

Iraq: 2007 Article IV Consultation, Fifth Review Under the Stand-By Arrangement, Financing Assurances Review, and Requests for Extension of the Arrangement, Waiver of Applicability, and Waivers for Nonobservance of Performance Criteria—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iraq

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2007 Article IV consultation, the fifth review under the stand-by arrangement, financing assurances review, and requests for extension of the arrangement, waiver of applicability, and waivers for nonobservance of performance criteria, the following documents have been released and are included in this package:

- The staff report for the combined 2007 Article IV Consultation, Fifth Review Under the Stand-By Arrangement, Financing Assurances Review, and Requests for Extension of the Arrangement, Waiver of Applicability, and Waivers for Nonobservance of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on June 10, 2007, with the officials of Iraq on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 18, 2007. 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 Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its August 1, 2007 discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- A statement by the Executive Director for Iraq.

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

Addendum to the Technical Memorandum of Understanding*
Letter of Intent sent to the IMF by the authorities of Iraq*
Supplementary Memorandum of Economic and Financial Policies by the Authorities
of Iraq*
Statistical Appendix
*Also included in Staff Report

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

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IRAQ

Staff Report for the 2007 Article IV Consultation, Fifth Review Under the Stand-By Arrangement, Financing Assurances Review, and Requests for Extension of the Arrangement, Waiver of Applicability, and Waivers for Nonobservance of Performance Criteria

Prepared by the Middle East and Central Asia Department

(In consultation with other departments)

Approved by Adam Bennett and Adnan Mazarei

July 18, 2007

- This report is based on discussions held during June 4–10 in Amman, Jordan. Staff met with Minister of Finance Jabr Al-Zubaydi, Governor of the Central Bank of Iraq (CBI) Al- Shabibi, other senior officials, members of parliament, and representatives from the banking and business community.
- A Stand-By Arrangement (SBA) for Iraq, in an amount equivalent to SDR 475.36 million (40 percent of quota), was approved on December 23, 2005. The first and second reviews under the arrangement were completed on August 2, 2006, and the third and fourth reviews were completed on March 12, 2007.
- Iraq continues to avail itself of the transitional arrangements under Article XIV. The Fund is conducting a review of Iraq's foreign exchange regulations. The de facto exchange rate regime is a crawling peg to the U.S. dollar.
- Data provision is broadly adequate for surveillance and program monitoring, but there are some delays in data provision and weaknesses exist that hamper economic analysis.
- The authorities are expected to continue their practice of publishing the PIN and the staff report.

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EXECUTIVE SUMMARY

Iraq's economic situation in recent years has been very difficult, mainly due to the deterioration in security, but progress was made in strengthening macroeconomic management while structural reforms continued. The insecurity hampered investment, keeping oil production and economic growth low. Shortages of key commodities contributed to sharply rising inflation in 2006. Following an intensified policy effort, in particular by appreciating the exchange rate, inflation came down markedly during the first part of 2007. Official fuel prices were increased to regional levels and progress was made in modernizing public financial management, strengthening central bank safeguards, and banking sector reform. Iraq continues to make progress in resolving debt to official and private creditors.

Together with the completion of the fifth review under the Stand-By Arrangement, the authorities have requested a three-month extension of the arrangement, to keep a policy framework in place during discussions for an envisaged successor arrangement.

Iraq's economic prospects for 2007 and beyond depend critically on the security situation. Provided the envisaged investments in the oil sector are realized, a gradual expansion of oil production is achievable. Given the current favorable world oil price projections, the medium-term outlook is promising. However, there are significant downside risks, including from volatile oil prices, and the political and security situation.

Iraq's key challenges are to increase economic growth and further reduce inflation. This requires: (i) increasing investment, especially in the oil sector; (ii) continuing macroeconomic policies to bring inflation down; and (iii) moving ahead with priority structural reforms.

- **The 2007 budget allows for an ambitious investment program but sustained efforts are needed to increase the project implementation rate.** Current spending, including on wages and pensions, needs to be strictly contained to maintain fiscal sustainability. It is crucial that the pension law amendments be enacted soon.
- **The authorities intend to allow the dinar to gradually appreciate in the coming months,** while the pace of appreciation will be adjusted and monetary policy will be tightened if inflation remains high. It is also important that the government actively supports private fuel imports to reduce shortages.
- **The authorities are aware of the need to accelerate structural reforms.** Their priorities are to: (i) broaden the coverage of the Financial Management Information System; (ii) develop a medium-term strategy to modernize the tax system and strengthen tax administration; (iii) further improve CBI internal controls and accounting; (iv) move ahead with banking sector reform; and (v) establish a new legislative framework for the oil sector.

I. INTRODUCTION

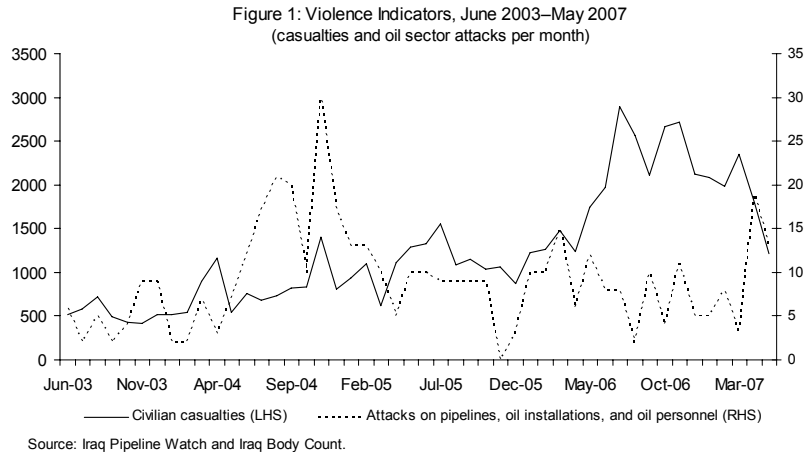
1. **Iraq's last Article IV consultation was concluded on August 1, 2005**, the first Article IV consultation in 25 years. The authorities indicated that they have drawn in their policy making on the Fund's advice, in particular with regard to the need to containing inflation and phasing out government subsidies on petroleum products.
2. **A Stand-By Arrangement (SBA) for Iraq was approved on December 23, 2005 in an amount equivalent to 40 percent of quota (SDR 475.4 million).** The arrangement originally ran through March 22, 2007, but was extended on March 12, 2007 to September 28, 2007. The first and second reviews of the arrangement were completed on August 2, 2006, and the third and fourth reviews were concluded on March 12, 2007. The SBA supported a program aimed at maintaining macroeconomic stability, paving the way for sustainable growth, and achieving external debt sustainability. Iraq continues to treat the SBA as precautionary.
3. **The Paris Club agreed on November 21, 2004 to a debt reduction for Iraq, equivalent to 80 percent in net present value (NPV) terms, to be achieved in three stages.** The first and second stages each comprised a 30 percent debt reduction in NPV terms and went into effect in November 2004 and in December 2005 (following approval of the SBA), respectively. The final stage will comprise an additional 20 percent debt reduction, and depends on completion by end-December 2008 of the final review of the third year of one or more upper credit tranche arrangements with the Fund.
4. **The International Compact with Iraq (ICI) was formally endorsed by the international community on May 3, 2007, in Sharm el-Sheikh, Egypt.** The ICI aims to put in place a medium-term framework for political, security and economic reforms. The Fund's main contribution to the ICI is through preparation of the medium-term macroeconomic framework of the SBA-supported program.

II. BACKGROUND

A. Political and Security Environment

5. **Iraq's first constitutional government since the fall of the Saddam Hussein regime was approved by the Council of Representatives (COR) on May 20, 2006, following elections on December 15, 2005.** While there have been political tensions within the coalition government, the prime minister and key ministers have kept their positions. The political consensus was, however, undermined by the resignation of six ministers from the Al-Sadr movement in April 2007.

6. **The security situation deteriorated in 2006.** Despite the implementation of a new security plan in 2007, Iraq continues to suffer serious security problems. This has further worsened living conditions, adversely affected economic activity, and induced the emigration of professionals and skilled labor.



B. Social and Human Development

7. **Living conditions in Iraq have further deteriorated in recent years.** The 2004 United Nations Development Program survey of living conditions shows Iraq's poor scores on the Millennium Development Goals, and reports widespread malnutrition, low primary school enrollment, and high child mortality. Although the survey has not since been updated, the results from the 2007 Iraq Poll provide indications of further deterioration in living conditions (Box 1).

8. **Large numbers of people have been displaced.** The United Nations' refugee agency estimates that over 4 million Iraqis are displaced, including some 1.9 million inside Iraq and over 2 million in neighboring countries. The economic and social costs are significant, with many professionals leaving the country.¹ The large numbers of refugees are putting a strain on Iraq's neighboring countries (Syria has 1.2 million refugees, and Jordan about 750,000 refugees), where the inflows are causing supply bottlenecks and rising real estate prices.

C. Institutional and Administrative Capacity

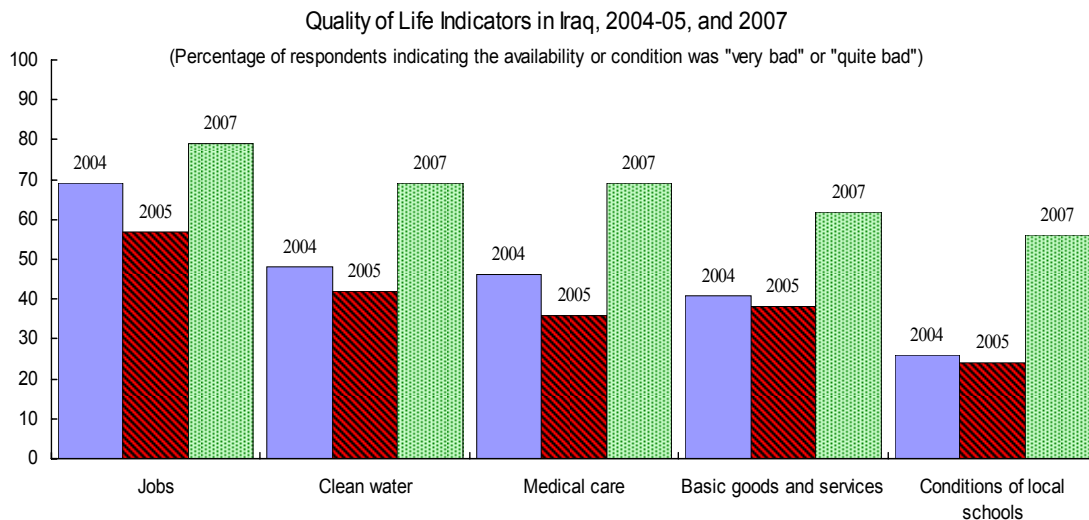
9. **Iraq has made progress with data provision, but weaknesses remain.** The data on the oil sector is generally adequate and timely, but there is little information on non-oil economic activity and on the balance of payments. The CBI balance sheet and consumer price data are available with relatively short lags but do not cover the Kurdish region. Recently, the CBI started producing a monetary survey, which also excludes the Kurdish region. Incomplete data on letters of credit issued by the Trade Bank of Iraq to finance government imports hampers the assessment of the fiscal stance.

¹ The Iraqi Medical Association, for example, estimates that at least one-third of the country's 40,000 doctors have fled to Jordan, Syria, and other countries.

Box 1. Quality of Life

The quality of life in Iraq has deteriorated in the last two years. When asked to indicate “how things are going in their lives these days?” 60 percent of respondents in the 2007 Iraq Poll answered “very bad” or “quite bad”, compared to 29 percent in 2004 and 2005¹. More than three quarters of Iraqis say that jobs are hard to find, which supports the official under-employment estimates ranging from 30 to 50 percent. The availability of clean water, medical care, and basic goods and services have, after some improvement in 2005, all deteriorated. Three out of five Iraqis consider the conditions of local schools to be bad, more than twice as many as in 2004.

The worsening security situation is perceived as the driving factor behind the deteriorating living conditions. When asked about the “biggest single problem facing Iraq” more than half of the respondents to the 2007 Iraq Poll mentioned security, followed by political and military issues (26 percent), social issues (12 percent), and economic issues (9 percent).



Source: Iraq Poll 2007, BBC News.

1/ The 2007 survey was commissioned by a consortium of international media outlets and 2,000 people across all 18 provinces in Iraq were questioned in February/March 2007 by an independent opinion research company. The same survey was conducted in 2004 and 2005.

10. **The International Advisory and Monitoring Board (IAMB) mandate to audit and oversee the Development Fund for Iraq (DFI; Box 2) was extended through December 2007.**² Meanwhile, the Council of Ministers approved the establishment of the Committee of Financial Experts (COFE) in October 2006, to be chaired by the president of the Board of Supreme Audit. The newly established COFE is working in parallel with the IAMB to smooth the transition of responsibilities from the IAMB to COFE once the IAMB’s mandate expires.

² UN Security Council Resolution 1723 (November 28, 2006).

Box 2. The Development Fund for Iraq

The DFI was established in May 2003 pursuant to UN Security Council Resolution 1483. The DFI was tasked with holding the proceeds of Iraq's oil exports, as well as the remaining balances from the UN Oil-for-Food Program and other frozen Iraqi funds. Disbursements from the DFI must be used for the benefit of the Iraqi people. The DFI consists of bank accounts held at the Federal Reserve Bank of New York and the CBI. On May 18, 2007, the U.S. President continued for one year the protections against claims available to the DFI in the U.S..

According to UN Security Council Resolution 1483, the IAMB is to act as an audit and oversight body for the DFI. UN Security Council Resolution 1723 extended the IAMB mandate until end-December 2007. The formal transfer of functions from the IAMB to the COFE is expected to take place at UN headquarters in December 2007.

Oil exports receipts are the main inflow in the DFI (over 95 percent of total). Other amounts accruing to the DFI are from returned Letters of Credit and interest earned on overnight deposits and U.S. T- Bill holdings, as well as surplus funds from the UN Oil For Food Program and transfers by UN member states of previously frozen funds of the Iraqi government.

The DFI is the main source for budgetary financing. For import financing, revenues from the DFI are channeled through the Trade Bank of Iraq. To finance domestic spending, the Ministry of Finance credits the CBI's dollar account from the DFI (thereby increasing the CBI's gross reserves), while receiving dinars in its account at the CBI in Baghdad.

11. **Despite the adverse security situation, progress was made in the delivery of technical assistance (TA).** In the monetary and banking area, Fund TA has resulted in: (i) the production of a monetary survey; (ii) replacing an obsolete paper-based system with modern electronic payment systems; (iii) improving banking supervision; and (iv) initiating the restructuring of the two largest state-owned banks. On the fiscal side, Fund TA has helped to design a Chart of Accounts and implement the financial management information system (FMIS). Fund TA in statistics, mostly in the form of training, has significantly improved the quality and coverage of fiscal, monetary and balance of payments data.

III. RECENT ECONOMIC DEVELOPMENTS

12. **The economy has not grown as fast as was expected at the time of the last Article IV consultation, although progress has been made in strengthening macroeconomic management and in implementing structural reforms.** The prevailing insecurity has seriously hampered reconstruction and investment, which resulted in lower-than-foreseen oil production and hence slower economic growth.³ It has also worsened shortages of key

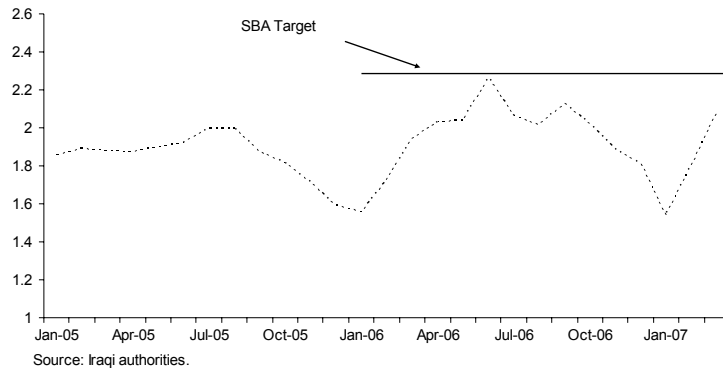
³ For example, in the 2005 Article IV consultation, oil production was projected at 2.4 million barrels per day (mbpd) in 2006 whereas the outcome was 2.0 mbpd.

commodities, contributing to rising inflation in 2006. The low implementation rate of the government's investment program resulted in large fiscal and external surpluses, with the balance in the DFI standing at \$8.6 billion at end-2006. The CBI gross international reserves increased to \$18.7 billion at end-2006 (almost 6 months of import cover).

13. Following a decline in oil production and real GDP in 2005, economic growth is estimated at 6¼ percent in 2006. Oil production increased slightly to 2 million barrels per day (mbpd) in 2006, but remained well below the 2.3 mbpd target for the year.

Although crude oil production recovered to 2.1 mbpd in March/April 2007, it averaged only 1.9 mbpd during the first four months of the year. Based on indicators for cement, fertilizers, and electricity production, real non-oil GDP is estimated to have increased by 7½ percent in 2006. Non-oil investment is also being adversely affected by the prevailing security situation.

Figure 2: Crude Oil Production, January 2005–March 2007
(In million barrels per day)

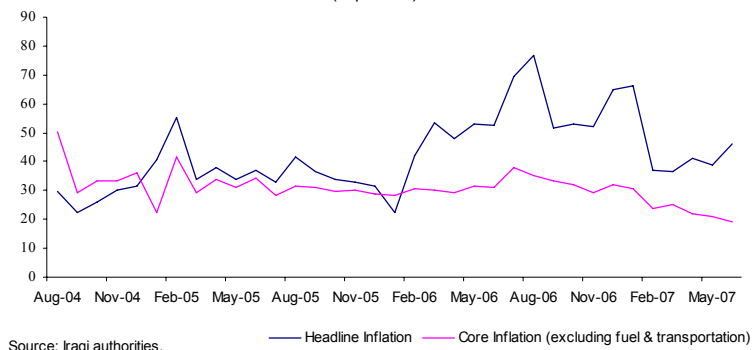


14. Inflation reached worrisome levels in 2006, but came down markedly during February through June. Annual consumer price inflation increased to 66½ percent in January 2007 from 31½ percent at end-2005, reflecting shortages of key commodities, primarily fuel. Core inflation

(excluding fuel and transportation) remained high at about 32 percent. The growth of the dinar money supply (currency in circulation) was, however, well below the rate of inflation in 2006. The increase in inflation appears instead to have been

accommodated by the pervasive cash dollarization. Following an intensified policy effort to bring inflation under control, the annual inflation rate declined to 38 percent in May 2007; core inflation decreased to 21 percent in May. Fuel shortages reportedly declined somewhat in the first months of the year, contributing to the narrowing of the gap between headline and core inflation. In June, however, fuel shortages worsened again and headline inflation increased to 46 percent; core inflation continued to decline to 19 percent.

Figure 3: Annual Consumer Price Inflation, August 2004–June 2007
(In percent)

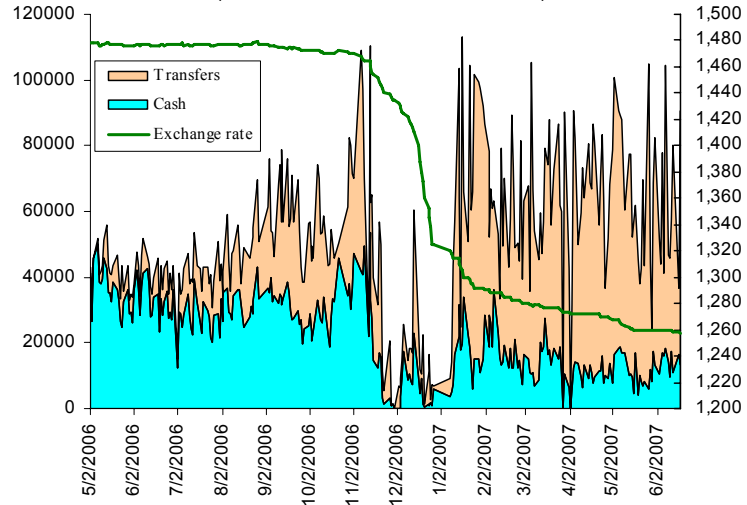


15. **Between mid-November 2006 and end-January 2007, the CBI raised its policy interest rate in two steps to 20 percent and allowed the exchange rate to appreciate by 12½ percent.** The exchange rate has since continued to appreciate gradually by a further 2½ percent through end-June. The objective was to counter dollarization and enhance the CBI's control over monetary conditions, as well as to reduce imported inflation. These policies have had some success in lowering inflation, de-dollarizing the economy, and increasing the demand for dinars. Dinar currency in

circulation expanded by 20½ percent between November 2006 and April 2007, while the CPI increased by only 13 percent over the same period. Also, cash sales of dollars at the foreign exchange auction dropped considerably in December, and have remained well below 2006 levels since then.⁴

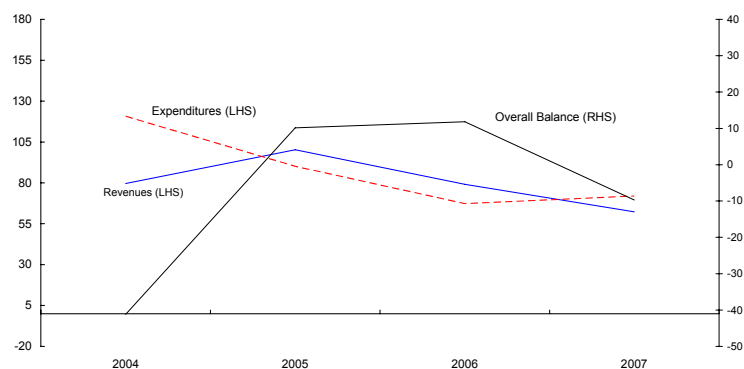
16. **Following a fiscal surplus of 11 percent of GDP in 2005, the fiscal outturn for 2006 showed yet another sizable surplus of almost 12 percent of GDP, largely due to underspending.⁵** The surplus resulted in an accumulation of balances in the DFI of \$2.4 billion and of government deposits at the CBI of ID 755

Figure 4: Daily Forex Sales and Nominal Exchange Rate
May 2006–June 2007
(In thousands of U.S. dollars and ID/\$)



Sources: Iraqi authorities and Fund staff

Figure 5: Fiscal Developments, 2004–07
(In percent of GDP)



Sources: Iraqi authorities; and Fund staff estimates.

⁴ Cash sales of dollars at auctions are considered to be a key indicator of dollarization. Dollar sales for bank transfers largely represent the financing of imports and the increasingly important remittances to Iraqi refugees abroad.

⁵ The final 2006 fiscal accounts have not yet been completed, mainly due to the damage caused by the recent car bomb explosion at the Ministry of Finance on March 21, 2007.

billion, while almost ID 950 billion of outstanding Treasury bills were redeemed. Preliminary information for the first quarter of 2007 indicates continued underspending resulting in a fiscal surplus, due to a shortfall in investment and partly also to the late adoption of the budget. However, budget execution is reported to have accelerated in April/May.

17. Progress in structural reforms has been made, despite the lack of security and capacity constraints:

- Important steps have been taken toward reducing subsidies, with several rounds of price increases for domestic petroleum products bringing these prices in line with those in other oil-exporting countries in the region. A recently promulgated law permitting the private importation of fuel products is expected to improve the domestic supply of these products and help reduce black market fuel prices. However, negotiations are still ongoing on a new legal framework for the oil sector.
- The government is also working to modernize public financial management, and the chart of accounts and budget classification are being brought in line with the *GFSM* 2001 within a cash accounting framework. On the other hand, the new pension law has yet to be amended in order to make it fiscally sustainable. The census of public service employees has started but will likely not be completed by the end of the year.
- The CBI is now using a modern real time gross settlement system and an automatic clearing house. Preparations for the restructuring of the two largest state-owned banks are underway. An audit of the CBI end-2006 net international reserves and the interim audit report of its 2006 financial statements have been completed. Also, the CBI's capital was raised to the statutory level.

18. Iraq has resolved most of its debt to Paris Club creditors, but progress in resolving debt to non-Paris Club official creditors has been limited. The authorities have signed bilateral agreements with all Paris Club creditors, except Russia, and nine (out of more than 30) non-Paris Club creditors. Six of these nine creditors (Czech Republic, Hungary, Indonesia, Malaysia, Romania, and South Africa) provided debt reduction comparable to the terms of the Paris Club agreement, while three others (Cyprus, Malta, and Slovak Republic) provided 100 percent reduction.⁶ In addition, the authorities have received confirmations from 20 countries that they do not have any claims on Iraq.

19. A Special Purpose Vehicle (SPV) was established in March 2007 to provide single securitization of restructured debt to official creditors. The SPV would issue

⁶ The total debt to non-Paris Club official creditors is estimated at \$67.7 billion, of which bilateral agreements have been signed for an amount of \$3.4 billion. The bulk of unresolved debt (more than 80 percent) is to the Gulf countries and China.

U.S. dollar-denominated notes in exchange for, and secured by, rights under bilateral agreements between one or more sovereign creditors and Iraq. The Paris Club has indicated that the establishment of the SPV does not raise any issue in terms of comparability of treatment among creditors. The scheme of the SPV does not preclude individual Paris Club member countries to participate as long as the Paris Club concurs.

20. **Iraq has resolved most private creditors' claims through debt and cash exchanges.** By mid-2007, Iraq had settled more than \$19.7 billion claims submitted by private creditors. Almost two-third of the remaining claims were withdrawn or cancelled during the process of reconciliation and settlement. Most of the unresolved claims (about 4 percent of total claims) are being reconciled with claims that are being settled as part of the liquidation of the London branch of Rafidain Bank.

IV. POLICY DISCUSSIONS

21. **The discussions were characterized by broad agreement between the authorities and staff on the key economic challenges facing Iraq and the policies needed to address them.** The authorities agreed that decisive actions are required to: (i) increase investment, especially in the oil sector; (ii) bring inflation down further; and (iii) move ahead with priority structural reforms.

22. **The authorities remain strongly committed to the program supported by the SBA.** In the attached third Supplementary Memorandum of Economic and Financial Policies (SMEFP-3) they outline their plans for the remainder of the program period.

A. Macroeconomic Outlook and Risks

23. **Iraq's economic prospects for 2007 and beyond depend critically on the security situation.** The authorities acknowledged that present circumstances constrain their ability to increase the rate of implementation of their investment program, including importantly in the oil sector. As a result, oil production would increase only gradually over the next few years. For 2007, oil production could reach close to 2.1 mbpd. With non-oil output continuing to grow moderately, real GDP growth is projected at about 6 percent in 2007. Over the medium term, output growth is projected to average some 6¾ percent in 2008–09; assuming progress is made in resolving the security problems, economic growth could increase to about 10 percent thereafter. Inflation is targeted to come down to about 30 percent by end-2007, reflecting the combined effects of the policy actions taken by the CBI, the strict control of government current spending, and the start of private imports of fuel products. The increase in government investments should only have a limited impact on inflation, given its high import content. From 2009 on, inflation is expected to gradually fall to single digit levels.

Iraq: Medium Term Outlook

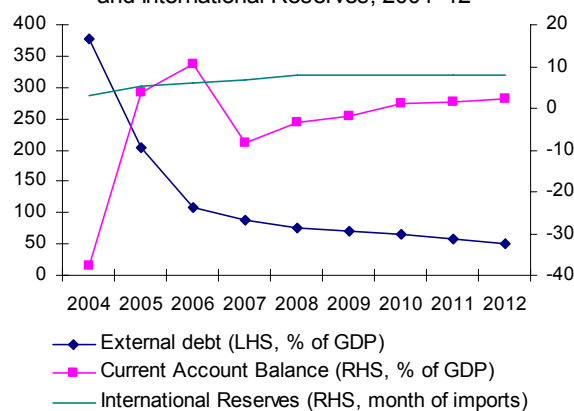
	2007	2008	2009	2010	2011	2012
Real GDP (percent change)	6.3	5.3	8.2	10.2	11.7	10.6
Oil production (In mbpd)	2.1	2.2	2.4	2.7	3.1	3.5
Consumer price inflation (percentage change)	30.0	12.0	7.0	5.0	5.0	5.0
Current account balance (percent of GDP)	-5.3	-2.8	-2.2	-0.2	3.0	6.6
Overall fiscal balance (percent of GDP)	-9.7	-6.6	-4.5	-1.9	1.5	5.1
DFI (in US\$ million)	4,808	1,736	425	332	285	4,077

Sources: Iraqi authorities and Fund staff projections.

24. **The fiscal situation remains vulnerable to declines in oil prices.** With the current favorable world oil price outlook and assuming a gradual increase in oil production and export volumes, the overall fiscal position would be sustainable. The government will need to continue to restrain current spending in order to allow for sufficient investment and security outlays, especially in view of the expected reduction in foreign grants starting in 2008 and sizable amortization payments of the rescheduled debt beginning in 2011. The balance of the DFI is projected to fall to a very low level during 2007–11 to absorb the projected fiscal deficits, leaving no room for fiscal slippage.

25. **Iraq's medium-term balance of payments and debt outlook remain heavily dependent on crude oil exports.** The current account balance is expected to deteriorate in 2007 and remain in sizable deficit through 2009, as oil exports would increase only slightly, and because of somewhat higher investment-related imports and lower inflows of foreign grants. With more rapidly increasing oil exports from 2010, the external current account balance would improve again over the medium term. Gross international reserves are expected to gradually increase to a level equivalent to eight months of import cover.

Figure 6. Current Account Balance, External Debt and International Reserves, 2004–12



26. **The unsettled security situation and possible terms of trade shocks continue to pose serious risks to the outlook.** The economy remains extremely vulnerable to the country's security problems, which impede investment, inhibit private economic activity, and hamper implementation of the structural reform agenda. In the event that investment and production in the oil sector cannot be increased as projected, lower oil revenue would result

in higher fiscal deficits and sizable financing gaps from 2008. Absent access to significant external borrowing, spending cuts would be necessary and unavoidable. The debt sustainability analysis indicates that Iraq's external debt remains also vulnerable to negative oil price and production shocks (Appendix I).

B. Fiscal Policy and Related Measures

27. **The 2007 budget allows for an ambitious investment program, while maintaining overall fiscal sustainability** (SMEFP-3, ¶8–10). The authorities indicated that they have already taken a number of administrative measures to increase the execution rate of investment projects, including accelerating cabinet approval of large projects and shortening the procurement period. However, they considered that, given the gestation period of new projects and the unsettled security situation, the impact of these measures in the short term will be limited. At the same time, they were determined to keep current spending, notably on wages and pensions, within budget to make room for public investment and security outlays, and to avoid putting excessive demand pressures on Iraq's small non-oil economy. Taking account of the effect of a further appreciation on oil revenues, the overall fiscal deficit would be kept below 10 percent of GDP in 2007.

28. **The authorities were committed to continue the phased adjustment of official fuel prices** (SMEFP-3, ¶13 and Box 3). Domestic fuel prices were raised on July 1, broadly in line with the program. The increase should avoid the emergence of explicit budgetary subsidies, except for a small subsidy on kerosene. With fuel prices now equal to or above regional averages, the authorities indicated that they will consider developing a rule-based mechanism for setting domestic fuel prices in the future.

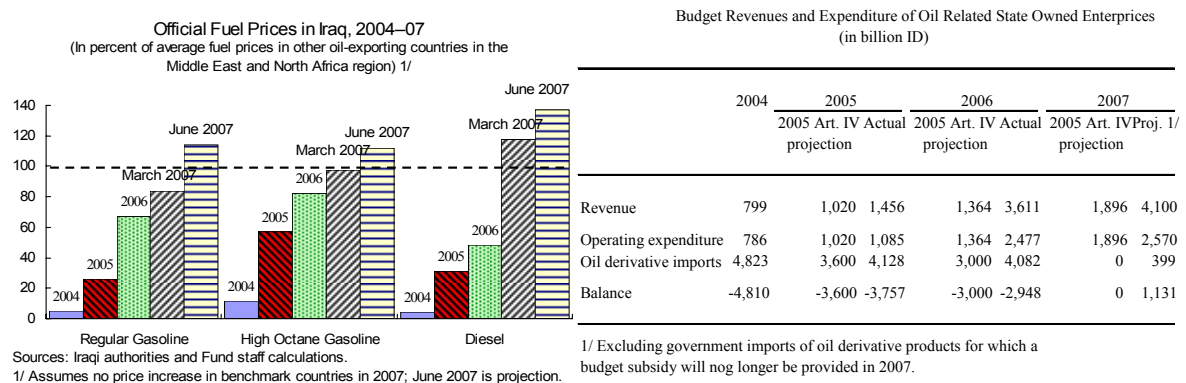
29. **To reduce fuel shortages, the authorities have issued about 20 licenses to private importers** (SMEFP-3, ¶12). They indicated that private imports in the Kurdish region have begun, but that the security situation in other parts of the country remains a deterrent for private sector involvement. The authorities also pointed out that they will take further steps to facilitate private sector imports of petroleum products, including by making storage facilities and pump stations available to private operators. The government will continue to put at the disposal of the State Oil Marketing Organization (SOMO) a revolving credit with a ceiling of ID 400 billion to finance its imports of fuel products.

30. **The government has begun to develop a medium-term tax reform strategy with technical assistance from international partners, including the Fund** (SMEFP-3, ¶18). The authorities explained that they aim to modernize the tax system to improve revenue collection without placing undue burdens on the economy. They are considering the introduction of a sales-tax as a precursor to a value-added tax, and aim to strengthen the tax and customs administration.

Box 3. Iraq: Official Fuel Price Adjustments

Despite initial political resistance, Iraq has made significant adjustments to official fuel prices in the past 18 months. Before the first adjustments, in December 2005, fuel prices were extremely low, even by regional standards, with regular gasoline selling in Baghdad for about 3 U.S. dollar cents per liter, and less than half of that outside the capital. In March and June 2007, the prices of regular and premium gasoline and diesel were increased to a level exceeding the regional average. Prices for regular gasoline are now 32 U.S. dollar cents per liter, while prices for premium gasoline largely reflect the actual import cost. With a view to reduce smuggling, the price differentials of premium gasoline between Iraq and its direct neighbors Iran and Kuwait were eliminated, while the price differentials with Syria and Jordan were reduced from more than ninety to less than fifty percent.

The fiscal gains of the fuel price adjustments are substantial. The main objective of the price adjustments is to gradually eliminate budgetary subsidies, and shift resources towards much needed investments in the oil sector, healthcare, education, and security spending. In 2004, the net budget subsidy for fuel imports was ID 4.8 billion (12¾ percent of GDP). By 2006, the price adjustments had reduced this subsidy to ID 3.2 billion (4½ percent of GDP). In the 2007 budget, explicit subsidies for fuel imports have been eliminated, except for a small subsidy for kerosene imports, mostly used by the poor for cooking. These developments were largely in line with the Fund staff recommendations at the time of the previous Article IV consultation and the target set under the SBA.



31. **The authorities underlined that they attach high priority to improving public financial management.** They were determined to complete the remaining steps needed to conform the chart of accounts and budget classification with the *GFSM 2001*, within a cash accounting framework, shortly (SMEFP-3, ¶14). The authorities also indicated that they have started using the Financial Management Information System (FMIS) on a trial basis since January 2007. Staff agreed that the existing legacy system should continue to be used by spending agencies in parallel until the FMIS is fully operational and tested. At the same time, the coverage of the FMIS is being expanded to spending units not yet connected.

32. **The authorities explained that the census of public service employees turned out to be more time-consuming than initially foreseen** (SMEFP-3, ¶16). They pointed out that the census is linked to the preparations for setting up a computerized payroll to better control

the wage bill, and that the security situation has resulted in unexpected delays. However, the preparations for the census have been completed and the census questionnaires have been sent to most relevant government agencies. The data collection phase of the census is expected to be completed by end-November.

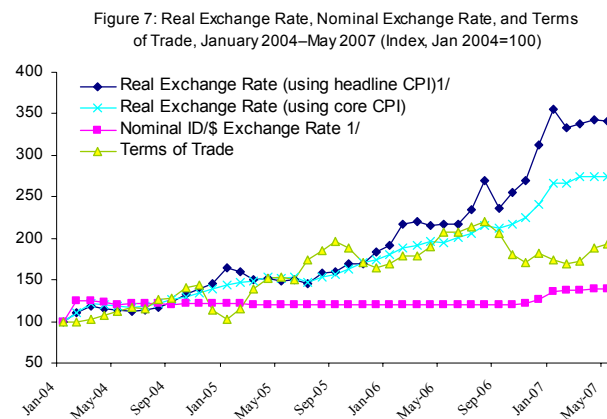
33. **The authorities indicated that they are actively seeking to have the amendments to the new pension law enacted by the CoR as soon as possible (SMEFP-3,¶15).** The new pension law that was passed in November 2005 is fiscally unsustainable over the medium term. The amendments, once enacted, will provide for a gradual reduction of replacement rates to sustainable levels and zero indexation in 2007, in line with earlier understandings with Fund staff. The authorities also indicated that progress is being made in streamlining the social safety net (SMEFP-3,¶17).

C. Monetary and Exchange Rate Policy

34. **The CBI will continue to manage the exchange rate with a view to reducing inflation and reversing dollarization, and monetary policy will be further tightened, if the inflation situation required this (SMEFP-3,¶11).** While the recent appreciation of the dinar has been successful in helping to reverse dollarization and contain inflationary pressures, the authorities agreed that inflation needs to be further reduced. To this end, they are committed to allow the exchange rate to appreciate gradually in the coming months, while closely monitoring the effects of this policy and adjusting the pace of appreciation as needed.

35. **The authorities intend to maintain the link of the dinar to the dollar.** In the absence of an effective monetary transmission mechanism and indirect monetary policy instruments, the CBI will continue relying on the exchange rate as the principal nominal anchor for the economy. While the exchange rate will remain the main policy instrument, it will be backed up, as needed, by adjustments in the policy interest rate.

36. **Due to data limitations and many structural changes in the economy, it is not possible to estimate the equilibrium real exchange rate.** Also, since Iraq is an oil economy, it is difficult to interpret real exchange rate developments based on simple intervention analysis and developments in Iraq's current account data. However, the improvements in the terms of trade over the past three years and higher current government spending in 2006 have most likely resulted in an appreciation of the



Sources: The Iraqi Authorities and Fund staff calculations.
1/ Increase denotes appreciation.

equilibrium real exchange rate. With the nominal exchange rate fixed to the dollar for most of the past two years, the adjustment of the real exchange rate to its new equilibrium was reflected in persistent high core inflation. With the policy of allowing the exchange rate to appreciate and the subsequent drop in inflation, the undervaluation of the exchange rate has been significantly reduced. Nevertheless, the real exchange rate likely remains somewhat undervalued as core inflation is still high. Therefore, the authorities agreed that the nominal exchange rate should appreciate further, which should also help to contain inflationary expectations. This policy of gradual appreciation is believed to have a minimal impact on competitiveness, given that Iraq's main export commodity is oil, and that to achieve lasting gains in competitiveness it is essential to improve security and implement productivity enhancing structural reforms.

37. **Iraq continues to maintain a liberal exchange regime.** The authorities confirmed that in practice there are no restrictions on current and capital transactions as long as underlying transactions are supported by valid documentation. However, it remains unclear whether Iraq maintains exchange restrictions subject to Fund jurisdiction as the review of exchange regulations by staff is ongoing. As part of this review, the authorities have submitted exchange regulations and recently provided clarifications requested by staff.

38. **The CBI's external audit firm, Ernst and Young (E&Y), has issued in July an interim audit report of the CBI 2006 financial statements summarizing control weaknesses and recommending remedial measures (SMEFP-3,¶19).** The CBI has indicated its commitment to addressing all of E&Y's audit observations during the course of this year, so that improvements as far as possible would be reflected in the 2007 financial accounts.

39. **The CBI has made some progress in addressing the concerns raised by staff and E&Y in the interim safeguards assessment report (ISAR) and the audit of 2005 CBI financial accounts (SMEFP-3,¶20).** The CBI Board has adopted a timetable that envisages full implementation of International Financial Reporting System (IFRS) as the CBI's financial reporting framework by end-2009, and the capital of the CBI was increased to the statutory level of ID 100 billion in February 2007. Furthermore, the CBI indicated to staff that work is underway in addressing the lack of proper accounting records maintained by the CBI, and in establishing adequate control procedures for reserves management.

D. Financial Sector Reform

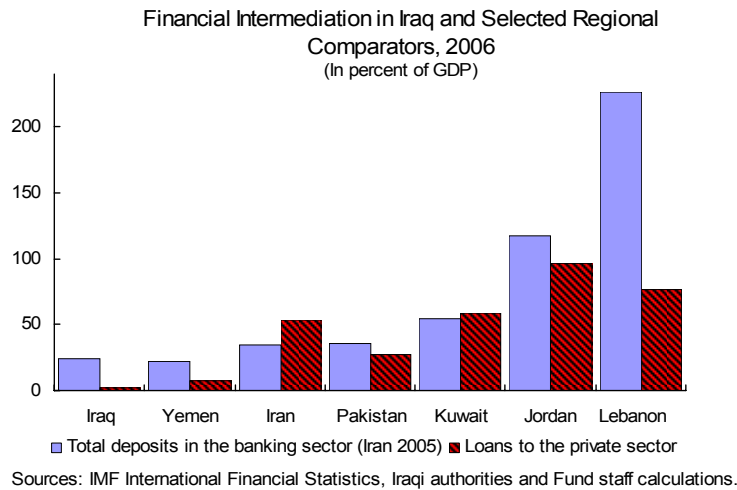
40. **The authorities indicated that they continue to expand the coverage of the new payment system (SMEFP-3,¶21).** The CBI will continue to encourage banks to connect to the real time gross settlement payment system and the automated clearing house, and expected to cover most banks by end-2007.

41. **The Memoranda of Understanding (MoUs) signed in December 2006 between the CBI and the ministry of finance for the restructuring of the two largest state-owned**

Box 4. Banking Sector

Iraq's banking sector comprises seven state-owned banks (SOBs) and 22 private banks as of end-2006. Their consolidated assets totaled about \$26 billion (or 51 percent of GDP). The SOBs account for 90 percent of the banking sector total assets (70 percent for Rafidain and Rasheed banks alone). The credit culture is poor with very little extension of credit to the private sector and an asset composition heavily tilted toward government securities. Very few banks offer loans with more than one year maturity as most banks lack the expertise to offer appropriate credit facilities or assess risks.

Financial intermediation in Iraq is weak. The total loans portfolio of the banks was only \$2.2 billion (4 percent of GDP) at end-2006, mostly in the form of overdrafts, despite the fact that credit to the private sector more than doubled in 2006. Total deposits in the banking sector were \$12.9 billion (26 percent of GDP). Compared to some other countries in the region the deposit base and loan portfolio of Iraqi banks is small.



Banking supervision, which involves both on-site (security permitting) and off-site supervision, has improved over the past two years, including as a result of the technical assistance provided by the Fund, which has encouraged the CBI to move from a rule-based to a risk-based system.

banks are being implemented (SMEFP-3, ¶22). As a first step, an international auditor has been selected to conduct operational and financial audits of both banks that are expected to be completed by early 2008. The restructuring of the remaining state-owned banks will be initiated later this year, in line with the approach adopted with Rasheed and Rafidain banks.

42. **The CBI issued implementing regulations for the 2004 Anti- Money Laundering (AML) law in September 2006.** A new AML office was set up within the CBI to implement these new regulations.

E. Other Structural Issues

43. **Negotiations on a new legal framework for the oil sector are ongoing** (SMEFP-3, ¶23). The authorities emphasized their commitment to develop a competitive and transparent hydrocarbon sector. The envisaged legal framework is provided by four draft laws, which in addition to the draft hydrocarbon law, include three accompanying draft laws pertaining to reestablishing the Iraq National Oil Company, reorganizing the ministry of oil, and setting the parameters for revenue distribution and intragovernmental fiscal relations.

44. **The authorities attached great importance to enhancing transparency and fighting corruption in the oil sector** (SMEFP-3, ¶24). Oil meters at the Basra export terminal have become operational for the most part. However, the work on the implementation of a comprehensive country-wide metering system is still underway. The authorities intend to join the Extractive Industries Transparency Initiative. As a first step, the ministry of oil will start, during the second half of the year, to publish oil-related data on its website.

45. **The authorities are in the process of rehabilitating commercially viable state-owned enterprises** (SMEFP-3, ¶25). They indicated that so far about 21 public enterprises have been selected, notably in the cement, textile, pharmaceutical, and petrochemical sectors. These enterprises have submitted a business plan to Rasheed and Rafidain banks to obtain financing for starting operations.

46. **The new investment law still needs an operational framework** (SMEFP-3, ¶26 and Box 5). The authorities indicated that they are working to set up the National Investment Commission, which would develop and monitor the implementation of investment policies and regulations to attract investments. They are also seeking to establish national and regional one-stop agencies that would be in charge of issuing investment licenses.

Box 5. The New Investment Law

In November 2006, the Presidential Council issued a new investment law, which covers all areas of investment except those in banking, insurance, and the extraction and production of oil and gas, which are covered by separate laws. The new law promotes equal treatment for investors regardless of nationality and stipulates the establishment of national and regional investment commissions. The commissions will develop and monitor the implementation of investment policies and regulations, and establish one-stop agencies at the national and regional levels to approve investments. The law also specifies the rights (e.g., leasing the land up to 50 years renewable), benefits, and obligations for investors.

The new investment law provides various tax holidays to promote investment. For example, an investment project may be exempted from taxes for a period of 10 years after the commercial operation starts. Also, imported assets for the project would be exempted from customs duties, provided that they are brought into Iraq within three years from the date of granting the investment license.

47. **Iraq continues to maintain an open trade regime and has made significant progress in the process of WTO accession.** The authorities intended to maintain the 5 percent custom duty (reconstruction levy) on imports, while reducing its numerous exemptions. However, the security situation and capacity constraints have hampered effective customs administration. The Working Party on Iraq's WTO accession met for the first time in Geneva in May 2007, and started the process of accession negotiations. Subsequently, the Iraqi delegation met bilaterally with representatives of more than ten WTO members, and has been invited to submit initial offers to advance their market access negotiations on goods and services.

48. **The authorities reiterated their commitment to resolving the remaining external claims** (SMEFP-3, ¶28). Official contacts have been established with key creditor countries in the Gulf region and China, and the process of debt negotiation and reconciliation is ongoing. The authorities hoped that the SPV for debt securitization would facilitate the negotiations with other official creditors. They also expected that the liquidation of the London branch of Rafidain Bank could be completed by end-2007, enabling them to complete the resolution of all private claims.

V. PROGRAM MONITORING AND FINANCING ASSURANCES

49. **All quantitative performance criteria set for end-March 2007 were met, but there have been slippages in structural conditionality** (Tables 7 and 8). The measures set as structural performance criteria for end-May and end-June are expected to be implemented partially or with delay. As a result, waivers are sought for the following performance criteria (LOI, ¶4):

- The audit of CBI net international reserves data was completed on time but the interim audit report of the CBI 2006 financial accounts has been delayed and was completed on July 15.
- The adoption of a fully detailed budget classification and chart of accounts in line with the IMF's *GFSM* 2001 within a cash accounting framework is expected shortly.⁷
- The census of public service employees, while in progress, was not completed by end-June as planned. This is mainly due to the prevailing security situation, and the fact that it is linked to the preparation for setting up a computerized payroll.

50. **The authorities have requested an extension of the SBA until December 28, 2007,** in order to keep a policy framework in place during the discussions for a successor arrangement they intend to seek (LOI, ¶3). The authorities have also requested a waiver of

⁷ Progress was hampered by the kidnapping of an external consultant in May.

applicability for all the end-June quantitative performance criteria. Data to verify performance against these targets will not be available by the time of the Board discussion (scheduled for August 1).

51. **The program will continue to be monitored through quantitative and structural performance criteria.** In light of the authorities' request to extend the SBA by three months to December 2007, they requested the establishment of the quantitative performance criteria proposed in the SMEFP-3 for end-September. The authorities requested that the structural performance criterion on completion of the census of all public service employees be redefined and rescheduled to completion of the data collection for the census of all public service employees by end-November 2007. They also requested that the penultimate purchase linked to the fifth review and the last purchase available upon observance of the end-June 2007 performance criteria be rephased, while leaving total access under the arrangement unchanged (Table 10). In case there remain arrears to private creditors by the end of the program period, a financing assurances review will be undertaken.

VI. STAFF APPRAISAL

52. **Iraq's economic situation in recent years has been very difficult because of the unsettled political situation and the deterioration in security in 2006.** Reconstruction and investment have proceeded at a slow pace, thereby keeping oil production low and hampering economic growth. Shortages of key commodities have contributed to sharply rising inflation in 2006.

53. **Under these circumstances, staff commends the authorities for having strengthened their economic policies and for having made progress in structural reforms.** In particular, the authorities have successfully intensified their policy response to bring the dangerously high inflation on a downward path, and have increased fuel prices to regional levels. Steps have also been taken to increase public investment, which is key to boosting growth and generating sufficient revenues to maintain fiscal sustainability. Despite delays caused by the lack of security and serious capacity constraints, structural reforms continued.

54. **The main economic challenges facing the Iraqi authorities are to increase economic growth and further reduce inflation.** This requires: (i) taking measures to speed up reconstruction and increase investment, especially in the oil sector; (ii) continuing macroeconomic policies to bring inflation further down; and (iii) pressing ahead with priority structural reforms.

55. **Much remains to be done to advance the reconstruction of Iraq's economy over the medium term.** Rebuilding infrastructure and reversing the decline in living conditions will depend critically on progress in establishing a broad-based political consensus and especially on improving security. Implementation of the investment program will also require

judicious management of the country's available resources by ensuring that these are used for priority investment projects and by containing current spending.

56. **It is extremely important that the authorities succeed in increasing investment in the oil sector. This will depend critically on improving security.** The staff believes that a gradual expansion of crude oil production is achievable, provided the protection of oil installations is reinforced and the envisaged investments in the sector are effectively realized. In this regard, staff welcomes the measures taken by the government to increase the implementation rate of its investment program, and urges it to take additional measures if needed.

57. **On this basis, and given the current favorable world oil price projections, the medium-term outlook for Iraq is promising.** However, since available resources (mainly expected oil revenues, domestic revenues, assets held in the Development Fund for Iraq, and some remaining external grants) will be limited in the next few years, fiscal prudence is of utmost importance. This is essential, as there are significant downside risks, including from volatile world oil prices, and the political and security situation.

58. **Staff welcomes the government's commitment to keep current spending in 2007 within the budget limits and seek to maintain fiscal sustainability over the medium term.** This will require resisting undue spending pressures and strictly containing the wage bill, pensions, and transfers. It remains crucial that the pension law amendments be enacted soon to ensure the long-run fiscal sustainability of the pension system. Staff welcomes the recent increase in official fuel prices, which will enable the government to continue avoiding direct subsidies on fuel products, except for kerosene. The expansion of the new social safety net and ongoing rationalization of the Public Distribution System are also encouraging.

59. **Staff supports the decision of the CBI to continue allowing the gradual appreciation of the dinar through end-2007.** This policy should contribute to reducing inflation and dollarization, and help correct for any modest undervaluation of the exchange rate in light of Iraq's favorable terms of trade. However, data and analytical limitations prevent confident estimation of the equilibrium real exchange rate in Iraq. The CBI should keep a close watch on inflationary developments, and be ready to increase the pace of appreciation and tighten monetary conditions further if inflation deviates from its downward path and dollarization is not reduced as expected. The government can further assist the fight against inflation by restraining public spending pressures on the small non-oil economy and by stepping up its efforts to reduce shortages, notably by supporting private sector fuel imports.

60. **Concerted efforts are needed to implement priority structural reforms as expeditiously as circumstances permit.** Following the modernization of the chart of accounts and budget classification, the authorities should broaden the coverage of the FMIS. Staff encourages the authorities to modernize and streamline the tax system with a view to

expanding the tax base and improving incentives for economic activity. It is also important to press ahead with the restructuring of the banking system, in order to enhance the banks' role in financing new investments. The efforts to rehabilitate viable public enterprises on a commercial basis are welcome; however, any government financial support should be efficient and fully reflected in the budget. In view of Iraq's large investment needs to increase oil production, a new legislative framework for the hydrocarbon sector should be put in place as soon as possible.

61. **Staff welcomes the authorities' intention to maintain open trade and investment regimes, and supports their efforts to secure WTO accession.** While keeping the present low import tariff (reconstruction levy), it is important to increase revenues by scaling down exemptions and strengthening the customs administration. The new investment law provides an important framework to attract much-needed foreign investment, although the numerous tax holidays seem excessive. Staff encourages the authorities to establish the National Investment Commission as soon as possible.

62. **Staff also welcomes the authorities' intention to establish a liberal exchange regime** and is in the process of examining additional information provided by the authorities to determine whether or not any exchange restrictions exist that might fall under Fund jurisdiction. Staff urges the authorities to remove any such restrictions, and encourages them to subsequently accept the obligations under Article VIII, Sections 2(a), 3, and 4.

63. **Staff urges the authorities to improve the transparency and accountability of public financial management and step up their fight against corruption,** which hurts the economy and undermines the credibility of their reform program. Staff underscores the need to put in place a comprehensive oil metering system and encourages the authorities to follow up on their intention to join the EITI.

64. **Staff welcomes the steps taken in the central bank safeguards area and urges the CBI to address all recommendations of the ISAR and the interim audit report on its 2006 financial statements.** Satisfactory progress in this area will be important in securing a successor arrangement.

65. **Staff urges the authorities to continue their efforts to conclude debt agreements with the remaining official and private creditors.** However, despite good faith efforts by the authorities, the process of resolving Iraq's debt to non-Paris Club official creditors remains slow.

66. **Staff underscores the importance of further improving the statistical database,** notably as regards real sector data, the balance of payments, and public finances.

67. **Staff recommends that the fifth review under the SBA be completed.** In view of the authorities' commitment to the program, and the policies and measures described in the third SMEFP, staff supports the authorities' request for: (i) a waiver of applicability of end-

June quantitative performance criteria; (ii) waivers for the nonobservance of the end-May and end-June structural performance criteria; (iii) an extension of the SBA through December 28, 2007, and the rephasing of purchases under the SBA; (iv) the establishment of quantitative performance criteria for end-September 2007; and (v) the setting of a new structural performance criterion (relating to the census of public sector employees) for end-November 2007.

68. **Staff supports the completion of the financing assurances review.** Staff believes that Iraq is making best efforts to reach bilateral agreements on its arrears to official non-Paris Club creditors and that the authorities have been negotiating in good faith to resolve the remaining arrears to private creditors, consistent with the Fund's policy on lending into arrears.

69. It is proposed that the next Article IV consultation be held according to the provisions applying to countries with Fund arrangements.

Table 1. Iraq: Selected Economic and Financial Indicators, 2004–12

	2004	2005		2006		2007	2008	2009	2010	2011	2012
		SBA	Est.	SBA	Est.							Projections
Economic growth and prices											
Real GDP (percentage change)	46.5	2.6	-0.7	10.4	6.2	6.3	5.3	8.2	10.2	11.7	10.6
Non-oil real GDP (percentage change)	14.9	8.0	12.0	8.0	7.5	5.0	6.0	7.0	7.0	7.0	7.0
GDP per capita (US\$)	951	1,189	1,124	1,452	1,722	2,109	2,321	2,510	2,730	3,049	3,369
GDP (US\$ million)	25,763	33,182	31,375	41,741	49,516	62,384	70,578	78,391	87,489	100,136	113,330
Oil production (In mbpd)	2.0	2.0	1.9	2.3	2.0	2.1	2.2	2.4	2.7	3.1	3.5
Oil exports (In mbpd)	1.4	1.4	1.4	1.65	1.5	1.6	1.6	1.8	2.0	2.5	2.9
Iraq oil export prices (US\$ pb)	31.6	43.0	43.9	46.6	55.7	50.6	55.8	56.0	54.8	54.5	54.5
Population growth (in percent)	3.0	3.0	3.0	3.0	3.0	2.9	2.8	2.7	2.6	2.5	2.4
Consumer price inflation (percentage change; end of period)	31.7	20.0	31.6	15.0	64.8	30.0	12.0	7.0	5.0	5.0	5.0
Exchange rate (dinar per US\$; period average) 1/	1,453	1,500	1,469	1,500	1,467	1,275	...	...	...	...	...
Total government debt (in billions of US\$)	97.6	51.2	68.9	52.2	54.7	56.4	59.4	62.5	65.2	63.7	61.7
(In percent of GDP)											
National Accounts											
Gross domestic investment	27.7	29.1	31.6	29.0	16.3	20.0	21.5	21.5	21.9	21.9	22.2
Of which: public	22.2	25.6	19.4	26.6	13.0	15.8	15.9	15.3	14.8	14.3	14.1
Gross domestic consumption	97.5	95.4	84.6	87.1	80.4	90.6	83.1	78.3	75.4	72.1	68.2
Of which: public	56.5	59.6	59.7	57.2	41.0	41.1	35.8	31.5	30.3	29.3	28.4
Gross national savings	-9.8	14.7	31.2	26.1	27.7	14.7	18.6	19.3	21.7	24.9	28.8
Of which: public	-39.2	14.6	30.9	17.6	25.3	6.1	9.3	10.8	12.9	15.8	20.5
(In percent of GDP, unless otherwise indicated)											
Public Finance											
Government revenue and grants	79.6	93.6	107.4	96.3	80.5	62.3	59.0	55.6	56.4	58.4	59.8
Government oil revenue	69.2	67.8	76.7	72.9	65.2	51.1	51.3	52.1	53.1	55.3	56.8
Government non oil revenue	1.3	2.6	2.8	3.0	2.9	2.9	3.2	3.3	3.2	3.1	3.0
Grants	9.1	23.2	27.9	20.4	12.5	8.3	4.5	0.2	0.0	0.0	0.0
Expenditure	120.8	104.5	96.6	105.3	68.5	72.0	65.7	60.1	58.3	56.9	54.7
Current expenditure	98.6	78.9	77.2	80.0	55.5	56.1	49.7	44.8	43.5	42.6	40.5
Capital expenditure	22.2	25.6	19.4	25.3	13.0	15.8	15.9	15.3	14.8	14.3	14.1
Overall fiscal balance (including grants)	-41.2	-10.9	10.9	-9.0	12.0	-9.7	-6.6	-4.5	-1.9	1.5	5.1
Primary fiscal balance	-40.2	-10.8	11.1	-8.2	12.5	-9.0	-5.7	-3.1	0.2	4.6	7.7
Gross borrowing/use of external assets	43.0	11.9	6.4	9.3	-2.3	8.4	5.4	3.4	1.9	1.6	-2.4
Amortization	1.8	0.6	0.5	0.3	2.5	0.3	0.0	0.0	0.0	3.1	2.8
Residual or financing gap/surplus	1.4	0.0	0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Tax revenue/non oil GDP (In percent)	1.3	2.4	2.8	4.2	1.9	1.9	2.2	2.7	2.7	2.7	2.7
External assets held abroad (In US\$ million)	4,577	3,992	6,203	285	8,624	4,808	1,736	425	332	285	4,077
(In percent)											
Monetary Indicators											
Growth in reserve money	116.9	12.9	12.0	20.6	29.0	38.9	20.3	...	...	...	...
Gross CBI foreign exchange assets/Reserve money	94.4	98.8	129.4	99.2	147.4	109.5	113.7	...	...	...	...
Gross reserves (In US\$ million)	7,902	9,311	12,024	11,013	18,723	21,313	24,279	26,391	29,149	31,150	33,306
In months of imports of goods and services	3.2	3.1	5.4	3.6	6.2	6.9	7.8	8.0	8.0	7.9	7.9
Policy interest rate (end of period) 2/	6.0	7.0	7.0	7.0	16.0	20.0	...	...	...	...	...
(In percent of GDP)											
Balance of payments											
Current account	-37.6	-14.4	-0.5	-2.7	11.4	-5.3	-2.8	-2.2	-0.2	3.0	6.6
Trade balance	-8.4	-4.9	3.3	1.1	14.0	-2.3	1.8	4.7	7.0	10.2	13.5
Exports of goods	69.0	68.7	63.0	68.9	57.4	47.3	47.5	47.4	47.8	49.8	51.1
Imports of goods	-77.5	-73.6	-59.8	-67.7	-43.4	-49.5	-45.7	-42.7	-40.8	-39.5	-37.6
Income and services	-36.8	-30.8	-30.2	-22.4	-13.5	-10.3	-8.5	-6.5	-6.6	-6.4	-5.9
Transfers	7.7	21.4	26.4	18.5	10.9	7.3	3.8	-0.4	-0.6	-0.9	-1.1
Financial account	42.8	18.6	11.6	6.8	3.9	9.5	7.0	4.9	3.3	-1.0	-4.7
Direct investment	0.8	0.9	1.3	0.7	0.6	0.6	0.9	1.0	1.5	1.6	1.7
Gross borrowing/use of external assets	42.0	23.2	18.5	14.3	2.0	12.0	8.4	5.7	3.3	1.6	-2.4
Amortization	0.0	-0.6	-0.5	-0.3	-2.5	-0.3	0.0	0.0	0.0	-3.1	-2.8
Overall external balance	6.6	4.2	11.2	4.0	15.1	4.3	4.2	2.7	3.2	2.0	1.9
Central bank reserves (increase -)	-26.3	-4.2	-13.1	-4.0	-13.5	-4.2	-4.2	-2.7	-3.2	-2.0	-1.9
Change in arrears	-134.8	-84.3	-103.4	-2.9	-32.3	-1.5	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.4	0.0	0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Iraqi authorities and Fund staff estimates and projections.

1/ For 2007, the average is for January–June.

2/ For 2007, as of January 7.

Table 2. Iraq: Fiscal and Oil Sector Accounts, 2004–12
(In billions of ID; unless otherwise indicated)

	2004	2005		2006		2007	2008	2009	2010	2011	2012
		SBA	Est.	SBA	Prel.							Projections
Revenues and Grants	29,784	45,490	49,505	60,316	58,497	48,453	56,997	62,528	72,734	88,628	105,641
Revenues	26,376	34,211	36,655	47,529	49,430	41,987	52,645	62,298	72,671	88,596	105,625
Crude oil export revenues	25,108	31,919	33,896	42,109	43,736	35,666	44,537	51,818	60,164	73,924	88,472
Revenues of oil-related public enterprises	799	1,020	1,456	3,513	3,611	4,100	5,032	6,765	8,357	10,003	11,902
Tax revenues	160	372	495	821	585	799	1,078	1,527	1,731	1,955	2,229
Direct taxes	78	119	207	222	345	471	576	699	833	991	1,181
Indirect taxes 1/	81	252	288	599	240	328	502	828	898	964	1,048
Non-tax revenues	309	900	809	1,087	1,498	1,422	1,999	2,188	2,420	2,713	3,022
Grants	3,408	11,279	12,850	12,787	9,067	6,466	4,352	230	63	32	16
Expenditures	45,202	50,797	44,497	65,935	49,756	55,983	63,399	67,565	75,185	86,369	96,590
Current expenditures	36,887	38,368	35,560	47,698	40,188	42,531	46,692	48,827	54,369	62,756	69,467
Salary and pension	4,532	8,591	9,282	12,899	10,959	15,244	17,323	18,636	19,836	21,836	23,804
Goods and Services (non-oil sector) 2/	10,998	13,600	13,019	15,265	12,193	12,650	13,108	11,948	13,877	16,530	19,472
Budgeted goods and services	6,985	4,094	3,135	6,802	5,818	8,011	10,145	11,948	13,877	16,530	19,472
Financed by oil-for-food program (OFFP; other than social safety net)	1,616	1,429	760	0	220	0	0	0	0	0	0
Overhead costs for donors' financed projects 3/	860	2,867	3,512	3,539	2,588	1,871	1,141	0	0	0	0
Other goods and services financed by donors 4/	1,538	5,210	5,612	4,925	3,567	2,768	1,823	0	0	0	0
Goods and Services (oil sector)	5,609	6,788	5,212	6,090	6,560	2,970	2,771	3,249	3,654	4,138	4,690
Oil derivative imports	4,823	5,768	4,128	4,090	4,082	399	0	0	0	0	0
Operating expenditures of oil-related public enterprises	786	1,020	1,085	2,000	2,477	2,570	2,771	3,249	3,654	4,138	4,690
Transfers	14,075	7,724	6,232	10,858	7,928	9,336	10,355	10,835	11,334	11,861	12,478
Social safety net (excluding OFFP)	3,829	4,500	3,751	5,000	5,500	4,848	5,582	6,134	6,608	7,112	7,647
Transfers to SOEs	1,237	1,160	900	1,260	1,299	1,726	1,680	1,391	1,250	1,100	1,000
Other transfers 5/	6,893	2,064	1,581	4,597	1,129	2,762	3,094	3,310	3,476	3,649	3,832
Interest payments	369	69	86	481	313	548	908	1,568	2,661	4,694	4,599
Domestic interest payments	369	69	86	249	182	337	298	262	226	190	154
External interest payments	0	69	0	237	131	211	610	1,306	2,434	4,504	4,445
War reparations 6/	1,304	1,596	1,730	2,105	2,235	1,783	2,227	2,591	3,008	3,696	4,424
Investment expenditures	8,314	12,430	8,936	15,862	9,464	12,315	15,370	17,201	19,079	21,676	24,985
Non-oil investment expenditures	6,126	8,800	6,587	10,530	7,703	9,354	11,203	11,658	12,760	14,041	16,285
Domestic financed reconstruction expenditure	4,087	3,049	2,189	6,050	4,693	7,172	8,323	9,356	10,367	11,633	14,536
OFFP financed reconstruction expenditure	1,079	1,070	478	0	0	0	0	0	0	0	0
Grant financed reconstruction expenditure	961	2,992	3,448	4,068	2,563	1,644	1,298	230	63	32	16
Loan financed reconstruction expenditure	0	0	0	413	0	537	1,581	2,072	2,330	2,376	1,734
Oil investment expenditures (including on refineries)	2,188	3,630	2,349	5,331	1,761	2,961	4,077	5,543	6,319	7,635	8,700
Contingency	0	0	0	2,375	104	1,137	1,337	1,537	1,737	1,937	2,137
Balance (including grants)	-15,417	-5,308	5,008	-5,619	8,741	-7,530	-6,402	-5,037	-2,451	2,259	9,051
Balance (excluding grants)	-18,826	-16,587	-7,842	-18,404	-326	-13,996	-10,754	-5,267	-2,514	2,227	9,035
Change in outstanding Letters of Credit [+ increase] 7/	...	...	2,947	...	2,226	...	...	...	...	...	...
Financing, Of which	14,893	5,308	-2,095	5,619	-6,354	7,530	6,402	5,037	2,451	-2,259	-9,051
External financing	15,426	5,484	2,721	5,619	-3,522	6,330	5,202	3,837	2,451	-2,259	-9,051
Assets held abroad	10,127	2,528	1,462	5,411	-2,147	6,001	3,621	1,765	121	58	-5,925
Project financing	0	0	0	413	0	537	1,581	2,072	2,330	2,376	1,734
Other financing 8/	5,969	3,249	1,486	0	458	0	0	0	0	0	0
Amortization	670	293	227	205	1,833	209	0	0	0	4,692	4,860
Domestic financing	-533	-176	-4,816	0	-2,833	1,200	1,200	1,200	0	0	0
Bank financing	-333	0	-5,124	0	-1,884	1,200	1,200	1,200	0	0	0
Non bank financing	-200	-176	308	0	-949	0	0	0	0	0	0
Residual or Financing gap[+]/surplus [-]	525	0	34	0	-161	0	0	0	0	0	0
Memorandum items:											
Security-related expenditure	...	3,360	2,405	8018	3,248	9,673	11,451	12,873	14,233	16,004	18,003
Primary fiscal balance	-15,048	-5,239	5,094	-5,136	9,054	-6,981	-5,494	-3,469	210	6,954	13,650
Non-oil primary fiscal balance	-33,159	-27,769	-22,696	-39,338	-29,973	-40,817	-48,124	-53,261	-58,338	-65,201	-73,333
External assets held abroad	6,650	5,988	9,111	428	11,996	5,995	2,375	610	489	431	6,357

Sources: Iraqi authorities, and Fund staff estimates and projections.

1/ Projections for 2008-12 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.

2/ Include goods and services financed by donors, including overhead costs for reconstruction projects.

3/ Overhead costs associated with donor-financed reconstruction.

4/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects.

5/ 2006 data includes ID270 billion allocated toward government's share of capital in new regional commercial banks. ID1,500 formerly recorded under this item were re-classified as non-oil investment expenditures in 2006 budget presentation. Finally, ID265 billion were re-classified as debt repayment.

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

7/ LCs in the Trade Bank of Iraq, for which 100 percent down-payment is customarily required.

8/ Includes financing from LCs previously issued under the UN oil-for-food program.

Table 3. Iraq: Fiscal and Oil Sector Accounts, 2004–12
(In percent of GDP)

	2004	2005		2006		2007	2008	2009	2010	2011	2012
		SBA	Est.	SBA	Prel.			Projections			
Revenues and Grants	79.6	93.6	107.4	96.3	80.5	62.3	59.0	55.6	56.4	58.4	59.8
Revenues	70.5	70.4	79.5	75.9	68.0	54.0	54.5	55.4	56.3	58.4	59.8
Crude oil export revenues	67.1	65.7	73.6	67.3	60.2	45.8	46.1	46.1	46.6	48.7	50.1
Revenues of oil-related public enterprises	2.1	2.1	3.2	5.6	5.0	5.3	5.2	6.0	6.5	6.6	6.7
Tax revenues	0.4	0.8	1.1	1.3	0.8	1.0	1.1	1.4	1.3	1.3	1.3
Direct taxes	0.2	0.2	0.4	0.4	0.5	0.6	0.6	0.6	0.6	0.7	0.7
Indirect taxes 1/	0.2	0.5	0.6	1.0	0.3	0.4	0.5	0.7	0.7	0.6	0.6
Non-tax revenues	0.8	1.9	1.8	1.7	2.1	1.8	2.1	1.9	1.9	1.8	1.7
Grants	9.1	23.2	27.9	20.4	12.5	8.3	4.5	0.2	0.0	0.0	0.0
Expenditures	120.8	104.5	96.6	105.3	68.5	72.0	65.7	60.1	58.3	56.9	54.7
Current expenditures	98.6	78.9	77.2	76.2	55.3	54.7	48.4	43.4	42.2	41.3	39.3
Salary and pension	12.1	17.7	20.1	20.6	15.1	19.6	17.9	16.6	15.4	14.4	13.5
Goods and services (non-oil sector) 2/	29.4	28.0	28.3	24.4	16.8	16.3	13.6	10.6	10.8	10.9	11.0
Budgeted goods and services	18.7	8.4	6.8	10.9	8.0	10.3	10.5	10.6	10.8	10.9	11.0
Financed by oil-for-food program (OFFP; other than social safety net)	4.3	2.9	1.7	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overhead costs for donors' financed projects 3/	2.3	5.9	7.6	5.7	3.6	2.4	1.2	0.0	0.0	0.0	0.0
Other goods and services financed by donors 4/	4.1	10.7	12.2	7.9	4.9	3.6	1.9	0.0	0.0	0.0	0.0
Goods and services (oil sector)	15.0	14.0	11.3	9.7	9.0	3.8	2.9	2.9	2.8	2.7	2.7
Oil derivative imports	12.9	11.9	9.0	6.5	5.6	0.5	0.0	0.0	0.0	0.0	0.0
Operating expenditures of oil-related public enterprises	2.1	2.1	2.4	3.2	3.4	3.3	2.9	2.9	2.8	2.7	2.7
Transfers	37.6	15.9	13.5	17.3	10.9	12.0	10.7	9.6	8.8	7.8	7.1
Social safety net (excl. OFFP)	10.2	9.3	8.1	8.0	7.6	6.2	5.8	5.5	5.1	4.7	4.3
Transfers to SOEs	3.3	2.4	2.0	2.0	1.8	2.2	1.7	1.2	1.0	0.7	0.6
Other transfers 5/	18.4	4.2	3.4	7.3	1.6	3.6	3.2	2.9	2.7	2.4	2.2
Interest payments	1.0	0.1	0.2	0.8	0.4	0.7	0.9	1.4	2.1	3.1	2.6
Domestic interest payments	1.0	0.1	0.2	0.4	0.3	0.4	0.3	0.2	0.2	0.1	0.1
External interest payments	0.0	0.1	0.0	0.4	0.2	0.3	0.6	1.2	1.9	3.0	2.5
War reparations 6/	3.5	3.3	3.8	3.4	3.1	2.3	2.3	2.3	2.3	2.4	2.5
Investment expenditures	22.2	25.6	19.4	25.3	13.0	15.8	15.9	15.3	14.8	14.3	14.1
Non-oil investment expenditures	16.4	18.1	14.3	16.8	10.6	12.0	11.6	10.4	9.9	9.2	9.2
Domestic financed reconstruction expenditure	10.9	6.3	4.8	9.7	6.5	9.2	8.6	8.3	8.0	7.7	8.2
OFFP financed reconstruction expenditure	2.9	2.2	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grant financed reconstruction expenditure	2.6	6.2	7.5	6.5	3.5	2.1	1.3	0.2	0.0	0.0	0.0
Loan financed reconstruction expenditure	0.0	0.0	0.0	0.7	0.0	0.7	1.6	1.8	1.8	1.6	1.0
Oil investment expenditures (including on refineries)	5.8	7.5	5.1	8.5	2.4	3.6	4.2	4.9	4.9	5.0	4.9
Contingency	0.0	0.0	0.0	3.8	0.1	1.5	1.4	1.4	1.3	1.3	1.2
Balance (including grants)	-41.2	-10.9	10.9	-9.0	12.0	-9.7	-6.6	-4.5	-1.9	1.5	5.1
Balance (excluding grants)	-50.3	-34.1	-17.0	-29.4	-0.4	-18.0	-11.1	-4.7	-1.9	1.5	5.1
Change in outstanding Letters of Credit [+ increase] 7/	...	...	6.4	...	3.1	...	...	...	...	...	...
External financing	41.2	11.3	5.9	9.0	-4.8	8.1	5.4	3.4	1.9	-1.5	-5.1
Assets held abroad	27.1	5.2	3.2	8.6	-3.0	7.7	3.8	1.6	0.1	0.0	-3.4
Project financing	0.0	0.0	0.0	0.7	0.0	0.7	1.6	1.8	1.8	1.6	1.0
Other financing 8/	15.9	6.7	3.2	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	1.8	0.6	0.5	0.3	2.5	0.3	0.0	0.0	0.0	3.1	2.8
Domestic financing	-1.4	-0.4	-10.5	0.0	-3.9	1.5	1.2	1.1	0.0	0.0	0.0
Bank financing	-0.9	0.0	-11.1	0.0	-2.6	1.5	1.2	1.1	0.0	0.0	0.0
Non bank financing	-0.5	-0.4	0.7	0.0	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Residual or financing gap[+]/surplus [-]	1.4	0.0	0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Security-related expenditure	...	...	5.2	12.8	4.5	12.4	11.9	11.5	11.0	10.5	10.2
Primary fiscal balance	-40.2	-10.8	11.1	-8.2	12.5	-9.0	-5.7	-3.1	0.2	4.6	7.7
Non-oil primary fiscal balance	-88.6	-57.1	-49.3	-62.8	-41.2	-52.5	-49.8	-47.4	-45.2	-42.9	-41.5

Sources: Iraqi authorities and Fund staff estimates and projections.

1/ Projections for 2008–12 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.

2/ Include goods and services financed by donors, including overhead costs for reconstruction projects.

3/ Overhead costs associated with donor-financed reconstruction.

4/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects.

5/ 2006 data includes ID 270 billion allocated toward government's share of capital in new regional commercial banks. ID1,500 formerly recorded under this item were re-classified as non-oil investment expenditures in 2006 budget presentation. Finally, ID 265 billion were re-classified as debt repayment.

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

7/ LCs in the Trade Bank of Iraq, for which 100 percent down-payment is customarily required.

8/ Includes financing from LCs previously issued under the UN oil-for-food program.

Table 4. Iraq: Central Bank Survey, 2004–08
(In billions of Iraqi dinars, unless otherwise indicated)

	2004	2005		2006		2007			2008
	Actual Dec.	Actual Dec.	SBA	Actual Dec.	SBA	Mar.	Apr.	Proj.	Proj.
Net foreign exchange assets 1/	10,743	17,078	12,993	25,413	15,869	21,713	25,073	31,352	36,042
Foreign exchange assets	11,538	17,724	13,639	26,043	16,515	22,308	25,668	31,981	36,333
Gold 2/	115	143	119	159	119	159	159	175	175
Other	11,422	17,581	13,520	25,885	16,397	22,150	25,509	31,806	36,158
CBI vaults	10,361	16,600	12,521	24,962	15,353	21,261	24,615	30,803	35,155
Fx claims on state banks	0	0	0	0	0	0	0	0	0
SDR Account 3/	1,061	982	999	922	1,044	888	894	1,003	1,003
Foreign exchange liabilities	-795	-646	-646	-630	-646	-596	-596	-630	-292
Of which: Borrowing from the MF	-637	-637	-637	-637	-637	-637	-637	-637	-298
Net domestic assets	1,485	-3,380	811	-7,749	777	-2,647	-6,266	-6,821	-6,533
Domestic assets	4,345	138	3,161	-308	3,161	1,629	925	204	685
Net claims on general government	4,336	128	3,152	-320	3,152	1,617	913	193	674
Holdings of treasury bills	2,589	2,560	2,528	4,675	2,528	4,675	4,495	3,988	3,269
Holdings of discounted treasury bills	709	707	707	719	707	719	719	719	719
Overdrafts	1,637	1,821	1,821	0	1,821	0	0	0	0
Domestic currency deposits	-596	-3,577	-596	-5,170	-596	-2,639	-2,647	-3,970	-2,770
Foreign currency deposits	-3	-1,382	-1,307	-544	-1,307	-1,138	-1,654	-544	-544
Claims on commercial banks	8.7	9.4	8.7	11.9	8.7	12.4	12.4	11.3	11.3
Monetary policy instruments 4/	0	-3,731	-3,316	-8,075	-3,350	-6,650	-7,877	-11,669	-11,863
Other items net	-2,859	214	966	635	966	2,374	686	4,644	4,644
Reserve money	12,228	13,698	13,804	17,664	16,646	19,066	18,807	24,531	29,508
Currency outside banks	7,163	9,110	8,815	10,789	10,949	11,560	11,600	15,289	18,695
Currency issued	8,021	10,257	9,679	11,917	12,022	12,924	12,963	16,886	20,499
Cash in vaults of commercial banks	858	1,146	864	1,127	1,073	1,363	1,363	1,597	1,803
Banks reserves	4,208	3,442	4,124	5,748	4,624	6,142	5,843	7,645	9,010
Required	2,287	2,596	3,329	3,572	3,829	4,275	4,338	5,062	6,190
Excess	1,921	845	795	2,176	795	1,868	1,506	2,583	2,820
Memorandum items:									
Reserve money (annual growth, in percent)	116.9	12.0	12.9	29.0	20.6	7.9	6.5	38.9	20.3
Currency issued (annual growth, in percent)	74.9	27.9	20.7	16.2	24.2	8.5	8.8	41.7	21.4
Gross foreign exchange assets (in millions of U.S. dollars)	7,941	12,067	9,346	17,749	11,012	17,469	20,195	21,313	24,279
Gold	79	97	82	108	81	124	125	139	117
CBI vault + DFI sub-account	7,132	11,302	8,582	17,012	10,235	16,649	19,367	20,535	23,437
SDR Account	730	668	682	629	696	696	703	796	726
Foreign exchange liabilities (in millions of U.S. dollars)	-547	-440	-441	-429	-431	-466	-469	-500	-195
Net foreign exchange assets (in millions of U.S. dollars)	7,394	11,627	8,905	17,320	10,581	17,003	19,727	20,813	24,085
Exchange rate (period average) 5/	1,453	1,469	1,500	1,467	1,500	1,277	1,271	...	...
Gross foreign exchange assets/reserve money (in percent)	94.4	129.4	99.2	147.4	99.2	117.0	136.5	109.5	113.7
Claims on banks/reserve money (in percent)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Reserve money coverage (in percent)	87.9	124.7	94.5	143.9	95.4	113.9	133.3	106.9	112.8
Currency outside banks/Reserve money (in percent)	58.6	66.5	63.9	61.1	65.8	60.6	61.7	62.3	63.4
Currency outside banks/Non-oil GDP (in percent)	59.3	52.3	...	35.0	...	...	...	36.3	37.4
Ratio of Currency outside banks to GDP	19.1	19.8	19.1	14.8	16.5	...	...	21.7	21.2
Ratio of Reserve money to GDP	32.7	29.7	30.0	24.3	36.1	...	...	31.5	30.6

Sources: Iraqi authorities, and Fund staff estimates and projections.

1/ Valued at market exchange rates.

2/ For 2005, valued at market prices.

3/ This includes both SDR holdings and the reserve tranche position.

4/ This mainly represents the ID and US\$ overnight standing deposit facilities.

5/ The balance sheet is valued using the program exchange rate; memorandum items are valued using the end-of-period exchange rate.

Table 5. Iraq: Depository Corporations Survey, 2004–06
(In billions of Iraqi dinars, unless otherwise indicated)

	2004	2005	2006
	Dec.	Dec.	Dec.
Net foreign assets	-5,944	15	10,889
Claims on nonresidents	18,440	27,470	37,264
less: Liabilities to nonresidents	-24,384	-27,456	-26,375
Domestic claims	2,711	-1,204	-4,458
Net claims on central government	1,917	-2,936	-7,314
Claims on central government	6,379	6,719	7,535
less: Liabilities to central government	-4,462	-9,655	-14,850
Claims on other sectors	794	1,732	2,856
Other items net	17,589	16,077	13,041
Broad money liabilities	14,356	14,888	19,472
Currency outside depository corporations	6,734	9,113	10,968
Transferable deposits	6,287	3,871	6,247
Other deposits	1,334	1,904	2,257
	(Percent change)		
Broad money liabilities	...	3.7	30.8
Currency outside depository corporations	...	35.3	20.4
Claims on other sectors	...	118.1	64.9

Sources: Iraqi authorities, and Fund staff estimates and projections.

Table 6. Iraq: Balance of Payments, 2004–12 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2004	2005		2006		2007	2008	2009	2010	2011	2012
	Est.	SBA	Est.	SBA	Prel.			Projections			
Trade balance	-2,173	-1,636	1,024	476	6,932	-1,410	1,283	3,701	6,111	10,257	15,314
(In percent of GDP)	-8.4	-4.9	3.3	1.1	14.0	-2.3	1.8	4.7	7.0	10.2	13.5
Exports	17,782	22,781	19,772	28,745	28,412	29,488	33,518	37,195	41,814	49,826	57,879
Crude oil	17,329	22,176	19,184	28,073	27,692	28,601	32,558	36,147	40,809	48,758	56,741
Other exports	452	605	589	672	720	887	960	1,049	1,005	1,069	1,138
Imports	-19,955	-24,416	-18,748	-28,269	-21,480	-30,898	-32,235	-33,494	-35,702	-39,569	-42,565
Government imports	-13,966	-14,596	-10,993	-14,456	-12,345	-15,966	-14,635	-15,736	-17,031	-18,873	-19,556
UN Oil for Food Program (OFFP)	-3,492	-1,929	-880	0	-272	0	0	0	0	0	0
Other consumption imports (non-OFFP)	-3,861	-3,528	-2,915	-5,089	-4,603	-6,283	-6,752	-7,256	-7,859	-8,691	-9,435
Other non-oil related capital imports (non-OFFP)	-2,362	-3,450	-2,625	-4,882	-3,225	-5,070	-5,468	-5,348	-5,700	-6,103	-6,103
Oil-related capital imports	-1,429	-2,261	-2,129	-2,113	-1,825	-2,248	-2,414	-3,132	-3,472	-4,079	-4,017
Refined oil products	-2,822	-3,428	-2,445	-2,372	-2,420	-2,364	0	0	0	0	0
Private sector imports	-5,989	-9,820	-7,755	-13,813	-9,135	-14,932	-17,601	-17,758	-18,671	-20,696	-23,009
Of which: refined oil products	0	0	0	-2,429	0	-3,010	-5,291	-4,456	-4,286	-3,919	-3,723
Income, net 2/	-5,159	-3,741	-3,349	-2,237	-1,344	-1,202	-1,448	-1,529	-1,988	-2,154	-2,113
Services, net	-4,325	-6,477	-6,119	-7,093	-5,317	-5,224	-4,520	-3,551	-3,788	-4,209	-4,532
Transfers, net	1,980	7,090	8,290	7,721	5,394	4,545	2,676	-345	-500	-859	-1,213
Private, net (incl. NGOs)	500	500	500	600	600	790	1,123	1,302	1,498	1,558	1,603
Official	1,480	6,590	7,790	7,121	4,794	3,755	1,553	-1,647	-1,998	-2,417	-2,816
Receipts	2,346	7,699	8,749	8,525	6,179	5,185	3,181	160	43	21	21
Payments	-866	-1,109	-959	-1,404	-1,385	-1,430	-1,628	-1,807	-2,040	-2,438	-2,837
Current account	-9,678	-4,763	-154	-1,133	5,666	-3,291	-2,009	-1,725	-165	3,036	7,457
(In percent of GDP)	-37.6	-14.4	-0.5	-2.7	11.4	-5.3	-2.8	-2.2	-0.2	3.0	6.6
Capital account	0	0	0	0	0	0	0	0	0	0	0
Financial account	11,018	6,172	3,639	2,821	1,932	5,945	4,975	3,837	2,922	-1,034	-5,301
Direct investment	200	300	400	300	300	400	600	750	1,311	1,588	1,973
Other capital, net	10,818	5,872	3,239	2,521	1,632	5,545	4,375	3,087	1,611	-2,622	-7,274
Official, net	10,839	7,504	5,680	5,839	720	7,399	5,928	4,485	2,869	-1,490	-5,805
Assets 3/	10,839	3,943	2,007	3,607	-1,150	4,812	2,647	1,231	82	38	-3,800
Liabilities	0	3,561	3,673	2,232	1,871	2,587	3,281	3,253	2,787	-1,528	-2,005
Loan disbursements	0	0	0	275	0	431	1,156	1,446	1,581	1,567	1,112
Amortization 4/ 5/	0	-200	-115	-136	-281	-103	0	0	0	-3,095	-3,117
Capitalized interest payment 5/	0	3,761	3,788	2,093	2,151	2,258	2,125	1,808	1,206	0	0
Financial corporations, net 6/	0	0	-2,007	-1,247	-1,517	0	0	0	0	0	0
Private, net	-21	-1,632	-435	-2,071	2,428	-1,854	-1,553	-1,398	-1,258	-1,132	-1,469
Errors and omissions	361	0	23	0	-110	0	0	0	0	0	0
Overall balance	1,701	1,409	3,508	1,688	7,488	2,655	2,966	2,112	2,757	2,002	2,156
(In percent of GDP)	6.6	4.2	11.2	4.0	15.1	4.3	4.2	2.7	3.2	2.0	1.9
Financing	-1,701	-1,409	-3,508	-1,688	-7,488	-2,655	-2,966	-2,112	-2,757	-2,002	-2,156
Central bank (increase -)	-6,768	-1,409	-4,122	-1,688	-6,698	-2,590	-2,966	-2,112	-2,757	-2,002	-2,156
Reserves (net; increase -)	-6,332	-1,409	-4,122	-1,688	-6,698	-2,590	-3,192	-2,338	-2,757	-2,002	-2,156
Liabilities (increase +)	436	0	0	0	0	0	-225	-226	0	0	0
Fund credit (net)	436	0	0	0	0	0	-225	-226	0	0	0
Disbursement	436	0	0	0	0	0	0	0	0	0	0
Repayments	0	0	0	0	0	0	-225	-226	0	0	0
Deferred accrued interest 7/	5,252	0	0	0	0	0	0	0	0	0	0
Change in arrears (net, decrease -) 8/	-34,723	-27,987	-32,448	-1,195	-16,005	-962	0	0	0	0	0
Debt forgiveness 9/	34,538	27,987	33,062	1,195	15,215	898	0	0	0	0	0
Memorandum items:											
Central bank reserves	7,902	9,311	12,024	11,013	18,723	21,313	24,279	26,391	29,149	31,150	33,306
Central bank reserves (in months of imports of goods)	3.2	3.1	5.4	3.6	6.2	6.9	7.8	8.0	8.0	7.9	7.9
GDP	25,763	33,182	31,375	41,741	49,516	62,384	70,578	78,391	87,489	100,136	113,330
Non-oil GDP	8,317	10,716	11,856	12,999	21,025	33,773	36,552	39,931	43,624	47,658	52,065

Sources: Iraqi authorities and Fund staff estimates and projections.

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

2/ Includes interest accrued, deferred, and capitalized.

3/ Includes the use/accumulation of the DFI resources and the UN Oil for Food letters of credit.

4/ Includes the estimates of cash payments to settle the debt owed to small private creditors through cash exchange offers.

5/ Based on the 2004 Paris Club agreement, the payments of principal and most interest during 2005–10 are deferred and capitalized.

6/ Reflects advance transfers for the execution of letters of credit (L/C).

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

8/ Includes debt forgiveness and clearance of arrears on multilateral debt and arrears related to fuel imports from Turkey.

9/ 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; and (iii) the settlement of debt owed to private creditors through cash and debt exchanges. Assumes debt reduction comparable to the Paris Club agreement on other debt to official creditors.

Table 7. Iraq: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement (SBA), 2005–07 1/
(In billions of Iraqi dinars, unless otherwise indicated)

	2005	Performance Criteria							
	9/30/05	12/31/05	3/31/06	6/30/06	9/30/06	12/31/06	3/31/07	6/30/07	9/30/07
<i>Cumulative change from September 2005</i>									
Net international reserves of the CBI (floor; in millions of U.S. dollars) (Actual)	8,500 2/	-1,000 +3,041	-1,000 +3,635	-1,000 +3,554	-1,000 +5,252	-1,000 +9,770	0 +8,503	0	0
Lending to the government and the private sector by the CBI (ceiling) 3/ (Actual)	5,100 2/	0 0	0 0	0 0	0 0	0 0	0 0	0	0
<i>Cumulative flow from beginning of calendar year</i>									
Government primary fiscal deficit (ceiling; deficit [+]/surplus[-]) 4/ 5/ (Actual)	...	5,400 -5,102	1,950 -819	3,600 -4,752	4,850 -11,220	5,300 -8,947	...	...	...
Central government total financing (ceiling) 4/ 5/ (Actual)	3,000 -1,688	5,350	5,700
Government wage and pension bill (ceiling) 4/ 6/ (Actual)	...	6,650 7,069	2,400 2,051	4,750 3,898	7,100 5,875	9,500 7,792	2,525 1,644	5,050	7,575
Revenue of oil related enterprises, including those remitted to the budget (floor) 4/ (Actual)	...	900 1,456	700 509	1,500 1,454	2,100 2,651	2,800 3,611	750 1,135	1,500	2,850
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) 4/ 7/ (Actual)	...	500 0	500 0	500 0	500 0	500 0	500 0	500	500
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 8/ (Actual)	...	0 653	0 0	0 0	0 0	0 0	0 0	0	0
<i>Indicative targets</i>									
Government imports of petroleum products (ceiling) 4/ 9/ (Actual)	...	6,000 4,128	1,700 1,045	3,400 1,884	4,000 3,120	4,200 4,082	100 104	200	300
Revolving government credit to the State Oil Marketing Organization (ceiling) (Actual)	300 400	400	400

1/ See Technical Memorandum of Understanding for precise definitions of all performance variables.

2/ Estimated.

3/ Rolling over t-bills does not constitute new lending.

4/ Flows for 12/31/05 are cumulative for 2005. Flows for 2006 and 2007 are cumulative starting 1/1/2006 and 1/1/2007, respectively.

5/ Starting in 2007, the budget deficit will be monitored from below the line (i.e., from the financing side).

6/ Excluding salaries paid by ministries of defense and interior (see Technical Memorandum of Understanding for precise definition).

7/ This ceiling excludes loans with a grant element of 35 percent or more of up to Yen 350 billion for reconstruction projects to be contracted with the government of Japan in 2007.

8/ This will be monitored on a continuous basis.

9/ Starting in 2007, this no longer comprises all imports of petroleum products made directly by the government of Iraq but instead comprise of imports of petroleum products financed from the budget.

Table 8. Iraq: Structural Performance Criteria and Structural Benchmarks Under the Stand-By Arrangement

	Date	Status
I. 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	Met
Final audit of CBI 2005 Financial operations and statements.	May 15, 2006	Waived; Completed on October 1, 2006
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. ^{1/}	June 30, 2007	Not met. Expected soon
Completion by Ernst & Young of (a) a final audit of the net international reserves data reported to the IMF as at December 31, 2006, including a full count by Ernst & Young of gold and foreign exchange holdings at the CBI, and (b) an interim audit report of CBI 2006 financial statements in accordance with International Standards on Auditing.	May 31, 2007	NIR audit completed on time; interim audit report completed on July 15
Completion of census of all public service employees (central government and military).	June 30, 2007	Not met; replaced with a new PC (see below)
Completion of the data collection for the census of all public service employees (central government and military).	November 30, 2007	
II. Structural Benchmarks		
Implementation of payment system regulations.	June 30, 2006	Met
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.	September 30, 2006	Met in November 2006; IAMB mandate has been extended to December 31, 2007
Reform of pension law in line with sustainable pension system	September 30, 2006	Underway
Approval by Council of Representatives of law liberalizing private gasoline imports	September 30, 2006	Met
Commencement of operation of Real Time Gross Settlement system (RTGS) linking headquarters of commercial banks to the CBI.	August 31, 2006	Met
Commencement of payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House (ACH).	November 30, 2006	Met
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	Met in February 2007
Adopt a CBI Board-approved timetable for the full implementation of IFRS as the bank's financial reporting framework	March 31, 2007	Met on April 1, 2007
Appoint an internationally reputable audit firm to conduct an operational and financial audit of Rasheed and Rafidain banks based on their 2006 financial accounts.	April 30, 2007	Underway; auditor selected and appointment process ongoing
Address the lack of proper accounting records being maintained by the CBI, one of the major issues giving rise to E&Y's disclaimed audit opinion for 2005. ^{2/}	June 30, 2007	Underway
Establish adequate control procedures for reserves management, including developing reserves management policy and investment guidelines.	June 30, 2007	Underway

^{1/} 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).

^{2/} The following issues should be addressed: (i) the lack of reconciliations of local bank's current accounts; (ii) unreconciled suspense accounts and interbranch accounts; (iii) unreconciled differences on accounts managed on behalf of the Ministry of Finance, including the DVI; and (iv) insufficient information to support amounts, and to ensure the completeness and valuation of off-balance sheet commitments.

Table 9. Iraq: Indicative Quantitative Benchmarks Under the Stand-By Arrangement
(In Iraqi dinars per liter, unless otherwise indicated)

	Sep. 2005	03/31/06		06/30/06		09/30/06		12/31/06		03/05/07		06/30/07		
		Prior Action	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Prior action 3rd & 4th reviews	Program	Actual	Program	Actual
Official domestic price of petroleum products (equal to or above, by specified dates)														
LPG (per 12 kg cylinder)	250	600	700	600	800	1,000	900	1,000	1,000	1,000	3,000	3,000	3,000	3,000
Regular gasoline	20	100	130	100	155	175	175	175	200	250	300	300	350	400
Premium gasoline 1/	50	250	300	250	350	350	400	350	450	350	...	...	...	...
Blended gasoline	...	...	...	...	...	...	...	...	...	350	400	400	400	450
Kerosene	5	25	50	25	75	75	90	75	115	75	150	150	200	150
Diesel	10	90	110	90	125	125	155	150	175	150	350	350	350	400

1/ Starting 2007, premium gasoline is to be sold only by the private sector at unregulated prices.

Table 10. Iraq: Availability of Purchases Under the Stand-by Arrangement, 2007

Availability date	Amount of Purchase		Condition
	SDR	% quota	
Current schedule			
March 12, 2007	316,906,668	26.67	Completion of third and fourth reviews and observance of end-December 2006 performance criteria
May 15, 2007	79,226,667	6.67	Completion of fifth review and observance of end-March 2007 performance criteria
August 15, 2007	79,226,665	6.67	Observance of end-June 2007 performance criteria
Total access	475,360,000	40.00	
Proposed new schedule			
August 1, 2007	369,724,447	31.11	Completion of fifth review and observance of end-March 2007 performance criteria
September 15, 2007	52,817,777	4.44	Observance of end-June 2007 performance criteria
December 15, 2007	52,817,776	4.44	Observance of end-September 2007 performance criteria
Total access	475,360,000	40.00	

Source: Fund staff projections.

Table 11. Iraq: Indicators of Fund Credit, 2004–11 ^{1/}
(In millions of SDRs, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011
Disbursements of Fund credit								
EPCA	297.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SBA	0.0	0.0	0.0	475.4	0.0	0.0	0.0	0.0
In percent of IMF quota	0.0	0.0	0.0	40.0	0.0	0.0	0.0	0.0
Obligations								
Clearance of arrears	55.3	0.0	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	0.0
Repayments of SBA 2/	0.0	0.0	0.0	0.0	0.0	52.8	237.7	184.9
Total charges and interest	0.7	10.5	14.4	15.4	38.5	30.6	19.1	6.0
Total obligations	56.0	10.5	14.4	15.4	187.1	232.0	256.7	190.9
Total obligations, in percent of:								
Exports of goods and services	0.5	0.1	0.1	0.1	0.8	0.9	0.9	0.6
External public debt	0.1	0.0	0.0	0.0	0.5	0.6	0.6	0.5
Gross reserves	1.0	0.1	0.1	0.1	1.2	1.3	1.3	0.9
GDP	0.3	0.0	0.0	0.0	0.4	0.5	0.4	0.3
IMF Quota	4.7	0.9	1.2	1.3	15.7	19.5	21.6	16.1
Outstanding Fund credit								
EPCA	297.1	297.1	297.1	297.1	148.6	0.0	0.0	0.0
SBA	0.0	0.0	0.0	475.4	475.4	422.5	184.9	0.0
Total outstanding Fund credit	297.1	297.1	297.1	772.5	623.9	422.5	184.9	0.0
Total outstanding Fund credit, in percent of								
Exports of goods and services	2.8	2.0	1.7	3.8	2.8	1.7	0.7	0.0
External public debt	0.5	0.6	0.8	2.1	1.6	1.0	0.4	0.0
Gross reserves	5.6	3.7	2.3	5.5	3.9	2.4	1.0	0.0
GDP	1.7	1.4	0.9	1.9	1.3	0.8	0.3	0.0
IMF Quota	25.0	25.0	25.0	65.0	52.5	35.6	15.6	0.0

Sources: Fund staff estimates and projections.

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

2/ The prospective SBA repayments are on an expectation basis.

APPENDIX I: IRAQ—EXTERNAL DEBT OUTLOOK

1. Iraq has received substantial debt reduction from official and private creditors, but the amount of external debt remains large. By assuming that debt reduction comparable to the Paris Club agreement is applied to non-Paris Club creditor's claims, the latest estimates of external debt indicate that the stock of debt was \$69 billion (220 percent of GDP) at end-2005 and \$55 billion (111 percent of GDP) at end-2006. Without the third stage of debt reduction, external debt would increase to about \$62 billion (about 55 percent of GDP) by 2012. The third stage reduction (expected in 2008) would further reduce Iraq's external debt to about \$36 billion (32 percent of GDP) by 2012 (Appendix, Table 1).¹ The medium term projections assume that new debt disbursement is mostly from multilateral creditors and Japan.

2. Under the program scenario, Iraq's external debt remains vulnerable to a negative oil shock, particularly when Iraq will start repaying the debt to official creditors. Based on the Paris Club agreement in 2004, the repayment of the remaining debt stock would start in 2011; the interest payments accrued during 2005–10 are mostly capitalized. The debt service would be relatively small until 2010 before it increases to about 10 percent of exports in 2011. Simulations for two oil shocks (a production shock that keeps oil production constant at 2.0 mbpd in 2007–08 followed by a gradual production increase of 0.2 mbpd per year, and a price shock that lowers the oil export price by \$4.5 per barrel (equivalent to one standard deviation) during 2008–12) show that Iraq would require significant borrowing from international markets to close the financing gaps (Appendix, Table 2).

¹ The third stage of debt reduction would be contingent on Iraq completing the final review of the third year of upper credit tranche arrangements with the Fund.

Table 1. Iraq: Estimated External Debt Stock, 2004–12
(In billions of U.S. dollar) 1/

	2004 before debt reduction	2004 after debt reduction	2005	2006	2007	2008	2009	2010	2011	2012
Without the third stage of debt reduction in 2008 (baseline) 4/										
Paris Club official creditors	42.6	28.4	19.2	19.9	20.7	21.4	22.0	22.4	21.3	20.3
Non-Paris Club official creditors 2/	67.7	47.4	28.4	29.8	31.3	32.7	33.9	34.7	32.7	30.7
Private creditors 3/	20.7	20.7	19.5	4.0	3.0	3.0	3.0	3.0	3.0	3.0
Multilateral creditors and others 4/	0.9	1.2	1.8	1.0	1.4	2.3	3.5	5.1	6.7	7.8
Total debt	131.9	97.6	68.9	54.7	56.4	59.4	62.5	65.2	63.7	61.7
In percent of GDP	512.0	378.9	219.5	110.5	90.4	84.2	79.7	74.6	63.6	54.5
Total debt service 5/	...	0.2	0.2	1.2	0.4	0.7	1.1	1.7	6.1	6.0
With the third stage of debt reduction in 2008 6/										
Total debt	131.9	97.6	68.9	54.7	56.4	32.3	34.4	36.6	36.6	36.1
In percent of GDP	512.0	378.9	219.5	110.5	90.4	45.7	43.9	41.8	36.5	31.9
Total debt service 5/	...	0.2	0.2	1.2	0.4	0.7	0.8	1.0	3.2	3.2

Sources: Iraqi authorities and Fund staff estimates.

1/ The assumptions made in this table 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. The estimates of the debt stock may differ from those in the IMF Country Report No. 07/115 to incorporate the latest results of debt reconciliation and settlement.

2/ Assumes debt reduction comparable to the Paris Club agreement in 2004.

3/ Assumes that by end 2007 all debt to private creditors would be settled by debt and cash exchanges.

4/ Includes new debt and arrears related to fuel imports from Turkey in 2006. The projections assume that new debt disbursement is mostly from multilateral creditors and Japan.

5/ Debt service is actual amount paid, including repayment of arrears to Turkey.

6/ Assumes precautionary SBA during 2005–08.

Table 2. Iraq: External Debt Sustainability Framework, 2004–12
(In percent of GDP, unless otherwise indicated)

	Estimates				Projections				
	2004	2005	2006	2007	2008	2009	2010	2011	2012
External debt	378.9	219.5	110.5	90.4	84.2	79.7	74.6	63.6	54.5
Change in external debt (1)	-656.6	-159.5	-108.9	-20.2	-6.2	-4.5	-5.1	-10.9	-9.2
Identified external debt-creating flows (2)	-530.2	-67.3	-89.7	-22.9	-10.0	-6.9	-8.2	-12.9	-11.1
Current account deficit, excluding interest payments	17.2	-11.6	-16.0	1.4	-0.8	-1.2	-3.0	-5.9	-9.1
Deficit in balance of goods and services	25.2	16.2	-3.3	10.6	4.6	-0.2	-2.7	-6.0	-9.5
Exports	69.0	63.5	57.7	47.5	47.7	47.7	48.0	49.9	51.2
Imports	94.2	79.7	54.4	58.2	52.3	47.5	45.3	43.9	41.7
Net non-debt creating capital inflows (negative) 1/	-44.3	0.0	2.2	-5.5	-2.4	-0.8	-0.2	-0.5	2.9
Automatic debt dynamics 2/	-503.1	-55.7	-75.9	-18.9	-6.8	-4.9	-5.0	-6.5	-4.9
Contribution from nominal interest rate	20.4	12.1	4.6	3.9	3.7	3.5	3.3	3.0	2.5
Contribution from real GDP growth	-238.2	2.3	-8.6	-5.6	-4.2	-6.2	-7.3	-7.6	-6.0
Contribution from price and exchange rate changes 3/	-285.2	-70.1	-71.8	-17.2	-6.3	-2.2	-1.0	-1.8	-1.4
Residual, incl. change in gross foreign assets (1-2)	-126.3	-92.2	-19.2	2.7	3.8	2.4	3.1	2.0	1.9
Of which: change in official reserves (increase = positive)	26.4	13.2	11.5	4.2	4.2	2.7	3.1	2.0	1.9
External debt-to-exports ratio (in percent)	549.0	345.8	191.7	190.2	176.5	167.2	155.4	127.4	106.3
Gross external financing need (in billions of US dollars) 4/ in percent of GDP	10.0 39.0	0.3 0.9	-5.5 -11.1	3.4 5.5	2.0 2.9	1.8 2.2	0.2 0.2	0.1 0.1	-4.3 -3.8
External debt service in percent of exports 5/	29.5	19.7	8.9	8.6	7.7	7.3	6.8	12.1	10.3
Debt-stabilizing non-interest current account (positive = surplus) 6/	-673.7	-147.9	-92.9	-21.6	-5.4	-3.3	-2.1	-5.0	-0.1
Key Macroeconomic Assumptions									
Real GDP growth (in percent)	46.5	-0.7	6.2	6.3	5.3	8.2	10.2	11.7	10.6
GDP deflator in U.S. dollars (change in percent)	38.0	22.7	48.6	18.5	7.5	2.6	1.2	2.5	2.3
Nominal external interest rate (in percent)	4.0	3.9	3.3	4.5	4.6	4.6	4.6	4.6	4.5
Growth of exports (U.S. dollar terms, in percent)	91.7	12.0	43.4	3.8	13.6	10.9	12.4	19.1	16.1
Growth of imports (U.S. dollar terms, in percent)	203.7	3.0	7.7	34.6	1.7	0.8	6.6	10.9	7.6
Stress Tests for External Debt Ratio									
Limited oil production 7/ Lower oil price in 2007–11 8/		219.5 219.5	110.5 110.5	93.1 90.4	94.0 88.0	94.3 87.8	95.8 85.3	93.2 76.0	88.3 64.7
Stress Tests for External Debt Service-to-Exports Ratio 5/									
Limited oil production 7/ Lower oil price in 2007–11 8/		19.9 19.9	12.3 12.3	9.4 8.8	8.7 8.3	10.8 8.1	14.1 10.0	25.1 17.2	28.6 16.6
Memorandum items:									
Real GDP growth under stress scenarios (in percent)									
Limited oil production 7/ Lower oil price in 2007–11 8/		-0.7 -0.7	6.2 6.2	3.4 6.3	2.5 5.3	8.7 8.2	8.2 10.2	7.8 11.7	7.4 10.6
Non-interest current account deficit under stress scenarios (in percent of GDP)									
Limited oil production 7/ Lower oil price in 2007–11 8/		-11.6 -11.6	-16.0 -16.0	3.7 1.4	3.5 1.8	2.7 1.4	2.6 -0.4	1.7 -3.4	0.1 -6.5

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

2/ 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.

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

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

5/ Debt service is total accrued amount.

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

7/ Assumes that oil production is constant at 2.0 mbpd in 2007-08, followed by a gradual production increase of 0.2 mbpd per year.

8/ Assumes that oil price in 2008–12 is US\$4.5 lower than in the baseline, equivalent to one standard-deviation shock.

ATTACHMENT I

Baghdad, July 17, 2007

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

Dear Mr. de Rato:

1. The Executive Board of the IMF approved a request for a Stand-By Arrangement (SBA) for Iraq on December 23, 2005. The first and second reviews under the SBA were completed on August 2, 2006, and the third and fourth reviews were completed on March 12, 2007. To allow more time to reach the objectives and complete the reforms under the SBA, the period of the arrangement was extended to September 28, 2007.
2. Despite the implementation of a new security plan in recent months, the security situation remains difficult. Nevertheless, we managed to make further progress in implementing our economic program supported by the SBA. Inflation, which rose to worrisome heights in 2006, has started to abate but additional actions are needed to bring it down further as described in the attached third Supplementary Memorandum of Economic and Financial Policies (SMEFP).
3. In order to keep a policy framework in place during discussions for an envisaged successor arrangement, we request an extension of the current SBA by three months to December 28, 2007. Completion of the final review of three years of implementation of upper credit tranche Fund arrangements by end-December 2008, will allow us to benefit from the last stage of the 2004 Paris Club debt reduction agreement. We intend to continue to treat the SBA as precautionary (i.e., we do not intend to make the purchases under the SBA that will become available after observance of its performance criteria and completion of the fifth review).
4. Iraq has met all quantitative performance criteria set for end-March 2007. The structural performance criterion on completion by May 31, 2007 of an audit of the net international reserves of the Central Bank of Iraq (CBI) was met, and the interim audit report of the CBI 2006 financial accounts was completed on July 15. The structural performance criterion for end-June, 2007 on adopting a chart of accounts and budget classification in line with the IMF's *Government Finance Statistics Manuel 2001*, and the structural performance criterion on completion of a census of all public service employees by end-June 2007 were, however, missed.

5. On the basis of corrective actions being undertaken as specified in the third SMEFP, we would like to request waivers for the nonobservance of these performance criteria, and completion of the fifth review under the SBA. We also request a waiver of applicability of end-June quantitative performance criteria and establishment of the quantitative performance criteria proposed in the third SMEFP for end-September 2007, as well as the rescheduling and redefinition of the missed performance criterion on completion of the census of all public service employees, as described in the third SMEFP.

6. In the period ahead, we shall strive to implement our investment program to increase oil-production, reduce inflation further, maintain a sustainable fiscal stance, and undertake reforms needed to spur the non-oil economy. We will continue to refrain from explicit budgetary subsidies on fuel products (except kerosene), as agreed under the program. To this end, we have raised the domestic prices of regular and blended gasoline and diesel as of July 1, 2007, as specified in the third SMEFP. We are paying special attention to the measures needed to facilitate private sector imports of gasoline. We will also make every effort to have the amendments to the pension law, as agreed with Fund staff, passed by the Council of Representatives as soon as possible.

7. We believe that the policies and measures set forth in the attached memorandum will allow achieving the objectives under the SBA. However, we stand ready to take any additional measures that may be needed to ensure that the program remains on track. We will consult with Fund staff on adoption of such measures in advance of revisions to the policies contained in the third SMEFP, in accordance with the Fund's policies on such consultation. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives. We consent to the publication of this letter, the third SMEFP, the attached Addendum to the Technical Memorandum of Understanding, and the staff report on the 2007 Article IV consultation and the fifth review under the SBA.

8. Finally, we wish to thank the Fund for its support of Iraq's economic program under these difficult circumstances. We look forward to continue our engagement with the Fund through the regular Article IV consultation process and technical assistance. We will also seek a successor to the present arrangement, for which we intend to initiate negotiations in the fall, to achieve macro-economic stability, continue our economic reform program, and reach the third and last stage of the 2004 Paris Club debt reduction agreement.

Sincerely yours,

/ s /

Dr. Sinan Al-Shabibi
Governor of the Central Bank of Iraq

/ s /

Mr. Baqir S. Jabr Al-Zubaydi
Minister of Finance of Iraq

ATTACHMENT II: IRAQ—THIRD SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2007

July 17, 2007

I. INTRODUCTION

1. This memorandum supplements the Memorandum of Economic and Financial Policies for 2005–06 (MEFP) and the first and second supplements thereto, annexed to our letters dated December 6, 2005, July 15, 2006, and February 23, 2007, respectively. It describes additional economic objectives and policies agreed in the context of the fifth and final review under the Stand-By Arrangement (SBA). Policies and unfulfilled commitments specified in the MEFP and previous supplements continue to be part of the program.

II. RECENT DEVELOPMENTS UNDER THE STAND-BY ARRANGEMENT

2. Macroeconomic stability came under pressure in 2006 with the pronounced deterioration in the security situation but decisive policy actions since mid-November have put inflation on a downward path. The Central Bank of Iraq (CBI) has tightened its monetary policy stance and allowed the exchange rate to appreciate, while the Government of Iraq (GoI) has kept its spending under control. Also, we have taken measures to reduce fuel shortages. As a result, annual consumer price inflation has come down to 46 percent in June, after reaching about 66 percent in January 2007. The core inflation rate (excluding fuel and transportation) has come down to 19 percent.

3. Lower-than-expected crude oil production has continued to suppress real GDP growth. Economic growth is estimated at 6¼ percent in 2006, compared to 10½ percent projected at the outset of the program. Security, technical, and other difficulties in undertaking the necessary investments kept average oil output at 2 million barrels per day (mbpd), below the target of 2.3 mbpd. Although crude oil production recovered in March and April, it averaged only 1.9 mpbd in the first four months of 2007. Based on indicators for the production of cement, fertilizer, and electricity the non-oil real GDP growth rate is estimated at 7½ percent in 2006. Non-oil real GDP growth is expected to continue at a rate of 5 percent in 2007.

4. The GoI has run a fiscal surplus through March 2007 because of continued underspending but budget execution accelerated in April. Oil revenue was broadly on target, with lower-than-projected production volumes compensated by higher-than-expected prices. Revenues of oil-related state owned enterprises were in line with full cost recovery of fuel imports. The mechanism of funding fuel imports through a revolving credit to the Ministry of Oil (MoO) has worked well, although the disbursement from the Ministry of Finance (MoF) exceeded the indicative target. The indicative target for kerosene was exceeded by a small margin. Non-oil revenue was in line with developments in the tax base.

5. The CBI has gradually appreciated the exchange rate to a level of ID 1,250 per dollar at end-June 2007, a 15 percent appreciation since mid-November 2006. Net international reserves continued to grow and reached a level of \$19.7 billion at end-April 2007. The CBI also raised its policy interest rate in two steps to 20 percent as of early January this year.

6. All quantitative performance criteria set for end-March 2007 were met (Table 1). The structural performance criterion set for end-May on completing a final audit of the CBI net international reserves as at December 31, 2006, was met and the structural performance criterion on completing the interim audit report of the CBI 2006 financial accounts was also met albeit with a delay. However, the structural performance criteria set for end-June 2007 on completion of a census of all public sector service employees (central government and military), and on adoption of a fully detailed budget classification and chart of accounts in line with the IMF's *GFSM 2001*, within a cash accounting framework, were missed (Table 2).

III. ECONOMIC AND FINANCIAL POLICIES IN 2007

7. The GoI's main macroeconomic policy objectives continue to be maintaining fiscal sustainability, further reducing inflation, and accelerating oil sector and other reforms to increase economic growth.

8. In the implementation of the 2007 budget, we are focusing on the need to increase investment, notably in the oil sector, which is key to achieving our growth objective and generating sufficient revenues to maintain fiscal sustainability. We have already taken a number of measures to increase the implementation rate of investment projects. In particular, the cabinet sub-committee on investment has accelerated the approval of large investment projects; the procurement period has been reduced from 60-90 days to no more than 30 days; the thresholds for projects that can be approved at the line-ministry or governorate level has been raised significantly; and budget allocations are being made available to the line ministries on a timely basis. In light of the gestation period of new investment projects in the oil sector and the continued unsettled security situation, however, we expect average crude oil production in 2007 to increase to 2.1 mbpd.¹

9. The GoI will continue keeping current spending within the 2007 budget limits. To this end, we will continue resisting undue wage and pension increases and bonuses, and strictly limit hiring, including in public enterprises, in order to keep the wage bill within the budgeted amount. Direct subsidies on fuel products will be avoided (except for a small subsidy for kerosene).

10. These policies, and taking account of the effect of a further appreciation of the exchange rate on oil revenues, should keep the overall government budget deficit below 10 percent of GDP. In case of a sizable shortfall of oil revenues or the need to reallocate capital expenditure, we intend, in consultation with Fund staff, to submit a supplementary budget to the Council of Representatives (CoR), in order to adjust government spending and

¹ Projects in the oil sector include the rehabilitation of 120–150 oil wells in the South.

keep the overall deficit in line with the level targeted in the 2007 budget. By the end of 2007, we aim to hold the equivalent of about ID 6 trillion in assets in the Development Fund for Iraq (DFI). To keep the option of domestic financing of the deficit open and maintain a market indicator for interest rates, we will step up the bi-weekly issuance of treasury bills to ID 150–200 billion.

11. We are committed to achieving a further reduction of inflation through the appropriate management of the exchange rate. The CBI will continue to allow the exchange rate to appreciate gradually in the coming months. We will closely monitor the effect of this policy on the dollarization of the economy and inflation, and will adjust the pace of appreciation as needed. While we consider the exchange rate the CBI's main policy instrument to bring down inflation, we will also stand ready to further increase the CBI's policy interest rate, if the inflationary situation requires this. The government will continue to support the anti-inflation policies of the CBI by avoiding to put excessive demand pressures on the economy and by taking further measures to reduce commodity shortages, in particular of fuel products.

12. The GoI will take further steps to facilitate private sector imports of petroleum products. We have issued some 20 licenses to private importers of fuel products and expect to issue more in the coming months. We will continue to make available to the private sector storage facilities and pump stations, and will respond promptly to any impediments to the importation of fuel products by the private sector. While private imports in the Kurdish region have begun, the security situation in other parts of the country remains a deterrent for getting the private sector involved in the importation of fuel products.

13. We have raised the domestic prices of fuel products to eliminate direct budgetary subsidies, except for a small subsidy on kerosene (Table 3). A further adjustment was made as of July 1 to bring domestic fuel prices closer to the regional average. By that date, regular gasoline was priced at ID 400 per liter, blended gasoline at ID 450 per liter, and diesel at ID 400 per liter. The State Oil Marketing Organization (SOMO) will continue to use the revolving credit with a ceiling of ID 400 billion provided by the MoF to finance its imports of fuel products. The GoI is willing to consider developing a rule-based mechanism for setting domestic fuel prices in the future. In the coming months we will seek technical assistance on the design and implementation of such a mechanism.

14. The GoI is determined to adopt soon a new chart of accounts and budget classification that is consistent with the Fund's *GFSM 2001*, within a cash accounting framework (structural performance criterion for end-June 2007). The MoF has started using the Financial Management Information System (FMIS) on a trial basis in January 2007 but the existing legacy system will continue to be used by spending agencies in parallel for the time being. The MoF has also adopted a plan to increase coverage of spending units not yet connected to the FMIS, which is currently being implemented. We are also working on entering opening balances and budget transfers in the FMIS and are reviewing the accuracy of the system's output. In order to supplement the functionality offered by the existing FMIS, we are in the process of developing user requirements for a purchasing and a budget module.

15. We are actively seeking to have the amendments to the new pension law enacted by the CoR as soon as possible. The amendments provide for a gradual reduction of replacement rates to fiscally sustainable levels and zero indexation in 2007, in line with earlier understanding with Fund staff. An extra-budgetary pension fund will be created, which will receive all pension contributions but will only pay out to new pensioners, while the budget will continue to be responsible for paying existing pensioners. These changes allow the pension outlays to stay within the budgeted envelope for 2007. We are committed to managing the extrabudgetary fund in a transparent manner, in line with international best practices, and will seek technical assistance from the IMF and the World Bank in this area.

16. The census for public sector employees (structural performance criterion for end-June 2007) has not yet been completed. This project turned out more complicated and time-consuming than initially foreseen as it is linked to the preparations for setting up a computerized government payroll. Also, the security situation has caused unexpected delays, in particular by disrupting the operations of the MoF Information Technology Department. Nevertheless, the preparations for the census have been completed and the census questionnaires have been sent to most relevant government agencies. We envisage to complete the data collection phase of the census (i.e., the completed questionnaires have been received back from the government agencies) by end-November 2007.

17. We are making progress in implementing the new Social Safety Net. To date more than 1 million families have been identified and received cash payments (of up to \$80 per month) under the program. This year, we aim to extend coverage to 1.5 million families. We remain committed to further rationalizing the Public Distribution System and have taken some measures in that regard. As a start, we have cancelled eligibility for support of some of the most well-off individuals (ministers, members of the CoR, and others).

18. We are developing a medium-term tax reform strategy. To this end, we have set up a Tax Policy Unit at the MoF and we are receiving technical assistance from international partners, including the IMF. We aim to develop a strategy that will equip Iraq with a tax system that significantly improves revenue collection while at the same time is conducive for economic development. Our tax strategy will cover the oil sector, personal and non-oil corporate income, and consumption taxes, as well as measures to strengthen the tax and customs administrations. We are considering to introduce a sales-tax as a precursor to a value added tax.

19. Ernst and Young (E&Y) has finalized the audit of the net international reserves data reported to the Fund as of December 31, 2006 (including a full count by the auditor of gold and foreign exchange holdings at the CBI) on May 20. It has also issued an interim audit report of the 2006 CBI financial statements in accordance with International Standards on Auditing on July 15. However, we missed the target date by a few weeks (performance criterion for end-May 2007). We intend to implement in full all recommendations provided in the final audit report of the 2006 CBI financial statements during the course of this year. The capital of the CBI was increased to the statutory level of ID 100 billion in late February (structural benchmark for end-December 2006).

20. We continue to address key concerns raised in the interim safeguards assessment report and the management letters from E&Y. The CBI Board recently adopted a timetable for full implementation of International Financial Reporting Standards as the CBI's financial reporting framework by end-2009 (structural benchmark for March 31, 2007). We are also taking steps to improve the quality of our accounting records and accounting control procedures, while work is underway to improve foreign reserves management by developing a foreign reserves management policy and investment guidelines (structural benchmarks for June 30, 2007).

21. We continue to make progress in expanding the coverage of the real time gross settlement payment system and the automated clearing house. Currently 10 commercial banks' headquarters and the MoF are connected to the CBI; we expect to cover most banks by the end of the year.

22. We have taken important steps towards the restructuring of Rafidain and Rasheed banks. The memoranda of understanding for operational restructuring of both state-owned banks, and a financial restructuring of Rasheed bank were approved by the economic committee of the Council of Ministers in March 2007.² The setting-up by the CBI of the secretariat of the Restructuring Oversight Committee has been completed. An international auditor has been selected in early June to conduct an operational and financial audit of both banks and will be appointed shortly (structural benchmark for end-April 2007). The audits will start soon thereafter and are expected to be completed by early 2008. Work has also begun on the reconciliation of the foreign debt held by both banks and the cleaning up of the banks' large suspense accounts. Later this year, we will initiate, in consultation with the IMF and the World Bank, the restructuring of the other four smaller state-owned banks in line with the approach adopted with regard to Rasheed and Rafidain banks.

23. The GoI will continue its efforts towards developing a competitive and transparent hydrocarbon sector. Draft hydrocarbon legislation will be submitted to the CoR when final agreement between all concerned parties has been reached, possibly in the next few months. The envisaged legislative package includes a draft oil and gas law to regulate the sector, a draft law to reestablish the Iraq National Oil Company, a draft law reorganizing the MoO, and a draft financial management law on the sharing of oil revenues.

24. We are committed to step up our efforts to enhancing transparency and fighting corruption in the oil sector. In this regard, the installation of meters at the Basra export terminal has been completed. These meters are for the most part operational but some of them still need to be certified. The comprehensive metering project with Shell and British Petroleum is underway. We are committed to joining the Extractive Industries Transparency Initiative. The MoO will start publishing on its website information on production, export, and processing of crude oil in the next few months.

² Financial restructuring (involving a recapitalization) of Rafidain bank will await the settlement of claims lodged against its London branch.

25. In order to promote economic activity, we have initiated a rehabilitation program for viable public enterprises, notably in the cement, textile, pharmaceutical, and petrochemical sectors. As a first step, we have encouraged 21 public enterprises to submit a business plan to Rasheed and Rafidain banks, in order to obtain financing to restart activities on a purely commercial basis. Any future government support that may be needed will be modest in size and for a limited period only; such support will be fully included in the government budget.

26. In November 2006, a new investment law was adopted that aims to encourage investment and promote equal treatment for domestic and foreign investors. We are now in the process of setting up the National Investment Commission that will develop and monitor the implementation of investment policies and regulations, and establish one-stop agencies at the national and regional levels to issue investment licenses.

27. We are committed to preserving open trade policies. We will maintain the 5 percent import duty (reconstruction levy), while significantly reducing the number of exemptions to increase customs revenue. In May 2007, the Working Party on Iraq's accession to the World Trade Organization (WTO) met in Geneva and started the process of accession negotiations. We will continue our efforts to secure the accession as soon as possible.

28. We will continue to work toward resolving outstanding external claims. Bilateral agreements with all Paris Club creditors, except Russia, and with nine non-Paris Club official creditors have been signed. Official contacts with key creditor countries in the Gulf region and China have been made, and the technical process of debt reconciliation is ongoing. A Special Purpose Vehicle has been established to facilitate official creditors desiring to securitize their claims, while avoiding the emergence of a multiplicity of different securitizations. Most of the remaining claims of private creditors are in the process of reconciliation with claims that are being settled as part of the liquidation of the London branch of Rafidain Bank. We expect the liquidation to be completed by end-2007, enabling us to complete the resolution of all private claims.

29. As part of the ongoing review of Iraq's exchange system by IMF staff, we have submitted additional exchange regulations and provided requested clarifications. We have also issued new regulations to apply the Anti Money Laundering (AML) Law and set up a new AML office within the CBI to implement the regulations.

30. The newly established Committee of Financial Experts (COFE) is fully operational, and is expected to continue the work of the International Advisory and Monitoring Board (IAMB) once it is dissolved. We are closely involving the COFE in the IAMB's regular work to provide it with relevant training prior to the eventual expiration of the IAMB mandate at the end of 2007. The mandate for the DFI expires at the end of this year. We hope to extend the DFI, with help from the international community, for another two years until end-2009. Meanwhile, the immunity of the DFI accounts held at the Federal Reserve Bank of New York has been extended for a year through May 22, 2008.

31. With the help of the international community we have launched an International Compact for Iraq (ICI) to spearhead a process of comprehensive political, security, and economic reform. The macroeconomic component of the ICI is consistent with the program under the SBA.

32. We appreciate the technical assistance received from the IMF, and hope to continue receiving such assistance in the areas of bank restructuring, banking supervision, monetary policy operations, reserves management, development of secondary markets, tax policy, tax and customs administration reform, public financial management, and statistics. We would also like to receive Fund technical assistance to implement the safeguards recommendations.

IV. PROGRAM MONITORING

33. In light of our request to extend the current SBA by three months, we would also like that the remaining two purchases under the arrangement be rephased accordingly and that the last purchase will be available upon observance of the end-September 2007 performance criteria.

34. Macroeconomic policy performance will continue to be monitored through quarterly quantitative performance criteria and indicative targets. The quantitative performance criteria under the original program will remain unchanged, and additional performance criteria have been set for end-September, as specified in Table 1. The missed structural performance criterion on completion of the census of all public service employees has been rescheduled and redefined, as specified in Table 2. We remain committed to submitting data to the Fund within the time lags agreed upon in the MEFP and its supplements.

35. The Technical Memorandum of Understanding is modified in the manner described in the attached addendum.

Table 1. Iraq: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement (SBA), 2005–07 1/
(In billions of Iraqi dinars, unless otherwise indicated)

	2005	Performance Criteria							
	9/30/05	12/31/05	3/31/06	6/30/06	9/30/06	12/31/06	3/31/07	6/30/07	9/30/07
<i>Cumulative change from September 2005</i>									
Net international reserves of the CBI (floor; in millions of U.S. dollars) (Actual)	8,500 2/	-1,000 +3,041	-1,000 +3,635	-1,000 +3,554	-1,000 +5,252	-1,000 +9,770	0 +8,503	0	0
Lending to the government and the private sector by the CBI (ceiling) 3/ (Actual)	5,100 2/	0 0	0 0	0 0	0 0	0 0	0 0	0	0
<i>Cumulative flow from beginning of calendar year</i>									
Government primary fiscal deficit (ceiling; deficit [+]/surplus[-]) 4/ 5/ (Actual)	...	5,400 -5,102	1,950 -819	3,600 -4,752	4,850 -11,220	5,300 -8,947	...	...	...
Central government total financing (ceiling) 4/ 5/ (Actual)	3,000 -1,688	5,350	5,700
Government wage and pension bill (ceiling) 4/ 6/ (Actual)	...	6,650 7,069	2,400 2,051	4,750 3,898	7,100 5,875	9,500 7,792	2,525 1,644	5,050	7,575
Revenue of oil related enterprises, including those remitted to the budget (floor) 4/ (Actual)	...	900 1,456	700 509	1,500 1,454	2,100 2,651	2,800 3,611	750 1,135	1,500	2,850
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) 4/ 7/ (Actual)	...	500 0	500 0	500 0	500 0	500 0	500 0	500	500
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 8/ (Actual)	...	0 653	0 0	0 0	0 0	0 0	0 0	0	0
<i>Indicative targets</i>									
Government imports of petroleum products (ceiling) 4/ 9/ (Actual)	...	6,000 4,128	1,700 1,045	3,400 1,884	4,000 3,120	4,200 4,082	100 104	200	300
Revolving government credit to the State Oil Marketing Organization (ceiling) (Actual)	300 400	400	400

1/ See Technical Memorandum of Understanding for precise definitions of all performance variables.

2/ Estimated.

3/ Rolling over t-bills does not constitute new lending.

4/ Flows for 12/31/05 are cumulative for 2005. Flows for 2006 and 2007 are cumulative starting 1/1/2006 and 1/1/2007, respectively.

5/ Starting in 2007, the budget deficit will be monitored from below the line (i.e., from the financing side).

6/ Excluding salaries paid by ministries of defense and interior (see Technical Memorandum of Understanding for precise definition).

7/ This ceiling excludes loans with a grant element of 35 percent or more of up to Yen 350 billion for reconstruction projects to be contracted with the government of Japan in 2007.

8/ This will be monitored on a continuous basis.

9/ Starting in 2007, this no longer comprises all imports of petroleum products made directly by the government of Iraq but instead comprise of imports of petroleum products financed from the budget.

Table 2. Iraq: Structural Performance Criteria and Structural Benchmarks
Under the Stand-By Arrangement

I. Structural Performance Criteria	Date	Status
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	Met
Final audit of CBI 2005 Financial operations and statements.	May 15, 2006	Waived; Completed on October 1, 2006
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. ^{1/}	June 30, 2007	Not met. Expected soon
Completion by Ernst & Young of (a) a final audit of the net international reserves data reported to the IMF as at December 31, 2006, including a full count by Ernst & Young of gold and foreign exchange holdings at the CBI, and (b) an interim audit report of CBI 2006 financial statements in accordance with International Standards on Auditing.	May 31, 2007	NIR audit completed on time; interim audit report completed on July 15
Completion of census of all public service employees (central government and military).	June 30, 2007	Not met; replaced with a new PC (see below)
Completion of the data collection for the census of all public service employees (central government and military).	November 30, 2007	
II. Structural Benchmarks		
Implementation of payment system regulations.	June 30, 2006	Met
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.	September 30, 2006	Met in November 2006; IAMB mandate has been extended to December 31, 2007
Reform of pension law in line with sustainable pension system	September 30, 2006	Underway
Approval by Council of Representatives of law liberalizing private gasoline imports	September 30, 2006	Met
Commencement of operation of Real Time Gross Settlement system (RTGS) linking headquarters of commercial banks to the CBI.	August 31, 2006	Met
Commencement of payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House (ACH).	November 30, 2006	Met
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	Met in February 2007
Adopt a CBI Board-approved timetable for the full implementation of IFRS as the bank's financial reporting framework	March 31, 2007	Met on April 1, 2007
Appoint an internationally reputable audit firm to conduct an operational and financial audit of Rasheed and Rafidain banks based on their 2006 financial accounts.	April 30, 2007	Underway; auditor selected and appointment process ongoing
Address the lack of proper accounting records being maintained by the CBI, one of the major issues giving rise to E&Y's disclaimed audit opinion for 2005. ^{2/}	June 30, 2007	Underway
Establish adequate control procedures for reserves management, including developing reserves management policy and investment guidelines.	June 30, 2007	Underway

^{1/} 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).

^{2/} The following issues should be addressed: (i) the lack of reconciliations of local bank's current accounts; (ii) unreconciled suspense accounts and interbranch accounts; (iii) unreconciled differences on accounts managed on behalf of the Ministry of Finance, including the DVI; and (iv) insufficient information to support amounts, and to ensure the completeness and valuation of off-balance sheet commitments.

Table 3. Iraq: Indicative Quantitative Benchmarks Under the Stand-By Arrangement
(In Iraqi dinars per liter, unless otherwise indicated)

	Sep. 2005	Prior Action	03/31/06		06/30/06		09/30/06		12/31/06		03/05/07		06/30/07	
			Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Prior action 3rd & 4th reviews	Program	Actual
Official domestic price of petroleum products (equal to or above, by specified dates)														
LPG (per 12 kg cylinder)	250	600	700	600	800	1,000	900	1,000	1,000	1,000	3,000	3,000	3,000	3,000
Regular gasoline	20	100	130	100	155	175	175	175	200	250	300	300	350	400
Premium gasoline 1/	50	250	300	250	350	350	400	350	450	350	...	...	...	...
Blended gasoline	...	...	...	...	...	...	...	...	...	350	400	400	450	450
Kerosene	5	25	50	25	75	75	90	75	115	75	150	150	200	150
Diesel	10	90	110	90	125	125	155	150	175	150	350	350	350	400

1/ Starting 2007, premium gasoline is to be sold only by the private sector at unregulated prices.

**ATTACHMENT III: IRAQ—ADDENDUM TO THE TECHNICAL MEMORANDUM OF
UNDERSTANDING**

July 17, 2007

1. All aspects of the Technical Memorandum of Understanding (TMU) of December 6, 2005 and the addenda thereto of July 15, 2006 and February 23, 2007 remain in effect, except for the changes described below.
2. Quantitative performance criteria for end-September 2007 are being added for: (i) the net international reserves of the CBI; (ii) lending to the government and the private sector by the CBI; (iii) central government total financing; (iv) the government wage and pension bill; (v) revenue of oil related enterprises, including those remitted to the budget; and (vi) new medium-and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government. The quantitative performance criterion for no external arrears on new borrowing will continue to be monitored on a continuous basis. Indicative targets are also being established for end-September 2007.
3. Cumulative flow variables for the quantitative performance criteria will be measured on a cumulative basis from January 1, 2007, except for the net international reserves of the CBI and the lending to the government and the private sector by the CBI, for which cumulative flow variables will be measured from September 30, 2005.
4. The indicative targets on the revolving government credit to the State Oil Marketing Organization and the government imports of petroleum products will be measured on a cumulative basis from January 1, 2007.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Iraq

On August 1, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iraq.¹

Background

The last Article IV consultation with Iraq was the first one in 25 years and was concluded on August 1, 2005. A Stand-By Arrangement (SBA) was approved by the Executive Board on December 23, 2005 in support of an economic program covering through March 22, 2007, which was later extended through September 28, 2007. The SBA-supported program underscores the authorities' commitment to stabilize macro-economic conditions in Iraq, while at the same time implement structural reforms to pave the way for sustainable economic growth. Under the program the authorities have taken measures needed to achieve macro-economic stability. Despite an unsettled political situation, capacity constraints, and the deterioration in security in 2006, progress has been made in implementing structural reforms, although much remains to be done.

Economic growth has been slower than expected at the time of the last Article IV consultation, mainly because the expected expansion of oil production has not materialized. Following a decline in oil production and real GDP in 2005, economic growth is estimated at 6¼ percent in 2006. Average annual crude oil production has remained at about 2 million barrels per day since 2004. Annual consumer price inflation increased to almost 65 percent at end-2006 from

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

31½ percent at end-2005 mainly due to supply bottlenecks, in particular of fuel products. Core inflation (excluding fuel and transportation) remained high at about 32 percent. Following policy efforts to bring inflation under control and some easing of fuel shortages, inflation has since then declined to 46 percent in June 2007, and core inflation has decreased to 19 percent.

Since November 2006 the Central Bank of Iraq (CBI) has allowed the exchange rate of the Iraqi dinar to appreciate by 15 percent and raised its policy interest rates in two steps to 20 percent. In addition to reducing inflation, these policies have also had some success in de-dollarizing the economy and increasing the demand for dinars. The CBI gross international reserves increased to \$18.7 billion at end-2006 (almost 6 months of import cover).

Following a fiscal surplus of 11 percent of GDP in 2005, the fiscal outturn for 2006 showed a surplus of almost 12 percent. This outcome is partly the result of underspending on investment reconstruction projects, including in the oil sector. The surpluses contributed to an accumulation of balances in the Development Fund of Iraq to a level of \$8.6 billion at end-2006.

Progress in implementing the structural reforms has been made. Official fuel prices have been increased to levels in other oil-exporting countries in the region, and private sector importation of fuel products has been liberalized. Negotiations on a new legal framework for the oil sector are ongoing. An interim audit of the CBI's 2006 financial statements and an audit of its net international reserves have been finalized. Progress has also been made in developing the financial system with the introduction of a payments clearing system and a Real Time Gross Settlement system. The process of restructuring Iraq's two largest state-owned banks has started. The Ministry of Finance has adopted a new chart of accounts and budget classification, but completion of a census of all public service employees has proven more time-consuming than foreseen and is still underway.

The Paris Club agreed on November 21, 2004 to a debt reduction for Iraq, equivalent to 80 percent in net present value (NPV) terms, to be achieved in three stages. The first and second stages each comprised a 30 percent debt reduction in NPV terms and went into effect in November 2004 and in December 2005 (following approval of the SBA), respectively. The final stage will comprise an additional 20 percent debt reduction, and depends on completion by end-December 2008 of the final review of the third year of one or more upper credit tranche arrangements with the Fund. Iraq continues to make progress in resolving debt to official and private creditors.

Executive Board Assessment

Directors commended the Iraqi authorities for keeping their economic program on track by strengthening economic policies and making progress in structural reforms, despite an unsettled political situation and a very difficult security environment. They noted, however, that the expansion of oil production is lagging, and that inflation, while on a downward path, remains high, reflecting in large part continued shortages, notably of fuel products. Directors considered that Iraq's economic prospects hinge critically on an improvement in the security situation.

Directors encouraged the authorities to take measures to speed up reconstruction and increase investment, especially in the oil sector. To that effect, they welcomed measures adopted by the authorities to increase the implementation rate of the public investment program, and urged them to take additional measures, if needed, and to strengthen the protection of oil installations.

Directors commended the government's commitment to pursue a prudent fiscal policy by keeping current spending in 2007 within the budget limits and to maintain fiscal sustainability over the medium term. They supported the authorities' decision to resist undue spending pressures and to strictly contain the wage and pension bill, as well as transfers. Directors encouraged the authorities to enact as soon as possible amendments to the new pension law to ensure the fiscal sustainability of the pension system.

Directors welcomed the increase in official fuel prices to regional levels. This will enable the government to continue avoiding direct subsidies on fuel products, except for kerosene. They were encouraged by the authorities' intention to consider developing a rule-based mechanism for setting domestic fuel prices in the future, which would prevent the re-emergence of budgetary subsidies, help fight corruption, and free up resources for much needed investment spending.

Directors were encouraged by the reduction in inflation. They generally supported the policy of the CBI to continue allowing the gradual appreciation of the dinar through end-2007. This would contribute to further reducing inflation and de-dollarizing the economy. Directors called on the CBI to stand ready to accelerate the pace of appreciation and tighten monetary conditions further if inflation deviates from its downward path and dollarization is not reduced as expected. Key to fighting inflation would be to continue restraining public spending pressures and stepping up efforts to reduce shortages, especially by actively supporting private sector fuel imports.

Directors stressed the need to implement priority structural reforms as expeditiously as circumstances permit. They encouraged the authorities to broaden the coverage of the Financial Management Information System, modernize and streamline the tax system with a view to expanding the tax base and improving incentives for economic activity, and to press ahead with the restructuring of the banking system so as to increase financial intermediation, especially for the private sector. Directors also welcomed the government's efforts to rehabilitate viable public enterprises on a commercial basis, while underscoring that any government financial support should be efficient and fully reflected in the budget.

Directors urged the authorities to improve the transparency and accountability of public financial management and step up their fight against corruption. They were encouraged by the authorities' intention to join the Extractive Industries Transparency Initiative and implement a comprehensive oil metering system as soon as possible.

Directors underscored the need to put in place a new legislative framework for the hydrocarbon sector as soon as possible, which, along with an improvement in the security situation, would help strengthen the investment environment to significantly increase oil production.

Directors welcomed the steps taken in strengthening financial safeguards at the central bank. They urged the CBI to step up its efforts to address all the recommendations of the Fund's interim safeguards assessment report, as well as the Ernst & Young interim 2006 audit report.

Directors commended the authorities' intention to maintain an open trade regime. They supported the authorities' efforts to secure World Trade Organization accession. While keeping the present low import tariff, Directors stressed the importance of increasing revenues by scaling down exemptions and strengthening the customs administration.

Directors commended the authorities for the new investment law, which provides an important framework for attracting much-needed foreign investment. They encouraged the authorities to establish the National Investment Commission as soon as possible.

Directors welcomed the authorities' efforts to conclude debt agreements with the remaining official and private creditors. They urged the government and those official creditors still to provide debt relief to conclude debt agreements expeditiously.

Directors stressed the critical need to further improve the statistical database.

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

Iraq: Selected Macroeconomic Indicators, 2004–07

	2004	2005	2006 Est.	2007 Proj.
Oil and gas sector				
Total exports of oil and gas (in billions of U.S. dollars)	17.3	19.2	27.7	28.6
Average crude oil export price (in U.S. dollars/barrel)	31.6	43.9	55.7	50.6
Crude oil production (in millions of barrels/day)	2.0	1.9	2.0	2.1
(Annual percentage change)				
Output and prices				
Real GDP	46.5	3.7	6.2	6.3
Non-oil real GDP	14.9	12.0	7.5	5.0
Consumer price inflation (end-of-period)	31.7	31.6	64.8	30.0
(In percent of GDP)				
Investment and Saving				
Gross domestic investment	27.7	31.6	16.3	20.0
<i>Of which:</i> non-government	5.5	12.3	3.3	4.2
Gross national savings	-9.8	31.2	27.7	14.7
<i>Of which:</i> non-government	29.4	0.2	2.4	8.6
(In percent of GDP, unless otherwise indicated)				
Public Finances (cash basis)				
Government revenue (including grants)	79.6	107.4	80.5	62.3
<i>Of which:</i> Oil revenue	69.2	76.7	65.2	51.1
Expenditure	120.8	96.6	68.5	72.0
<i>Of which:</i> Current	98.6	77.2	55.5	56.1
<i>Of which:</i> Capital	22.2	19.4	13.0	15.8
Budget balance (including grants)	-41.2	10.9	12.0	-9.7
Primary fiscal balance	-40.2	11.1	12.5	-9.0
Non-oil primary fiscal balance	-88.6	-49.3	-41.2	-52.5
Total government debt (in billions of U.S. dollars)	97.6	68.9	54.7	56.4
(Annual percentage change unless otherwise indicated)				
Monetary Sector				
Base money	116.9	12.0	29.0	38.9
Currency issued	74.9	27.9	16.2	41.7
(In percent of GDP, unless otherwise indicated)				
External Sector				
Non-oil exports of goods (in U.S. dollars, percentage change)	...	30.3	22.2	23.2
Imports of goods (in U.S. dollars, percentage change)	216.7	-3.1	12.4	42.6
Trade balance	-8.4	3.3	14.0	-2.3
Current account excluding official transfers	-43.3	-18.9	2.9	-11.5
Current account including official transfers	-37.6	3.9	12.3	-5.5
Overall external balance	6.6	11.2	15.1	4.3
Foreign Direct Investment	0.8	1.3	0.6	0.6
Total external debt	378.9	219.5	110.6	90.4
Central banks gross reserves (in billions of U.S. dollars)	7.9	12.0	18.7	21.3
In months of imports of goods and services	3.2	5.4	6.2	6.9
Memorandum Items				
Nominal GDP (in billions of U.S. dollars)	25.8	31.4	49.5	62.4
Unemployment rate 1/	10.5	18.5	...	...
Local currency per U.S. dollar (period average) 2/	1,453	1,469	1,467	1,275
Real exchange rate (Jan. 2004 = 100) 3/	145.5	183.4	311.9	341.8

Sources: IMF staff estimates and projections.

1/ Iraq Living conditions survey 2004, UNDP.

2/ For 2007, January–June.

3/ Calculated as the nominal exchange rate adjusted for the inflation differential between Iraq and the United States.

Increase in the index denotes appreciation. For 2007, as of May.



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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review and Review of Financing Assurances under Iraq's Stand-By Arrangement, and Approves Three-Month Extension of the Arrangement to December 2007

The Executive Board of the International Monetary Fund (IMF) has completed the fifth review of Iraq's performance under its economic program supported by a Stand-By Arrangement and a financing assurances review under the Arrangement. The Stand-By Arrangement is being treated as precautionary by the Iraqi authorities, and no purchase is planned.

The Stand-By Arrangement in an amount equivalent to SDR 475.36 million (about US\$727.4 million) was approved on December 23, 2005 (see [Press Release No. 05/307](#)). In completing the review, the Executive Board also approved the authorities' request for a three-month extension of the Arrangement through December 28, 2007.

The Board also approved the authorities request for the waivers of the non-observance of the structural performance criteria on the interim audit of the Central Bank of Iraq's 2006 financial statements, on completing a census of all public service employees (central government and military), and on the adoption of a fully detailed budget classification and chart of accounts, and request for waivers of the applicability of the June 30, 2007 quantitative performance criteria under the Arrangement.

The Executive Board also concluded the Article IV Consultation with Iraq.

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

“Despite a persistently difficult security environment, the Iraqi authorities have taken important measures to keep their economic program on track. However, the expansion of oil production is lagging and inflation, while on a downward path, remains high reflecting in large part shortages associated with the security situation, notably of fuel products. A turnaround hinges critically on an improvement in the security situation.

“Measures to speed up reconstruction and increase investment, especially in the oil sector, are needed. The measures adopted by the authorities to increase the implementation rate of the public investment program are encouraging. Enhancing the protection of oil installations is also important.

“The government is showing a commendable commitment to pursue a prudent fiscal policy, by keeping current spending in 2007 within the budget limits and by seeking to maintain fiscal sustainability over the medium term. It remains essential to amend the new pension law in order to ensure fiscal sustainability of the pension system.

“The recent increase in official fuel prices to regional levels is an important step in the right direction. The authorities are considering the development of a rule-based mechanism for setting domestic fuel prices in the future, which should prevent the re-emergence of budgetary subsidies (except for kerosene), help fight corruption, and free up resources for much-needed investment spending.

“Inflation has come down, reflecting the appropriate policy actions taken by the Central Bank of Iraq (CBI). The CBI will need, however, to continue its tight monetary and exchange rate policies to further reduce inflation and de-dollarize the economy. The government should also help to fight inflation by restraining public spending pressures and by stepping up efforts to reduce shortages, notably by actively supporting private sector fuel imports.

“Structural reforms remain the cornerstone of the reconstruction process. However, much remains to be done and the pace of implementation needs to be stepped up. Key actions include the broadening of the coverage of the Financial Management Information System, and modernizing and streamlining the tax system. The government is committed to restructuring the largest two state-owned banks and to rehabilitate viable public enterprises on a commercial basis.

“Transparency needs to be enhanced and corruption to be brought under control, in order to reinforce the credibility of the government’s reform program. In this connection, it is important to put in place a comprehensive oil metering system as soon as possible.

“Unlocking Iraq’s oil wealth requires advancing the enactment of a new legislative framework for the hydrocarbon sector, in view of the large investments needed to increase oil production.

“The CBI has taken steps to strengthen CBI safeguards area. The CBI should continue its efforts to address all the recommendations of the Fund’s interim safeguard assessment report, as well as the Ernst & Young interim 2006 audit report.

“Good progress has been made in settling arrears with the remaining official and private creditors. However, further progress is needed towards resolving non-Paris Club official claims,” Mr. Kato said.

Statement by A. Shakour Shaalan, Executive Director for Iraq
August 1, 2007

1. The Iraqi authorities would like to express their deep appreciation for the Fund's Executive Board, Management, and Staff, for their ongoing support under difficult circumstances. They are particularly grateful for staff's continued contributions to the formulation of sound economic policies in Iraq. The excellent advice and technical assistance delivered under the framework of the Stand-By Arrangement (SBA) continue to afford a coherent context for the elaboration of a consistent set of policies, aimed at rebuilding the foundations for macroeconomic stability and promoting economic development. The authorities remain strongly committed to the program, whose objectives they view as clearly beneficial to Iraq.
2. Improvement on security remains, however, a prerequisite for the ability of the Iraqi government to effectively implement its policies. The marked deterioration in the security situation in 2006 has unfortunately undermined the prospects of continued economic improvement, notably with regard to two fundamental indicators of macroeconomic stability: growth and inflation. Indeed, the violent conflict severely hampered the implementation of budgeted investment projects, particularly in the oil sector, thereby slowing down growth. Moreover, the shortages of key commodities gave rise to the sharp rise in inflation.
3. Notwithstanding the security situation and severe capacity constraints—exacerbated by the emigration of professionals and skilled labor—the authorities have achieved major strides in enhancing their economic policies while advancing their structural agenda. They have adopted decisive policy measures to bring down inflation and have raised fuel prices to regional levels. And to the extent possible, they have also introduced vigorous steps to increase public investment. At the same time, bold measures have been taken to advance structural reforms in the monetary and fiscal areas, while negotiations on a new legal framework to develop a competitive and transparent hydrocarbon sector are ongoing. In an effort to enhance transparency and fight corruption in the oil sector, the authorities are also committed to joining the Extractive Industries Transparency Initiative. They have initiated a rehabilitation program for viable public enterprises and are striving at developing an operational framework for the recently adopted investment law. Iraq has also made significant progress in the process of WTO accession. Notwithstanding these favorable developments, the authorities are well aware of the challenges facing the reconstruction of a sustainable macroeconomic environment over the medium-term. Accordingly, they stand ready to take any additional measures that will enhance economic growth prospects and help in further reducing inflationary pressures.

Fiscal Sector Policies and Reforms

4. Oil production and export volumes in 2006 have been lower than anticipated under the program, due to the inability to expand capacity. Higher oil prices however more than compensated for the lower output, resulting in oil revenues slightly above the budgeted levels, and triggering a slight overperformance in overall revenue. Expenditures, on the other hand, have been substantially lower than planned, essentially due to much lower than anticipated investment spending related to the deteriorating security conditions. The fiscal outturn in 2006 was therefore very strong and contributed to a sharp increase in the accumulation of foreign exchange resources in the Development Fund for Iraq.

5. The authorities are aware that medium-term growth prospects hinge on the capacity to increase investment in infrastructure, notably in the oil sector, which is key to generating sufficient revenues to maintain fiscal sustainability. The implementation of the 2007 budget is therefore geared toward the need to increase investment, mainly in the oil sector. The authorities have also adopted a series of measures to increase the implementation rate of investment projects, including accelerating the approval of large investment projects and reducing the procurement period. However, considering the effect of a further dinar appreciation on oil revenues, the authorities are well aware that they need to further control current expenditures going forward, to be able to fund the needed infrastructure investments as well as to follow through on their commitments relating to security and the social sector. Current spending this year will therefore be kept within the 2007 budget limits, without the need for a supplementary budget. The authorities will continue resisting undue pressures on the wage bill.

6. The government has continued to pursue the process of realigning domestic fuel prices with regional levels, in line with the program. Except for a small subsidy for kerosene, direct subsidies on fuel products will therefore be avoided in 2007. At this stage, the authorities are willing to consider developing a rule-based mechanism for setting domestic fuel prices in the future, and will seek technical assistance in this regard. The authorities have also adopted measures to reduce fuel shortages by promoting the implementation of the 2006 law authorizing the private import of petroleum products. Private sector imports have so far been limited to the Kurdish region due to the security conditions prevailing in the rest of the country. So far, the authorities have issued about 20 licenses to private importers and will take further steps to encourage private sector imports, including making storage facilities and pump stations available to private operators.

7. Considerable effort is being devoted to advancing fiscal reforms. The government is making every effort to ensure that amendments to the new pension law are enacted by the Council of Representatives as soon as possible. The amendments provide for a gradual reduction of replacement rates to fiscally sustainable levels and zero indexation in 2007, in

line with earlier understanding with Fund staff. Envisaged changes would allow the pension outlays to stay within the budgeted envelope for 2007. The extrabudgetary pension fund will be managed transparently in line with best practices, and the authorities will seek technical assistance from the Fund and the World Bank in this respect. Furthermore, the government has made progress in implementing the new Social Safety Net. More than 1 million poor families have received in 2006 cash payments under the program, and the coverage is expected to increase to 1.5 million families this year. At the same time, efforts to rationalize the Public Distribution System are ongoing, starting with a narrowing of the eligibility criteria.

8. A medium-term tax reform strategy aimed at modernizing the tax system to enhance non-oil revenue collection has been initiated. The authorities are considering introducing a sales-tax as a precursor to a value added tax, and aim at strengthening the tax and customs administration. Further efforts to improve public financial management are under way, including completion of the remaining steps needed to conform the chart of accounts and budget classification with the GFSM 2001. At the same time, coverage of the recently operationalized Financial Management Information System is being expanded to new spending units.

Monetary and Financial Sector Policies and Reforms

9. Decisive and mutually reinforcing policy measures have, since November 2007, contributed to curbing inflation. The Central Bank of Iraq (CBI) has tightened its monetary stance by raising its policy interest rate in two steps to 20 percent. It has also allowed the exchange rate to appreciate by some 14 percent. These measures, alongside the increases in domestic fuel prices, efforts to reduce fuel shortages, and continued fiscal restraint, succeeded in containing inflationary pressures. Annual consumer price inflation declined to 46 percent in June 2007 after having peaked at about 66 percent in January 2007, while the annual core inflation rate has dropped to 19 percent in June, compared to 32 percent at end-2006. At the same time, cash dollarization declined and the demand for dinars picked-up, pointing to increased confidence in the monetary stance of the CBI. This is evidenced by the expansion in the dinar currency in circulation and the noticeable substitution, at the daily foreign exchange auctions, in favor of transfers within the banking system instead of cash sales of dollars.

10. The authorities acknowledge that inflation needs to be further reduced and are committed to further monetary tightening if needed. However, as discussed at previous occasions, inflation is essentially supply-driven, as it is intrinsically linked to the security situation and to the resulting shortage of key commodities. Without a clear improvement on this front, it would be difficult to see significant progress in disinflation. Nevertheless, to signal its firm commitment to reducing inflation, the CBI is planning to allow the exchange

rate to gradually appreciate by 1 percent per month until end-2007, while closely monitoring the effects of this policy. While the exchange rate is the main policy instrument for the CBI to bring down inflation, it stands ready to consider further increasing the policy interest rate, if needed.

11. The CBI continues to address concerns raised in the interim safeguards assessment report and the 2005 audit of CBI. The CBI Board has recently adopted a timetable for full implementation of International Financial Reporting System as the CBI's financial reporting framework by end-2009. Moreover, the capital of the CBI was increased to the statutory level of ID 100 billion in February 2007. The CBI is also taking steps to improve the quality of its accounting records and control procedures, and in establishing adequate control procedures for reserves management. Important progress was achieved in terms of payment systems reforms and the CBI is now in the process of expanding the coverage of the real time gross settlement payment system and the automated clearing house.

12. The effectiveness of monetary policy in Iraq continues to be hampered by the weakness of the monetary transmission channels due to an inefficient banking sector. A restructuring of the sector is therefore a major objective of the authorities and should play an important role in the development of the Iraqi economy. Important steps have been taken towards the restructuring of the two largest state-owned banks, Rafidain and Rasheed. The economic committee of the Council of Ministers approved in March 2007 the memoranda of understanding for the operational restructuring of both state-owned banks, and a financial restructuring of Rasheed bank. An international auditor has been selected to conduct these audits, which are expected to be completed by early 2008. Later this year, the authorities intend to initiate, in consultation with the IMF and the World Bank, the restructuring of the other four smaller state-owned banks, in line with the approach adopted with regard to Rasheed and Rafidain banks.

Debt Restructuring

13. The authorities are making best efforts in trying to reach agreements with remaining official creditors, including Gulf countries and China, and the technical process of debt negotiation and reconciliation is ongoing. A Special Purpose Vehicle (SPV) has been established to securitize the debt held by private and public creditors, which would help create liquidity for Iraqi debt. The authorities hope that the SPV for debt securitization would facilitate the negotiations with other official creditors. Most of the remaining claims of private creditors are in the process of reconciliation with claims that are being settled as part of the liquidation of the London branch of Rafidain Bank. The authorities expect the liquidation to be completed by end-2007, enabling them to complete the resolution of all private claims.

Performance Under the SBA

14. Despite the adverse circumstances, Iraq continues to make clear progress in implementing the SBA. While the persistently unsettled security situation has caused delays in the implementation of some structural performance criteria (PC) under the SBA, all quantitative PCs set for end-March 2007 were met. On the basis of corrective actions being undertaken as specified in the Supplementary Memorandum of Economic and Financial Policies (SMEFP) for 2007, the authorities would like to request waivers for the nonobservance of these performance criteria, and completion of the fifth review under the SBA. They also request a waiver of applicability of end-June quantitative performance criteria and establishment of the quantitative performance criteria proposed in the SMEFP for end-September 2007, as well as the rescheduling and redefinition of the missed performance criterion on completion of the census of all public service employees, as described in the SMEFP. In order to ensure continuity in the policy framework during discussions for an envisaged successor arrangement, they also request an extension of the current SBA by three months to December 28, 2007. They intend to continue to treat the SBA as precautionary. The Iraqi authorities remain fully committed to the implementation of the arrangement, which has served Iraq well, providing cohesion to the policy framework while anchoring and furthering progress towards macroeconomic stability. Moreover, the SBA-supported program will continue to provide the macroeconomic framework for the International Compact with Iraq, which was initiated with the help of the United Nations and formally endorsed by the international community in May 2007, with an aim at putting in place a medium-term framework for political, security and economic reforms.