
Total	2.95	12.28	12.28	158.04	151.87

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

VIII. **Safeguards Assessments**

Under the Fund's safeguards assessment policy, the Central Bank of Iraq is subject to safeguards assessment policy. This assessment is in progress, focusing initially on the Central Bank's external audit mechanism and foreign reserves management.

IX. **Exchange Rate Arrangement**

The Central Bank of Iraq has been conducting foreign exchange auction on a daily basis since October 4, 2003. The central bank has followed a policy of exchange rate stability which has translated in a *de facto* peg of the exchange rate since early 2004. Iraq continues to avail itself of the transitional arrangements under Article XIV. It is unclear whether Iraq maintain any restrictions subject to Fund jurisdiction under Article VIII, Sections 2,3, and 4.

X. **Article IV Consultations**

The 2005 Article IV consultation was concluded on August 1, 2005. The previous Article IV consultation took place in November 1979. A report for the 1983 Article IV consultation was issued to the Executive Board on August 5, 1983; however no Board meeting was convened.

XI. **Recent Technical Assistance**

Department	Date	Topic
FAD	July 15–31, 2003	Public expenditure management
	December 2003	Public expenditure management
	February–March 2004	Fiscal seminar for high level officials
	April 2004	Training course in budget preparation
	May–June 2004	Tax policy and tax administration workshop
	June 2004	Expenditure management
	December 2004	Fiscal decentralization
	January 2005	Petroleum sector policies
	February 2005	Public financial management
	April 2005	Fiscal management reform
LEG	October 2003	Central bank legislation (in consultation with MFD)
	October 2003	Commercial banking legislation (in consultation with MFD)
	October 2003	Currency legislation (in consultation with MFD)
	February–May 2004	Public debt legislation
	February–May 2004	Budget law
	August 2005	Payments system regulation (jointly with MFD)
MFD	July 2003	Monetary and financial systems areas
	November 2003	Market policy and operations
	December 2003	Accounting and financial reporting
	January 2004	Central bank reform
	June 2004	Banking supervision
	June 2004	Market policy and operations
	June 2004	Payment and settlement systems
	March 2005	Payment and settlement systems
STA	July 2003	Monetary and financial statistics (jointly with MFD)
	December 2003	Multisector statistics
	January 2004	National accounts statistics
	January 2004	Consumer price statistics
	October 2004	Price statistics
	November 2004	National accounts
	April 2005	Balance of payment statistics
	April 2005	National accounts
	April 2005	Consumer price statistics
	May 2005	General data dissemination system
	July 2005	Monetary and financial statistics
INS	April 2005	External sector policies

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 was in non-accrual status from 1990 to December 2004, when it paid its arrears to IBRD (about US$108 million).

A. The Bank Group Strategy and Operations

2. **Progress under the World Bank's First Interim Strategy.** The First Interim Strategy, was discussed by the Executive Directors in January 2004. It relied on the World Bank Iraq Trust Fund (ITF) within the grant-funded International Reconstruction Fund Facility for Iraq (IRFFI) to finance projects. So far the Bank approved and launched nine ITF projects amounting in total to US$366 million. A first capacity building project is completed, an emergency textbook project is nearly completed, and seven additional operations are under implementation, addressing capacity building, healthcare, private sector development, rural infrastructure, school construction, urban upgrading, and water supply and sanitation. The ITF project portfolio balances immediate needs and near-term employment with medium-term interventions to improve service delivery.

3. **The Bank also used its own budget to support Iraq's medium-term reform program through analytical and advisory activities (AAA).** To fully exploit cross-sectoral synergies, the AAA program is grouped into three clusters: (i) economic reform and transition; (ii) poverty, safety nets, and social development; and (iii) public sector reform and governance. The Bank's AAA program delivers short notes to provide timely policy advice, and detailed reports that offer more comprehensive analytical assessments. The Bank supported Iraq's elaboration of a National Development Strategy (NDS), the updated version of which was presented to donors in July 2005. A Country Economic Memorandum (CEM), completed in June 2005, drew on sectoral studies of Iraq's economy undertaken by the Bank in 2003–2005. To create jobs, restore basic services, and protect the vulnerable, the CEM identifies three main policy instruments: (i) reforming incentive systems and supporting institutions to generate more efficient growth in private sector jobs; (ii) establishing strong safety nets to protect the poor and vulnerable as prices are freed; and (iii) strengthening accountable management of public resources, particularly oil.

4. **The Second Interim Strategy Note (ISN), covering IDA credits and additional ITF fund resources, was discussed at the Board on September 15, 2005.** The Board was supportive of the Bank's work in Iraq, and particularly stressed the importance of helping Iraq with policy reforms. The Second Interim Strategy Note provides the framework for up to US$500 million from IDA and additional resources from the ITF. To provide a continuum of resources, up to US$500 million of IBRD lending could supplement the IDA and ITF envelope, assuming critical progress regarding IBRD creditworthiness.

5. As requested by the Iraqi authorities, the Bank is initiating IDA lending in four sectors: education; electricity; transport (roads); and water supply and sanitation. These areas represent basic needs and sectors where the Iraqi authorities desire Bank involvement to create jobs, catalyze and harmonize government and donor activities, and help build needed systems for public expenditure management and delivery of public services. The Bank is already providing support in two of these areas through the ITF and builds on its experience to deepen its support. Project designs maximize local ownership, local content, and near term employment. Projects will be clustered geographically to facilitate implementation, institution building, and impact. Given the difficulty of implementation in Iraq, IDA- and ITF-financed investment projects will focus mainly on straightforward rehabilitation, and the Bank will expand cautiously into new sectors. The first IDA-financed project to Iraq, the Third Emergency Education Project, has been distributed to the Bank's Executive Directors for consideration on November 29, 2005.

6. As regards additional ITF financing, the Bank and the EC signed an Administration Agreement on October 25, 2005, for an additional EC contribution of Euro 40 million (US$49 million) which will support operations in the social areas, including education, health, poverty reduction, and economic management. The Bank and Iraqi authorities are advanced in preparing two new ITF-funded operations, which will be financed by the new EC contribution. On November 17. 2005, negotiations have successfully been completed for one operation which aims to strengthen the provision of services to the disabled by upgrading specialized rehabilitation centers and supporting the development of a national policy on disabilities. The second operation will finance a comprehensive Iraq Household Socio-Economic Survey (IHSES), which will enable the Iraqi authorities to establish a poverty line and will provide the foundation for effective policy decisions, including in the areas of fuel and food subsidy reforms.

7. **Ongoing analytical and advisory activities will continue to be clustered into three themes:** (i) economic reform (e.g. subsidy reform, restructuring of public banks and enterprises, oil revenue management); (ii) poverty, safety nets, and social development (e.g. poverty assessment including IHSES; pension reform, social protection strategy); and (iii) public sector management (e.g. public finance management, fiscal federalism, payroll reform). Advisory activities will aim to lay out options available to Iraqi policymakers and discuss trade-offs under each option.

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

9. **The International Finance Corporation (IFC) has made progress in supporting the financial sector through investments and technical assistance.** IFC acquired in March 2005 a minority stake in Credit Bank of Iraq, in partnership with the National Bank of Kuwait (NBK). IFC also set up the Iraq Small Business Financing Facility (ISBFF) which combines investment and technical assistance to support financing of SMEs by Iraqi banks. The ISBFF made the first commitment of US$12 million in June 2005 to the Iraq National Bank (INB), which entered into a joint venture with Jordan's Export and Finance Bank.

IFC has also lined up a technical partner, Rabobank of the Netherlands, for a twinning program to train staff. IFC has helped upgrade INB's financial statements to international standards. Under the Private Enterprise Partnership for MENA (PEP-MENA) trust fund, IFC has provided training to the 19 private banks in a wide range of areas, including asset/liability management, credit analysis, etc. Currently, IFC is in discussions with interested investors in a possible intervention in the cement sector.

B. IMF-World Bank Collaboration in Specific Areas

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

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

11. Through ITF- and IDA-funded projects the Bank is providing emergency support to rehabilitate vital public services—education, health, water supply and sanitation, urban infrastructure, power, and telecommunications. The Bank anchors its project work in focused analysis of sector issues, and supports Iraqi capacity-building via policy workshops and training courses. The Bank leads work on gender issues; and is helping the Government of Iraq to undertake an IHSES and a Poverty Assessment.

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

12. The Bank has provided policy advice and inputs to the Prime Minister's Supreme Economic Committee and to key ministries. Bank inputs are provided in the form of just-in-time notes and policy papers on key reform areas and sectors, such as subsidy reforms, pension system and social protection, oil revenue governance, public finance management, civil service and payroll reform , restructuring of SOEs and public banks,, investment climate, and trade policy and facilitation.

13. 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 nontransparent quasi-fiscal operations). The IMF has also a strong interest in governance issues, in particular with regards to oil revenue management.

E. Areas of Shared Responsibility

14. The IMF and the World Bank are working together on macroeconomic and fiscal sustainability, revenue management, the reform of domestic subsidies, financial sector reform (comprising state bank restructuring, strengthening payment system and banking supervision and regulation), public debt management and statistical capacity building. The Bank and the Fund closely coordinate their capacity building activities in macroeconomic management, public sector governance, private sector development, and social safety nets. The Bank also coordinates with the IMF its macro-modeling work (which includes the formulation of a computable general equilibrium model to evaluate the impact of reforms). The Bank's design of the IHSES benefited from comments provided by the Fund.

F. Areas in Which the Fund Leads and Its Analysis Serves as Input into the World Bank–Supported Programs

15. 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 the overall macroeconomic and fiscal framework.

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

16. 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.

Table 1. Iraq: Bank-Fund Collaboration

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

Iraq: Statistical Issues

A. Background

1. Iraq's macroeconomic statistics, which were once among the most developed in the region, have suffered from years of neglect. Statistics were mostly confidential and had limited use. There was little or no incentive to improve or even preserve quality. There was not much contact with the outside world, and only a few Iraqi statisticians were able to gain knowledge of the latest statistical manuals. Recent turmoil has added to the difficulties. Given all these setbacks, the extent to which statistical data are available is remarkable.

2. The long period of neglect by government institutions under the previous regime has had devastating effects in many respects and has reduced statistical capacity. Although the Central Organization for Statistics and Information Technology (COSIT) remained in place, its technical expertise was at best obsolete. For instance, national accounts experience was solely with *System of National Accounts, 1968* (*1968 SNA*). The CBI's statistical capacity is slightly better, although the staff need training.

3. The Statistics Department (STA) has provided technical assistance (TA) in statistics since 2003. After the June 2003 Fund assessment mission in which STA also took part, the first monetary statistics mission visited Baghdad in July as part of an MFD-led mission. In December 2003, a multisector statistics mission met with Iraqi representatives from the CBI, COSIT, and the ministry of planning (MoP) in Amman, Jordan. The mission covered money and financial statistics, balance of payments and foreign trade statistics, national accounts, and consumer price statistics. In January 2004, STA hosted two workshops for Iraqi statisticians, also in Amman, one workshop on national accounts, and one workshop on consumer price indices. During FY 2005, follow-up missions, held in Amman, were conducted in national accounts, price statistics, and balance of payments statistics. In May 2005, STA, the IMF's Middle East Technical Assistance Center, and the World Bank, jointly hosted a workshop in Amman for Iraqi statisticians and statisticians from the West Bank and Gaza on General Data Dissemination System (GDDS) metadata development. The objective of the workshop was to assist the authorities in drafting GDDS metadata in a view of their participation in the GDDS. In September, 2005, Iraqi authorities indicated their intention to participate in the GDDS and have nominated a national GDDS coordinator. A monetary and financial statistics mission took place during July 23–28, 2005 and reviewed the framework for the compilation of a depository corporations survey. STA continues to deliver its TA mission program taking due account of the absorptive capacity of the statistical agencies involved, and the contributions of other donors.

B. Shortcomings with Statistical Framework

National accounts

4. The COSIT compiles national accounts statistics mainly for government use and the existing Statistical Act has the COSIT reporting to the minister of planning who has to agree on the data before its release. This procedure affects the COSIT's statistical independence. COSIT releases national accounts statistics to the public only in a limited form. It publishes current price estimates in the Statistical Yearbook, but this has limited circulation. It is available but only after application to, and approval of, the minister of planning.

5. 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 have not—since 1991—included the northern region of the country (Kurdistan). The national accounts do not cover the informal sector and the surveys used are out of date. Also, they miss a significant portion of the building industry. Further, there are many gaps in the coverage of business, community, social, and personal services. The COSIT uses out-of-date classifications, which do not follow standard international best practice.

6. The data collections are reasonably comprehensive for current price data in the formal sector. Under current procedures, businesses employing more than 10 people must 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.

7. 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.

8. Technical assistance by STA consultants is continuing. Areas in need of improvement include the implementation of *1993 SNA*, improvement of data on external trade and capital formation, the compilation of the accounts by institutional sectors, and updating of surveys.

Consumer price index

9. The staff is inadequate in number and has only recently received training during STA technical assistance missions. There is not enough computer hardware and software to process the CPI efficiently. Recent technical assistance missions have focused on providing hands-on training on methodologies for compiling the CPI and on methods for making adjustments in the CPI for changes in the quality of goods and seasonality. Improvements in the CPI are limited by outdated weights, which date back to 1993, but cannot be updated

until the next household budget survey is conducted in 2005/2006. Limited training has also been provided on methods for constructing the producer price index (PPI) and the wholesale price index (WPI) and on documenting the procedures and methods used to compile the CPI (metadata); work in this area is continuing.

Monetary and financial statistics

10. Notable progress has been made in developing the components and structure for compiling a depository corporations (monetary) survey, but the quality of the data continues to be hampered by several factors: (i) the lack of sufficiently trained staff and internal cooperation within the CBI; (ii) difficulty in collecting information on banking transactions in the northern region (Kurdistan); (iii) a chart of accounts that is not fully compliant with current monetary and financial data requirements; (iv) the use of pre-conflict forms for reporting monetary statistics; and (v) balance sheet presentations for the commercial banks that do not conform with the sectorization and instrument classification of the *Monetary and Financial Statistics Manual 2000 (MFSM)*.

11. The recent monetary and financial statistics mission in July 2005 reviewed with the CBI staff aspects related to the institutional coverage, residency criterion, sectorization of domestic institutional units, and classification of financial instruments. The mission also reviewed the concepts and presentation formats of the Central Bank Survey (CBS), the Other Depository Corporations Survey (ODCS), and the Depository Corporations Survey (DCS). The CBI staff have begun to compile the CBS, in parallel with their current reporting format. As regards the CBI balance sheet, a few outstanding issues remain, specifically with respect to the treatment of previous transactions with or on behalf of the public sector.

12. The CBI has recently prepared a consolidated balance sheet of the commercial banks. Together with Bearing Point consultants, CBI staff have been working with staff at the commercial banks to produce "best immediately available" correspondences to populate the standardized reporting forms for commercial banks and compile an ODCS. While progress has been made in compiling the data necessary for an ODCS, it is not yet clear whether the financial statements from which they are derived conform fully with generally accepted accounting principles. Consequently, data integrity remains an issue. Also, reporting from some branches lack timeliness and the reporting forms used currently by the CBI do not allow a complete mapping to the sectorization and classification requirements of the *MFSM*. However, a new reporting form to be used by the commercial banks for reporting data to the CBI, which captures more detail from line items in the chart of accounts, is to be introduced. The CBI plans to provide training to the commercial banks on how to complete the new forms by end-December 2005. This initiative should help to refine the classification and sectorization of the data available.

Balance of payments statistics

13. There are time series available from 1988 to 2002 presented according to the IMF's *Balance of Payments Manual, fourth edition (BPM4)* format. However, there are deviations in definitions, data coverage, classification, valuation, and sectorization for the *BPM4* time series. For 2002 to 2004, the balance of payments statistics are also in the IMF's *Balance of Payments Manual, fifth edition (BPM5)* format. Although the quality of the information for the past three years has improved, the presentation is still limited by deviations from the internationally acceptable methodologies.

14. A balance of payments technical assistance mission met with Iraqi counterparts from the Balance of Payments Statistics Division's (BOPSD) of the CBI in Jordan from April 9-21, 2005. The mission provided assistance in improving collection and compilation methods for the balance of payments components, applied hands-on training on several aspects of external sector statistics methodology, and guided CBI staff in preparing a methodological note describing current statistical production and dissemination practices of external sector statistics.

15. The mission found that some progress has been made since the multisector mission in December 2003 in the following areas: (a) the new CBI Law and the Banking Law make reference to the compulsory reporting of information of banks and any other entities for publication, among others, of balance of payments statistics; (b) the exchange rate problems have been largely eliminated as most transactions are currently reported and compiled in U.S. dollars; (c) the stock data have been removed from the historical transactions series; and (d) new reporting forms for the commercial banks have been designed.

16. The mission noted that the quality of information has been seriously hampered by incorrect interpretation of key balance of payments concepts; lack of human and technological resources; lack of internal cooperation within the CBI; nonresponse to surveys and reporting forms by external sources; difficulties in collecting information due to the current security situation; and exclusion of the Kurdish areas in most of the balance of payments statistics components.

17. These problems have made the balance of payments largely dependent on the BOPSD's ad-hoc observations and estimates. The lack of information is affecting the quality of the data in various components, notably in services, income, and transfers in the current account, and for all components in the capital and financial account.

18. The mission's main recommendations were to:

- improve human and technological resources for the BOPSD;
- strengthen the legal framework for collecting and compiling balance of payments statistics, particularly with regard to confidentiality and penalties for nonreporting;

- align the concept of residence with the fifth edition of the *Balance of Payments Manual (BPM5)* in order to be consistent with international methodologies;

- present the balance of payments with the required *BPM5* components and breakdown by sector;

- reintroduce customs forms for compiling goods data;

- improve coverage of services, income and current transfers account, by introducing the new surveys developed by the mission;

- use the results of the exploratory survey by the ministry of planning conducted in 2003 to create a business directory register and participate in the review of the forthcoming FDI survey to be implemented by the ministry of planning in 2005;

- compile financial account data, within the current limitations of the compilers, with more reliable data sources; and

- compile and disseminate data on external debt consistent with the international guidelines.

A follow up balance of payments technical assistance mission is scheduled to take place from January 25–February 6, 2006.

External trade statistics

19. The COSIT does not have enough staff in the section responsible for compiling external trade data. The software for data entry as well as the single computer available for use by staff are both outdated. The staff's main responsibility is checking the customs declaration forms for consistency and keypunching relevant data into computer files. In addition, gaps in the customs data occur in 2003 and 2004 because there were no customs inspections at the borders.

20. The Customs Department declaration forms reflect an outdated declaration method are old, often unreadable, and miss important information. There is currently a customs form for exports; however, it is not used by the CBI as the primary source for compiling trade data. Furthermore, customs forms for imports have not been used since 2003.

21. The coverage of the external trade statistics does not include the northern region of the country (Kurdistan). The Customs Department classifies items often by customs duties, which makes it difficult for the COSIT to reclassify. As a result, there is a large margin of error in the final product.

22. The foreign trade data are reported 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.

23. The external trade data from the COSIT and the data compiled by the CBI are not consistent. The Balance of Payments Division of the CBI does not use external trade data from the COSIT.

Government finance

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

Table 1. Iraq: Table of Common Indicators Required for Surveillance

(As of October 31, 2005)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	10/31/05	10/31/05	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	08/05	10/21/05	M	M	M
Reserve/base money	08/05	10/21/05	M	M	M
Broad money	08/05	10/21/05	N/A	N/A	N/A
Central bank balance sheet	08/05	10/21/05	M	M	M
Consolidated balance sheet of the banking system	08/05	10/21/05	N/A	N/A	N/A
Interest rates[2]	10/05	10/31/05	W	W	W
Consumer price index	09/05	10/21/05	M/	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	2004	06/06/05	A	N/A	N/A
Revenue, expenditure, balance and composition of financing[3]– central government	2004	06/06/05	A	N/A	N/A
Stocks of central government and central government-guaranteed debt	N/A	N/A	N/A	N/A	N/A
External current account balance	2004	04/09/05	A	A	A
Exports and imports of goods and services	2004	04/09/05	A	A	A
GDP/GNP	N/A	N/A	N/A	N/A	N/A
Gross external debt[5]	N/A	N/A	N/A	N/A	N/A

Sources: CBI, Ministry of Finance, COSIT.

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

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

3/ Foreign, domestic bank, and domestic nonbank financing.

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

5/ Including currency and maturity composition.

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

Iraq: External Debt Outlook[1]

Iraq received substantial debt forgiveness from the first stage of debt reduction in 2004, but without additional debt reductions, Iraq's external debt would not be sustainable. After the first stage of debt reduction, total external debt is estimated at about $79 billion (309 percent of GDP) by end-2004, and is projected to increase to about $101 billion (136 percent of GDP) by 2010. The second stage of debt reduction upon approval of an upper credit tranche arrangement with the IMF at end-2005 would provide a notional debt reduction of about $26 billion for Iraq[2]. The first and second debt reductions do not apply to Iraq's debt owed to small private creditors since this debt is to be resolved through cash exchange offer of 10.25 cents to the dollar. The claims of small private creditors amounted to about $2.2 billion (principal only), and these claims are expected to be resolved during 2005–06. By end-2005, the stock of total external debt is estimated at about $51 billion (154 percent of GDP), and without the third stage debt reduction, external debt would increase to about $63 billion (about 84 percent of GDP) by 2010. The third stage of debt reduction (expected in 2008) would further reduce Iraq's external debt to about $33 billion (45 percent of GDP) by 2010 (see Appendix V, Table 1).

Iraq's external debt also remains vulnerable to a negative oil shock, although the amount of debt service would be relatively small through 2010. Based on the Paris Club agreement in 2004, the repayment of the remaining debt stock would start in July 2011, and the interest payments accrued during 2005-2010 are mostly capitalized. However, simulations for two oil shocks—a production shock that limits oil production to 3.0 mbpd in 2008-10, and a price shock that lowers oil export price by $4.5 per barrel (equivalent to one standard deviation) during 2006-10—show that Iraq would require significant borrowing from the international markets to close the financing gaps. Even with the second stage of debt reduction in place, Iraq's external debt would increase substantially under these two scenarios (see Appendix V, Table 2).

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[1] The assumptions made and the scenarios shown in this outlook are for purposes of illustration and discussion only. While the process of Iraq's debt reconciliation is ongoing, the IMF has had to base its analysis on information that may include as yet unreconciled data. Such use of data by the IMF does not amount to a recognition or denial of any particular claims.

[2] The projection assumes that debt owed to non Paris Club official creditors and to large private creditors follows a debt reduction scheme comparable to the Paris Club agreement.

Table 1. Iraq: Estimated External Debt Stock, 2004–10 1/,2/
(In billions of U.S. dollars)

	2004 before debt reduction 3/	2004 after debt reduction	2005	2006	2007	2008	2009	2010
Without the second and third stages of debt reduction								
Paris Club creditors	36.6	23.8	25.0	26.3	27.6	28.8	29.9	30.6
Non-Paris Club creditors	76.7	54.7	55.3	56.7	59.5	62.2	64.4	66.0
Of which: official creditors	61.4	43.0	45.2	47.4	49.8	52.0	53.9	55.2
Multilateral creditors 4/	0.6	0.9	0.9	1.2	1.6	2.3	3.1	4.2
Total debt	113.9	79.4	81.2	84.1	88.7	93.3	97.4	100.8
In percent of GDP	442.8	308.6	244.7	201.5	168.2	151.7	142.1	135.6
Total debt service	...	0.0	0.2	0.3	0.2	0.9	1.7	2.8
With the second stage of debt reduction in 2005 (baseline) 5/								
Paris Club creditors	36.6	23.8	18.1	18.7	19.3	19.8	20.3	20.6
Non-Paris Club creditors	76.7	54.7	32.2	32.4	34.0	35.5	36.8	37.7
Of which: official creditors	61.4	43.0	25.8	27.1	28.4	29.7	30.8	31.5
Multilateral creditors 4/	0.6	0.9	0.9	1.2	1.6	2.3	3.1	4.2
Total debt	113.9	79.4	51.2	52.2	54.9	57.6	60.2	62.5
In percent of GDP	442.8	308.6	154.3	125.2	104.1	93.7	87.8	84.1
Total debt service 6/	...	0.0	0.2	0.3	0.2	0.7	1.1	1.6
With the second and third stages of debt reduction in 2005 and 2008 7/								
Total debt	113.9	79.4	51.2	52.2	54.9	29.9	31.7	33.4
In percent of GDP	442.8	308.6	154.3	125.2	104.1	48.7	46.2	44.9
Total debt service 6/	...	0.0	0.2	0.3	0.2	0.7	0.8	1.0

Sources: The Paris Club and staff estimates and projections.

1/ The process of Iraq's debt reconciliation is ongoing and the IMF has had to base its analysis on information that that may include as yet unreconciled data. Such use of data by the IMF does not amount to a recognition or denial of any particular claims. Further, the assunptions made and scenarios shown in the external debt outlook are for purposes of illustration and discussion only.

2/ The projection assumes: i) the reduction of debt and the deferral of payments of principal and most interests until 2011 comparable to the Paris Club agreement to all external debt, except the debt owed to small private creditors; and ii) the debt owed to small private creditors is settled through cash exchange offer of 10.25 cents to the dollar in 2005 and 2006.

3/ During the ongoing reconciliation process some debt has been reconciled and repaid, and the amount of reconciled debt may differ from the initial claim. As a result, the estimates of debt outstanding are different from those in the 2004 EPCA and the Staff Report of the 2005 Article IV Consultation.

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

5/ Assumes precautionary SBA during 2005-07.

6/ Debt service is actual amount paid, not accrued, excluding repayment of arrears.

7/ Assumes precautionary SBA during 2005–08.

Table 2. Iraq: External Debt Sustainability Framework, 2004–10 1/

(In percent of GDP, unless otherwise indicated)

	Est.	Projections					
	2004	2005	2006	2007	2008	2009	2010
External debt	308.6	154.3	125.2	104.1	93.7	87.8	84.1
Change in external debt (1)	-527.8	-154.3	-29.2	-21.1	-10.4	-5.9	-3.7
Identified external debt-creating flows (2)	-399.7	-62.9	-30.5	-23.8	-12.9	-8.1	-5.5
Current account deficit, excluding interest payments	15.8	3.0	-2.5	-0.8	-0.8	-0.7	-1.2
Deficit in balance of goods and services	23.6	24.4	16.1	0.3	-2.3	-2.8	-3.1
Exports	69.1	69.1	69.2	68.9	69.1	68.0	65.6
Imports	92.7	93.5	85.3	69.1	66.8	65.1	62.5
Net non-debt creating capital inflows (negative) 2/	-42.8	-7.9	-1.8	-1.4	-1.4	-1.6	-1.4
Automatic debt dynamics 3/	-372.6	-58.0	-26.3	-21.6	-10.7	-5.8	-3.0
Contribution from nominal interest rate	21.0	11.3	5.4	4.5	4.1	3.9	3.8
Contribution from real GDP growth	-206.0	-6.1	-12.8	-15.3	-11.7	-8.1	-5.8
Contribution from price and exchange rate changes 4/	-187.6	-63.2	-18.9	-10.8	-3.0	-1.6	-1.0
Residual, incl. change in gross foreign assets (1-2)	-128.1	-91.4	1.3	2.7	2.5	2.2	1.8
Of which: change in official reserves (increase = positive)	26.3	4.3	4.2	2.7	2.9	2.5	1.8
External debt-to-exports ratio (in percent)	446.5	223.4	180.8	151.1	135.7	129.2	128.2
Gross external financing need (in billions of US dollars) 5/	9.3	4.6	1.1	2.0	2.0	2.2	1.9
in percent of GDP	36.1	13.8	2.6	3.7	3.3	3.2	2.6
External debt service in percent of exports 6/	30.3	15.5	7.3	6.5	5.9	5.7	5.8
Debt-stabilizing non-interest current account (positive = surplus) 7/	-543.6	-157.3	-26.7	-20.3	-9.5	-5.2	-2.5
Key macroeconomic assumptions							
Real GDP growth (in percent)	46.5	2.6	10.4	15.5	13.1	9.6	7.1
GDP deflator in U.S. dollars (change in percent)	28.9	25.8	13.9	9.4	3.0	1.8	1.1
Nominal external interest rate (in percent)	4.7	4.7	4.4	4.5	4.6	4.6	4.7
Growth of exports (U.S. dollar terms, in percent)	91.7	28.9	26.1	25.8	16.9	9.7	4.6
Growth of imports (U.S. dollar terms, in percent)	198.3	30.1	14.7	2.5	12.6	8.7	4.0
		Stress Tests for External Debt Ratio					
Limited oil production 8/		154.3	125.2	104.1	97.9	104.8	112.8
Lower oil price in 2006–10 9/		154.3	140.4	124.2	119.2	118.8	120.7
		Stress Tests for External Debt Service-to-Exports Ratio 6/					
Limited oil production 8/		17.3	8.3	6.5	6.2	7.3	10.7
Lower oil price in 2006–10 9/		17.3	9.2	9.3	11.2	14.0	17.9
Memorandum items:							
Real GDP growth under stress scenarios (in percent)							
Limited oil production 8/		2.6	10.4	15.5	10.7	3.3	3.5
Lower oil price in 2006–10 9/		2.6	10.4	15.5	13.1	9.6	7.1
Non-interest current account deficit under stress scenarios (in percent of GDP)							
Limited oil production 8/		3.0	-2.5	-0.9	1.3	6.2	8.6
Lower oil price in 2006–10 9/		3.0	2.6	5.8	5.8	5.9	5.2

Source: Staff estimates and projections.

1/ The process of Iraq's debt reconciliation is ongoing and the IMF has had to base its analysis on information that that may include as yet unreconciled data. Such use of data by the IMF does not amount to a recognition or denial of any particular claims. Further, the assumptions made and scenarios shown in the external debt outlook are for purposes of illustration and discussion only.

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

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

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

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

6/ Debt service is total accrued amount.

7/ Balance that stabilizes the debt ratio at its previous year's level, given assumptions on real GDP growth, nominal interest rate, dollar deflator growth, and

8/ Assumes that oil production reaches its peak by 2008 at 3.0 mbpd.

9/ Assumes that oil price in 2006–10 is US$4.5 lower than in the baseline, equivalent to one standard-deviation shock.

INTERNATIONAL MONETARY FUND

IRAQ

Iraq—Request for Stand-by Arrangement
Supplementary Information

Prepared by the Middle East and Central Asia Department

Approved by Lorenzo Pérez and Juha Kähkönen

December 21, 2005

1. This supplement provides an update on developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged.

2. **Staff has received confirmation that the prior action on petroleum product prices was implemented according to schedule and as specified in the Iraqi Memorandum of Economic and Financial Policies** (MEFP)**.**[1] An administrative order was issued on December 11 by the Ministry of Oil instructing the State Oil Marketing Organization to sell petroleum products at the new prices starting December 18. We have been informed that the new prices are now in effect throughout Iraq.

3. **All three elements of the prior action regarding the audit by Ernst & Young (E&Y) of the Central Bank of Iraq (CBI) have been completed.** Staff has received (i) the E&Y assessment of the 2004 audit conducted by the Supreme Board of Audit, (ii) the E&Y procedures review of reserves, currency and lending as of June 2005, and (iii) the E&Y timetable for the 2005 audit.[2] This work will provide input into the staff's ongoing safeguards assessment.

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[1] Effective December 18, 2005, nationwide prices (per liter) were raised as follows: regular gasoline to ID100 (from ID20), premium gasoline to ID250 (from ID50), diesel to ID90 (from ID10), and kerosene to ID25 (from ID5). The price of LPG was raised to ID600 (from ID250) per 12kg cylinder. See Table 6 of the Staff Report for further information.

[2] In the safeguards area, as a prior action, Ernst & Young completed (i) a special audit of international reserves for end-June 2005, and (ii) an assessment of the 2004 financial statements as audited by the Board of Supreme Audit. These audits have been extremely helpful in identifying key priorities for strengthening the accounting and control framework of the CBI in the future. Ernst & Young's work on these audits also helped advance the preparation of the audit of the 2005 financial statements, for which a detailed timetable has been agreed, with completion of the audit by May 15, 2006. The audits revealed a number of errors in the data and shortcomings in the quality of accounting information and financial controls at the CBI. To mitigate the risk in respect of reliability of data, as part of the ongoing safeguards assessment, the staff will work with the auditors during their audit of the December 31, 2005 financial statements to ensure that reported data on the reserve position are reliable and to determine whether further measures are necessary during the program.

4. **Iraqi officials (including the minister of finance and governor) and their advisors met with representatives of Iraq's private creditors in Singapore during December 6-7 for a "due diligence" session related to the Iraqi offer on debt resolution** (for large creditors with claims in excess of $35 million each)**.** Following the due diligence session, the Iraqi advisors held technical meetings on a bilateral basis with creditors. The deadline for responding to this offer is December 21.

5. **Iraq continues to make progress toward reaching bilateral agreements with non-Paris club official creditors.** Two bilateral agreements have already been signed, and one more is expected very soon. A number of other agreements should be finalized in January. Progress in reaching agreement with Gulf country creditors has been slow, but should be facilitated by the formation of a constitutional government in Iraq in 2006.

6. **The outgoing Transitional National Assembly (TNA) passed a law reducing the retirement age from 65 to 63, and setting pensions of public employees at 55 percent of final salary after fifteen years of service, rising to 80 percent after 30 years.** This law was passed at the last minute and over the objections of the ministry of finance. The minister of finance has informed staff that the law cannot made be effective without an allocation in the 2006 budget (which it lacks). He has reiterated his position that the entire pension reform issue should be tackled in an integrated way with the help of the World Bank during 2006, as envisaged in the MEFP. The law has been put on hold and has not been submitted to the Presidential Council for ratification pending resolution of administrative inconsistencies in its text.

7. **The staff will take the pension issue up with the incoming government following the elections, and also in the context of the first review of the program.** The program already incorporates a performance criterion on the wage and pension bill, which should help guide the new government to resist pressure for a supplementary budget to accommodate this pension plan.

8. **Consumer prices in Iraq rose by 6.4 percent in October and a further 4.6 percent in November, bringing the cumulative increase in prices since the beginning of the year to 28.5 percent.** The main elements pushing up prices in these months were food, fuel and light, and transportation and communication. The consumer price index remains volatile, and the staff's projection for end-2005 of 20 percent will be exceeded.

9. **Net international reserves in September remained stable at $8.7 billion.** Currency issued increased by 14.3 percent in the nine months to September, while reserve money increased by 7.9 percent over the same period. The slower growth of the latter reflects the introduction of dinar deposit facilities at the CBI (which do not count toward banks reserves).

10. **Preliminary fiscal data indicate that the primary fiscal balance in the first nine months of 2005 was in substantial surplus.** While spending in the final quarter of the year is expected to pick up, the primary balance for 2005 as a whole is likely to be well within the target. This reflects slightly higher oil export revenues as well as underspending on goods and services, and on investment.

11. **Elections based on the new constitution proceeded smoothly on December 15.** There was a very good turnout out (by all groups, including Sunnis) and relatively little violence. Staff will remain engaged with the current government, which will continue as caretaker until a new government is formed in early 2006. Staff will make contact with the new government as soon as it is formed.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 05/307
FOR IMMEDIATE RELEASE
December 23, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves First Ever Stand-By Arrangement for Iraq

The Executive Board of the International Monetary Fund (IMF) today approved the institution's first-ever Stand-By Arrangement for Iraq, which is designed to support the nation's economic program over the next 15 months. The IMF arrangement, for an amount equivalent to SDR 475.4 million (about US$685 million), is being treated as precautionary by the Iraqi authorities.

Iraq, a founding member country of the IMF, received its first-ever loan from the Fund in September 2004 through Emergency Post Conflict Assistance (see Press Release No. 04/206). The initial credit was designed to facilitate Iraq's negotiations with its Paris Club creditors over a debt-restructuring agreement that is now in place, and to support the nation's economic programs through 2005. Approval of the Stand-By Arrangement is a condition for the second stage of debt reduction agreed with Iraq's Paris Club creditors.

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

"The Iraqi authorities were successful in promoting macroeconomic stability in 2005, despite the extremely difficult security environment. Economic growth was modest, following the strong rebound recorded in 2004, and inflationary pressures moderated, although prices remained volatile. The Central Bank of Iraq built up reserves and the exchange rate remained stable. The projected fiscal deficit is much lower than expected under the EPCA-supported program, mainly due to higher than projected export prices for crude oil. On the other hand, because of security concerns and capacity constraints, the implementation of structural benchmarks specified in the EPCA-supported program was slower than envisaged.

"The authorities' program for 2006 aims to allocate resources towards the planned expansion of the oil sector, redirect expenditures away from general subsidies towards providing improved public services, and strengthen administrative capacity. The program, which envisages an increase in economic growth, a reduction in inflation, and an increase in net international reserves, maintains a focus on macroeconomic stability, while improving governance and advancing Iraq's transition to a market economy.

"A critical component of the overall strategy is to contain expenditures within revenues and available financing, by prioritizing expenditures, controlling the wage and pensions bill, reducing subsidies on petroleum products, and expanding the participation of the private sector in the domestic market for petroleum products, while strengthening the social safety net.

“The authorities have recently increased prices of refined petroleum products and will need to press ahead with other structural reforms, including measures to enhance the efficiency and transparency of public financial management and the development of a comprehensive restructuring strategy for the state-owned banks. At the same time, the Central Bank of Iraq aims to establish a modern payments system, implement modern supervisory frameworks, facilitate the proper functioning of foreign exchange and money markets, and conduct a monetary policy geared to ensuring financial stability.

“The medium term outlook for Iraq is favorable, but subject to many risks. A strengthening of the security situation will help the authorities to implement the program. Moreover, Iraq remains vulnerable to shocks, particularly those relating to oil production development and oil export price movements,” Mr. Kato said.

Background and 2006 Program Summary

The Stand-By Arrangement is intended to support Iraq’s economic program for 2006. The authorities’ policies under the Emergency Post Conflict Assistance (EPCA) have succeeded in promoting overall macroeconomic stability despite the extremely difficult security environment. Economic growth in 2005 is estimated at 2.6 percent, following a rebound of almost 50 percent in 2004. Inflationary pressures have moderated in 2005, though prices remain volatile.

Iraq’s projected fiscal deficit in 2005 is much lower than expected under the EPCA-supported program, which is mainly due to higher than projected export prices for crude oil. The Iraqi dinar’s exchange rate has remained stable at about ID 1460-1480 to the U.S. dollar, and the international reserves of the Central Bank of Iraq (CBI) have continued to increase.

Implementation of structural benchmarks specified in the EPCA-supported program was slower than scheduled, and Iraq’s commitment to increase domestic fuel prices of refined petroleum products was not implemented.

For 2006, the authorities aim to strengthen administrative capacity, allocate resources towards the planned expansion of Iraq’s oil sector, and to redirect expenditures away from general subsidies towards providing improved public services. The IMF-supported program envisages an acceleration of economic growth to 10 percent in 2006, and a reduction in the rate of inflation to around 15 percent. Net international reserves of the CBI, which stood at about US$8.7 billion at the end of September 2005, are expected under the program to increase further in 2006

Iraq’s fiscal stance in the near term will be driven by reconstruction needs, subject to constraints on financing. The primary fiscal deficit in 2006 is projected to be about 8 percent of GDP, following of deficit of nearly 11 percent of GDP in 2005. Over the medium term, and as reconstruction needs subside, the government’s fiscal deficit should gradually decline to zero. To begin the process of appropriate fiscal adjustment and to meet previous commitments to the Fund, the Iraqi authorities have increased domestic prices of all refined petroleum products.

In addition, an audit of the Central Bank of Iraq has reached an advanced stage, which was another pre-condition for the IMF Executive Board’s consideration of the Stand-By Arrangement.

Iraq joined the IMF on December 27, 1945. Its quota is SDR 1.188 billion (about US$1.71 billion), and its outstanding obligations to the Fund as of November 30, 2005 is SDR297.1 million (about US$428.12 million).

Table 1. Iraq: Selected Macroeconomic Indicators, 2004–06
(Quota: SDR 1188.4 million)
(Population: 27.1 million)
(Per capita GDP, 2004: US$ 942)
(Poverty rate: 7 percent; 2004) 1/

	2004		2005		2006
	EPCA	Actual	EPCA	Est.	Proj. 2/
Oil and gas sector					
Total exports of oil and gas (in billions of U.S. dollars)	16.5	17.8	17.6	22.8	28.7
Average crude oil export price (in U.S. dollars/barrel)	30.4	31.6	26.0	43.1	46.6
Crude oil production (in millions of barrels/day)	2.1	2.0	2.4	2.0	2.3
	(Annual percentage change)				
Output and prices					
Real GDP	51.7	46.5	16.7	2.6	10.4
Consumer price inflation (end-of-period)	7	32	15	20	15
	(In percent of GDP)				
Investment and saving					
Gross domestic investment	34.9	26.5	44.8	29.1	29.0
Of which: non-government	8.5	4.3	7.4	3.5	2.4
Gross national savings	17	-10.2	26.6	14.7	26.1
Of which: non-government	33.4	28.9	16.9	0.1	8.5
	(In percent of GDP)				
Public Finances					
Government revenue (including grants)	90.6	80.0	97.7	93.6	96.2
Oil revenue	76.7	69.6	74.6	67.8	72.9
Expenditure	133.5	120.6	125.4	104.5	105.3
Current	107.1	98.3	88.0	78.9	76.2
Capital	26.4	22.3	37.4	25.6	25.3
Budget balance (including grants)	-42.9	-40.5	-27.7	-10.9	-9.0
Primary fiscal balance	-41.9	-39.6	-27.3	-10.8	-8.2
Non-oil primary fiscal balance	-103.7	-88.4	-80.5	-57.1	-62.8
	(Annual percentage change unless otherwise indicated)				
Monetary sector					
Gross central bank foreign exchange assets/base money (in percent)	68.0	94.4	75.0	98.8	99.2
Claims on banks/base money (in percent)	6.5	0.1	5.7	0.1	0.1
Base money	117.0	116.9	32.8	12.9	20.6
Currency issued	118.4	74.9	32.8	20.7	24.2
	(In percent of GDP, unless otherwise indicated)				
External sector					
Imports of goods	-102.6	-76.2	-104.9	-73.6	-67.7
Merchandise trade balance	-24.3	-7.0	-32.4	-4.9	1.1
Overall external balance	-4.8	6.1	-14.9	4.2	4.0
Foreign Direct Investment 3/	0.9	0.8	1.2	0.9	0.7
Total external debt 4/	588.2	308.6	541.3	154.3	125.2
Current account (in percent of GDP)	-17.8	-36.8	-18.2	-14.4	-2.7
Central banks gross reserves (in millions of U.S. dollars)	5,691	7,902	8,353	9,311	11,013
In months of imports of goods and services	2.6	3.2	3.7	3.1	3.6
Memorandum Items					
Nominal GDP (in billions of U.S. dollars)	21.1	25.7	24.3	33.2	41.7
Unemployment rate 1/,5/	...	11	...	...	...
Local currency per U.S. dollar (period average)	1,500	1,460	1,500	...	...

Source: Staff estimates and projections.
1/ Iraq Living conditions survey 2004, UNDP, and ministry of planning and development cooperation. However, the survey notes that 96 percent of households receive food rations.
2/ Tentative projection, based on SBA medium-term framework.
3/ Estimate for 2004.
4/ Data for EPCA are prior to Paris Club agreement of November 21, 2004.
5/ Other estimates range from 28 percent (ministry of planning) to 70 percent (Baghdad University) .

Statement by A. Shakour Shaalan, Executive Director for Iraq
December 23, 2005

1. On behalf of the Iraqi authorities, I would like to thank the Fund's Executive Board, Management and Staff, for the support provided to Iraq throughout these difficult times, in assisting the initiation of the process of overhauling the country's economic institutions and promoting the transition to a modern market economy. Under very trying conditions, and with the support of the Emergency Post Conflict Assistance (EPCA), Iraq has achieved strong advances in macroeconomic stabilization. However**, in order to anchor the progress achieved so far and to support the continuation of economic and institutional reforms, the authorities are requesting a fifteen months Stand-By Arrangement from the Fund.** Such an arrangement will also be helpful in ensuring external debt sustainability, as Iraq would face a solvency problem unless its debt is broadly restructured[1]. With an SDR 475.4 million (40 percent of quota) access, the program will be treated as precautionary, in view of the authorities' expectation that they will be able to secure adequate financing for their program within the available resource envelope, barring severe unanticipated shocks. In this regard, I would like to convey the authorities' continued commitment to sound policies and to the needed structural reforms as outlined in the excellent staff report. I am pleased to confirm that the two prior actions on the audit of the Central Bank of Iraq (CBI), and the increases in the prices of domestic petroleum products, according to the agreed upon schedule, have been met, as the staff supplement states.

2. **A major landmark in the political reconstruction of Iraq was reached on December 15, as the first parliamentary elections under the framework of the new constitution—endorsed through a public referendum in October 2005—was successfully held that day**. More than 10 million people, representing over two thirds of the registered voters participated, and, importantly, the elections witnessed an active involvement of all major factions of the populations. These elections, which come after more than two years of transitional administration of the country since the onset of the war in 2003, open the way for a representative government with broader legitimacy to take the helm in Iraq. It is hoped that the successful representation of all segments of the population in an active and open political process will contribute to the reduction of violence and to an environment more conducive to economic prosperity.

3. **The violent conflict that has marked the difficult and complex restructuring of the political and economic landscape in Iraq since 2003 has been of longer duration and greater intensity than was expected**. It is hard to overstate the adverse implications that this open conflict has had on the pace of reconstruction and economic restructuring, and the ability to implement policy and reform measures. Whether directly or indirectly, the conflict has undermined the reform of the public sector, the functioning of institutions, investment in oil capacity and the rebuilding of infrastructure. Clearly, the ability of the government to

[1] The Paris Club agreement on Iraq's debt restructuring is conditional on an SBA by end-2005.

enact very unpopular reforms, such as the increase in domestic petroleum product prices envisaged in the EPCA, was also curtailed by the risks that an ill-timed move in this respect could have caused.

4. **In spite of these difficulties, the authorities have spared no effort to stabilize the economy and create a more hospitable environment.** On the macroeconomic front, they have succeeded in putting in place a broad-based stabilization, and established a reasonably advanced framework for policy making. Economic activity rebounded strongly in 2004, and growth was maintained in 2005. At the same time inflation, which reached more than 30 percent at end-2004, essentially due to security-related shortage of basic goods, is declining, but remains somewhat volatile. The CBI has focused its efforts on seeking price stability in the context of an exchange rate peg. To defend the peg, and improve confidence in the system, the CBI has accumulated sizeable foreign currency reserves amounting to about $8.7 billion, well in excess of the EPCA target, which puts it in a relatively comfortable position to address potential pressures on the currency, such as those that occurred in the summer of 2005. On the fiscal level, in 2004, higher than anticipated security-related spending led to a somewhat larger nominal deficit. For 2005 however, the overall balance is expected to be about half the level anticipated under the EPCA, essentially on account of higher oil revenues. Investment outturns have also been significantly lower than planned for 2005, partly reflecting weaker than expected disbursement from donors.

5. Looking forward, the overarching objective of the Iraqi authorities remains to systematically lift the population's standard of living, to recover the high level it has reached in the recent past. In order to place Iraq on a sustainable path to this objective, **the authorities have elaborated a program that will pursue, first, institutional reforms with an emphasis on good governance, second, the development of the oil sector as a strategic focus, and third, the strengthening of macroeconomic stability** to encourage the development of a dynamic market economy. Strong emphasis will be accorded, moreover, to the provision of better social and public services and the improvement of the social safety net to protect vulnerable segments of the population.

6. **While the broader political institutions of democratic governance are being firmly established, the authorities recognize the need to strengthen economic governance and reduce corruption within the existing public institutions.** To this effect, they have established a cabinet-level committee to review tenders above $3 million and created an Integrity Commission to investigate corruption cases throughout the government. These measures will be accompanied by an effort to improve the administrative capacity and transparency in policy making institutions and the implementing agencies. In particular, to enhance the effectiveness and transparency of the budget process, the ministry of finance has taken steps to ensure that the disbursements of all funds are made strictly on the basis of budget appropriations. Moreover, with assistance of the Fund, and the World Bank, a set of measures on budget reporting, projections, financial management, and training, as described in the staff report, will be implemented. Similarly, in order to enhance transparency, and comply with a requirement of the Fund, the CBI has been engaged in an audit of its financial operations and statements, and has appointed Ernst & Young to perform the task. Moreover, the authorities have also agreed to set up an audit oversight committee that will include the

participation of independent international experts to carry on the work of the International Advisory and Monitoring Board (IAMB) in overseeing the transparent use of the funds of the DFI and oil export sales.

7. **The restructuring of the oil sector will, naturally, be a major focus of the authorities, given that it represents the main source of revenues for the government** now and in the foreseeable future**.** The planned expansion of the oil sector is, therefore, the key ingredient of the program agreed with the Fund. Thus, oil production is projected to expand from 2.0 million bpd in 2005 to 2.3 million bpd in 2006. The government's approach will involve allocating substantial investments to the sector to upgrade and expand oil production and refining, as well as reforming the institutional and legal framework. In this regard, they will aim at restructuring the oil sector in such a way as to put the oil enterprises on a full commercial basis under the regulatory watch of the ministry of oil. Moreover, they will draft a new petroleum law according to the directives of the new constitution on oil revenue allocations.

8. **A cornerstone of the program agreed with the Fund is the reduction of the very large government subsidy of the domestic sale of petroleum products—and hence of smuggling—which will free up oil revenues to fund the major priority needs of the country**. The agreed-upon schedule of price increases of petroleum products is very ambitious, but the authorities believe it is achievable. The public is now more aware of the need to do so, and the political situation, it is hoped, is more favorable for action on this front. Following the large price adjustments announced last week that increased gasoline and kerosene fivefold, and diesel ninefold, prices will continue to go up in a gradual manner each quarter and will be, by the end of 2006, relatively close to prices of similar products in the Gulf region. While such significant and sustained increases in prices could provoke inflationary pressures, their impact is expected to be subdued in part due to the already high prices in the black market for these products. As the official market gradually replaces the black market for the provision of petroleum products, large gain in efficiency and the reduction of uncertainty in supply, will also help reduce the overall cost of these measures. These actions will be supplemented by a ceiling on the government's import of petroleum products, while allowing private companies to import and sell the product at market prices. The revenue gains to the government from these measures are unquestionably critical for the sustainability of public finances and the financing of security, social and infrastructural needs.

9. **Given the large, urgent, and competing need for resources from different sectors, the government will seek to put in place a fiscal strategy focused on an adequate prioritization of the allocation of its limited resources**. In this regard, the National Assembly has passed a 2006 budget in line with the program objectives. Operating expenditures are projected to increase significantly in 2006 mainly on account of security-related needs, guided by the requirement to maintain and improve public order. However, non-security related public pensions and wages will be tightly controlled. Moreover, the overall balance as a percent of GDP is expected to improve in 2006, due to economic growth and the strengthening of revenues. Indeed, the authorities expect to raise ID1.5 trillion (about $1 billion) in 2006 from the reduction in oil subsidies. Non-oil revenues are also set to

increase by more than 15 percent, albeit from a low base. In line with the commitment under the EPCA, the authorities have adopted a uniform 10 percent duty to replace the construction levy, strengthened custom collection and will introduce additional levies at the beginning of 2006.

10. **In their allocation strategy, the authorities will strive to preserve the integrity of the budget without compromising priority spending in the social sectors, the provision of basic services and critical infrastructure**, which are deemed necessary for the sustainability of the economic recovery, the reconstruction process and social cohesion. In this respect, they plan to allocate large investment outlays to the oil sector, to ensure the expansion of the revenue base. They also intend to finance important projects for the provision of basic services such as electricity, education and health. To protect the low income segment of the population, they have provisioned ID 500 billion in the 2006 budget for a social assistance program to improve the new social safety net, and introduced a voucher system for kerosene and LPG in Baghdad. Additionally, the government aims, with World Bank assistance, to reform the Public Distribution System (PDS) and, through tighter control, reduce waste and abuse of the system. It plans, ultimately to replace the PDS with a more effective cash-based system that will better target the poor. This reform will await the completion of the ongoing improvement of the payment system and the completion of a household survey.

11. **The monetary policy framework is centered around the need to support the exchange rate peg, which has served the country well in providing a firm anchor and helping stabilize the macroeconomic situation.** The CBI remains committed to defending the currency, and has pursued a policy of foreign reserves accumulation to foster stability and confidence. As part of the program, the CBI has agreed to a floor on net international reserves with a significant margin to allow it the flexibility to respond to the demand for foreign currency. In this respect, the CBI stands ready to supply the full amount of foreign exchange the market demands in the daily auctions, and has agreed to refrain from the use of administrative measures to intervene in that market. The CBI will continue to develop its capacity and broaden the menu of policy instruments at its disposal. It has created separate dinar and dollar overnight deposit facilities, and seven and fourteen days facilities with higher interest rates. Eventually it will conduct open market operations, which will provide it with a much better instrument to manage liquidity apart from the use of foreign exchange transactions. Towards this end, the CBI will seek the establishment of a secondary market for treasury bills, a securities' depository and a clearing and settlement system. In light of the outcome of the external audit of its operations, the outstanding claims of the CBI on the government will be restructured. However, sufficient treasury bills will be held by the central bank to allow it to conduct open market operations.

12. **A major reform that is being implemented is the plan to establish a modern payment system, which will be critical to the development of the financial sector and the expansion of economic activity**. It will also facilitate fiscal and financial management, and the reform of the social safety net. The CBI is also developing a restructuring strategy for the banking sector. For the two main banks, Rafidain and Rasheed, an initial assessment is being provided with US technical assistance, while future development of the strategy will be

subject to close scrutiny by the Fund. The development of Islamic banking and the restructuring of smaller banks is also being considered.

13. **Iraq's external debt will not be sustainable without the full implementations of the Paris Club restructuring agreement**, which sets the benchmark for all other debt resolutions. The negotiations on the restructuring of external debt have advanced steadily as the authorities concluded and signed bilateral agreements with nine of its eighteen Paris Club creditors, and have reached an advanced stage of negotiations with an additional four members. Iraq will continue to seek to engage all remaining Paris Club countries to reconcile claims and sign definitive bilateral agreements. As for non-Paris Club official creditors, from the list of 50 potential countries, only 24 had definitive claims. Of these countries, bilateral agreements have been signed with, Malta and Romania and Iraq hopes to have signed agreements with at least six more non-Paris club creditor countries by the end of January. Negotiations with remaining claimants are being pursued.

14. **Progress on commercial debt restructuring has also proceeded rapidly after the announcement of the terms of the commercial debt settlement offer last July**, and discussed at the Board meeting on Iraq in August 2005. The offer included a cash buyback component for small claims and a debt exchange component for larger ones. Iraq successfully concluded two rounds under the cash tender offers and expects to make a final round of offers to the remaining smaller commercial claimants early next year. On November 16, the authorities made a debt exchange offer to large commercial claimants with a deadline for responses of December 21. Results are expected soon. The government remains committed to maintain a constructive dialogue with all its private creditors in a manner consistent with the Fund's lending into arrears policy.

15. Iraq has made, under very difficult circumstances, impressive progress in macroeconomic stabilization and the establishment of a modern framework for policy formulation. The support of the Fund has been a critical element of this success. **The challenges ahead remain daunting, and the authorities hope that the Board will support their request for an SBA in view of its importance for domestic and external sustainability.** The designed program is strong, and through the prior actions, performance criteria and structural benchmarks, along with the frequency of reviews, its monitoring will be adequate. This close engagement with the Fund will be needed in the medium-term to provide the essential support for Iraq's efforts to establish a thriving economy.