

IRAQ



ECONOMIC MONITOR

Harnessing the Oil Windfall for Sustainable Growth

Spring 2022



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Iraq Economic Monitor

Harnessing the Oil Windfall
for Sustainable Growth

With a Special Focus

COVID-19 and the Human Capital Crisis: Recovering
Educational Losses for Future Productivity and Growth

Spring 2022



Middle East and North Africa Region

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ACRONYMS

AML/CFT	Anti-Money Laundering and Countering Financing of Terrorism	ISHM	Iraq Security and Humanitarian Monitor
AQR	Asset Quality Reviews	LAYS	Learning-Adjusted Years of Schooling
BOP	Balance of Payments	LHS	Left hand side
CAB	Current Account Balance	M2	Broad Money
CBI	Central Bank of Iraq	mbpd	Million barrel per day
CFI	Competitive Fund Initiative	MENA	Middle East and North Africa
COSIT	Central Organization for Statistics and Information Technology	MMT	Million Metric Ton
COVID-19	Coronavirus Disease 2019	MOED	Ministry of Education
EGMA	Early Grade Mathematics Assessment	MOHESR	Ministry of Higher Education and Scientific Research
EGRA	Early Grade Reading Assessment	MoF	Ministry of Finance (Iraq)
EMIS	Education Management Information System	MoO	Ministry of Oil (Iraq)
ER	Exchange Rate	MT	Metric Ton
EU	European Union	NCR	Norwegian Refugee Council
FAO	Food and Agriculture Organization	NRA	National Risk Assessment
FDI	Foreign Direct Investment	NPLs	Non-performing Loans
FINDEX	Financial Inclusion Database	OPEC (+)	Organization of Petroleum Exporting Countries (plus other non-OPEC partner countries)
FSAP	Financial Sector Assessment Program	PDS	Public Distribution System
GDP	Gross Domestic Product	pp	Percentage points
GoI	Government of Iraq	RHS	Right hand side
HCI	Human Capital Index	SMEs	Small and Medium-Sized Enterprises
H2	Second Half of the Year	SOBs	State-owned banks
IEM	Iraq Economic Monitor	SWIFT	Rapid Welfare Monitoring Survey
IHFPS	Iraq High Frequency Phone Survey	TIMSS	Trends in International Mathematics and Science Study
IHSES	Iraq Household Socio-Economic Survey	TEIs	Tertiary Education Institution (s)
ILO	International Labour Organization	UN	United Nations
IMF	International Monetary Fund	UNCTAD	United Nations Conference on Trade and Development
IOM	International Organization for Migration		
IQD	Iraqi Dinar		

UNESCO	United Nations Educational, Scientific and Cultural Organization	USDA	United States Department of Agriculture
UNICEF	United Nations International Children's Fund	WB(G)	World Bank (Group)
UMICs	Upper middle-income countries	WDI	World Development Indicators
US	United States	WFP	World Food Program
		y/y	Year-on-year (growth)



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The Iraq Economic Monitor provides an update on key economic developments and policies over the previous six months and presents findings from recent World Bank work on Iraq, placing them in a longer-term and global context and assessing the implications of these developments and other changes in policy regarding the outlook for Iraq. Its coverage ranges from the macro-economy to business environment and private sector development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Iraq.

The Iraq Economic Monitor is a product of the Middle East and North Africa (MENA) unit in the Macroeconomics, Trade & Investment (MTI) Global Practice of the World Bank Group. The report was written by Majid Kazemi (Economist, MTI) and Ashwaq Maseeh (Economist, MTI).

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EXECUTIVE SUMMARY

Recent Economic and Policy Developments

Iraq's economy is gradually emerging from the deep recession caused by the pandemic and the plunge in oil prices in 2020. After contracting by more than 11 percent in 2020, real GDP grew by 2.8 percent in 2021, supported by the solid expansion of non-oil output, in particular services, driven by the easing of the COVID-19 movement restrictions. Non-oil industries and agriculture continued to contract in 2021, affected by frequent power cuts, rising input prices, and severe droughts. Oil GDP fell by 0.7 percent in 2021, as rising oil prices and easing of the production cuts since August 2021 were unable to compensate for forgone revenue from the OPEC+ production quota early in the year.

Higher oil revenues pushed Iraq's overall fiscal and external balances into a surplus in 2021. Total government revenues surged by 73 percent in 2021, spurred by higher oil prices which averaged US\$68.4 per barrel in 2021 (78 percent increase). Despite persisting budget rigidities, notably the high wage bill share and other transfers, improved oil receipts turned the overall fiscal balance to a surplus of 4 percent of GDP in 2021. The favorable fiscal outcomes improved the public debt-to-GDP ratio;

however, unaccounted arrears and contingent liabilities remain significant. On the external side, higher oil exports and lower imports pushed the current account balance (CAB) into a surplus of 11.4 percent of GDP (US\$24 billion) in 2021. Notwithstanding a decline in net foreign investments, in part due to heightened political uncertainties, a five-decade record high of monthly oil exports in March 2022 (US\$11 billion) brought international reserves (excluding gold) to over US\$61 billion.

The turnaround in oil markets has significantly improved Iraq's economic outlook in the medium term. Overall growth in 2022 is now forecast at 8.8 percent, driven in part by the end of the OPEC+ pandemic-related quotas restrictions. As a result, Iraq's production is projected to surpass its pre-pandemic level of 4.6 mbpd in the second half of 2022. Growth in the outer years is projected to remain modest, at 4.2 percent on average, as oil production moderates. Non-oil GDP growth is projected to converge to its long-term potential growth trend in part aided by higher investments that would be financed through the oil windfall. However, the delay in government formation and the ratification of the 2022 budget, if continued, could limit the use of the fiscal windfalls as the de-facto ceilings from the 2021 budget are reached, which could reduce economic

growth. Moreover, in the absence of an accelerated process of reforms, growth (and sorely missing job creation) will remain constrained by the economy's limited absorptive capacity and other inefficiencies.

Iraq's economic outlook remains subject to significant risks. The recent geopolitical tensions related to the war in Ukraine highlight risks for Iraq's economy both on the upside and downside. While any further oil price hikes would improve Iraq's fiscal balance, rising food prices and disruption to agriculture imports would exacerbate pre-existing poverty trends and increase food security risks. The conflict also poses risks to Iraq's crude oil production if operations of Russian oil companies in Iraq are impacted by international sanctions on Russia. Crucially, higher oil prices could hurt the domestic drive for reforms thereby deepening Iraq's structural economic challenges. Further intensified climate change effects and water shortages will decrease agricultural production. Additionally, COVID-19 vaccination in Iraq remains very low, posing risks from the spread of possible new variants. Other risks include the decline in oil prices, and a deterioration of the security situation stemming from existing fragilities and structural challenges of the economy including overdependence on oil.

Iraq's fiscal and socio-economic fragilities underscore the urgency of wide-ranging structural reforms by the new government. Reorienting fiscal resources for growth-enhancing programs in human and physical capital will be key for diversification and job creation. To this end, key priority reform areas include rightsizing the wage bill and improving spending efficiency. Efforts are needed to strengthen public financial management, reduce inefficient energy subsidies, and minimize fiscal risks arising from off-budget expenditures and government guarantees. These measures need to be complemented with integrated social assistance programs that facilitate targeted transfers to the most vulnerable households. Accelerating state-owned banks reforms by enhancing their efficiency and governance would bolster the financial sector and increase private sector's access to finance. Embedding climate-related policies at the heart of Iraq's development plan will also be essential for raising revenues, inducing growth and job creation in the medium term. The

Government of Iraq (GoI) White Paper remains a bold blueprint for a comprehensive program of economic reforms towards economic diversification.

Iraq's existing food security challenges have intensified with the recent surge in global commodity prices. Even before the recent disruptions in global food supplies, Iraq faced significant food security risks as domestic food production fell short of demand from the country's rapidly growing population. Agricultural production has suffered from recent severe droughts, record temperatures, soil erosion and salination, and rising price of agricultural inputs as well as production disruptions due to episodes of insecurity and conflict. To plug the food supply gap, Iraq has become increasingly reliant on imports for more than half of its food consumption, which has increased the country's exposure to global food price and supply shocks. Subsidies and direct transfers, including recently new measures announced by GoI, partly mitigate the impact of rising global prices in the short term. However, achieving food security calls for coordinated efforts to improve domestic production including through raising the efficiency of irrigation water, reducing and rehabilitating soil degradation, improving land management, and implementing climate change adaptation and mitigation measures including the adoption of climate-smart agriculture.

COVID-19 and the Human Capital Crisis: Recovering Educational Losses for Future Productivity and Growth

Iraq is facing a human capital crisis. Important health and education outcomes have been low and declining in recent years. According to the 2020 Human Capital Index (HCI), a child born in Iraq just before the COVID-19 pandemic could expect to be only 41 percent as productive by age 18 as she could be with complete education and full health. Despite the country's oil wealth, investment in human capital has accounted for a relatively low share of the public budget—about 10 percent for education and 4 percent for health. Multiple inefficiencies in public spending have prevented these investments from translating into better human capital outcomes.



COVID-19 has exacerbated existing gaps in human capital and led to substantial learning losses. The pandemic took a toll on Iraq's human capital by negatively affecting the health and economic well-being of today's workers, as well as by reducing the potential productivity of Iraq's future generation. Prolonged school closures have had devastating effects on children's learning. Before the pandemic, an average child in Iraq could expect to complete 6.9 years of schooling; however, when taking into account the amount of learning that actually takes place, this child would achieve only 4.0 learning-adjusted years of schooling (LAYS) by age 18. As a result of the school closures, the World Bank estimates this indicator to decrease to between 2.6 and 3.0 LAYS—a decline of 1.0 to 1.4 years of learning. This would translate into lifetime earnings for the affected students to be reduced by between 8.4 and 11.2 percent (approximately US\$ 20,000 to 28,000 lost per future worker) and economywide losses of US\$47.1 to US\$63.1 billion over the course of their working lives—equivalent to more than one-third of Iraq's total gross domestic product in 2020.

A recent World Bank report *Building Forward Better to Ensure Learning for All Children in Iraq* lays out an education reform path for better learning and skills development to improve human capital outcomes. The main education reform priorities include: (i) Crisis response: mitigating immediate learning loss and preventing further dropouts; (ii) Improving foundational skills to set a trajectory for learning through improved learning materials and strengthened teacher practices that support learning for all children; (iii) Focusing on most urgently needed investments, while ensuring better utilization of resources; (iv) Improving governance of the education sector and evidence-based decision-making; (v) Adopting the National Education Strategy (2022–2030) that focuses on learning and “building forward better”; and (vi) Aligning skills with labor market needs through vocational education and training (VET) programs and higher education offerings that impart market-relevant skills. With the recovery in global oil prices, channeling additional public revenues into human capital investments is an urgent priority that is essential for Iraq's future productivity and growth.

ملخص تنفيذي

التطورات الاقتصادية والسياسية الأخيرة

يخرج اقتصاد العراق تدريجياً من الركود العميق الذي تسببت به جائحة كوفيد-19 والتراجع الحاد في أسعار النفط في عام 2020. فبعد التقلص بأكثر من 11 بالمائة في عام 2020، ارتفع إجمالي الناتج المحلي الحقيقي بـ2,8 بالمائة في 2021، مدعوماً بتوسع المخرجات غير النفطية في خدمات معينة، وبتخفيف القيود المفروضة على التنقل نتيجة كوفيد-19. أما بالنسبة إلى الصناعات غير النفطية والزراعة، فاستمرت في التقلص في عام 2021، بفعل انقطاع الكهرباء المتكرر وارتفاع أسعار المدخلات وموجات الجفاف الحادة. وقد تراجع إجمالي الناتج المحلي في قطاع النفط بـ0,7 بالمائة في 2021، إذ أن ارتفاع أسعار النفط والتخفيف من تخفيضات الإنتاج منذ أغسطس 2021 لم يتمكننا من التعويض عن الإيرادات الضائعة جراء حصص إنتاج «أوبك بلاس» في وقت مبكر من العام.

أدى الارتفاع في إيرادات النفط إلى تحقيق فائض في عام 2021 في الأرصدة المالية والخارجية الكلية في العراق. فارتفع إجمالي الإيرادات الحكومية بـ37 بالمائة في عام 2021 بفضل ارتفاع أسعار النفط التي بلغت في المتوسط 68,4 دولاراً أمريكياً لكل برميل في 2021 (زيادة بنسبة 87 بالمائة). وعلى الرغم من استمرار أوجه الجمود في الموازنة، لا سيما مع حصة الأجور المرتفعة وتحويلات أخرى، حوّلت عائدات النفط المحسنة الرصيد المالي العام إلى فائض بنسبة 4 بالمائة من إجمالي الناتج المحلي في عام 2021. وحسّنت النواتج المالية المؤاتية نسبة الدين العام إلى الناتج المحلي الإجمالي. ومع ذلك، تبقى المتأخرات غير المحصلة والخصوم الطارئة كبيرة. وعلى الصعيد الخارجي، دفعت صادرات النفط المرتفعة والواردات المنخفضة الحساب الجاري إلى فائض بنسبة 11,4 بالمائة من إجمالي الناتج المحلي (42 مليار دولار أمريكي) في عام 2021. وبصرف النظر عن التراجع في صافي الاستثمارات الأجنبية، الذي يعود جزئياً إلى عدم اليقين السياسي

المتزايد، حققت صادرات النفط الشهرية في مارس 2022 رقماً قياسياً مقارنة بالعقود الخمسة الماضية (11 مليار دولار أمريكي)، ما دفع الاحتياطيات الدولية (باستثناء الذهب) إلى أكثر من 61 مليار دولار أمريكي.

حسّن التحوّل في أسواق النفط على نحو ملحوظ آفاق الاقتصاد العراقي على المدى المتوسط. فمن المتوقع أن يصل النمو الإجمالي إلى نسبة 8,8 بالمائة في عام 2022، مدفوعاً جزئياً بانتهاء قيود حصص «أوبك بلاس» المرتبطة بالجائحة. ونتيجة لذلك، يُتوقع أن يتجاوز الإنتاج العراقي مستواه ما قبل الجائحة البالغ 4,6 مليون برميل في اليوم في النصف الثاني من 2022. أما بالنسبة إلى النمو في السنوات اللاحقة، فمن المتوقع أن يبقى متواضعاً، بمعدل 4 بالمائة في المتوسط، مع الاعتدال في إنتاج النفط. ومن المتوقع أن يعود نمو إجمالي الناتج المحلي غير النفطي إلى اتجاه نموه المحتمل على المدى الطويل، جزئياً بفضل ارتفاع الاستثمارات التي يمكن تمويلها من مكاسب النفط المفاجئة. وعلى الرغم من ذلك، يمكن للتأخير في تشكيل الحكومة وإقرار موازنة عام 2022، إذا استمر، أن يحدّ من استخدام المكاسب المالية المفاجئة بما أنه قد تم بلوغ السقوف الفعلية لموازنة 2021، ما قد يخفّض النمو الاقتصادي. بالإضافة إلى ذلك، في ظل غياب إجراءات متسارعة لتطبيق الإصلاحات، سيبقى النمو (وغياب خلق فرص العمل) مقيّداً بالقدرة الاستيعابية المحدودة للاقتصاد فضلاً عن أمور أخرى تتسم بعدم الفعالية.

تبقى آفاق العراق الاقتصادية عرضة لمخاطر كبيرة. فالتوترات الجيوسياسية المتعلقة بالحرب في أوكرانيا تسلط الضوء على المخاطر التي يواجهها الاقتصاد العراقي في المنحنيين الإيجابي والسلبي على حد سواء. مع أنّ أي ارتفاع كبير في أسعار النفط قد يحسّن رصيد العراق المالي، فإن ارتفاع أسعار المواد الغذائية والاضطراب في الواردات الزراعية قد يفاقم اتجاهات الفقر الراهنة ويزيد من المخاطر على الأمن الغذائي. علاوةً على ذلك، يفرض الصراع أيضاً مخاطر على إنتاج العراق للنفط الخام

وتخفيف انحلال التربة وإعادة تأهيلها، وتحسين إدارة الأراضي، وتطبيق تدابير التكيف مع تغيّر المناخ والتخفيف من آثاره بما في ذلك اعتماد الزراعة الذكية مناخياً.

كوفيد-19 وأزمة رأس المال البشري: تعويض الخسائر التعليمية من أجل الإنتاجية والنمو في المستقبل

يواجه العراق أزمة رأسمال بشري. فحاصل الصحة والتعليم منخفضة ومتراجعة في الأعوام الأخيرة. فوفقاً لمؤشر رأس المال البشري للعام 2020، الطفل المولود في العراق قبيل جائحة كوفيد-19 قد تبلغ إنتاجيته عند بلوغه سن الـ18 نسبة 41 بالمئة فقط مما كانت ستكون عليه لو كان يتمتع بتعليم كامل وصحة تامة. وعلى الرغم من ثروة البلاد النفطية، يشكل الاستثمار في رأس المال البشري حصة قليلة نسبياً من الموازنة العامة - حوالي 10 بالمئة للتعليم و4 بالمئة للصحة. تجدر الإشارة إلى أن العديد من أوجه القصور قد حال دون ترجمة هذه الاستثمارات إلى حواصل فضلى في رأس المال البشري.

فاقمت جائحة كوفيد-19 الثغرات الموجودة في رأس المال البشري وأدت إلى خسائر كبيرة في التعلّم. فقد أثرت الجائحة في رأس المال البشري العراقي من خلال التأثير سلبياً على صحة العاملين اليوم ورفاههم الاقتصادي، كما من خلال تخفيض الإنتاجية المحتملة لجيل المستقبل في العراق. فكان لإغلاق المدارس لفترات طويلة تأثيرات مدمرة على تعلّم الأطفال. قبل الجائحة، كان يمكن للطفل العادي في العراق توفّق إتمام 6,9 سنوات دراسة؛ مع ذلك، حين يؤخذ بعين الاعتبار مقدار التعلّم الحاصل بالفعل، يحصل هذا الطفل على 0.4 من سنوات الدراسة بحسب مقدار التعلّم الفعلي قبل بلوغه سن الـ8.1. ونتيجة لإغلاق المدارس، يقدر البنك الدولي أن يتراجع هذا المؤشر إلى ما بين 2,6 و3,0 سنوات دراسة معدّلة بحسب مقدار التعلّم - أي تراجع يتراوح ما بين 1,0 و1,4 في التعلّم. وقد يتّرجم هذا إلى انخفاض أرباح على امتداد عمر الطلاب المتأثرين بنسبة تتراوح بين 8,4 و11,2 بالمئة (خسارة حوالي 20 ألف دولار أميركي إلى 28 ألف دولار أميركي لكل عامل في المستقبل) وخسائر على نطاق الاقتصاد تتراوح ما بين 47,1 مليار دولار أميركي و63,1 مليار دولار أميركي على مدار حياتهم العملية - ما يوازي أكثر من ثلث إجمالي الناتج المحلي في العراق في 2020.

رسم تقرير حديث للبنك الدولي «البناء إلى الأمام بشكل أفضل لضمان التعلّم لجميع الأطفال في العراق» مساراً لإصلاح التعليم من أجل تحسين التعلّم وتنمية المهارات بهدف تحسين حواصل رأس المال البشري. وتتضمن أولويات إصلاح التعليم الرئيسية: (i) الاستجابة للأزمة: تخفيف خسائر التعلّم الفورية والحوّول دون المزيد من المتسرّبين؛ (ii) تحسين مهارات أساسية من أجل تحديد مسار للتعلّم عبر مواد تعليمية محسّنة وممارسات معزّزة للمعلّمين تدعم تعلّم الأطفال كافة؛ (iii) التركيز على الاستثمارات الأكثر إلحاحاً، مع ضمان استخدام أفضل

إذا تأثرت عمليات شركات النفط الروسية في العراق بالعقوبات الدولية على روسيا. ومن المهم للغاية الإشارة إلى أن ارتفاع أسعار النفط يمكن أن يؤثر سلباً على الجهد المحلي نحو الإصلاحات، ما يعمّق بالتالي التحديات الاقتصادية البنيوية التي يواجهها العراق. كذلك، إنّ التأثيرات الحادة لتغيّر المناخ وشحّ المياه ستخفّف من الإنتاج الزراعي. أضف إلى ذلك أن التلقيح المضاد لكوفيد-19 لا يزال منخفضاً جداً في العراق، ما يطرح مخاطر انتشار محتمل لمتحورات جديدة. وتشمل مخاطر أخرى تراجع أسعار النفط، وتدهور الوضع الأمني الناجم عن أوجه الهشاشة القائمة أصلاً وتحديات اقتصادية بنيوية تتضمن الاعتماد المفرط على النفط.

نظراً للهشاشة المالية والاجتماعية والاقتصادية للعراق

تبرز حاجة ملحة إلى إصلاحات بنيوية واسعة النطاق يجب أن تطبقها الحكومة الجديدة. فإعادة توجيه الموارد المالية من أجل برامج معززة للنمو في رأس المال البشري والمادي ستكون جوهرية من أجل التنويع وخلق فرص العمل. لتحقيق هذه الغاية، تتضمن مجالات الإصلاح ذات الأولوية الرئيسية تصحيح تكلفة الأجر وتحسين فعالية الإنفاق. لذا يجب بذل الجهود من أجل تعزيز الإدارة المالية العامة، وتقليص دعم الطاقة غير الفعّال، وتقليل المخاطر المالية الناتجة عن النفقات من خارج الموازنة والضمانات الحكومية. ويجب أن تتكامل هذه التدابير مع برامج متكاملة للمساعدة الاجتماعية لتسهيل التحويلات التي تستهدف الأسر الأكثر ضعفاً. بالإضافة إلى ذلك، يمكن لتسريع الإصلاحات الخاصة بالمصارف المملوكة من الدولة من خلال تعزيز فعاليتها وحوكمتها أن يقوّي القطاع المالي ويزيد وصول القطاع الخاص إلى التمويل. كما ينبغي أيضاً تضمين سياسات متعلقة بالمناخ في صلب خطة التنمية العراقية من أجل زيادة الإيرادات والحث على النمو وخلق فرص العمل على المدى المتوسط. وتبقى الورقة البيضاء للحكومة العراقية نموذجاً جريئاً لوضع برنامج إصلاحات اقتصادية شامل نحو التنويع الاقتصادي.

اشتدت التحديات المتعلقة بالأمن الغذائي القائمة في

العراق مع الارتفاع الحاد الأخير في أسعار السلع العالمية. حتى قبل الاضطرابات الأخيرة في الإمدادات الغذائية العالمية، كان العراق يواجه مخاطر هامة على الأمن الغذائي بما أنّ إنتاج الغذاء المحلي فشل في تلبية الطلب الناجم عن النمو السكاني السريع. فالإنتاج الزراعي قد عانى مؤخراً موجات جفاف حادة، وارتفاعاً قياسياً في درجات الحرارة، وتآكل التربة وتملّحها، وارتفاع أسعار المدخلات الزراعية، فضلاً عن الاضطرابات في الإنتاج الناجمة عن فترات انعدام الأمن والنزاعات. لذلك وبهدف سد ثغرة الإمدادات الغذائية، أصبح العراق معتمداً بصورة متزايدة على الواردات التي تشكل أكثر من نصف ما يستهلكه من غذاء، ما زاد من تعرّض البلاد إلى صدمات أسعار الغذاء والإمداد العالمية. تجدر الإشارة إلى أنّ الإعانات والتحويلات المباشرة، بما في ذلك التدابير الجديدة المتخذة مؤخراً والتي أعلنت عنها الحكومة العراقية، تخفف جزئياً من تأثير ارتفاع الأسعار العالمية على المدى القصير. مع ذلك، يتطلب تحقيق الأمن الغذائي تنسيق الجهود لتحسين الإنتاج المحلي بما في ذلك من خلال زيادة فعالية مياه الري،

والتدريب المهني وعروض التعليم العالي التي تنقل مهارات ذات صلة بالسوق. ومع تعافي أسعار النفط العالمية، يُعتبر تحويل إيرادات عامة إضافية إلى استثمارات في رأس المال البشري أولوية ملحة وضرورية من أجل إنتاجية العراق وموهه في المستقبل.

للموارد؛ (iv) تحسين حوكمة قطاع التعليم واتخاذ القرارات القائمة على الأدلة؛ (v) اعتماد الاستراتيجية الوطنية للتعليم (2022-2030) التي تركز على التعلّم و«البناء إلى الأمام»؛ و(vi) اتّساق المهارات مع حاجات سوق العمل من خلال برامج التعليم

RECENT ECONOMIC AND POLICY DEVELOPMENTS

Output and Demand

Iraq's economy is gradually emerging from the deep recession caused by the pandemic and the oil price collapse of 2020. Iraq's real Gross domestic Product (GDP) edged up by 2.8 percent in 2021, after a sharp contraction of over 11 percent in 2020 (Figure 1). The recovery was driven primarily by the strong rebound of non-oil output, in particular the service sector, which grew by almost 15 percent, on account of the gradual relaxation of the containment measures and the vaccination rollout. In contrast, the oil sector contracted by 0.7 percent, as output levels were lowered in line with OPEC+ production quota early in the year (Figure 3). GDP per capita grew by 0.4 percent, lagging average growth of the upper-middle income countries (UMICs) (Figure 2).

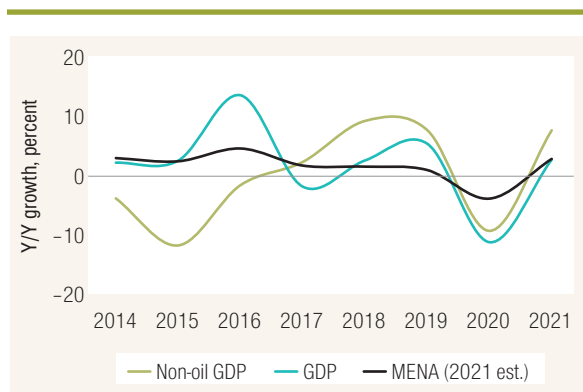
Services growth was driven by a strong recovery in high contact sectors. The easing of the pandemic-related restrictions allowed transport, accommodation and retail, and government-related services to rebound strongly by nearly 23, 25, and 17 percent in 2021, respectively (Figure 3). Non-oil industries, on the other hand, contracted by 5.6 percent, as higher price of construction materials

(mainly imported) and frequent energy blackouts, hard hit the construction sub-sector. A sharp drop in agricultural value-added, of 18 percent, also weighed heavily on growth in 2021 (Figure 4). A combination of harsh droughts and rising temperatures severely crippled Iraq's food production, including wheat and barley, the two most important staples in Iraq, highlighting growing threats of climate change to food security.¹ Though Iraq increased its wheat planted area in 2021/22 by 10.4 percent compared to the previous season (USDA, 2022), the harvested area was much lower, due to reduced water availability, which reached as low as 25 percent in the hardest hit governorate (Nineveh).² Food production constraints, due to the recent severe droughts and higher global price of inputs, could have significant implications on

¹ Around 37 percent of Iraqi wheat farmers and 30 percent of barely farmers are reported to have experienced crop failure of at least 90 percent of expected harvest following a bumper harvest in 2019-20 (Norwegian Refugee Council (NRC), December 2021).

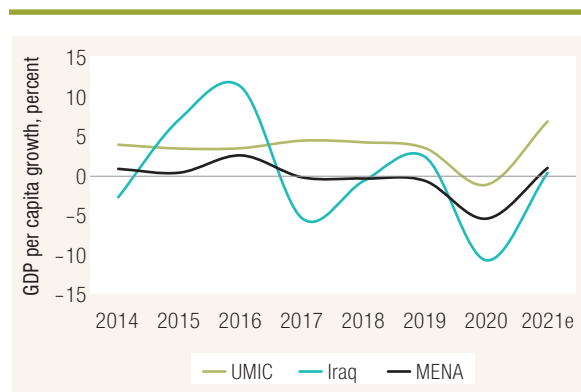
² Nineveh, the largest cereal producer in the country, was severely affected by drought. Its entire barley area is rain fed and failed almost completely due to lack of rainfall.

FIGURE 1 • The Economy is Gradually Emerging from the Pandemic



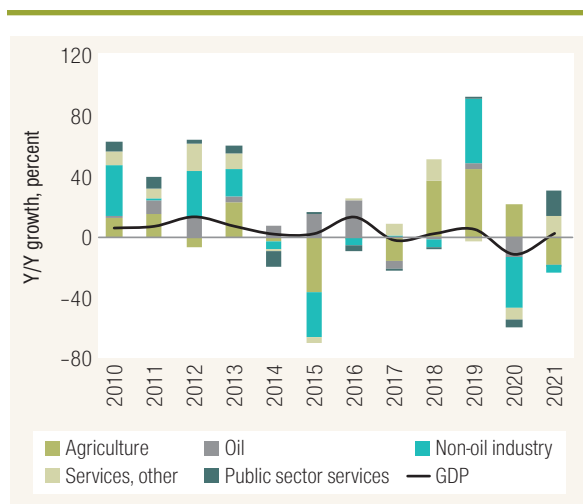
Source: Iraqi Central Organization for Statistics and Information Technology (COSIT), World Development Indicators (WDI) and World Bank staff calculations.

FIGURE 2 • Per Capita GDP Contraction Narrowed Though Remained behind Income Peers



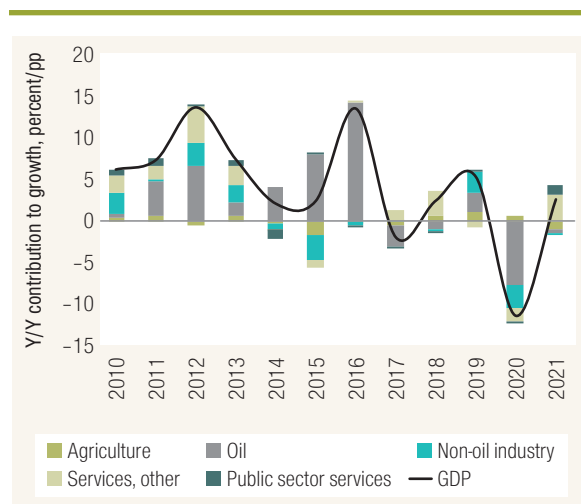
Source: COSIT, WDI and World Bank staff calculations.

FIGURE 3 • The Economic Rebound in 2021 was driven by services Sector...



Source: COSIT, WDI and World Bank staff calculations.

FIGURE 4 • ...and was Despite Negative Contribution from Oil, Agriculture, and Construction



Source: COSIT, WDI and World Bank staff calculations.

food security, especially in rural areas (see Box 1 on Iraq's food security challenges).

On the demand side, GDP growth in 2021 was driven by consumption. Google Mobility indicators show that mobility flows in Iraq started to increase in the second quarter of 2021 (Q2-21), following the easing of the movement restrictions and the gradual pick-up in the vaccination coverage.³ The COVID-19 Stringency Index declined from the peak of 84 in February 2020 to 46 by end-March 2022 (Figure 6). As a result, private consumption growth accelerated to 4.5 percent in 2021 (Figure 5). Public consumption

also grew robustly by almost 6 percent on the back of higher oil receipts. Primary government spending (i.e., expenditures excluding interest payments) rose by 26 percent in 2021, including a 2 percent increase in social welfare expenditures.

³ However, COVID-19 vaccination in Iraq remains very low among the lowest in the region and well below the global rate. It remains low even among the most vulnerable group, the elderly, and among those with high risk of exposure to the virus – poorer households and informal workers.

BOX 1 IRAQ'S FOOD SECURITY AND GLOBAL COMMODITY PRICES

Iraq confronts significant food security challenges. Domestic food production faces a multitude of challenges including water shortage, soil erosion and salination, and rising price of agricultural inputs. Record high temperatures and severe droughts have reduced agricultural production, making Iraq more reliant on imports as commodity prices rise. The country experienced the driest rainfall seasons in the past 40 years. According to Food and Agriculture Organization (FAO), extreme temperature and insufficient precipitation reduced Iraq wheat production by an estimated 70 percent in 2021 and brought barley production to negligible levels. These climate challenges have significant implications for food security and poverty, especially in rural areas.

Food consumption in Iraq has been growing rapidly in line with its young and fast-growing population but also due to subsidies that have encouraged over-consumption and wastage. Iraq's Public Distribution System (PDS) accounts for a large percentage of Iraqi wheat consumption, requiring an estimated 5 million Metric Ton (MMT) of wheat annually. The Iraqi government only procured 3.4 MMT of local wheat in 2021 for the PDS program, short of the 5 MMT collected the previous year.⁸ Figure B1.1 shows that Iraq's subsidized wheat and bread through the PDS, as in other countries in MENA region, leads to over consumption.

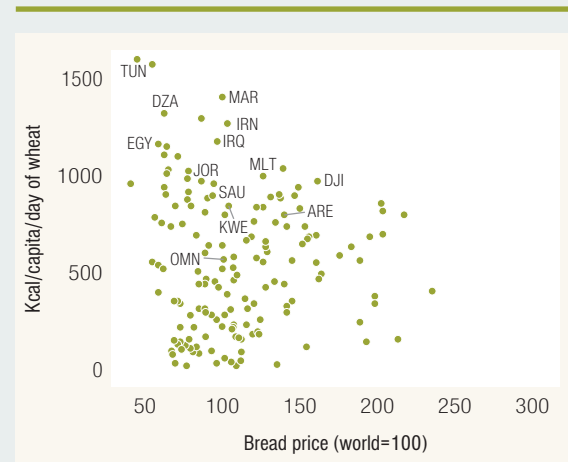
To plug the supply gap, Iraq sources almost half of its food consumption through imports. Total food imports account for around 20 percent of the import bill with 9 percent accounting for cereal imports. This import reliance exposes the food security of the country to exchange rate and global commodity price shocks. Following the currency devaluation announced in December 2020, food prices rose by 5 percent in 2021, led by large increase in dairy (12%), vegetable oil (8.3%), and fish and meat (7%). In Q1-22 food prices also saw a significant increase of over 8 percent (y/y) (Figure B1.2). A recent report published by the World Food Program (WFP) reveals that during the first two weeks of March, average, wheat flour price increased by 9 percent at national level. Comparing the prices of the first two weeks of March 2022 with November 2020 (i.e., before the devaluation of Iraqi dinar) show significant increase observed in the prices of the main food staples (Figure B1.3). The ongoing war in Ukraine (with Russia and Ukraine accounting for one-third of global wheat supply) is exacerbating Iraq's fragile food security, through disruptions to the availability of global food supplies and the resulting higher food prices. These food price shocks put pressures on the Public Distribution System (PDS) which provides a level of broad food security.

The government has taken measures to mitigate the impact of the food shortage, notably that related to wheat supply, and the price hike.

Wheat supply measures:

- In January-March 2022, the government bought 150,000 ton and 100,000 ton of wheat from Australia and Germany, respectively.
- Iraq plans to allocate US\$100 million to purchase wheat and create a strategic stock by importing 3 million tons of the grain.^b
- In March 2022, the cabinet approved increase the price of government-purchased locally grown wheat for the current season to support local food subsidies program.^c

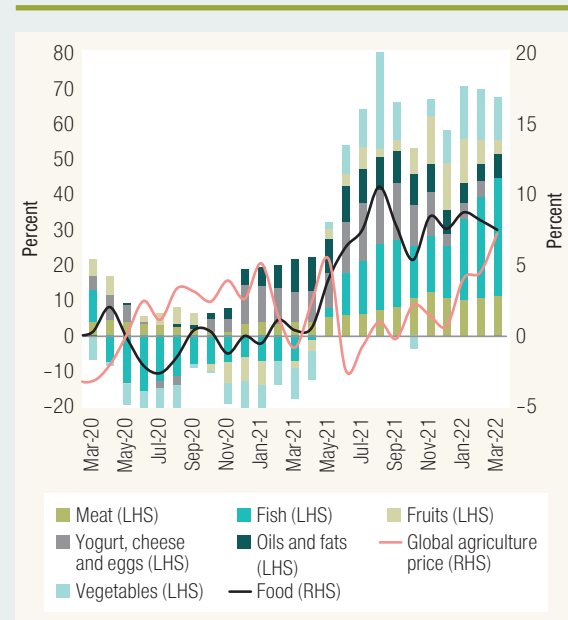
FIGURE B1.1 • Wheat Consumption and Bread Price



Source: Massimiliano Cali, World Bank, 2022.

Note: Data for 2017.

FIGURE B1.2 • Food Inflation has Increased in Line with Global Food Commodity Prices



Source: COSIT; and World Bank staff calculations.

(continued on next page)

BOX 1 IRAQ'S FOOD SECURITY AND GLOBAL COMMODITY PRICES *(continued)*

- In March 26, Iraqi parliament conducted the first reading of a proposed bill called the “Emergency Support for Food Security and Development” which is yet to be approved by the cabinet. The bill will support the creation of a special account that authorizes the government to support food security and reduce poverty.

Price measures:

The Iraqi cabinet agreed on several measures in March 2022, in response to protests in Central and Southern Iraq over the rise in food prices. These include:

- A monthly allowance of about US\$70 for low-income civil servants and pensioners and the doubling of food rations.
- Three-months suspension of custom duties on food products, basic consumer goods and construction materials.
- Providing bakeries with free fuel and gas to help control the price of bread.

PDS reforms: In June 2021, Gol introduced several PDS reforms to exempt the following populations from receiving PDS rations.^d

- Single family members with an income exceeding IQD1.5 million/month (US\$1,027.40/month)
- Company owners registered in the official corporate registration service
- Individuals registered in the Chamber of Commerce associations up to second class, business unions, as well as doctors, dentists and pharmacists' unions
- Individuals with a tax accountability over IQD18 million/year (US\$12,328.77/year)
- Travelers outside Iraq for more than 3 months until their return is proven
- Iraqi permanent residents in other countries and who have citizenship in other countries
- Central prison inmates (until released), deceased inside prisons, belonging to terrorist organizations, and fleeing justice
- Arabs, foreigners, and refugees (except Palestinian families)

Achieving food security calls for coordinated efforts to improve domestic production including raising the efficiency of irrigation water, reducing and rehabilitating soil degradation, improving land management practices, and implementing climate change adaptation and mitigation measures including the adoption of climate-smart agriculture.

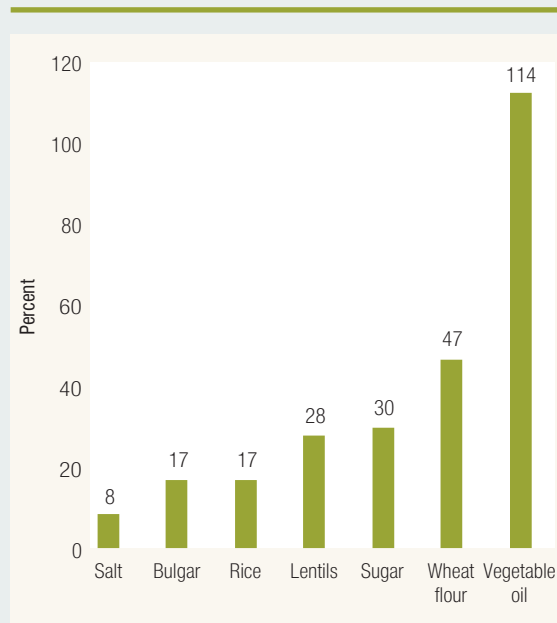
^a United States Department of Agriculture (USDA), Foreign Agricultural Service, April 15, 2022.

^b Nasdaq, Reuters, March 7, 2022.

^c The Arab Weekly, March 2022.

^d United States Department of Agriculture USDA, Foreign Agricultural Service, April 15, 2022.

FIGURE B1.3 • Food Staples Prices Were Significantly Higher in the First 2-Weeks of March Compared to Prior to the Dinar Devaluation



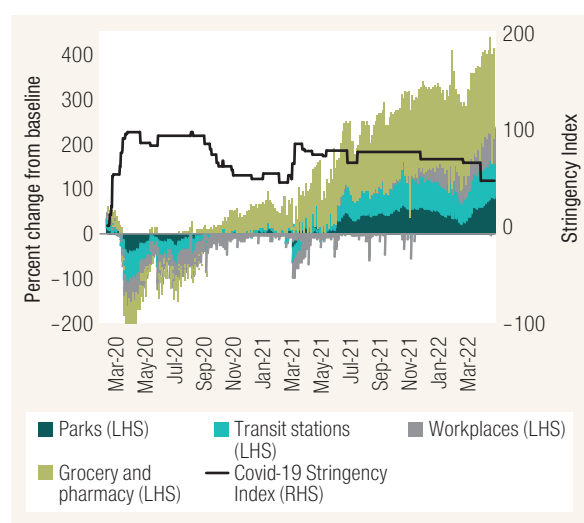
Source: World Food Program (WFP), March 2022.

Overall investment also aided the economic rebound in 2021 in line with higher oil revenues.

The Government of Iraq (Gol) made noticeable strides to develop a more friendly-investment environment. These included the devising of a new online single-window platform for business registration and facilitating access to international arbitration for commercial conflict resolution. These measures coupled

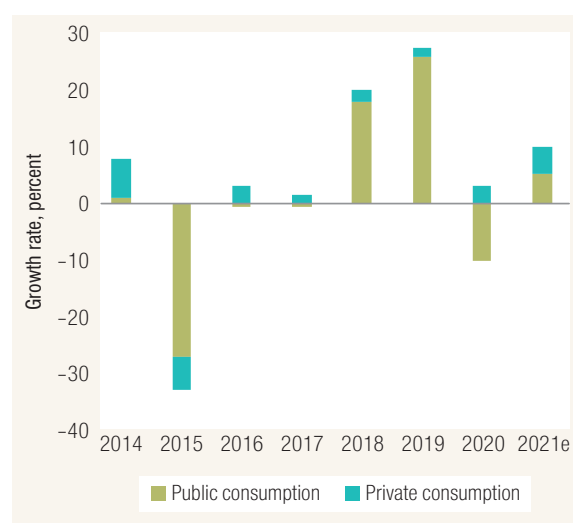
with higher oil prices allowed overall public investment to pick up from only 1.5 percent of GDP in 2020 to 4.4 percent of GDP in 2021 though it remained well below the pre-pandemic rate of 8.8 percent of GDP in 2019. However, business-friendly legislation remains insufficient to attract foreign investment due to Iraq's volatile security environment, high corruption, and administrative inefficiencies.

FIGURE 5 • Easing of Pandemic-Related Restrictions and Progress in Vaccination Raised Mobility and Consumption



Source: Coronavirus Government Response Tracker, University of Oxford.

FIGURE 6 • On the Demand Side, Government consumption was the main Driver of GDP Growth in 2021



Source: COSIT and World Bank staff calculations.

Oil and Gas Developments

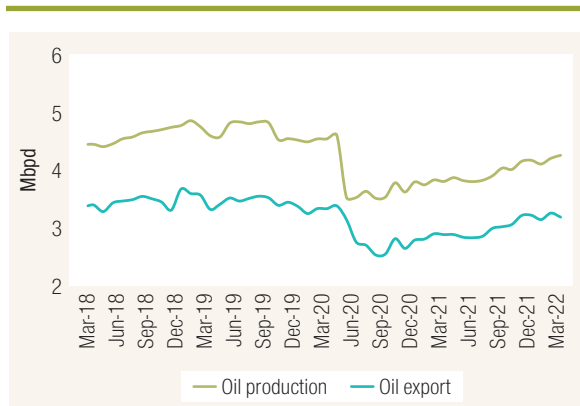
Oil production steadily grew since mid-2021 as OPEC+ production quotas were eased. In July 2021, OPEC+ members agreed to increase crude production by 400,000 barrels per day (b/d) each month starting in August 2021. This agreement, which came against the backdrop of higher global oil demand, led Iraq's crude oil production to reach an average of 4.11 million barrel per day (mbpd) in August–December 2021, 11 percent higher compared with the same period in 2020 (Figure 7).⁴ In December 2021, oil production reached 4.23 mbpd, the highest level since the production cuts were introduced in June 2020. Oil output in 2021 averaged 4 mbpd, which was 24,100 bpd lower than 2020. Since the beginning of 2022, Iraq's crude production has been disrupted owing to a combination of protests, maintenance, and field outage.⁵ Oil output dipped by 81,000 bpd on average during January–March 2022, to 4.24 mbpd, which was 2 percent short of Iraq's OPEC+ quota for these months. The opportunity cost of such disruptions was especially high at a time of soaring oil prices and highlights risks to the ambitious plan of expanding oil production.

Since the second half of 2021 (H2-21), higher oil export prices and increased production volumes have led to an oil windfall—providing a breathing space to Iraq's economy. Oil exports rose to 3.1 mbpd in H2-21 (a 14 percent growth y/y) in line with higher production quotas. Meanwhile, Iraq's average oil export prices recovered to US\$68.4 per barrel (pb) in 2021 from an average of only US\$38.4 pb in 2020, a 78 percent increase (Figure 8). As a result, crude oil export receipts surged to US\$76 billion in 2021, registering an 81 percent increase compared to 2020. This trend continued in Q1-22 as export prices and volumes increased by a further 40 percent and 6.2 percent from end-2021, respectively. While higher global oil prices sustain Iraq's economic recovery in the short run, it highlights the magnitude of macroeconomic volatility, and the possibility of a strong negative impact should oil prices

⁴ The new OPEC+ agreement, is allocating higher output quotas to five member countries, increasing Iraq's quota for September 2022 by 150 kbpd.

⁵ Protests erupted in the southern Dhi Qar province Dhi Qar province over demand for jobs.

FIGURE 7 • Oil Production and Export Volumes Increased as OPEC+ Cuts Were Gradually Tapered



Source: Iraq's Ministry of Oil (MoO), and World Bank Staff calculations.

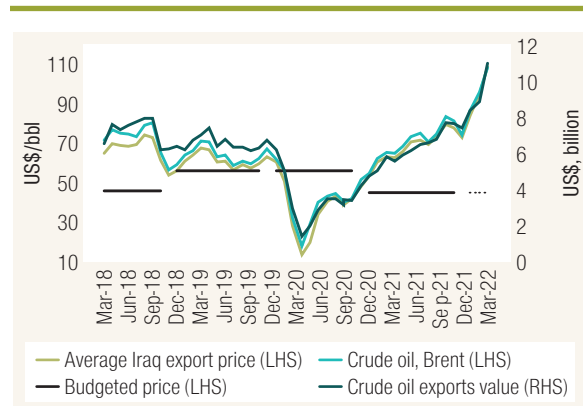
fall again—as witnessed during the pandemic-related downturn in global oil markets.

Iraq is pursuing an ambitious plan in upgrading and expanding its energy industry. The Government has announced plans to boost the oil production to 8 mbpd by 2027. To this end, the country has signed a series of investment contracts to develop its energy infrastructure in a wide range of areas including associated gas capture, development of oilfields solar energy production, and further regional integration of the electricity grid.⁶ These efforts aim to tackle the widespread power cuts (and resulting public grievances), reduce reliance on gas and electricity imports,⁷ and recover foregone income from flaring associated gas in the crude oil extraction process. However, the successful implementation of these projects and achieving the desired outcomes hinges on strong institutional and governance arrangements that can foster improved efficiency and accountability.

Public Finance

Higher oil revenues pushed Iraq's overall fiscal balance into a surplus in 2021, while overall fiscal policy remained procyclical. Total government revenues surged by 73 percent in 2021, spurred by higher oil prices. These budgetary gains were additionally boosted by the measures to mobilize non-oil domestic revenues mainly from customs and

FIGURE 8 • The Impact of Higher Oil Prices was even more Significant



Source: MoO, Iraq's Ministry of Finance (MoF), and World Bank Staff calculations.

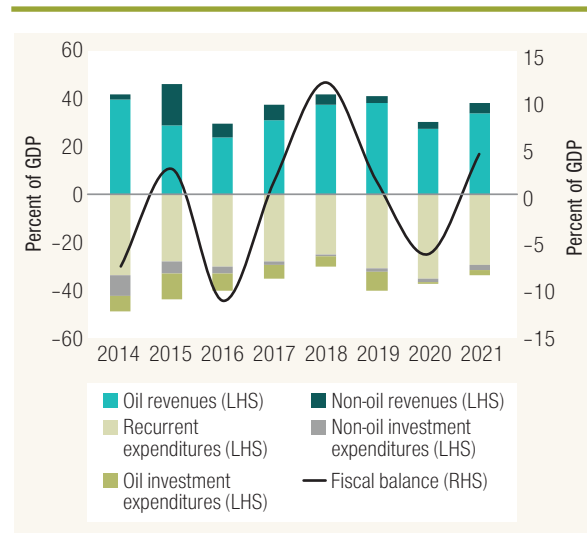
the currency devaluation of December 2020, which significantly increased oil revenue in dinar terms. Despite persisting budget rigidities, notably the high wage bill share and other transfers, improved oil receipts turned the overall fiscal balance to a surplus of 4 percent of GDP (cash basis) in 2021, from a deficit of 5.8 percent in 2020 (Figure 9). Due to significant unaccounted domestic and external areas Iraq's fiscal accounts, when expressed on an accrual basis, would be less favorable.⁸ Overall fiscal policy in 2020–21 remained procyclical as plummeting oil revenues in 2020 translated to reductions in discretionary spending

⁶ GoI signed a sizeable US\$27 billion deal with TotalEnergies in September 2021 to develop its energy sector over 25 years. The agreement includes four projects: (i) develop Ratawi oilfield in the southern province of Basra to raise production capacity from 85,000 to 210,000 bpd; (ii) develop a gas processing plant at Ratawi with a capacity of 600 million cubic feet a day; (iii) a seawater supply facility project with a capacity of 7.7 mbpd to maintain production levels; and (iv) develop a 1GW solar power plant.

⁷ Iraq is heavily reliant on gas and electricity imports from Iran to meet domestic demand, however, these flows have been volatile due to Iraq's arrears on payments to Iran and Iran's declining spare capacity, especially during peak consumption periods.

⁸ Most of the domestic arrears are owed to domestic banks and the Central Bank of Iraq, and external arrears relate to those owed to international oil companies and to Iran for energy imports.

FIGURE 9 • Higher Oil Revenues Pushed the Fiscal Balance Into Surplus in 2021

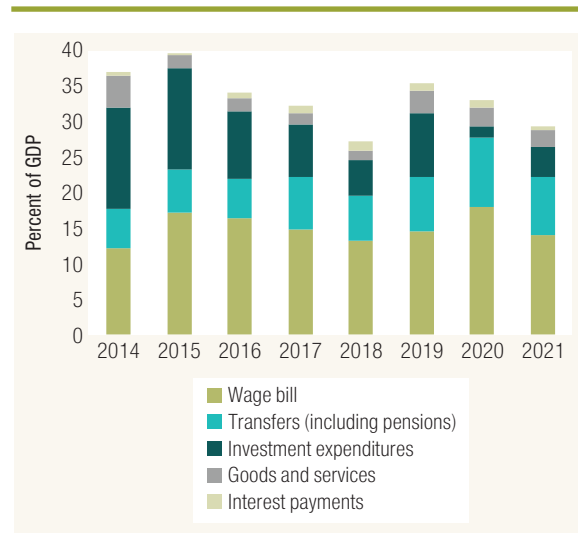


Source: MoF and World Bank staff calculations.

and accumulation of arrears, while the situation reversed towards end-2021 (72 percent y/y growth in Q4-21 expenditures) in line with the recovery in oil prices.

Despite some progress in raising non-oil domestic revenues, budgetary revenues remained dominated by oil receipts. The country has undertaken steps towards strengthening the capacity to increase the effectiveness of non-oil revenue collection as outlined in the 2021 budget.⁹ These efforts contributed to a 58 percent increase in non-oil budgetary revenues in 2021. Despite this progress, the budget remains heavily dependent on oil receipts, accounting for over 87 percent of total government revenues in 2021, which makes the budget vulnerable to oil price volatility. At less than 5 percent of GDP, Iraq's non-oil revenue are small relative to not only UMICs but also MENA oil exporters, whose non-oil revenues exceed 18 and 8 percent of GDP, respectively. In addition, Iraq's tax revenue collection performs poorly at less than 2 percent of GDP, which is constrained by limited administrative capacity and inefficient tax policy such as widespread exemptions and low tax compliance. Implementation of systematic reforms to further diversify revenues away from oil, as outlined in the White Paper, will help Iraq shift away from volatile oil revenues and reduce the procyclicality of fiscal policy.

FIGURE 10 • Wage Bill and Transfers Continue to Dominate Expenditures



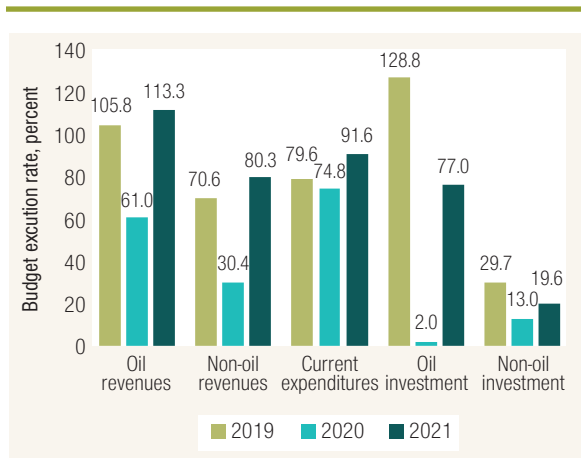
Source: MoF and World Bank staff calculations.

Government spending remained beset by rigid recurrent expenditures, particularly those of wages and transfers. In 2021, recurrent spending accounted for over 86 percent of total budget (or 28 percent of GDP), largely associate with wage and transfer components. While the wage bill rose by a more moderate rate of 6 percent compared to pre-pandemic period (2018–19), it still accounted for 14 percent of GDP in 2021 (Figure 10).¹⁰ Social transfers were the other main component of the recurrent

⁹ In May 2021, Iraq signed a contract with the United Nations Conference on Trade and Development (UNCTAD) to automate its customs procedures and custom data to eliminate corruption, and reform customs clearance process. According to Iraq's General Customs Commission, customs' revenues increased by 15 percent in 2021, generating just over IQD1 trillion (US\$690 million) by pursuing reform through automating customs clearance process by pursuing reform through automating customs clearance process (Iraq Security and Humanitarian Monitor (ISHM), January 6, 2022).

¹⁰ In November 2020, Iraq's Cabinet approved a draft pension and social security law that expands the public pension benefits to the private sector, but without providing equivalent adjustment of contribution rates to cover the cost. If ratified by the legislature, the proposal could further increase budget rigidities if the decision is converted to law.

FIGURE 11 • Oil Revenue Volatility has Translated to Volatile Public Investment



Source: MoF and World Bank staff calculations.

expenditures, which accounted for over 6 percent of GDP due to budgetary pension payments of over 4 percent of GDP. In addition, the fuel and electricity subsidies represent a big drain on government resources, accounting for about 6 percent of GDP in 2021.¹¹ Despite being an oil exporter, Iraq imports refined petroleum products (US\$3.7 billion imported in 2021), which means that the size of energy subsidies also increase with higher oil prices and overconsumption. These budget rigidities limit fiscal space, thereby undermining the ability to buffer the impact of external shocks. The COVID-19 pandemic shock underlined these pre-existing vulnerabilities, including the need for rightsizing the wage bill and energy subsidies. Additional efforts are needed to increase fiscal space to meet the increased challenges posed by climate change and the prospective decline in global demand for fossil fuels.

Despite some improvement in 2021, public investment remained low considering the surge in oil revenues and despite the collapse experienced in 2020. In 2021, total investment increased to 4.4 percent of GDP, out of which less than half was non-oil related investment (Figure 9). Despite their collapse in 2020, this investment in 2021 was substantially below that of the pre-pandemic rate of almost 9 percent of GDP in 2019. Public investment has acted as a residual item in budget allocations and suffered from low budget execution rates, especially

for non-oil investment, due to the limited absorptive capacity and other public investment management inefficiencies. In 2021, oil-related investment reached 77 percent of the budget target, while the execution rate was less than 20 percent for non-oil investment (Figure 11). A large share of investment is dedicated to the oil economy at the expense of non-oil investment. This lopsided investment allocation has negative implications on service delivery, closing the infrastructure gap, and progress in the reconstruction program, putting a drag on long-term growth. Even at existing levels, public investment continues to suffer from significant inefficiencies due to a lack of comprehensive strategy, corruption, and cumbersome bureaucracy.

The favorable fiscal outcomes reduced the public debt-to-GDP ratio; however, significant contingent liabilities remain. The improved fiscal situation in tandem with the base effect of high nominal GDP growth (37 percent y/y) is estimated to have reduced the debt-to-GDP ratio to 53.2 percent in 2021, down from 64.7 percent in 2020. The domestic debt stock is estimated at US\$53 billion (26 percent of GDP) in 2021. The external debt stock structure remains favorable due to significant legacy debt to Non-Paris Club countries acquired prior to 1990. Almost two-thirds of the latter debt is long-term and relatively concessional. In January 2022, Iraq also paid-off the final instalment of the US\$52.4 billion UN-mandated compensation for the 1990 invasion of Kuwait. However, fiscal risks remain significant, which relate to significant arrears,¹² electricity sector guarantees (estimated at over 20 percent of GDP in 2017-IMF, 2020) and contingent liabilities related to Iraq's largest state-owned banks (SOBs). The adoption of a medium-term debt management strategy would

¹¹ This amount only includes explicit energy subsidies (IMF Energy Subsidy Template – September 2021, <https://www.imf.org/en/Topics/climate-change/energy-subsidies>).

¹² According to the 2021 budget law, arrears for electricity and gas imports, and for independent power producers amounted to IQD2.3 trillion (1 percent of GDP). This is added to the wage and pensions arrears estimated at IQD 11.9 trillion (6 percent of GDP) in 2020.

reduce these risks through a structured clearance of arrears, maintaining cash or reserve buffers, and mitigate other macro-fiscal risks.

The fiscal space created from the recent oil windfall and the previously ear-marked oil revenues call for measures to safeguard Iraq's oil wealth. Iraq's monthly oil export revenues rose to a five-decade high of US\$11 billion in March 2022. Furthermore, the end of payment to legacy debt

to Kuwait, which were directly paid from Iraq's oil revenues, frees up fiscal space by 1 percent of GDP (equivalent to 3 percent of total oil proceeds paid in 2021). The magnitude of these revenues highlights the need for effective fiscal management to safeguard macroeconomic stability, prepare for external shocks, and save the national wealth for future generations (see Box 2 on fiscal rules and sovereign wealth funds). Such measures will help avoid procyclical

BOX 2 FISCAL RULES AND SOVEREIGN WEALTH FUNDS (SWFs)^a

Like many resource-rich economies, high dependence on oil, procyclical fiscal policy and the absence of an oil revenue management mechanisms has left Iraq vulnerable to volatility and exogenous commodity price shocks. Low savings rates and boom-bust cycles have plagued economic development in resource-rich Iraq. This condition was strongly illustrated in the aftermath of the 2014 commodity price shock and the recent COVID-19 crisis. The large loss in oil revenues forced important budget cuts notably in social and capital expenditures with impact on economic growth, human capital accumulation, and service delivery.

Iraq could establish fiscal rules that leverage the depleting oil wealth to build buffers and promote sustainable economic development.^b These rules can help foster commitment to fiscal discipline, such as a ceiling on the current primary spending of the central government and constrain spending on salaries and subsidies while creating space for investment. They can also help correct inefficiencies in fiscal policy such as procyclicality, and curb overspending (World Bank 2020). During the past decades, a growing number of countries across the world have adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule (IMF, 2022).^c

Carneiro and Kouame (2019) argue that the use of fiscal rules in resource-rich countries has been associated with better fiscal/debt outcomes and lower procyclical bias in fiscal policy.^d However, international experience highlights several lessons for the successful implementation of rules in resource-rich countries, these include:

- Political commitment
- A clear and stable link between the numerical target and the ultimate objective, such as fiscal balance rule and annual borrowing to achieve debt sustainability
- Sufficient flexibility to respond to shocks that allows for course correction with clearly defined escape clauses in times of economic shocks
- Supporting institutions that enhance fiscal transparency and accountability—such as fiscal councils, which act as public watchdogs to evaluate fiscal policy.

Having fiscal rules in place, two mechanisms can be established in the short and medium to long term:

The short-term view: Oil revenue stabilization fund. Many oil exporting countries established a so-called oil revenue stabilization funds to mitigate the impact of the volatility of oil revenues on the budget. These funds act as a commitment device that accumulate reserves when oil revenues are high and allow the government to draw down from it when oil revenues fall. It helps to mitigate the adverse macroeconomic effects associated with oil price volatility such as the recent crises brought by COVID-19. Saudi Arabia, Norway, and Chile are examples for using the buffers from these funds to stabilize expenditure by adopting countercyclical fiscal policies. However, an oil revenue mechanism alone is not enough to bolster strong, sustainable, and balanced growth for a country like Iraq. This is particularly true in the event of extreme price shocks such as those illustrated by the COVID-19 crisis. Prudent fiscal management as well as increased economic diversification remain key elements to face crises of this magnitude.

The medium-long term: Sovereign wealth funds (SWFs). Advanced and developing countries alike, particularly resource-rich ones, have established SWFs that channel windfalls during commodity booms and accumulate national savings. These saving funds are important tools to address risks posed by the depletion of oil by transforming the income generated from this commodity into permanent wealth in the form of a portfolio of financial assets and its investment income. They also serve as precautionary buffers to face the challenges from the shifts in the global energy landscape from fossil oil to renewables. SWFs could develop their green investment capacity through various structures and collaborations, including public-private partnerships, private-private partnerships, and joint investments in climate-friendly projects with multilateral development banks (World Bank 2017).^e

(continued on next page)

BOX 2 FISCAL RULES AND SOVEREIGN WEALTH FUNDS (SWFs)^a (continued)

Function	Investment objectives	Strategic asset allocation
Saving	Inter-generational equity, national endowment, meeting long-term liabilities or contingent liabilities (pensions)	Long term investment horizon, diversification with moderate to high risk tolerance, and low liquidity requirement in short medium run
Precautionary	Stabilize spending in the face of short-term and medium-term volatility in resource income	Liquidity, safety (capital preservation), short to medium term investment horizon
"Buffer"	Hold committed funds to pace disbursements in line with absorptive capacity constraints	Safety (capital preservation), liquidity, short to medium term investment horizon

Source: Sovereign Wealth Funds and Long-Term Development Finance, Risks and Opportunities, WB, WPS6776, February 2014.

Given the relative size of Iraq's public spending, it is critical that spending allocations get effectively translated into productive assets. A sovereign wealth fund coupled with economic diversification can reduce the costs of external shocks and decouples the economy from oil dependence in the long run. Meanwhile, if well designed, adequately structured, managed following best international practices, and adhering to strict regulatory framework, the SWF could help the Iraqi government invest in longer-term stability. The SWFs are becoming important game changers in green investment. For example, by using oil revenues, Norway built the largest SWF in the world (more than US\$1.3 trillion); this is also implemented in other countries such as the GCC. According to S&P Global, oil-rich countries such as Qatar, the UAE, and Saudi Arabia are directing state funds towards renewable energy and carbon capture, use, and storage (CCUS). The Singapore and UAE funds have invested in solar power projects in India in the last two years. The recent discussions of the Iraqi Cabinet to establish a sovereign wealth fund to divert one percent of oil sales to finance renewable energy projects and build up a cash reserve for future generations, if implemented, would be a step in the right direction.^f

It is important to note that fiscal rules and SWFs are not a panacea for achieving macroeconomic sustainability. For example, if the institutional pre-requisites are not in place, SWFs could be used for off-budget expenditures, which could be inconsistent with the government's fiscal and monetary policies. Moreover, following the large global macroeconomic volatilities seen over the last decade, many countries (e.g., Malaysia) have resorted to suspending fiscal rules through emergency clauses, demonstrating the limitations of fiscal rules.^g

Country and SWF(s)	US\$ billion
Norges Bank Investment (Norway)	1,332
China Investment Corporation (China)	1,222
Abu Dhabi Investment Authority (Abu Dhabi)	829
State Administration of Foreign Exchange (China)	817
Government of Singapore Investment Corporation (Singapore)	744
Kuwait Investment Authority (Kuwait)	693
Hong Kong Monetary Authority (Hong Kong SAR)	520
Public Investment Fund (Saudi Arabia)	480
National Council for Social Security Fund (China)	452
Qatar Investment Authority (Qatar)	366
Investment Corporation of Dubai (Dubai)	302
Temasek (Singapore)	283
Mubadala (Abu Dhabi)	243
Korea Investment Corporation (Korea)	201
National Wealth Fund (Russia)	185

Source: Statista, January 2022.

(continued on next page)

BOX 2 FISCAL RULES AND SOVEREIGN WEALTH FUNDS (SWFs)^a (continued)

^a Box 2 is adapted from the Iraq Country Climate Development Report, World Bank (forthcoming).

^b Fiscal rules are institutional mechanisms that impose numerical limits on budgetary aggregates such as expenditure, revenue, the budget balance, and debt to ensure fiscal discipline and credibility.

^c IMF, Fiscal Rules and Fiscal Councils Recent Trends and Performance during the COVID-19 Pandemic, WP/22/11.

^d Brookings, Procyclicality trap in resource-rich countries and how to escape from it, February 7, 2020.

^e World Bank Blog, Sovereign wealth funds: the catalyst for climate finance? March 16, 2017.

^f Iraq oil report, January 2022.

^g See, Natural Resource Governance Institute (2018), How did fiscal rules hold up in the commodity price crash?

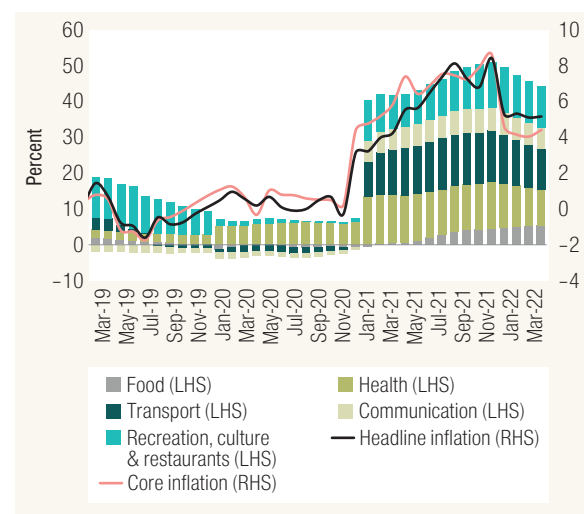
spending and direct any additional spending toward human capital and mitigation and adaptation to climate change in line with the absorptive capacity of the economy.

Monetary Policy and Prices

Inflation accelerated in 2021 driven by rising demand pressures, the dinar's devaluation, and lower agriculture output.

A combination of higher domestic demand, the pass-through effect of the 23 percent devaluation of Iraqi dinar in December 2020, and lower crop yields (impacted by the drought), placed upward pressure on consumer prices. Headline and core inflation edged up to an average of 6 and 6.6 percent in 2021, respectively (Figure 12). Food inflation rose to 5 percent and was driven by a steep increase in the price of dairy (11.5 percent), cooking oils (8.1 percent), and meat and fish (7 percent). The increase in the price of imported refined products and the demand on health services also pushed the prices of transportation and health care to 13.6 and 12.2 percent, respectively. In addition, the rebound in electricity consumption due to increased reliance on private electricity generation pushed the electricity and water supply prices up by 13.3 percent. The decline in inflation in Q1-22 was significantly less than what would have been expected once the effect of the devaluation dropped off, which in part was related to the global upward trend in inflation. In Q1-22, food prices rose by over 8 percent (y/y) that followed the recent disruption to the supply of key agricultural commodities, including wheat and barley, the two most important staples in Iraq

FIGURE 12 • Demand Pressures and Currency Devaluation have Spurred Inflationary Pressures



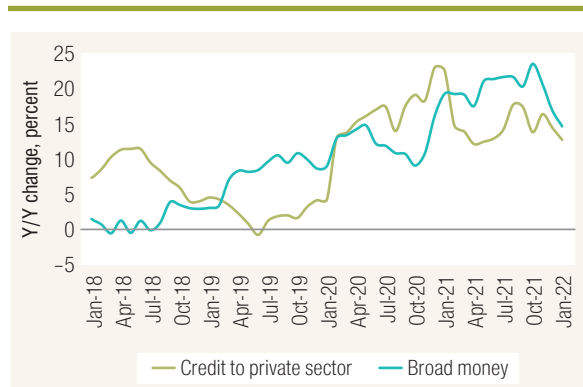
Source: Central Bank of Iraq (CBI) and World Bank staff calculations.

(See Box 1 on Iraq's food security challenges). Nonetheless, the continued depreciation of the Turkish and Iranian currencies, Iraq's main import partners, partially mitigated inflationary pressures.

In response to inflationary pressures, the CBI phased out some of the policy interventions introduced in 2020, which led credit to private sector growth to slow in 2021. At the outset of the pandemic, the Central Bank of Iraq (CBI) introduced measures to increase liquidity and support firms, which accelerated the credit growth to the private sector by 20 percent in Q4-2020 (y/y).¹³ In 2021, the

¹³ Key measures included lending to households, lowering the reserve requirement and extend repayments on directed lending initiatives.

FIGURE 13 • Credit to Private Sector Growth Decelerated in 2021 with CBI Phase out of Pandemic-Related Schemes

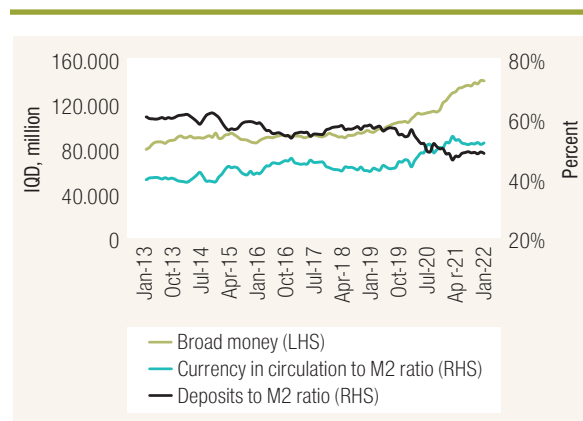


Source: CBI and World Bank staff calculations.

CBI scaled back some of these stimulus measures to contain inflation which contributed to decelerating credit growth to the private sector to almost 15 percent in Q4-2021 (y/y), and further to less than 13 percent (y/y) in January-2022 (Figure 13). At less than 10 percent of GDP, private sector credit in Iraq is one of the lowest in the MENA region (32 percent average), reflecting the shallow financial depth, credit infrastructure shortfalls, and weak banking sector that tend to cater primarily to large and inefficient state-owned enterprises (SOEs). This has crowded out the private sector, deterred prospective private investors, and held back financial sector development. Broad money (M2) grew by 20 percent in Q4-2021(y/y), driven by the pick-up in non-oil economic activity and abundance of cash held outside banks, which contributed to inflationary pressures. Latest available data also shows the non-performing loans (NPLs) at SOBs¹⁴ have increased to 18 percent in 2020, from 10 percent in 2019.¹⁵ Similarly, NPLs at private banks are reported as high as 37 percent in 2020.

Iraq's economy remains predominantly a cash economy. Iraq's banking system remains highly liquid with cash being the key medium of exchange for payment. The currency in circulation makes up the vast majority of the broad money (52 percent in 2021). In 2021, along with the recovery in non-oil economy, additional liquidity was converted into cash, while the banking deposits declined further.

FIGURE 14 • The Economy Operates Predominantly Thorough Cash



Source: CBI and World Bank staff calculations.

This could also partially reflect more drawdown of dollar savings triggered by the dinar devaluation. Data reveal that the currency in circulation to broad money rose from 39 percent in 2013 to over 51 percent by December-2021, while the share of deposits declined from 61 percent to less than 49 percent same period (Figure 14). This situation reflects a lack of confidence in the banking system and low banking inclusion. In 2017, only 23 percent of Iraqis held a bank account compared to 48 percent in MENA.¹⁶ The CBI is making important efforts to modernize the payment systems and encourage the greater use of digital financial services and financial technologies (see below).

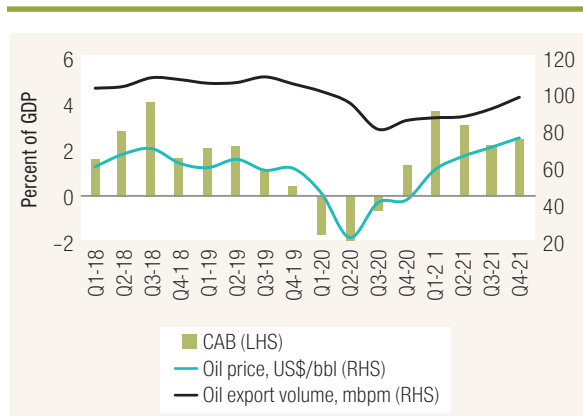
Iraq is making steady progress in developing its financial sector in line with the reforms visualized in the Gol White Paper. The CBI is implementing key reforms and initiatives to transform its banking system and financial industry. The Iraqi authorities have made considerable progress in strengthening their Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT)

¹⁴ Iraqi banking sector is dominated by under-capitalized and under-provisioned state-owned banks primarily used for quasi-fiscal operations.

¹⁵ NPLs at SOBs are likely understated, as they do not reflect loans to public entities with uncalled government guarantees.

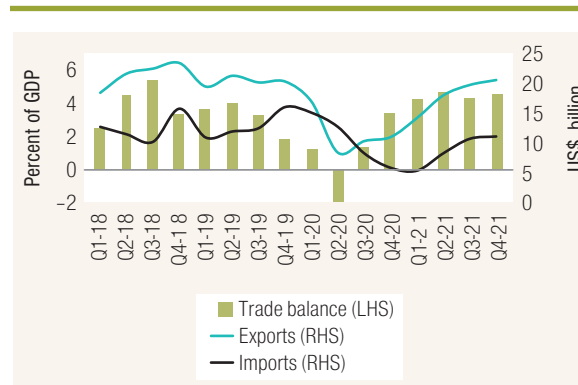
¹⁶ World Bank Financial Inclusion database (FINDEX).

FIGURE 15 • The CAB Returned to Surplus in 2021...



Source: CBI, MoO and World Bank staff calculations.

FIGURE 16 • ...as Higher Oil Exports and Lower Private Imports Drove Up the Trade Balance



Source: CBI and World Bank staff calculations.

regulatory framework, which resulted in delisting of Iraq from the European Union (EU) “Grey List” in December 2021.¹⁷ This major development has also eased de-risking pressures on the Iraqi banks’ correspondent banking lines and facilitated remittance and trade transactions.¹⁸ Additionally, a joint World Bank/IMF team recently completed Iraq’s first ever Financial Sector Assessment Program (FSAP) Development Module and has presented its final report incorporating a set of key recommendations to the authorities to reform the financial sector. Standard and Poor (S&P) has maintained Iraq’s sovereign rating at “B-”, with stable outlook based on increasing oil revenues and much improved foreign exchange reserves which have reached over US\$67 billion by March-2022.

In line with the directions to abide by the decisions of the Paris Climate Conference, the CBI issued regulations in January 2022, for funding renewable energy power generation systems, with its climate change initiative through banks to shift to clean energy. Meanwhile, it has stepped up efforts to increase funds for small and medium projects one trillion dinars to become two trillion dinars. The said initiative has contributed to creating job opportunities and financing nearly three thousand housing units throughout Iraq, according to the CBI. Despite some ongoing challenges,¹⁹ these developments highlight a part of wide range of reforms outlined in the White Paper to help the financial system fulfill its full potential.

External Sector

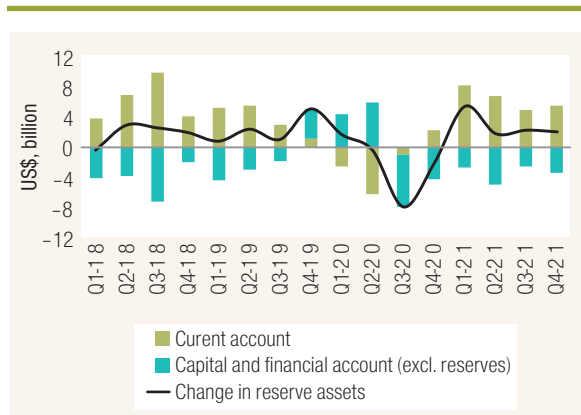
Higher oil prices and exports improved Iraq’s external accounts. After registering a deficit of 4.8 percent of GDP in 2020, higher oil prices and exports pushed the current account balance (CAB) into a surplus of 11.4 percent of GDP (US\$24 billion) in 2021 (Figure 15). Exports, almost entirely consisting of crude oil, surged by almost 56 percent in 2021, expanding the country’s goods trade balance to over 18 percent of GDP (US\$37 billion). (Figure 16). This sharp increase in exports was driven by rising oil prices (78 percent increase), as oil export volumes remained close to the 2020 level. The CAB improvement was also aided by the significant decline in imports, 16 percent in 2021,

¹⁷ The is with the technical assistance of the WB to undertake a National Risk Assessment (NRA) of AML/CFT risks and also supporting the authorities during their evaluation by the European Union.

¹⁸ The move is also expected to pave the way for a greater degree of trade and investment exchange between Iraq and European countries.

¹⁹ The delays in government formation have slowed the pace and implementation of some of the financial sector reforms. These include critical measures to reform the under-capitalized and under-provisioned SOBs such as the proposed Corporate Governance bylaws for the two largest SOB’s Rafidain and Rasheed Banks. The initiation of the Asset Quality Reviews (AQR) are also awaiting endorsement by the new government.

FIGURE 17 • Improved Trade Balance and Financial Account in 2021 Drove Up Reserves



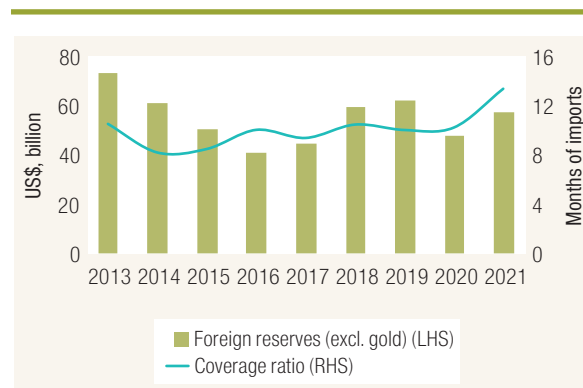
Source: CBI; and World Bank staff calculations.

which pushed up the trade balance by almost US\$7 billion (3 percent of GDP) compared to 2020 during the peak of the pandemic.

The decline in imports, especially that of private imports, followed the exchange rate devaluation. Public imports increased by 40 percent in 2021, mainly due to an 82 percent increase in consumption goods and refined oil products—imports which Iraq heavily relies on. The government also increased imports of capital goods (71 percent growth) to meet the need for the energy sector’s expansion. However, private sector imports (73 percent of total imports) fell by 26 percent owing to the adjustments following dinar’s devaluation which made imports more expensive in dinar terms. Capital goods constituted a large share of private sector imports (75 percent), thus, their decline reduced total capital imports by over 23 percent.

Notwithstanding the decline in net foreign investment, stronger trade balance has

FIGURE 18 • Reserves have Increased to 13 Months of Imports in Line with Better Trade and Financing Conditions



Source: CBI; and World Bank staff calculations.

enhanced Iraq’s external position and strengthened CBI’s international reserves. While the trade balance improved, net FDI flows declined by 8.6 percent in 2021 (y/y) and remained low at 1.3 percent of GDP, reflecting political and social instability, opaque regulatory environment that put downward risk on prospective FDI inflows. However, the recovery in trade credits has resulted in a marked outcome in net official investment which registered a total of US\$8.5 billion in 2021, pushing up the financial account (Figure 17). This outcome along with stronger trade balance aided by the devaluation has pushed the readily usable component of reserves (i.e., reserves excluding gold) to over US\$58 billion (covering 13.6 months of imports), up from US\$48 billion in 2020 (covering 10 months of imports) (Figure 18). These reserves further rose to over US\$61 billion in March 2022 as oil prices climbed to US\$110 pb.

OUTLOOK AND RISKS

Outlook

The turnaround in oil markets has significantly improved Iraq's economic outlook in the medium term. Overall growth in 2022 is now forecast at 8.8 percent, driven in part by the end of the OPEC+ pandemic-related quotas restrictions. As a result, Iraq's production is projected to surpass its pre-pandemic level of 4.6 mbpd in the second half of 2022. Growth in the outer years is projected to moderate to 3.7 percent per year on average, largely as oil production growth eases in line with a gradual increase in oil production capacity. Non-oil GDP growth is projected to converge to its long-term potential growth trend in part aided by higher investments that would be financed through the oil windfall. However, in the absence of an accelerated process of reforms, growth (and sorely missing job creation) is forecast to remain constrained by the economy's limited absorptive capacity and other inefficiencies.

Higher oil prices, projected during 2022–2024, are forecast to significantly improve Iraq's fiscal outlook. Due to their high dependence on oil, government revenues are projected to grow

significantly through both price and volume channels. In the absence of a fiscal rule, part of the new fiscal space is likely to be absorbed by higher investment expenditures along with other procyclical discretionary spending. The delay in government formation and the ratification of the 2022 budget, if continued, could limit the use of the fiscal windfalls as the de-facto ceilings from the 2021 budget are reached which could constrain economic growth. Furthermore, *structural budget rigidities including an oversized wage and pension bill* are projected to offset a significant part of the revenue increases. As such, Iraq's overall fiscal surplus is projected to moderate from an initial high of 13 percent of GDP in 2022 to 6.4 percent of GDP in 2024, while the debt-to-GDP ratio gradually improves to an annual average of 35 percent in 2022–24. The windfall from rising oil prices *provides the government with enough resources to continue service its domestic and external debt.*

Stronger oil exports will continue to drive a current account surplus, thereby strengthening foreign exchange reserves. At an average oil price of over US\$90 pb in 2022–24, oil exports are forecast to rise to an average of 46 percent of GDP annually,

accounting for over 96 percent of goods exports. Imports are forecast to grow over the outlook, in line with the gradual recovery in domestic consumption and the upward trajectory in global commodity prices but remain below exports. This trade trajectory is forecast to keep the current account balance in a significant surplus in 2022–24. This strong current account position is expected to result in sustained accumulation of gross CBI foreign currency reserves (Table 1).

Risks and Opportunities

Iraq's economic outlook remains subject to significant risks. The recent geopolitical tensions related to the war in Ukraine highlight risks for Iraq economy both on the upside and downside. While any further oil price hikes would improve Iraq's fiscal balance, rising food prices and disruption to agriculture imports will exacerbate pre-existing poverty trends and increase food security risks. The conflict also poses risks to Iraq's crude oil production if operations of Russian oil companies in Iraq are impacted by international sanctions on Russia.²⁰ Crucially, higher oil prices could hurt the domestic drive for reforms thereby deepening Iraq's structural economic challenges.

The legacy of previous policies and structural features of government finances raise fiscal risks. The very heavy dependence of government revenues on oil exposes Iraq's fiscal finances to international oil market volatility, which further complicates fiscal management and weakens fiscal discipline. In the absence of revenue management mechanisms, such as fiscal rules, Iraq is vulnerable to volatility and exogenous commodity price shocks. With an oil price assumption of US\$100 per barrel and an oil export volume of 3.5 mbpd, a US\$1 pb oil price decline would directly reduce government revenues by 0.5 percent of GDP (or US\$1.3 billion) per year. Public spending also is dominated by non-discretionary spending that often leaves limited fiscal space for public investment in non-oil sectors. Other fiscal risks also relate to the accumulation of unaccounted arrears to domestic banks and the energy sector. Iraq could seize

current high oil prices to fast-track the diversification and energy transition agenda, which would cement macroeconomic stability and pave the way for more inclusive growth.

Iraq also faces a pressing set of climate change challenges that, if left unaddressed, would impact the country's economic and social prosperity.²¹ Climate change risks are expected to prominently shape Iraq's development path through impacting its growth and potential for economic diversification. Record high temperatures and severe droughts are severely impacting agricultural production, making Iraq more reliant on food imports, with implications for food security and poverty, especially in rural areas. These challenges exacerbate existing inequalities and social grievances, further straining the country's fragile social contract. Additional efforts are needed to tackle the increased risks posed by climate change and an expected long-term decline in global demand for fossil fuels. These measures include a rethinking of the fiscal policy management framework in Iraq including the role of fiscal rules and sovereign wealth funds especially as the current global transition away from carbon intensive sources of energy progresses.

Iraq's fiscal and socio-economic fragilities underscore the urgency of wide-ranging structural reforms by the new government. Reorienting government expenditure to growth-enhancing programs in human and physical capital will be key for diversification and job creation. To this end, key priority reform areas include rightsizing the wage bill and improving spending efficiency. Efforts are needed to strengthen public financial management, reduce inefficient energy subsidies, and minimize fiscal risks arising from off-budget expenditures and government guarantees. These measures need to be complemented with integrated social assistance programs that enhance

²⁰ Three prominent Russian firms, Lukoil, Gazprom Neft and Rosneft are among the major oil companies operating in Iraq.

²¹ The World Bank's forthcoming Iraq Country Climate Development Report (CCDR) takes stock of the magnitude of Iraq's climate challenges and lays out steps towards climate change mitigation and adaptation.

targeting of transfers to the most vulnerable households. Accelerating SOBs reforms by enhancing their efficiency and governance would bolster the financial sector and increase private sector's access to finance. Embedding climate-related policies at the heart of

Iraq's development plan will also be essential for raising revenues, inducing growth and job creation in the medium term. The GoI White Paper remains a bold blueprint for a comprehensive program of economic reforms towards economic diversification.

TABLE 1 • Iraq: Selected Economic and Financial Indicators, 2019-2024

	2019	2020	2021	2022e	2023p	2024p
Economic growth and prices						
Real GDP (percentage change)	5.5	-11.3	2.8	8.8	4.5	3.0
Non-oil real GDP (percentage change)	7.9	-9.4	7.8	2.5	3.0	3.0
GDP per capita (US\$)	5,943	3,768	5,048	6,196	6,185	5,934
GDP (in IQD trillion)	276.2	219.8	301.4	378.8	387.1	380.2
Non-oil GDP (in IQD trillion)	161.8	156.4	163.8	193.0	206.7	218.7
GDP (in US\$ billion)	233.6	151.6	207.9	261.2	267.0	262.2
Oil production (mbpd)	4.74	4.00	3.97	4.51	4.76	4.90
Oil exports (mbpd)	3.54	2.99	3.02	3.48	3.70	3.81
Iraq oil export prices (US\$ pb)	61.1	38.4	68.4	100.0	92.0	80.00
Consumer price inflation (percentage change; average)	-0.2	0.6	6.0	5.3	4.0	2.7
In percent of GDP						
Public Finance						
Government revenue and grants	39.0	28.7	36.2	52.4	50.3	46.4
Government oil revenue	35.9	26.0	31.6	48.7	46.6	42.5
Government non-oil revenue	3.0	2.7	4.6	3.7	3.8	4.0
Expenditures	37.7	34.6	32.2	39.3	40.1	40.0
Current expenditure	28.8	33.1	27.8	27.6	30.1	31.5
Wages and salaries	14.7	18.2	14.1	14.0	15.8	16.5
Goods and Service	3.2	2.9	2.3	2.3	2.3	2.4
Interest payment	1.1	1.0	0.5	0.7	0.8	1.0
Other	9.8	11.0	10.9	10.6	11.1	11.6
Investment Expenditure	8.8	1.5	4.4	11.7	10.0	8.5
Oil investment	6.9	0.1	2.6	8.0	7.0	6.0
Non-oil investment	2.0	1.3	1.9	3.7	3.0	2.5
Primary fiscal balance, cash basis	2.4	-4.8	4.5	13.8	11.1	7.4
Budget balance	1.3	-5.8	4.0	13.1	10.3	6.4
Gross budget financing needs	-1.5	-8.3	2.1	9.4	6.7	2.8
In percent of GDP, unless otherwise indicated						
Public Debt						
Total government debt (percent of GDP)	44.7	64.7	53.2	39.8	33.9	32.0
Total government debt (US\$ billion)	104.4	98.1	110.5	104.0	90.4	84.0
External government debt (percent of GDP)	23.1	33.5	27.5	20.6	17.5	16.6
External government debt (US\$ billion)	54.0	50.7	57.1	53.7	46.7	43.4

(continued on next page)

TABLE 1 • Iraq: Selected Economic and Financial Indicators, 2019-2024 *(continued)*

	2019	2020	2021	2022e	2023p	2024p
Monetary indicators						
Growth in broad money	8.4	15.9	16.7	n.a	n.a	n.a
Policy interest rate (end of period)	4.0	4.0	4.0	4.0	4.0	4.0
In percent of GDP, unless otherwise indicated						
External sector						
Current account	5.8	-4.8	11.4	16.0	12.6	8.4
Trade balance	12.9	3.2	17.9	25.0	21.6	17.4
Exports of goods	34.9	30.9	35.0	50.5	48.3	44.1
Imports of goods	22.0	27.7	17.1	25.4	26.7	26.6
Gross reserves (US\$ billion, excl. gold)	62.9	48.1	58.2	86.6	105.9	113.4
In months of imports of goods and services (excl. gold)	10.1	10.3	13.6	11.2	12.9	14.1
Exchange rate (IQD per US\$; e.o.p)	1182	1450	1450	n.a	n.a	n.a

Source: Iraqi authorities and World Bank staff estimates and projections.



SPECIAL FOCUS: COVID-19 AND THE HUMAN CAPITAL CRISIS: RECOVERING EDUCATIONAL LOSSES FOR FUTURE PRODUCTIVITY AND GROWTH

Human capital consists of the knowledge, skills, and health that people accumulate over their lives. While people's health and education have undeniable intrinsic value, human capital accumulation also enables individuals to realize their potential as productive members of society. More human capital is associated with higher earnings for people, higher income for countries, and stronger cohesion in societies.²² The link between human capital and economic growth has been well-documented in the academic literature, demonstrating that human capital is a central driver of sustainable growth and

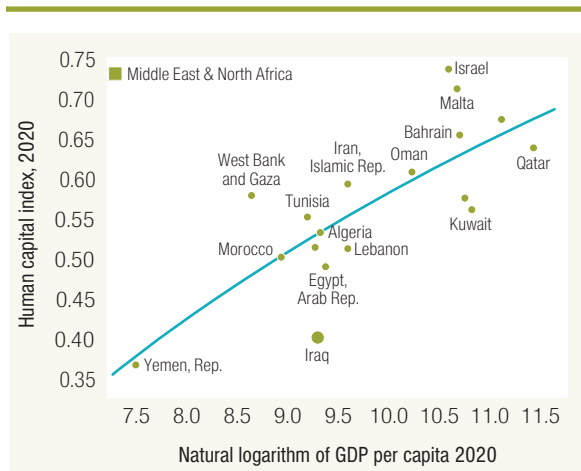
poverty reduction.²³ Governments can make investing in people a priority by ensuring that individuals have the opportunity to develop their human capital at all stages of life, especially during the early years when human capital investments are most crucial.

The levels of human capital in Iraq, already in decline before the COVID-19 pandemic, have been negatively affected by recent shocks. Prolonged school closures have had devastating

²² World Bank (2020).

²³ Smith (1776); Becker (1962); Flabbi and Gatti (2018).

FIGURE 19 • Human Capital Index in Iraq Compared to MENA Countries, 2020



Source: World Bank Human Capital Project.

effects on children’s learning. Without effective remediation, this “lost year” (or more) of learning will have important lifelong impacts on the affected students’ earning capacity, leading to sizable losses for the Iraqi economy in the decades to come. The impacts will be especially severe for children from more vulnerable groups. Reforms of the education sector are urgently needed to recover learning losses, align education with labor market needs, and prepare future workers for higher skilled jobs—a key prerequisite for the diversification of the Iraqi economy.

1. Iraq is facing a human capital crisis

a. Key human capital outcomes were already low before the COVID-19 pandemic

Once a leader in the Middle East and North Africa (MENA), Iraq’s human capital outcomes have stagnated in recent decades. The World Bank’s 2020 Human Capital Index (HCI) suggests that a child born in Iraq just before the COVID-19 pandemic could expect to be only 41 percent as productive by age 18 as she could be with complete education and full health (Figure 19). This is substantially lower than the MENA regional average of 57 percent and largely due to low educational outcomes of Iraqi children and relatively low levels of public investment in health and education. Based on current enrollment

rates, an average Iraqi child can expect to complete only 6.9 years of schooling. However, when taking into account the amount of learning that actually takes place, this child will achieve only 4.0 learning-adjusted years of schooling (LAYS) by age 18.²⁴ As a result, 40 percent of the (already low) time spent in school fails to translate into productive skills when this child enters the workforce.

Years of conflict and structural inefficiencies have resulted in an education system that is not adequately conveying foundational skills—the basis for future learning and skills development.

The most recent learning assessments for Iraq—the 2012 Early Grade Reading Assessment (EGRA) and Early Grade Mathematics Assessment (EGMA)—highlight large learning gaps in the foundational years.²⁵ By grade 3, over 90 percent of students in Iraq were not able to read with comprehension. Twenty-nine percent of grade 3 students could not answer a single question correctly after reading an age-appropriate text (EGRA), and 41 percent were unable to answer a single subtraction problem question correctly (EGMA). These results highlight the large proportions of poor performing students who are at the highest risk of being left behind and dropping out of the education system.

The low levels of human capital development, coupled with limited opportunities to gain job-relevant skills, have translated into worsening economic and social outcomes. A key theme of the nationwide protests that took place in Iraq before the pandemic (October 2019) was the high unemployment rate. The unemployment rate for youth ages 15 to 24 stands at an alarmingly high of 25 percent (2019 International Labour Organization [ILO] estimates). This is higher than both the average for its region (22 percent) and the average for its income group (22 percent) (ILO 2020). These poor labor market

²⁴ Learning-adjusted years of schooling (LAYS) is a concept that combines quantity (access) and quality (learning outcomes) of schooling into a single easy-to-understand metric of progress. More information about the LAYS measure can be found here: <https://openknowledge.worldbank.org/handle/10986/30464>.

²⁵ The most recent EGRA and EGMA were carried out by USAID in 2012 in 54 primary schools in 6 governorates of Iraq (Anbar, Baghdad, Karbala, Missan, Najaf, and Wasit). More information can be found here: https://earlygradereadingbarometer.org/pdf/Iraq_2012_MAHARAT.pdf.

outcomes among youth are, among others, the results of an education system that is not aligned with the skills demanded by today's labor market.

b. Investing in human capital has been low and inefficient in recent years

Iraq's relatively low human capital outcomes are partly due to the country's underinvestment in health and education.²⁶ Decades of conflict have resulted in substantial internal displacement and destruction of the country's health and education infrastructure. Despite efforts to address these infrastructure gaps, overall public spending on health and education is low and falling. Iraq spends a lower share of its budget on these two sectors than the average for MENA and upper middle-income countries (UMICs). In 2019, only about 4 percent of Iraq's federal budget was spent on health (versus around 9 percent for an average MENA country and 12 percent on average for UMICs) and only 10 percent of Iraq's federal budget was spent on education (versus around 13 percent on average in MENA and 15 percent on average for UMICs).

Low efficiency of public spending also holds back the improvements in human capital outcomes.

Iraq achieves lower levels of health and education outcomes than other countries in the region with similar levels of public spending. This is partly driven by a large wage bill that crowds out investment and other inputs critical to quality service-delivery. Governance and public financial management challenges also hamper the effectiveness and efficiency of social spending. Political fragility, partial decentralization, and corruption in public procurement negatively affect the budget processes that prevent the appropriated funds from translating into better social sector outcomes.²⁷

2. COVID-19 has exacerbated existing gaps in human capital

a. The pandemic took a toll on Iraq's human capital through both direct and indirect channels

The COVID-19 pandemic has exacted a heavy toll in lost lives and disrupted human capital

accumulation in Iraq. According to the Iraqi Ministry of Health, COVID-19 has caused over 25,000 deaths in the country between March 2020 and March 2022.²⁸ While older people face the highest risk, with adults 60 and older accounting for 61 percent of COVID-19 deaths in Iraq, COVID-19 has also caused a large number of deaths among adults ages 30 to 59 (accounting for 36 percent of deaths), contributing to a substantial decrease in life expectancy.

Besides the direct impact of illness and lost lives, the indirect impact of COVID-19 and its control measures can be felt across different stages of the life cycle. For young children, the disruption to the health system significantly impaired their access to essential health services—such as vaccination programs and maternal health and childcare services. The resulting health gaps and malnutrition pose significant risks of human capital setbacks. For school-age children, COVID-19-related school closures threaten to undo learning progress, increase dropouts, and lead to substantial learning losses (discussed below). The effects are likely larger for girls and children from disadvantaged families, further exacerbating existing inequalities.

The COVID-19 pandemic significantly impacted Iraq's household welfare, disproportionately affecting children and vulnerable households. For the working-age population, job losses and declines in earnings have affected many Iraqi families. Between March and August 2020, the share of households with at least one working member fell by 16 percentage points, to 62 percent, with the decrease being more intense in rural areas and among the poorest households. More than a third of private sector wage workers and the self-employed have lost their jobs during these times, especially those that were informal, and some of the unemployed decided to stop looking for jobs altogether.²⁹ World Bank projections suggest that the poverty rate in Iraq could increase from 20 percent in 2017–2018 to 31.7 percent as a result of the crisis. This translates into 4.5 million additional poor, adding to the 6.9 million

²⁶ World Bank (2021a).

²⁷ Ibid.

²⁸ Ministry of Health, Iraq (2022).

²⁹ Krahe et al. (2021).

already living in poverty before the crisis. Children face a higher increase in poverty, bringing the projected poverty rate among those under 18 to 37.9 percent.³⁰

b. School closures negatively impacted students' learning outcomes and future earnings

Between March 2020 and October 2021 schools in Iraq were completely or partially closed for approximately 62 weeks—among the longest such closures in the MENA region—impacting more than 11 million Iraqi students.^{31,32} Only partially mitigated by limited and unequal remote learning opportunities, which favored those with access to technology and limited support to caregivers to assist their children's learning at home, the prolonged school closures have had devastating effects on children's learning. In addition to forgoing learning that would have occurred had schools been open, many children have also forgotten what they learned in the months before the pandemic.³³ School closures also risk further exacerbating student dropout, especially among the most marginalized students who are less likely to return when schools reopen.

World Bank simulations suggest that school closures can lead, on average, to a loss of at least one full learning-adjusted year of schooling (LAYS) from an already low baseline of 4.0 LAYS in Iraq. Based on a range of scenarios to account for various levels of effectiveness of remote learning mitigation measures, an average Iraqi student is estimated to have lost between 1.0 and 1.4 LAYS during the pandemic (Figure 20). Students from disadvantaged socioeconomic backgrounds are likely to be closer to the "pessimistic" end of the range due to both increased likelihood of dropping out and lower levels of learning resulting from lower access to the technology required to participate in remote learning, and adequate resources to support their learning at home. Meanwhile, students from more advantaged backgrounds will find themselves closer to the "optimistic" estimate.

Without effective remediation, this "lost year" (or more) of learning will have important lifelong impacts on the affected students' earning

capacity, leading to sizable losses for the Iraqi economy in the decades to come. Based on the simulated range of learning losses of 1.0–1.4 LAYS, the generation of Iraqi students affected by school closures can expect to see their lifetime earnings reduced by 8.4–11.2 percent (approximately US\$ 20,000–28,000 lost per future worker). This translates to an economywide loss of US\$ 47.1–63.1 billion over the course of the working life of these students—equivalent to between 23 and 31 percent of Iraq's total gross domestic product in 2021 (Figure 20).

3. Building Forward Better: An Education Reform Path

a. Priority education sector reforms are more crucial than ever

With the recovery in global oil prices, channeling additional public revenues into human capital investments will be essential for Iraq's future productivity and growth. Addressing infrastructure needs, closing access gaps, and recovering human capital losses caused by the COVID-19 pandemic require increased public spending to be directed toward the social sectors. Increasing the effectiveness of education and health service delivery, particularly pro-poor, in the short-term will ensure that additional funds are spent efficiently for improving human capital outcomes in the medium and long term.

While the COVID-19 crisis has further exacerbated inequities in access to education and dampened learning outcomes, systemic

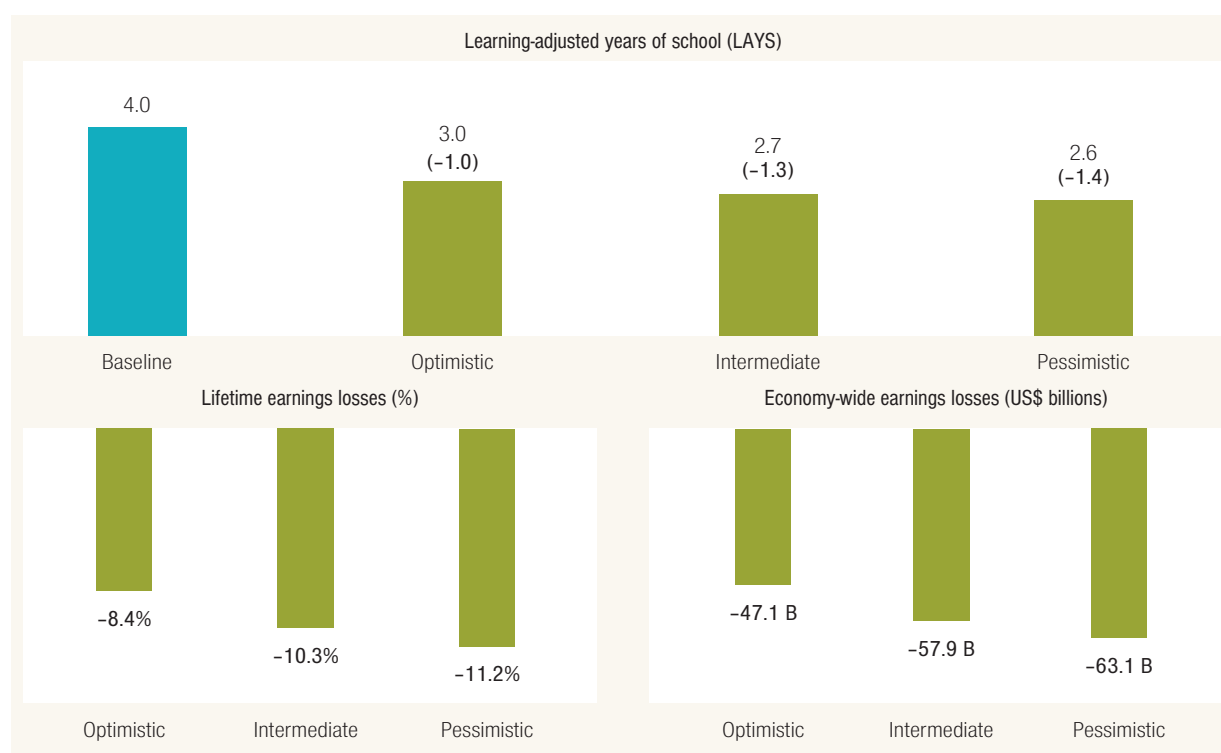
³⁰ UNICEF and World Bank (2020).

³¹ The global average of the duration of total and partial school closures during this period was 38 weeks, while the MENA regional average was 45 weeks, according to the global monitoring of school closures by UNESCO (n.d.)

³² While schools in Iraq (Center) have reopened from November 2021, they remain on a hybrid teaching model with four days of in-person learning per week. With limited access to technology and little support to caregivers, further learning losses are likely compared to a fully in-person mode of learning.

³³ Azevedo, et al. (2021).

FIGURE 20 • Estimated Impacts for Students Affected by School Closures in Iraq



Source: World Bank calculations using the methodology described in UNESCO, UNICEF, and World Bank (2021).

Notes:

^a Learning loss simulation results are based on the actual observed length of school closures in Iraq and assumptions about the mitigation effectiveness of remote learning compared to in-person learning of 40, 20, and 10 percent in the “Optimistic”, “Intermediate”, and “Pessimistic” scenarios, respectively.

^b Earnings loss estimates translate the amount of learning lost (in LAYS) into present-value US dollars using the expected returns to education and labor market earnings data from the ILO and economic forecasts from the World Bank Global Economic Prospects. Results are conditional on the country’s life expectancy, expected work life of a typical adult as well as their human capital utilization, and assume that none of these aspects will be affected by the COVID-19 crisis. The results also assume that the returns to education remain constant at 8% in the long run.

shortcomings in the education sector have been long-standing and need to be addressed. Iraq can use lessons learned from the current health crisis, turn recovery into opportunity, and “build forward better” to ensure it provides learning opportunities for its poorest and most vulnerable children.

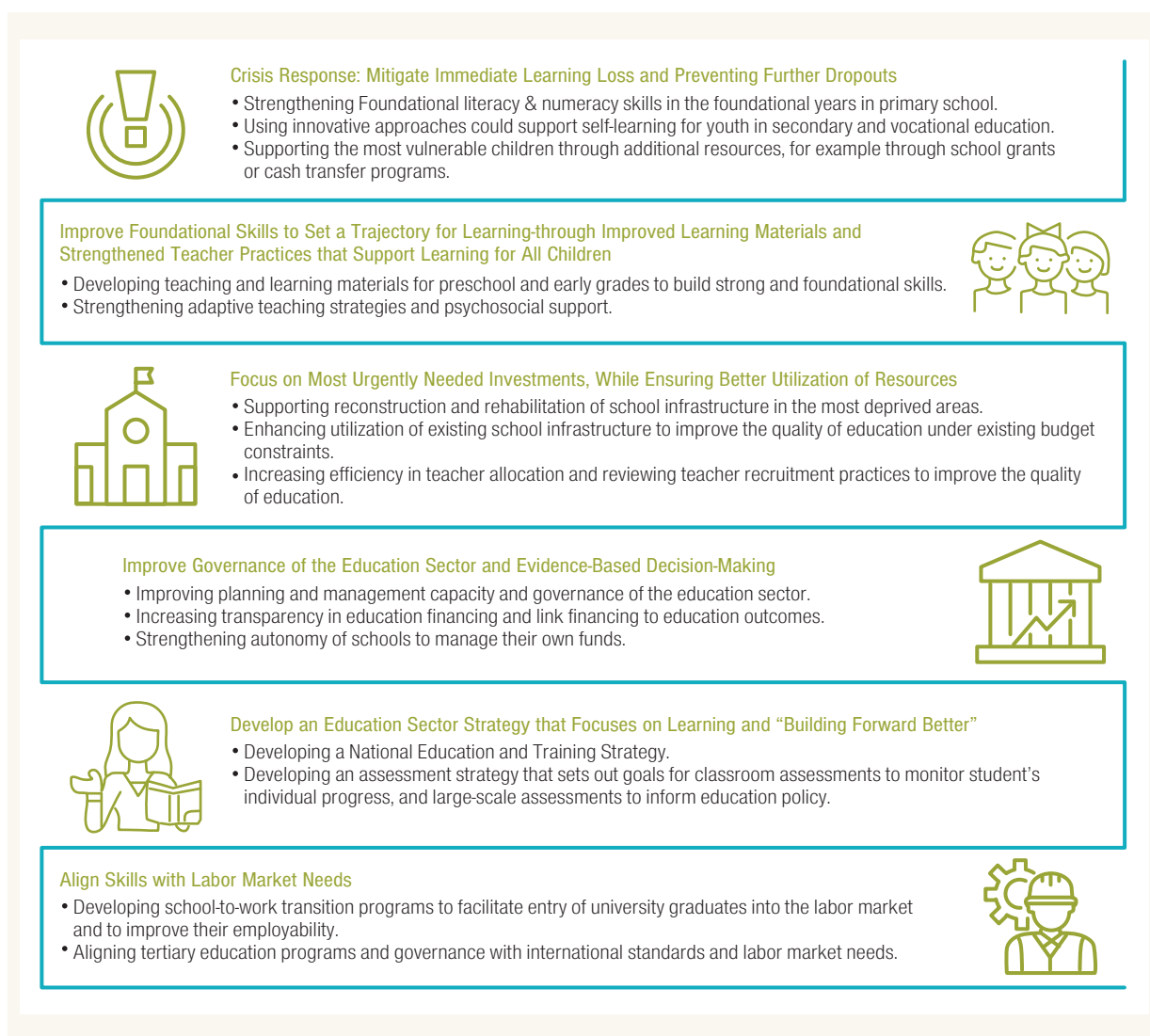
While more investments in the Iraqi education sector are urgently needed, the Government of Iraq (GOI) recognizes that these investments need to be accompanied by a comprehensive education sector reform agenda. This reform agenda should address both long-standing inefficiencies in the education sector—such as infrastructure deficiencies and inadequate teacher deployment—as well as provide short-term measures to recover learning losses. Accelerating human capital accumulation is at the heart of the GOI’s economic growth and poverty

alleviation goals. A top national priority of Iraq’s Vision 2030 is to “invest in human capital and stop wasting it and benefit from the demographic dividend phase which Iraq is undergoing”—with one of the goals being a high quality and inclusive education system.³⁴ Furthermore, the GOI White Paper, published in October 2020, acknowledges the need to identify the various factors that contribute to learning and skills development, and develop actionable reform plans to improve their quality.

The recently published World Bank education sector reform note Building Forward Better to Ensure Learning for All Children in Iraq builds on the GOI’s goals and proposes actionable reforms for key education sector inputs to lead to

³⁴ Ministry of Planning, Iraq (2019).

FIGURE 21 • Iraq Education Sector Reform Path



Source: World Bank (2021b).

better learning and skills development.³⁵ Figure 21 presents a short overview of key reform areas that are crucial for improving quality and governance of education in Iraq to promote learning and skills, which are further described in the Appendix and in the education sector reform note.

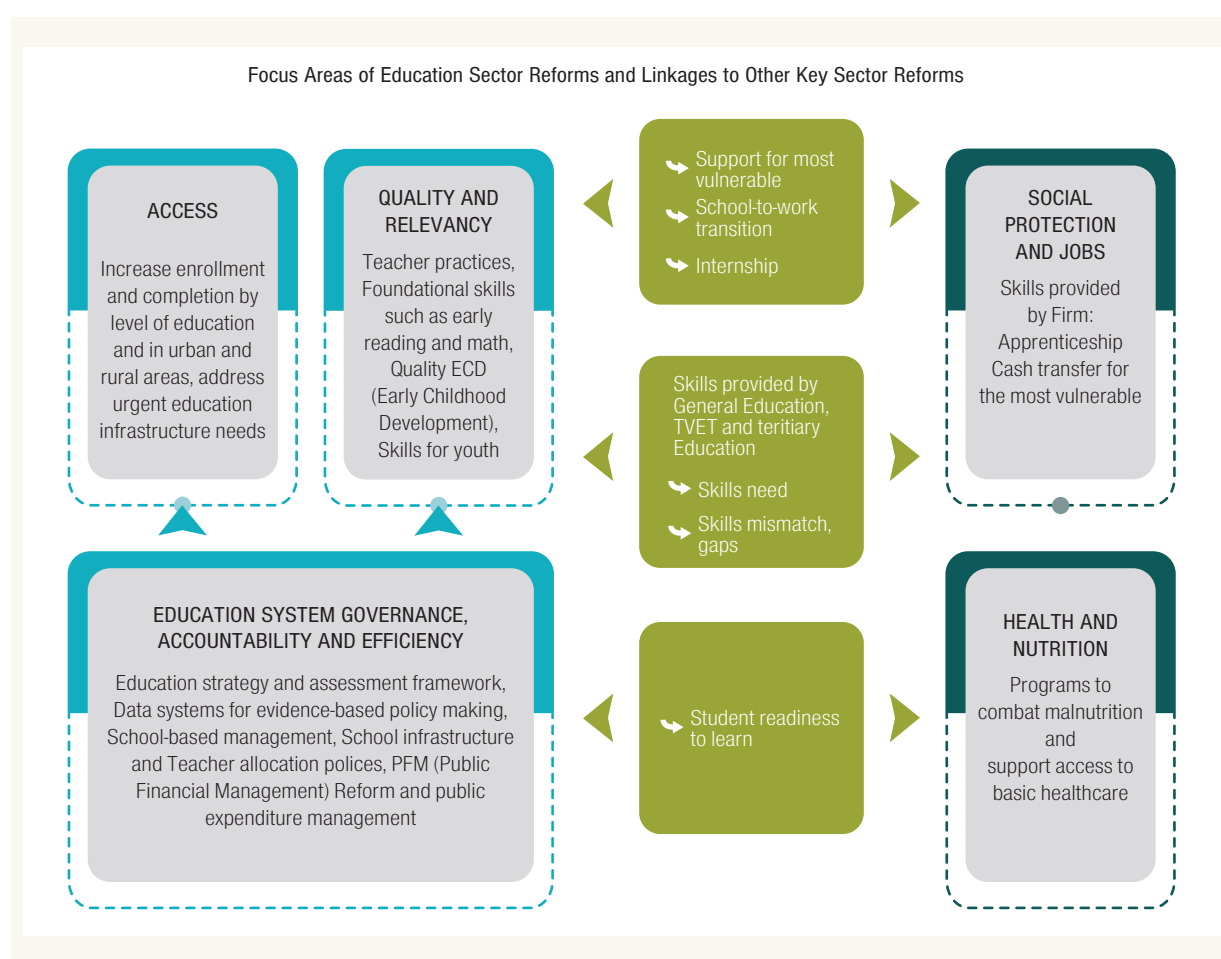
b. A ‘whole-of-government’ approach is needed to improve human capital across sectors

To sustainably improve human capital outcomes, countries need to adopt a concerted whole-of-

government approach. Past experiences of countries that have successfully managed to implement such an approach show that several elements are important. First is the *continuity* to sustain reform efforts across political cycles. Second is the effective *coordination* of reform implementation across different sectors, ministries, and levels of government. And third is ensuring that the policies and programs are designed in a way that is *evidence-based* to effectively improve human capital of the population. Coun-

³⁵ World Bank (2021b).

FIGURE 22 • Human Capital Reform Process



Source: World Bank (2021b).

tries that managed to include all three of these elements in advancing human capital reforms were more successful in reaping their many lasting social and economic benefits.³⁶

Key to boosting human capital is a holistic education sector reform approach that is linked to reform in other human development sectors—specifically health and social protection and jobs—to leverage synergies and ensure maximum impact on development. Successful reforms that can boost human capital through the education sector should address the pillars of access, quality and relevant,

and education system governance, accountability and efficiency. In addition, as highlighted in Figure 22, important linkages to other sectors highlight the need for a multisectoral approach to create sustainable reforms to boost human capital. These include programs to combat malnutrition and support access to basic healthcare, cash transfers for the most vulnerable, and firm-provided skills programs such as apprenticeships.

³⁶ World Bank (2019).



APPENDIX: SUMMARY OF EDUCATION REFORM PRIORITIES FOR IRAQ

Firstly, crisis response needs to focus on mitigating immediate learning losses and preventing further dropout. Mitigating learning loss can be achieved through a community-based approach to learning, with a focus on the most vulnerable students. Especially in remote areas, schools can best reach and coordinate support to students, teachers and caregivers. In addition, using a blended approach for online and offline content delivery can ensure that the most vulnerable children have access to continued learning. The focus in primary schools should be on strengthening foundational literacy & numeracy skills in the foundational years, by providing supplementary reading and numeracy materials for students, and teaching materials and coaching for teachers. In secondary and vocational education, innovative approaches could support self-learning for youth by making complementary, quality learning content available to students, while also supporting learning and teaching of relevant skills for life and jobs.

Secondly, realigning the education system to learning means improving Foundational Skills to Set a Trajectory for Learning—through Improved Learning Materials and Strengthened Teacher Practices That Support Learning for All Children. The current Iraqi curriculum is largely outdated and is not focused sufficiently on learning, knowledge, and innovation, or conveying 21st century skills. New learning and teaching materials should complement the ongoing curriculum reform through the reform of remaining subjects and the introduction of 21st century skills, such as socioemotional and digital skills, promoting knowledge, innovation and skills over credentials, and enhancing the curriculum to support themes of inclusion, especially for girls, children with disabilities, and marginalized groups. New content can also promote themes of social cohesion, diversity, and tolerance. Development of teaching and learning materials can focus on preschool and early grades to build strong foundational skills. At the same time, adaptive teaching strategies for early numeracy

and literacy and psychosocial support need to be developed.

Thirdly, with demand for investments into education far exceeding supply, the GOI needs to focus on most urgently needed interventions, while ensuring better utilization of resources. The infrastructure need in Iraq represents an additional 70 percent of school buildings.³⁶ The resources available should focus on the most deprived areas. With demand for new school infrastructure far exceeding supply and current infrastructure developments, a prioritization mechanism on school construction, including options to utilize existing infrastructure, needs to be established to address the most immediate shortages. This also requires the adoption of a school construction policy that includes national planning guidelines and improved designs compatible with international standards to help create conducive learning environments. In addition, suboptimal teacher allocation—with too many teachers in urban and too few teachers in rural areas—is a pervasive problem in Iraq that further exacerbates inequities in access and learning. The GOI should develop and adopt a teacher allocation policy that focuses on catering toward teachers, especially in disadvantaged areas, and consider incentive schemes for teacher relocation, especially to remote areas. In addition, the GOI can develop a comprehensive teacher recruitment and teacher professional development strategy that is aligned with the goals set forth in the Iraq National Education Strategy (2022–2030).

Fourth, education sector reform should focus on improving governance of the education sector and strengthen evidence-based decision-making. Continuously monitoring student progress and other education indicators is key for evidence-based policy making towards the objective of improved learning. Firstly, this will require moving toward a comprehensive Education Management Information System (EMIS) while gradually building the capacity of the Ministry of Education (MOED) to collect, analyze, and use the data. In addition, the MOED needs to focus on building internal capacity of key education sector entities to be able to implement capital investment projects. Secondly, increasing transparency in education financing and link financing

to education outcomes, can be achieved through operationalization of an Open Data Portal to increase accountability around the use of financial and non-financial resource. Thirdly, strengthening the autonomy of schools to manage their own funds, has not only proven internationally to promote better learning outcomes, but will also give schools the flexibility to address the priorities of individual communities and to harness knowledge of the local context to identify the most appropriate interventions that can boost learning.

Fifth, adapting education sector strategies that focus on learning. Iraq's education sector has so far been lacking a clear vision and strategy toward the development of human capital. The GOI is nearing the completion of a National Education Strategy (2022–2030) that will guide the future development of the education system that focus on learning and supporting resource mobilization. Iraq had so far not participated in any international large-scale assessments or institutionalized the use of formative and diagnostics assessments. Over the last year however, Iraq has begun to develop a national assessment strategy, which is nearing completion, and signed up to participate in Trends in Mathematics and Science Study (TIMSS) in 2023.

Sixth, aligning skills acquired in school with labor market needs is imperative for human capital driven sustainable economic growth. With the evidence of a large skills mismatch between skills conferred through education and the labor market, effective school-to-work transition programs are needed. MOHESR can take advantage of innovative financing mechanisms developed under the recent Competitive Fund Initiative (CFI) initiative, which establishes tertiary education institutions' (TEIs) partnerships with the private sector to deliver joint training programs and ensure students are equipped with the skills needed to succeed in the labor market.

³⁷ In addition, about 50 percent (6,961 school buildings) of the 14,032 school buildings currently in operation need rehabilitation and additional resources to meet basic safety and hygiene standards, such as sewer systems, and so forth. Information provided by MOED to World Bank during consultations in August 2020.

More broadly, aligning tertiary education programs and governance with international standards, labor market needs and the national education and training strategy, will be imperative to promote better labor market outcomes. This should include developing a roadmap for tertiary education sector reform, that 1) proposes and implements a more agile sector governance structure, (2) establishes mechanisms

for additional resource mobilization, (3) implements a National Qualification Framework, (4) develops a long-term roadmap for international accreditation of university programs, (5) incentivizes partnerships between higher education or vocational institutions and the private sector, and (6) implements teacher training development programs, that are aligned with international standards of teaching and research.



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