INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/235

IRAQ

August 2015

2015 ARTICLE IV CONSULTATION AND REQUEST FOR PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR IRAQ

In the context of the Staff Report for the 2015 Article IV Consultation and Request for Purchase Under the Rapid Financing Instrument, the following documents have been released and are included in this package:

- **Press Releases** including a statement by the Chair of the Executive Board and summarizing the views of the Executive Board as expressed during its July 29, 2015 consideration of the staff report on issues related to the Article IV Consultation and Request for Purchase Under the Rapid Financing Instrument.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 29, 2015, following discussions that ended on June 5, 2015, with the officials of Iraq on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 10, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Iraq.

The document listed below will be separately released.

Selected Issues*

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 15/382
FOR IMMEDIATE RELEASE
August 18, 2015

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2015 Article IV Consultation with Iraq

On July 29, the Executive Board of the International Monetary Fund (IMF) concluded the 2015 Article IV consultation[1] with Iraq.

Iraq is facing a double shock arising from the ISIS insurgency and the plunge in global oil prices. In 2014, real GDP contracted by 2.1 percent mainly due to the impact of the conflict, while oil production and exports increased slightly compared to 2013. This year, overall economic activity is expected to see a modest recovery of 0.5 percent thanks to oil sector expansion, while non-oil activity is expected to contract further.

The decline in oil prices has driven the decline of Iraq's international reserves (including the Development Fund for Iraq) from $84 billion at end-2013 to $67 billion at end-2014. Fiscal pressures are intensifying, with the government deficit expected to expand from 5.3 percent of GDP last year to 18.4 percent of GDP in 2015 due to continuing weak oil prices and rising humanitarian and security spending.

The authorities have appropriately maintained the exchange rate peg. Liberalization steps taken by the Central Bank of Iraq led to a decline in the parallel market spread to less than 2 percent by end-2014. The imposition of new restrictions triggered significant market volatility and a sharply wider spread in the first months of this year, but their recent removal has helped narrow the spread back to 4 percent by July.

Medium term growth prospects remain positive, though less favorable than before the crisis. Growth will be driven by the projected ramp-up in oil production and the rebound in non-oil growth supported by the expected improvement in security and implementation of structural reform. Risks remain very high, however, arising primarily from an escalation of the conflict, political tensions, and poor policy implementation.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

The Fund is supporting Iraq through a disbursement under the Rapid Financing Instrument in the amount of SDR 891.3 million ($1.242 billion), equivalent to 75 percent of quota[2].

Executive Board Assessment[3]

Directors noted the severity of the double shock facing Iraq as a result of the continuing ISIS insurgency and the global oil price decline. The risks remain very high, emanating from an extension of the conflict, political tensions, weak policy implementation, and further shocks from oil markets. In this context, Directors noted that the steps taken by the authorities are in the right direction, but urged further determined efforts to address the large financing gap and maintain the momentum for reforms.

Directors welcomed the 2015 budget as a good step toward addressing pressures from lower oil revenues amid higher humanitarian and security spending, and commended the introduction of new revenue measures. While recognizing that the current adjustment plans may be socially and politically challenging, Directors saw a need for additional measures to help close the large financing gap and build fiscal buffers. Some Directors expressed disappointment over the delay in implementing the electricity tariff reform. In this regard, Directors welcomed the authorities' commitment to implement the reform as soon as possible or adopt compensatory fiscal measures. They also recommended expenditure rationalization while safeguarding priority social and capital spending and making social safety nets more efficient. Directors urged the authorities to tap domestic markets and seek further external financial support, while avoiding the buildup of domestic and external arrears. Over the medium term, strengthening public financial and debt management will be crucial.

Directors noted that indirect central bank financing of the government is necessary at this juncture given the lack of other sources of financing, but stressed that this should not become a recurring source of financing. They, therefore, welcomed the authorities' intention to firmly limit such support and clarify the terms of the related financial operations between the central bank, the state-owned banks, and the government. Directors supported the authorities' commitment to maintain the exchange rate peg, which has served as a sound nominal anchor for Iraq. They also welcomed the steps taken to liberalize the foreign exchange market and urged the removal of remaining exchange restrictions and multiple currency practice as external conditions evolve.

[2] The Executive Board approved the Rapid Financing Instrument for Iraq on July 29, 2015 (see Press Release No. 15/363)

[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors underscored the risks from rising tensions in the banking system arising from the impact of the crisis on the assets and activity of private banks, and the increasing role of state-owned banks in financing the government. In this regard, they welcomed the steps taken to strengthen banking supervision and the authorities' commitment to press ahead with the restructuring of Rasheed and Rafidain banks. Directors emphasized the importance of bringing Iraq's frameworks for combating corruption, money laundering, and terrorism financing in line with international standards and implementing them effectively.

Directors welcomed the authorities' recognition of the need to maintain the momentum on restructuring the economy despite the current difficulties, and emphasized the importance of staying committed to reforms. They highlighted the need to diversify the economy and improve the resilience and inclusiveness of economic growth. They supported the focus on strengthening fiscal institutions, completing the transition to a market economy through further private banking sector development and state-owned enterprise restructuring, and improving the business environment, governance, and the labor market. In this context, they noted the need for Fund technical assistance in strengthening Iraq's institutions. Recognizing the difficult circumstances, Directors agreed that a realistic implementation timeline is important, while pressing ahead with high-priority reforms. Looking ahead, a forward-looking policy framework could help the adjustment process and allow the authorities to build a track record of strong policy implementation.

Table 1. Iraq: Selected Economic and Financial Indicators, 2012–20

(Quota: SDR 1,188.4 million / 0.5 percent of total)

(Population: 33.4 million; 2013)

(Poverty rate: 23 percent, 2014)

(Main export: Crude oil)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Actual	Actual	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Economic growth and prices									
Real GDP (percentage change)	13.9	6.6	-2.1	0.5	7.6	8.1	7.6	7.5	7.1
Non-oil real GDP (percentage change)	15.0	10.2	-8.8	-11.2	2.0	3.0	4.0	5.0	5.0
GDP deflator (percentage change)	2.7	0.1	-1.8	-22.4	5.1	3.6	2.6	1.7	1.3
GDP per capita (US$)	6,693	6,957	6,520	4,960	5,470	5,971	6,421	6,843	7,241
GDP (in US$ billion)	218.0	232.5	223.5	174.4	197.3	220.9	243.7	266.4	289.1
Oil production (mbpd) 1/	3.0	3.0	3.1	3.4	3.8	4.3	4.7	5.1	5.5
Oil exports (mbpd) 2/	2.4	2.4	2.5	3.1	3.3	3.6	3.8	4.1	4.4
Iraq oil export prices (US$ pb)	106.7	102.9	97.0	54.7	62.0	67.1	69.9	71.0	71.5
Consumer price inflation (percentage change; end of period)	3.6	3.1	1.6	3.0	3.0	3.0	3.0	3.0	3.0
Consumer price inflation (percentage change; average)	6.1	1.9	2.2	2.1	3.0	3.0	3.0	3.0	3.0
	(In percent of GDP)								
National Accounts									
Gross domestic investment	22.1	27.0	26.1	29.8	27.3	25.8	26.0	25.2	25.9
Of which: public	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Gross domestic consumption	69.4	69.5	74.7	78.5	77.1	73.3	72.0	72.6	72.3
Of which: public	20.7	21.2	19.0	25.9	23.1	21.3	20.2	19.4	18.7
Gross national savings	28.8	28.3	23.3	21.3	20.4	26.4	27.9	27.4	27.8
Of which: public	17.9	11.6	13.7	3.4	9.6	15.7	18.3	19.9	22.9
Saving - Investment balance	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.8	2.2	1.9
	(In percent of GDP, unless otherwise indicated)								
Public Finance									
Government revenue and grants	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Government oil revenue	43.4	39.0	37.8	35.9	38.7	40.0	40.7	40.6	42.4
Government non-oil revenue	4.0	3.6	2.3	4.8	4.6	4.4	4.3	4.2	4.2
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure, o*f which:*	42.9	48.4	45.4	59.2	53.6	47.6	46.1	43.8	43.2
Current expenditure	29.7	30.9	26.4	37.6	33.9	29.0	27.0	25.4	24.1
Capital expenditure	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Primary fiscal balance	4.5	-5.5	-5.0	-17.4	-8.9	-1.2	0.8	2.8	5.0
Overall fiscal balance (including grants)	4.1	-5.8	-5.3	-18.4	-10.3	-3.2	-1.1	1.0	3.5
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-68.6	-61.8	-59.0	-58.6	-55.6	-55.4
Memorandum items:									
Tax revenue/non-oil GDP (in percent)	2.1	2.0	1.8	3.6	3.8	3.8	3.8	3.8	3.8
Development Fund of Iraq/MoF US$ account (in US$ billions) 3/	18.1	6.5	0.9	1.0	1.0	1.0	1.0	1.0	6.3
Total government debt (in percent of GDP)	34.7	31.9	38.9	70.0	74.0	68.7	63.3	57.0	49.1
Total government debt (in US$ billion)	75.7	74.3	87.0	122.1	145.9	151.8	154.4	151.9	141.9
External government debt (in percent of GDP)	27.7	25.5	28.8	37.0	35.5	31.0	26.6	22.8	19.8
External government debt (in US$ billion)	60.3	59.2	64.3	64.5	69.9	68.4	64.9	60.9	57.4
	(In percent, unless otherwise indicated)								
Monetary indicators									
Growth in reserve money	8.3	12.6	-9.6	-1.0	-6.5	10.0	10.0	10.0	10.1
Growth in broad money	3.4	16.7	3.6	17.5	8.7	13.5	12.7	11.1	10.3
Policy interest rate (end of period)	6.0	6.0	6.0	…	…	…	…	…	…
	(In percent of GDP, unless otherwise indicated)								
External sector									
Current account	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.8	2.2	1.9
Trade balance	14.3	9.5	6.6	-1.3	2.6	7.1	8.2	8.4	8.4
Exports of goods	43.2	38.5	37.4	35.6	38.3	39.6	40.4	40.2	42.1
Imports of goods	-28.9	-29.0	-30.9	-36.9	-35.8	-32.6	-32.2	-31.9	-33.7
Overall external balance	4.4	-1.3	-7.6	-13.6	-7.9	0.1	1.7	2.7	2.5
Gross reserves (in US$ billion) 4/	69.3	77.8	66.7	50.4	41.5	41.7	45.6	52.8	60.0
In months of imports of goods and services	9.8	10.4	9.9	6.9	5.5	5.1	5.2	5.2	5.2
Exchange rate (dinar per US$; period average)	1,166	1,166	1,166	…	…	…	…	…	…
Real effective exchange rate (percent change, end of period) 5/	-1.7	6.5	4.6	…	…	…	…	…	…

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

1/ Does not reflect KRG production during 2013 and 2014.

2/ Reflects KRG exports through State Organization for Marketing Oil (SOMO).

3/ Reflects the balances of the Development Fund of Iraq which were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

4/ Starting 2014 includes US$ account balances from oil revenues.

5/ Positive means appreciation.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No.15/363
FOR IMMEDIATE RELEASE
July 30, 2015

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$1.24 Billion in Financial Support for Iraq

On July 29, 2015, the Executive Board of the International Monetary Fund (IMF) approved SDR 891.3 million (about US$1.24 billion or 75 percent of quota) for Iraq under the Rapid Financing Instrument (RFI)[1]. The purpose of this financial assistance is to help Iraq address present and urgent balance of payment and budget needs in 2015 related to the ISIS insurgency and a decline in oil prices. The IMF financing will support the authorities' current economic program, which includes fiscal adjustment measures and structural reforms.

Following the Executive Board's discussion of Iraq, Mr. Mitsuhiro Furusawa, IMF Deputy Managing Director and Acting Chair of the Board, issued the following statement:

"The twin shocks faced by Iraq from the ISIS insurgency and the drop in global oil prices have severely widened the government deficit and caused a decline in international reserves. The authorities' policies to deal with the shocks, including sizable fiscal adjustment and maintenance of the exchange rate peg, go in the right direction. Access under the IMF's Rapid Financing Instrument will help address Iraq's urgent balance of payments and budget needs. However, large fiscal and external financing gaps remain.

"The large financing gap calls for the rigorous implementation of the authorities' policies, but also additional fiscal adjustment measures and identification of domestic and internal financing. In this context, it will be important to implement the new electricity tariff schedule as soon as possible, or adopt compensatory measures. Looking ahead, the authorities should lay the ground for medium-term structural reforms that would better support macroeconomic policy management and boost the economy's resilience to shocks."

[1] The RFI provides rapid and low-access financial assistance to member countries facing an urgent balance of payments need, without the need to have a full-fledged program in place. It can provide support to meet a broad range of urgent needs, including those arising from commodity price shocks, natural disasters, conflict and post-conflict situations, and emergencies resulting from fragility. Access under the RFI is limited to 75 percent of quota per year and 150 percent of quota on a cumulative basis. Financial assistance under the RFI is provided in the form of outright purchases without the need for a full-fledged program or reviews.

INTERNATIONAL MONETARY FUND

IRAQ

July 10, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION AND REQUEST FOR PURCHASE UNDER THE RAPID FINANCING INSTRUMENT

KEY ISSUES

Context: Iraq is facing a double shock arising from the ISIS insurgency and the sharp drop in global oil prices. The conflict is hurting the non-oil economy through destruction of infrastructure and assets, disruptions in trade, and deterioration of investor confidence. The impact of the oil price decline—already felt in 2014—will fully unfold in 2015, affecting the budget, the external sector, and medium-term growth potential. The authorities are responding to the crisis through mix of fiscal adjustment and financing, maintaining their commitment to the exchange rate peg.

Rapid Financing Instrument: To help address the present and urgent balance of payment and budget needs triggered by the ISIS insurgency and the collapse in oil prices, the authorities have requested financial assistance under the Rapid Financing Instrument (RFI) for 50 percent of quota (SDR 594.2 million).

Outlook and Risks: Assuming a resolution of the conflict in the coming years, the baseline medium-term outlook still looks positive, even though it would be significantly less favorable than at the time of the 2013 Article IV report. Under much improved security conditions, the macroeconomic scenario would continue to be driven by the expansion in oil production and non-oil sector growth, assuming the implementation of structural reform to diversify the economy and support private sector development. But risks remain very high, arising primarily from a worsening of the conflict, political tensions, and poor policy implementation.

Key Article IV Policy Recommendations:

- In 2015, strong fiscal consolidation is needed to address the fall in oil revenues and contain central bank financing to the budget.
- In the medium term, continued fiscal discipline, supported by stronger public financial management, will be essential to raise investment and eventually rebuild fiscal buffers.
- The exchange rate peg remains appropriate, but the authorities should press ahead with the gradual liberalization of the foreign exchange market.
- Close monitoring of the financial sector is warranted in light of the impact of the conflict, the state-owned banks' financing of the budget, and AML/CFT shortcomings.
- The authorities should continue to pursue medium-term structural reform, including: strengthening public financial management and governance and streamlining public spending; improving the business environment and restructuring state-owned enterprises; and promoting private sector job creation.

Approved By
Aasim M. Husain and Taline Koranchelian

Discussions took place in Amman during March 6–15 and May 26–June 5, 2015. Staff representatives comprised C. Sdralevich (head), K. Gvenetadze (advance team lead), A. Hegazy (all MCD), C. Blair, C. El Khoury (all LEG), C. Baba (MCM), C. Kneer (SPR), M. Al Nasaa (Resident Representative). M. Choueiri (Senior Advisor, OED) joined the missions. M. Orihuela-Quintanilla and Y. Liu assisted in the preparation of the report.

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Glossary

AML/CFT	Anti Money Laundering/Combating the Financing of Terrorism
CAMELS	Capital Adequacy, Assets, Management Capacity, Earnings, Liquidity, Sensitivity
CBI	Central Bank of Iraq
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
DFI	Development Fund for Iraq
EBA-lite	External Balance Assessment
GDP	Gross Domestic Product
GST	General Sales Tax
ID	Iraqi Dinar
IDP	Internally Displaced Persons
IFMIS	Integrated Financial Management Information System
IOCs	International Oil Companies
IMF	International Monetary Fund
ISIS	Islamic State of Iraq and Syria
KRG	Kurdistan Regional Government
Mbpd	million barrels per day
MCP	Multiple Currency Practice
MENAFATF	Middle East and North Africa Financial Action Task Force
MOF	Ministry of Finance
MOU	Memorandum of Understanding
OPEC	Organization of the Petroleum Exporting Countries
PDS	Public Distribution System
PFM	Public Financial Management
RFI	Rapid Financing Instrument
SMP	Staff Monitored Program
USAID	United States Agency for International Development

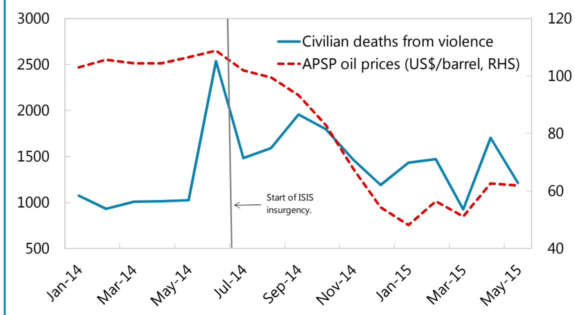
BACKGROUND: A DOUBLE-EDGED CRISIS

A. Crisis Triggers

1. **Iraq is facing an existential threat from the ISIS insurgency and a large external shock from the collapse in oil prices**. The insurgency that started in June 2014 is putting the political and social structure of the country under unprecedented stress. Almost simultaneously, the Iraqi economy—highly dependent on hydrocarbons—has been hit by the fastest decline in oil prices in five years, with severe consequences for its external position, budget revenues and fiscal space.

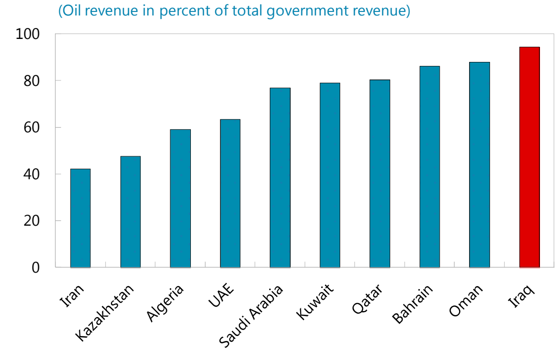
2. **One year into the conflict, ISIS remains firmly entrenched in Iraq**. Since last summer, government forces have retaken some of the ISIS-controlled territory, but progress has been slow and the recent loss of the key city of Ramadi shows that the fight against ISIS is likely to be protracted. The conflict has also created a humanitarian crisis (Box 1).

Double Shock – ISIS insurgency and Declining Oil Prices



Sources: Iraq Body Count Database; and Bloomberg.

Budget Oil Dependency, 2014
(Oil revenue in percent of total government revenue)



Sources: Iraqi authorities; IMF WEO Database; and IMF staff calculations.

3. **As the insurgency was expanding, world oil prices started a dramatic decline**. Its impact on Iraq has been particularly intense given Iraq's extreme dependence on oil. In 2014, oil exports represented almost 100 percent of total exports; oil sector GDP was more than 50 percent of the total (with much of the non-oil activity indirectly driven by oil revenues); and oil exports constituted over 93 percent of government revenues.

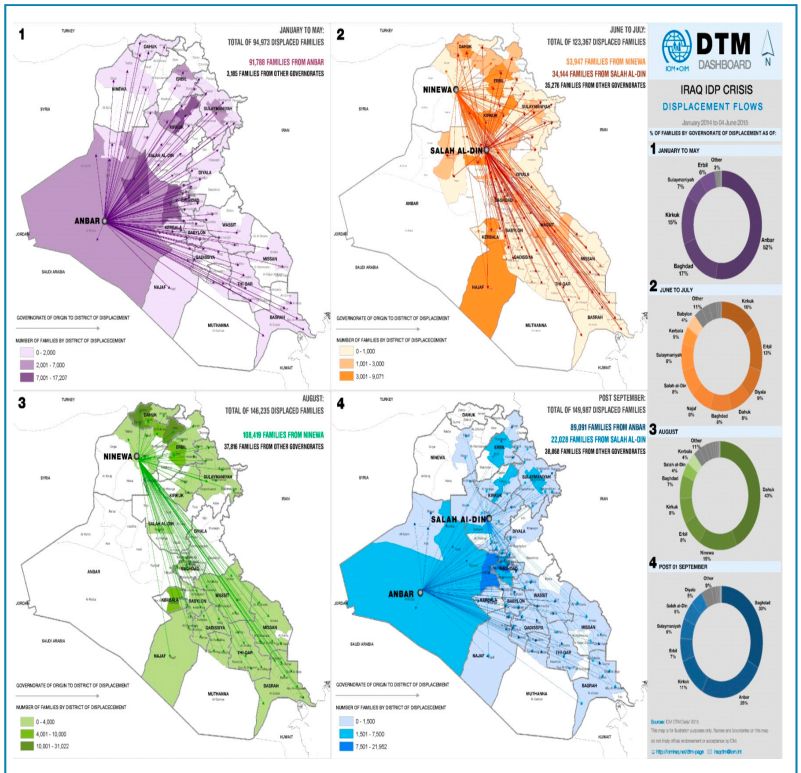
4. **The two shocks are affecting all aspects of the Iraqi economy**:

- **Medium-term oil sector prospects** have worsened as the government focuses on the war effort and oil prices are expected to remain low—but in the short term the oil sector performance has proved more resilient than expected;

- **Non-oil activity** has been harmed by the violence, particularly in the ISIS-controlled areas, but also in the rest of Iraq as productive assets and infrastructure have been destroyed, internal and external trade disrupted, and the confidence of households and investors undermined. In addition, lower oil revenue is leading to a compression of government spending, particularly investment, further dragging down the economy.

Box 1. Humanitarian Conditions in Iraq

The conflict in Iraq has created one of the largest internally displaced populations in the world. Over three million have been displaced internally since mid-2014. Close to 10 million Iraqis (or almost one third of the population) are deemed to need humanitarian assistance. Living conditions across the country have deteriorated, and the government's ability to provide basic public goods and services is highly curtailed. Destruction to physical infrastructure is hampering access to—and services provided by—schools and hospitals due to lack of medical facilities, supplies and healthcare assistance: 14 major hospitals and over 170 health facilities are reportedly dysfunctional or destroyed. Food security is at risk given destruction to agricultural, livestock and irrigation systems. Water, power, and sanitation cuts are also reportedly widespread. More than 2.9 million Internally Displaced Persons (IDPs) are expected to need nonfood assistance (including shelter) throughout the remainder of 2015, mostly in the center and south of Iraq. Poverty rates have risen in conflict areas given escalating inflation due to supply disruptions. Support in these areas through the Public Distribution System (PDS) is limited, with four-fifths of households reportedly receiving no rations in April. According to Iraq Body Count, the number of casualties since the beginning of 2015 has climbed to over 7,300, following 17 thousand reported deaths during 2014.



Source: United Nations Office for the Coordination of Humanitarian Affairs.

Iraq has also received about a quarter of a million Syrian refugees. Refugees—60 percent of whom are women and children—mostly reside in the north, including the Kurdistan Regional Government where they have been granted residency status including rights to work. This refugee inflow is adding to the already difficult internal humanitarian situation faced by the Iraqi government.

The government response is constrained by the budgetary crisis, but is receiving support from the international community. The government is struggling to meet rising humanitarian spending needs. Outlays on socio-economic infrastructure have been delayed or postponed, and payment of salaries in some regions has been delayed. However, the Ministry of Displacement and Migration has started rolling out new smart cards to IDPs allowing families to withdraw about $336 as monthly financial assistance. The government has also set up a $500 million Reconstruction Fund. The U.N. has launched a $500 million humanitarian response plan for Iraq in Brussels in June 2015, targeting over 5.5 million Iraqis over a six month period. The U.N. also recently welcomed a $300 million donation from Kuwait as a humanitarian response for both Iraq and Yemen. Nevertheless, delivering aid to affected areas is challenging because of restrictions to access and limited security.

- **Commercial banks** are suffering from the looting of cash by ISIS, asset losses, and the decline in economic activity and trade.

B. Recent Developments and Short-Term Outlook

Growth slows down

5. **Economic growth has been slowing since 2013**. An expansionary fiscal stance pushed GDP growth to 6.6 percent in 2013, but the economy contracted by 2.1 percent in 2014 because of the onset of the insurgency and the slowdown in government spending. GDP is expected to register only a modest recovery of 0.5 percent this year:

- **Oil production and exports** were flat in 2013 over 2012 because of technical issues, security problems (particularly the sabotage of the northern pipeline to the Turkish port of Ceyhan), and the suspension of exports from the Kurdistan Regional Government (KRG).[1] In 2014, oil production and exports rose at a moderate pace (Box 2 and Selected Issues Paper), but are projected to rise by 11 and 23 percent in 2015, respectively, partly on account of the agreement with the KRG.

- **Non-oil sector growth** accelerated to 10 percent in 2013 due to strong government spending, but contracted by almost 9 percent in 2014 because of the collapse of activity in the areas occupied by ISIS and the contraction of government spending. In 2015, these factors will continue to weigh on the non-oil activity, which also suffered from the recent exchange restrictions in the first half of the year, given the importance of cash transactions for big-ticket items and dependence on imports.

Selected Economic Indicators, 2012–20

	2012 Act.	2013 Act.	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
Real GDP Growth (percent)	13.9	6.6	-2.1	0.5	7.6	8.1	7.6	7.5	7.1
Non-oil real GDP (percent)	15.0	10.2	-8.8	-11.2	2.0	3.0	4.0	5.0	5.0
Fiscal balance (percent of GDP)	4.1	-5.8	-5.3	-17.2	-10.2	-3.2	-1.0	1.1	3.5
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-66.6	-61.8	-59.0	-58.6	-55.6	-55.4
Inflation (eop, y-o-y)	3.6	3.1	1.6	3.0	3.0	3.0	3.0	3.0	3.0
Current account balance (percent of GDP)	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.9	2.2	1.9
Gross international reserves (billion US$)	69.3	77.8	66.7	50.0	41.0	41.3	45.4	52.7	60.2
Oil production (millions bpd)	3.0	3.0	3.1	3.4	3.8	4.3	4.7	5.1	5.5
Oil exports (millions bpd)	2.4	2.4	2.5	3.1	3.3	3.6	3.8	4.1	4.4

Sources: Iraqi authorities; and Fund staff estimates.

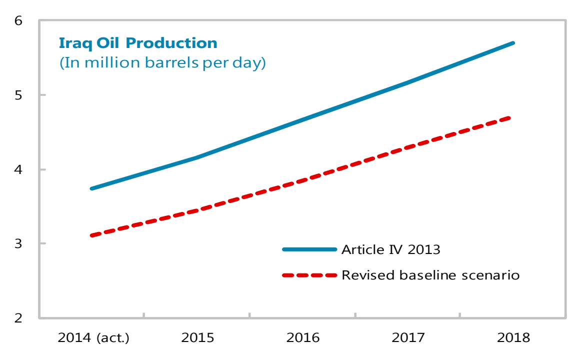
[1] These figures do not include oil production and exports by the KRG for 2013 and most of 2014.

Box 2. Why Oil Production and Exports Have Held Up Despite the Conflict

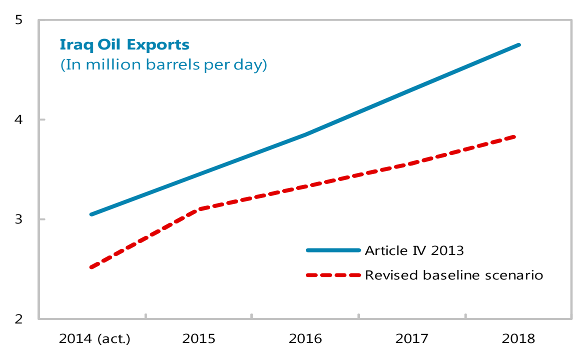
Despite the security challenges, Iraq's oil sector has expanded slightly in 2014 as most of the oil infrastructure is in the south, beyond ISIS' reach. While oil exports in value fell by about 7 percent in 2014 from the previous year, oil production increased by 0.1 million barrels per day (mbpd), supported by the southern fields, which accounted for most of the production (87 percent) and exports (98 percent). In contrast, deteriorating security took a toll on oil sector activities in northern Iraq. The northern Kirkuk-Ceyhan pipeline—the principal export outlet for the Kirkuk oil fields—has been put out of commission indefinitely in March 2014, effectively shutting down oil exports from the Kirkuk fields. As a result, northern Iraq produced 0.40 mbpd oil, 40 percent less than in 2013, and exported just 0.06 mbpd compared to 0.26 mbpd in 2013.

The December 2014 agreement between Baghdad and KRG is opening up northern exports again. The landmark agreement envisages the resumption of the budget transfer from Baghdad to the KRG (equivalent to 17 percent of the federal budget, minus certain central expenditures) in exchange for exports of 0.25 mbpd from the KRG and 0.3 mbpd from the Kirkuk fields, now controlled by the KRG. The northern oil is exported to Ceyhan through a new pipeline in the KRG that bypasses ISIS-controlled territory. But the agreement is vulnerable to continued tensions between Baghdad and Erbil on the balance between budget transfers and oil exports from the north.

The crisis will negatively affect the medium-term outlook for the oil sector. Already this year, International Oil Companies (IOCs) have lowered their investment plans at the request of the Ministry of Oil to reduce pressure on struggling government finances (the government pays back investment and fees to IOCs). Low oil prices also triggered the renegotiation by the federal government of the existing service contracts, which may be modified to link IOCs' profits to oil price levels. Weak oil prices will also make IOCs less inclined to invest in expanding production.



As a consequence, oil production targets are being revised downward. The Iraqi government aimed to increase oil production capacity to over 13 mbpd when it signed service contracts with IOCs during 2009–10. Production targets have been revised downwards repeatedly since then. In line with most market analysts, Fund staff has revised downward medium-term production and exports. Oil production is now seen to reach 4.7 mbpd in 2018 compared to 5.7 mbpd at the time of the 2013 Article IV consultation, and exports have been reduced from 4.75 mbpd to 3.84 mbpd.



Sources: Iraqi authorities; and IMF staff calculations.

Nevertheless, Iraq will remain a big player in the oil market. According to the International Energy Agency, Iraq is still expected to account for the largest individual contribution (40 percent, or 1.07 mbpd) to OPEC's crude oil production capacity growth over 2014–20, albeit lower compared to 61 percent projected a year earlier.

6. **Inflation remains in the low single digits, but is probably underestimated**. In line with weakening domestic demand and world commodity prices, CPI inflation was about 2 percent in 2013–14 and just 0.5 percent at end-April 2015. However, official data do not cover the four ISIS-occupied provinces, where fuel and goods shortages are reportedly pushing prices much higher. Inflation is projected to rise slightly to 3 percent by end-2015 because of continued trade disruptions and the volatility in the parallel market.

7. **Credit growth to the private sector moderated to 5 percent in 2014, likely due to falling business confidence**. Broad money growth slowed to 4 percent (compared to 17 percent in 2013) largely because of the contraction of net foreign assets, but is expected to grow by about 18 percent this year as foreign exchange sales decrease.

External sector conditions deteriorate

8. **Reflecting expansionary fiscal policies in 2013 and the conflict and oil price collapse in 2014–15, Iraq's foreign assets have been declining steeply**. Total foreign assets (including the Development Fund for Iraq (DFI)) declined by $21 billion over 2013–14.[2] In the first five months of 2015, international reserves grew slightly to $68 billion, due to the weak imports by the private sector and government's postponement of imports and some foreign payments. But, the continued weakness of oil prices will push the current account deficit to almost 9 percent of GDP, and reserves are expected to decline to $50 billion by end-year (just below seven months of imports).

9. **Foreign exchange market conditions improved in 2014, but worsened this year following the imposition of new restrictions, which have been since partly lifted**. Steps toward liberalization taken by the CBI in the course of 2013–14 resulted in a decline in the parallel market spread to less than 2 percent in December 2014, despite the security crisis. In January 2015, however, the CBI reduced the volumes of cash currency sales and imposed a 15-day advance deposit requirement for foreign currency transactions. In addition, the government introduced a 5 percent customs duty advance payment and a 3 percent presumptive income tax to be paid at the time of request for foreign exchange to finance imports. In June, because of the negative impact on the parallel market (the spread rose to a record 16 percent) the authorities removed this measure and shortened the advance deposit requirement to five days. As a result, the spread quickly declined to about 6 percent by end-month. As of end-April, the CPI-based real effective exchange rate (measured using the official rate) appreciated by about 16 percent since end-2012, largely because of the strengthening of the U.S. dollar.

[2] The DFI was closed in May 2014, and its balances transferred to the CBI as part of its international reserves. Oil revenues now feed directly into CBI reserves, and a government account at the CBI is credited correspondingly.

The fiscal position weakens

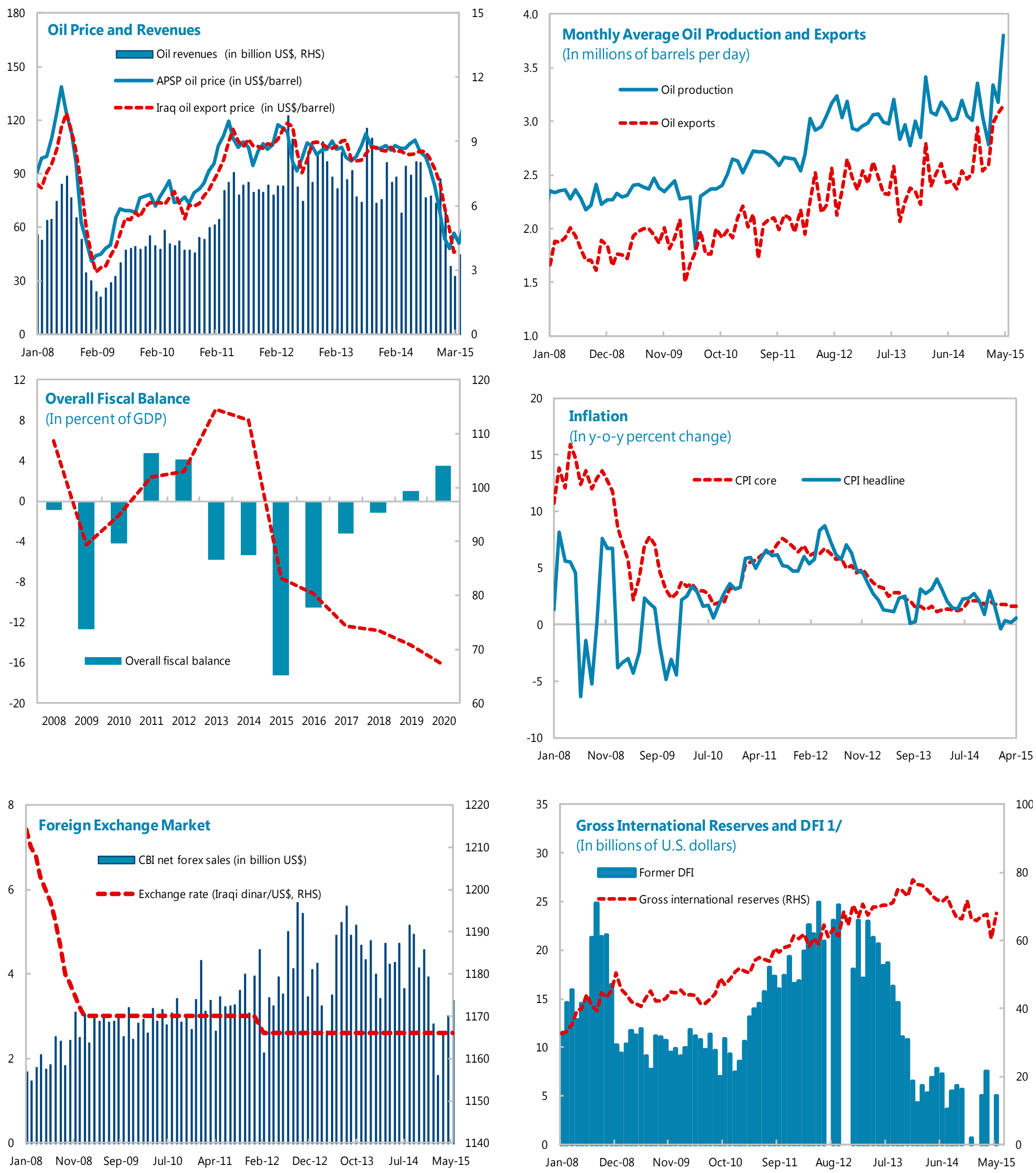
10. **Fiscal performance weakened in 2013–14**. In 2013, when prices were still high, government spending increased strongly, also because of the April 2014 elections, and the government balance moved to a deficit of 5.8 percent of GDP, from a surplus of 4 percent of GDP in 2012 Article IV. In 2014, the fiscal rule triggered by the absence of a parliament-approved budget improved the fiscal position slightly to a deficit of 5 percent of GDP by automatically prorating current spending and postponing new investment projects. In addition, escalation of the disagreement between Baghdad and Erbil over oil revenue sharing led to the suspension of the budget transfer to the autonomous region, delivering savings of about 9 percent of the federal budget. However, limited financing forced the government to accumulate external arrears to the International Oil Companies (IOCs) of $6.8 billion—which were repaid in the first half of 2015—and of ID 2.3 trillion (1 percent of GDP) to domestic contractors.

Implementation of Key Recommendations from the 2013 Article IV Consultation

Recommendation	Status
Ensuring fiscal sustainability and building fiscal buffers to address volatility in oil revenues.	Not done. Assets of the Development Fund of Iraq has been almost fully depleted by end-2014.
Stepping up the liberalization of the foreign exchange market.	Partly done. The authorities have removed a number of exchange restrictions subject to Article VIII, Section 2(a) but continue to maintain a few more.
Continuing the prudent management of reserves held by the Central Bank of Iraq and the Development Fund for Iraq.	Partly done; the CBI is strengthening the management of its reserves.
Deepening the reform of the financial sector, including the creation of a level playing-field for private banks.	Partly done; restructuring of the two large state owned banks has stalled, but recent measures open up government business to private banks.
Accelerating structural reform to promote private sector growth and employment creation.	Not done.

11. **Fiscal pressures are intensifying this year**. Revenues are expected to decline by 21 percent this year due to the full-year effect of the oil price decline. At the same time, government spending cannot be easily compressed in light of large security and humanitarian expenditures. As a result, even with the large adjustment in spending that is underway, the government deficit is expected to rise to 17 percent of GDP.

Figure 1. Iraq: Macroeconomic Indicators



Sources: Iraqi authorities; Bloomberg; and IMF staff calculations.

1/ Starting from May 2014 DFI balances, previously held abroad in an account at the Federal Reserve Bank of New York, were moved to the CBI as a U.S. dollar account, and reflected in gross reserves of the CBI (U.S. dollar balances from oil revenues).

2016: still not out of the woods

12. **In 2016, growth is expected to pick up, but fiscal conditions will continue to be challenging**. Oil production and exports will continue to grow in line with the revised medium term projections. Furthermore, assuming that the conflict with ISIS will start to be resolved in 2016, the non-oil economy is projected to recover by about 2 percent. Total GDP is expected to grow by about 8 percent. The improvement in export revenues will push the trade balance into positive territory and lower the current account deficit to around 7 percent of GDP. Nevertheless, CBI international reserves are still projected to fall to $41 billion by end-year (5.5 months of imports). The government's fiscal position is projected to improve thanks to higher oil revenues and moderating expenditures, but the deficit will still remain high at around 10 percent of GDP.

C. Medium-Term Outlook and Risks

13. **The baseline medium-term outlook is still positive, but hinges on the resolution of the conflict**. Assuming that the conflict with ISIS is resolved starting in 2016–17, the macroeconomic scenario would be driven by the expansion in oil production and non-oil sector growth. Even under much improved security conditions, however, the baseline outlook is significantly less favorable than at the time of the 2013 Article IV report, reflecting lower oil prices and the impact of the conflict:

- **GDP growth** should recover to around 7.5 percent on average during 2016–20, driven by the expansion in oil production, albeit at a slower pace than forecasts before the crisis, as the government's financial difficulties and lower oil prices slow down investment in the sector (see charts in Box 2). Non-oil sector growth is expected to stabilize at about 4 percent on average during 2017–20, about half the pace of 2008–13, supported by structural reforms to diversify the economy, develop the financial sector, and improve the business environment.

- **Inflation** is expected to remain low at 3 percent, reflecting a differential of 1–2 percent over U.S. dollar inflation.

- **The fiscal position** should improve from 2016 thanks to the ramp-up in oil export volumes and continued fiscal discipline, moving to surplus from 2019. Current spending growth is projected to moderate gradually, reflecting the full impact of the measures taken in 2015 and the assumption of zero real growth in other current items. Capital spending would increase gradually in line with growing fiscal space to accommodate Iraq's reconstruction and investment needs.[3]

[3] Security spending is assumed to remain relatively high beyond the end of the ISIS insurgency, partly to reflect reintegration/demobilization costs.

- **International reserves of the CBI** are expected to decline until 2016–17, but should start a rebound in 2018, reaching $60 billion, or 5 months of next year's imports of goods and services, in 2020. In parallel, the current account deficit is expected to improve gradually in line with the fiscal consolidation and the recovery in exports, returning to surplus in 2017, and remaining at about 2 percent of GDP during 2018–20.

14. **The medium-term fiscal path is consistent with intergenerational equity considerations**. Based on the revised outlook, a non-oil primary deficit of no more than 50 percent of non-oil GDP (in line with the 2013 Article IV results) would be needed to ensure adequate saving of oil revenues for future generations, based on a Permanent Income Hypothesis (PIH) framework consistent with the staff's baseline macroeconomic scenario. The projected medium-term fiscal path, which takes into account the social and reconstruction needs of the country, would converge to the PIH-consistent non-oil primary balance by 2023–25.

15. **But, downside risks to the macroeconomic outlook are very high**:

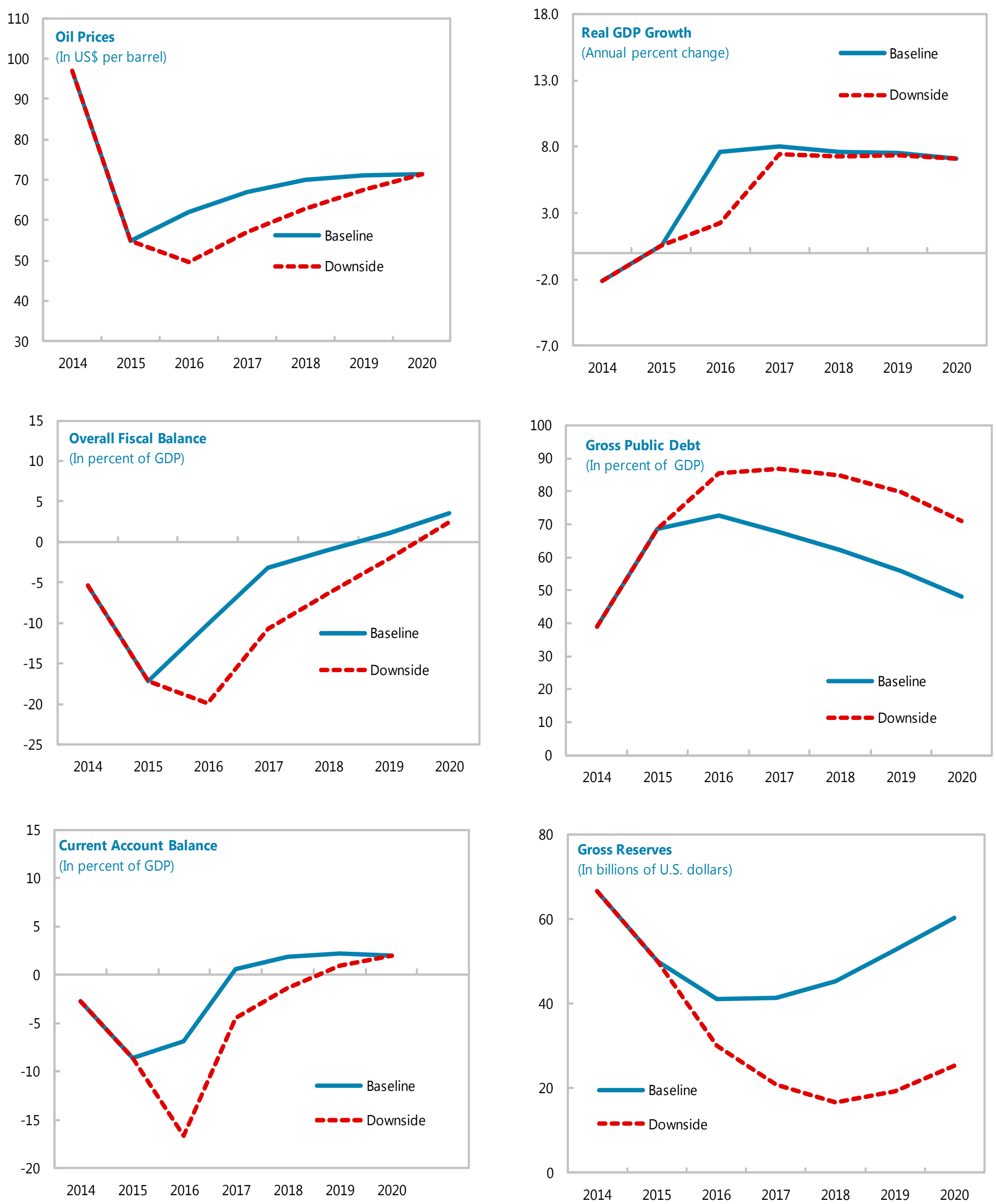
- **Key domestic risks**: The main risk to the outlook is an entrenchment or escalation of the conflict, which could in an extreme case extend to areas currently spared by the violence. In such a scenario, non-oil growth would continue to stagnate or even decline further, while the expansion in oil production would be delayed. In addition, political tensions could rise, threatening the reform effort or undermining the agreement with the KRG over oil revenue sharing, leading to lower oil production. Poor fiscal policy implementation could undermine the government's ability to address the crisis, depress investment in the oil sector, and harm medium-term growth and the economy's resilience to shocks. Finally, the intensification of foreign exchange restrictions could lead to a deterioration of the foreign currency market, with negative impact on the economy.

- **Key external risk**: Oil revenues could be affected by a further decline in oil prices or a weakening of world demand. Possible adverse regional security developments continue to represent a destabilizing factor.

16. **Iraq's undiversified economic structure and high oil dependency exacerbates its vulnerability to a fall in oil prices**. In staff's adverse scenario, a 20 percent decline of oil prices, which would then converge only gradually to the baseline, would cause a significant drop in growth, putting pressure on external and fiscal accounts (Figure 2).

17. **The authorities broadly agreed with staff's macroeconomic outlook, but were more optimistic about oil sector expansion and oil prices**. The authorities shared staff's view that support for growth and containment of risks should come from well-designed fiscal consolidation, improvement in oil revenue management, build-up of fiscal buffers, reform of the banking sector, removal of impediments to business environment, and, overall, reduction of the economy's dependence on the oil sector. They underlined that restoring security will be a precondition to achieve these goals. They thought however that staff was overly cautious on the pace of oil sector expansion, pointing to their plans for large investment in oil production and export infrastructure.

Figure 2. Iraq: Downside Scenario (20 percent lower oil price in 2016) vs. Baseline



Sources: Iraqi authorities; and IMF staff calculations.

ECONOMIC POLICIES TO ADDRESS THE CRISIS

Discussions on policies to address the immediate impact of the crisis focused on: (i) measures to deal with the fiscal crisis in 2015 and put the economy on a sustainable medium-term fiscal path; (ii) the external imbalance and the decline in CBI international reserves; and (iii) threats to financial stability and development of the financial system.

A. Managing the Fiscal Crisis

The authorities are addressing the fiscal pressure through a mix of adjustment and financing. The immediate priorities are introducing consolidation measures and identifying adequate financing sources, relying if needed on indirect financial support from the CBI.

18. **The 2015 budget was designed to address the fiscal pressures from low oil revenues and the conflict**. In the initial draft 2015 budget, the government tried to balance weakening oil revenues with pent-up spending requests from 2014, increasing security and humanitarian needs, and the resumption of the transfer to the KRG. But, after consultations with staff in December 2014, the government withdrew the draft budget from parliamentary discussion to introduce new measures amounting to ID 27 trillion (13 percent of GDP) including taxation on cars, internet, and mobile telephony, a higher custom tariff schedule, and further spending cuts agreed with line ministries. As a result, the final budget approved by Parliament would deliver a deficit of ID 46 trillion (23 percent of GDP) based on staff's oil export and price projections, and taking into account payments to IOCs for 2015 that had not been adequately budgeted.[4]

Fiscal Adjustment in 2015

	No-adjustment Scenario	Approved Budget 1/	RFI Adjustment Scenario
	In trillion of Iraqi Dinars		
Revenue	80.9	82.9	82.9
Oil 2/	72.1	72.1	72.1
Non-oil	8.8	10.8	10.8
Expenditure	154.3	129.4	117.8
o/w savings from fiscal measures			-11.5
Current expenditure	103.7	76.5	74.0
o/w savings from fiscal measures	-	-	-2.5
A. electricity subsidy savings	-	-	-2.5
Capital expenditure	50.6	52.9	43.9
o/w savings from fiscal measures			-9.0
B. investment project cuts	-	-	-9.0
Deficit	73.4	46.5	34.9
	In percent of GDP		
Revenue	39.8	40.8	40.8
Oil 2/	35.5	35.5	35.5
Non-oil	4.3	5.3	5.3
Expenditure	75.9	63.6	57.9
o/w savings from fiscal measures			-5.7
Current expenditure	51.0	37.6	36.4
o/w savings from fiscal measures			-1.2
A. electricity subsidy savings	-	-	-1.2
Capital expenditure	24.9	26.0	21.6
o/w savings from fiscal measures			-4.4
B. investment project cuts	-	-	-4.4
Deficit	36.1	22.9	17.2

Sources: Iraqi authorities; and IMF staff calculations.

1/ Capital spending shown under the Approved budget column includes payments to international oil companies.
2/ Oil revenues are based on Staff assumption on prices and volumes in all three scenarios.

[4] The 2015 budget law approved by Parliament envisaged a deficit of 11.5 percent of GDP.

19. **The government is introducing additional measures amounting to 6 percent of GDP**. The authorities plan to increase soon electricity tariffs (ID 2.5 trillion for 2015), and further rationalize the capital budget (ID 9 trillion) by end-July through a rigorous prioritization process. These measures became necessary partly to compensate for the delayed introduction of the 2015 budget's tax measures and the custom tariff increase to August because of legal and technical issues. As a result, the spending envelope would decline to 58 percent of GDP (a reduction of 4 percentage points of GDP in spending compared to 2014, adjusting for the KRG transfer) and the deficit would fall to 17 percent of GDP.

20. **The authorities stepped up their efforts to identify financing sources**. With fiscal buffers in the DFI almost completely depleted by end-2014, the authorities have to borrow from state-owned banks, which will be supported in turn by the CBI via the discount of government bonds for about 9 percent of GDP in 2015. The authorities intensified their efforts to find other financing sources, including: (i) Fund financing through the drawdown of the SDR allocation and the RFI purchase equivalent to SDR 594.2 million or about $830 million; (ii) Eurobonds planned for $6 billion over two years, with an issuance this year of at least $2 billion, tentatively scheduled for the summer; and (iii) World Bank financing of $350 million in urgent reconstruction financing and a possible Development Policy Loan (for a total of $1–1.5 billion in 2015). Even with these additional sources, total financing would not be sufficient to meet the government needs, leaving a residual gap of about 7 percent of GDP. The government is considering filling the shortfall by tapping the domestic bond market and loans from international partners. Staff inquired whether further reduction in spending, particularly current items such as public sector wages and subsidies (other than electricity) could be undertaken, but the authorities felt that they are already reaching the limits of politically and socially feasible adjustment.

Financing the Budget Deficit, 2015–16

	2015 Proj.	2016 Proj.	2015 Proj.	2016 Proj.
	In trillion Iraqi dinars		*In percent of GDP*	
Financing, *of which:*	34.9	23.5	17.2	10.2
External financing	-9.6	-0.7	-4.7	-0.3
Assets held abroad	0.0	0.0	0.0	0.0
Project financing	0.0	0.5	0.0	0.2
Amortization	-1.7	-1.2	-0.8	-0.5
Arrears	-7.9	0.0	-3.9	0.0
Domestic financing	26.2	2.2	12.9	1.0
SDR Allocation	1.7	0.0	0.8	0.0
Commercial bank loans	1.5	0.0	0.7	0.0
T-bills	26.2	3.0	12.9	1.3
o/w CBI purchases	19.0	0.0	9.3	0.0
Arrears	-2.3	0.0	-1.1	0.0
Amortization	-0.8	-0.8	-0.4	-0.3
Financing gap	18.3	22.0	9.0	9.6
IMF	1.0	0.0	0.5	0.0
World Bank	1.7	0.6	0.9	0.3
Eurobond	2.3	2.3	1.1	1.0
Other unidentified	13.3	19.1	6.5	8.3

Sources: Iraqi authorities; and IMF staff calculations.

21. **Relying on indirect CBI financing is not ideal, but there are no viable alternatives**. In the authorities' views, the CBI's support for the banking sector is a liquidity intervention and as such is allowed by the 2004 CBI law. Staff noted that discounting large volumes of government securities could undermine the CBI's independence and credibility, and weaken the government's incentives to maintain fiscal discipline. However, in the current crisis, the lack of alternative sources of financing makes this option unavoidable given the infeasible level of adjustment in government spending that would otherwise be needed, which would threaten Iraq's delicate social and political balance.

Inflation concerns are limited, because of the overall contraction in government spending, partial leakage through foreign exchange purchases, and current low inflation.

22. **Consolidation efforts should continue in 2016 and beyond**. In 2016, the measures introduced this year will bring savings for about 4 percent of GDP, which, combined with the expected increase in oil revenues and a very gradual increase in capital spending should allow the government to lower the budget deficit to 10 percent of GDP. However, given limited borrowing available from the domestic banking system and no plan for further indirect CBI support, in staff's projections a residual gap of about 8 percent of GDP will remain even counting for World Bank support and Eurobond issuance. The authorities might fill this residual gap with domestic debt issuances or further international borrowing, but should also consider additional fiscal consolidation. In following years, the medium term scenario is predicated on continued fiscal discipline bringing fiscal surpluses starting in 2019.

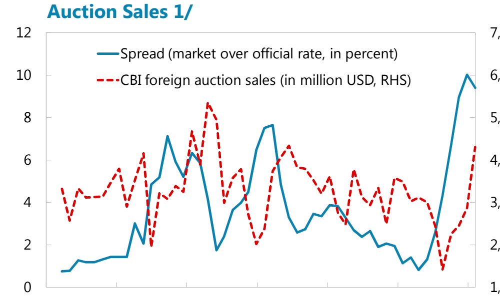
23. **Public debt remains sustainable, but its rapid increase calls for stronger debt management**. Borrowing required to finance the 2015 budget deficit is projected to raise total debt from 39 percent of GDP (of which 10 percent of GDP is domestic debt) in 2014 to 69 percent of GDP (of which 33 percent of GDP is domestic debt) this year, with further domestic borrowing expected for 2016. The DSA shows that risks increase, but also that the debt is sustainable and will decline over time, converging to 48 percent of GDP in 2020. In this context, the authorities should develop a debt management strategy to ensure debt sustainability while minimizing costs and risks of borrowing to the government. The issuance of Eurobonds and, internally, of domestic bonds, would increase debt management capacity, contribute to the development of an efficient government securities market, deepen Iraq's financial system, and reduce the government's reliance on T-bills.

B. Addressing External Pressures

The authorities are appropriately maintaining the exchange rate peg with the dollar despite the worsening of the external position, but the recently introduced restrictive measures increased the spread between the official and parallel market exchange rates.

24. **The authorities are committed to maintain the peg with the US dollar**. The peg has provided a key nominal anchor in a highly uncertain environment with weak policy capacity. The External Balance Assessment (EBA-Lite) suggests that the real effective exchange rate is broadly in line with fundamentals (Annex I). The authorities shared staff's view that accommodating external shocks through more exchange rate flexibility—as opposed to fiscal adjustment—is not advisable as the large proportion of foreign-currency denominated government spending, and the dollarization of the economy (real estate, rents, and vehicles) would limit the scope of import compression and create strong pressures to adjust public sector wages and nominal (monetary) transfers.

Exchange Rate Spread and CBI Foreign Auction Sales 1/



Sources: Central Bank of Iraq; and IMF staff calculations.
1/ Parallel market rate data were not available for Feb. 20, 2015–Apr. 5, 2015.

25. **The restrictive foreign exchange measures helped maintain reserves**. The effective depreciation of the exchange rate and the increase in the parallel market rate contributed to lower demand for foreign exchange this year. As a result, in the first half of the year foreign exchange sales were on average much lower in 2015 than in previous years. However, the uncertainty on the availability of foreign currency also undermined confidence and impacted trade. Nevertheless, the authorities saw this as a useful side-effect of the measures to the extent it avoided pressure on international reserves, which actually increased slightly in the first five months of the year.

CBI Foreign Exchange Sales
(In billions of U.S. dollars)

	2013	2014	2015 1/
Annual			
Cash	11.8	14.5	2.6
Transfers	42.1	37.0	15.8
Total	53.9	51.5	18.3
Monthly average			
Cash	1.0	1.2	0.4
Transfers	3.5	3.1	2.6
Total	4.5	4.3	3.1

Source: Central Bank of Iraq.

1/ For six months.

26. **The level of international reserves still appears adequate** (Annex I). Compared to the 2013 Article IV report, the projected external position is much weaker. Nevertheless, the projected level of international reserves at end-2015 exceeds conventional reserve adequacy indicators, at almost seven months of imports of goods and services and 175 percent of the Fund's reserve adequacy (ARA) metric. Reserves are projected to decline further by end-2016, but they are expected to remain at over five months of imports.

27. **The authorities are adopting a cautious approach to foreign exchange liberalization**. Since the last Article IV consultation, Iraq has removed most of the exchange restrictions previously maintained. However, one new exchange restriction has been identified arising from the weekly limits on cash purchases by financial institutions from the CBI.[5] Furthermore, Iraq continues to maintain a Multiple Currency Practice (MCP), which arises from the absence of a mechanism to ensure that the official exchange rate and the parallel market exchange rate do not deviate by more than two percent (see Informational Annex). The CBI confirmed its intention to remove the remaining exchange restrictions and the MCP, in line with Iraq's objective of accepting Article VIII obligations. The authorities also removed the advance customs duty and income tax payment because of their negative impact on market volatility. They also committed to removing the weekly limits on cash transactions, once external conditions allow. Staff welcomed these steps and recommended that the CBI set the appropriate pace of liberalization on the basis of the volumes of auction sales and the behavior of the spread, which could be a good gauge of depreciation pressures. Staff underlined that AML/CFT concerns should be best addressed through the improvement of the relevant legislative and institutional framework.

[5] In addition, Iraq continues to impose two exchange restrictions identified in 2009 (see Informational Annex).

28. **The CBI plans to centralize the management of international reserves**. Currently, CBI reserves are mainly managed through the Federal Reserve Bank of New York and other central banks. The CBI has as a long-term objective to move management of its reserves back to Baghdad, which will require planning and implementation of concrete steps. Staff supported the CBI's intentions, but recommended to adopt a very gradual approach hinging on the build-up of adequate capacity at the CBI. Furthermore, with technical assistance from the Fund the CBI updated the 2008 guidelines for reserve management to bring them in line with the CBI Law and address quantitatively all key reserve management strategic objectives, such as Strategic Asset Allocation, credit risk limits, or liquidity needs. The next challenge for the CBI will be to effectively implement this new framework.

C. Monitoring Financial Risks

The crisis is putting the banking system under stress, prompting the authorities to increase financial system monitoring and push ahead with the reform of state-owned banks.

29. **The crisis will delay the development of the banking sector**. With end-2014 deposits of 22 percent of GDP and credit to the private sector of 7 percent of GDP, the banking system remains underdeveloped due to lack of competitiveness, dominance of state-owned banks, and limited business opportunities. The largest state-owned banks, Rasheed and Rafidain, which account for 90 percent of banking sector assets, are severely undercapitalized and largely illiquid following years of quasi-fiscal operations. Private banks' activities are mainly limited to trade finance transactions. There is a lack of automated banking systems, reporting practices are not up to International Financial Reporting Standards (IFRS), and audits of financial statements are often of poor quality. Nonperforming loans (NPL) are likely increasing due to the effects of the conflict and the external shock, and data quality remains poor.[6]

Selected Banking Indicators

	2011	2012	2013	2014	Mar-15
Banking assets (in percent of GDP)	66.2	75.1	77.0	86.9	...
State bank assets (in percent of GDP)	60.4	68.2	69.3	78.5	...
Credit to private sector (in percent of GDP)	5.4	5.9	6.4	7.0	...
Credit to private sector (annual growth)	34.6	28.2	15.5	4.5	...
NPL/total loans					
State Owned	1.3	1.0	1.4	1.6	1.5
Private	0.9	0.7	5.3	5.4	6.0
Total	2.3	1.8	6.7	6.9	7.6
Share of NPL (in percent)					
State Owned	41	41	79	78	80
Private	59	59	21	22	20
Deposits in percent of GDP	21.1	18.3	20.1	21.7	...

Source: Central Bank of Iraq.

[6] NPL data should be treated with caution as Iraq does not compile Financial Soundness Indicators (FSI) that are in line with international standards. Upcoming technical assistance in this area from the Statistics Department of the IMF, funded by the UK Department for International Development, will enhance CBI capacity to monitor banking system developments.

30. **The fiscal crisis risks worsening the financial condition of the state-owned banks**. The ballooning financing needs of the government—even though partially alleviated by CBI refinancing—are putting additional stress on the state-owned banks, in particular Rasheed and Rafidain banks. The banks have long suffered from extensive quasi-fiscal operations—such as loans to state owned enterprises to pay employee salaries—and as a result are illiquid and likely insolvent, despite a recent, modest increase in their capital. Furthermore, to allow state-owned banks to provide more liquidity to the government, the CBI recently started allowing all commercial banks to substitute half of their reserve requirement held as liquidity at the CBI with government securities. Staff noted that this measure can be detrimental to banks' liquidity and welcomed the authorities' intentions to reverse it as soon as market liquidity conditions allow.

31. **Mindful of the risks, the CBI is stepping up the monitoring and supervision of the banking sector**. Supervisory coverage is still spotty, with state-owned banks effectively outside the CBI supervision. Resources are limited, and standards are poor. To address these long-standing weaknesses, the CBI continues its collaboration with Ernst and Young (E&Y) to co-train inspectors and support the implementation of the CAMEL system (on-site inspections have already been carried out for 15 out of 50 private banks) and has requested Fund technical assistance to improve supervision regulatory framework and practices. The CBI also hired 35 additional staff in the supervision department. It is promoting the implementation of information technology (IT) core banking system in their operations. The CBI indicated that it would review the reserve requirement measure as soon as conditions allow.

32. **The authorities are committed to accelerate the restructuring of Rasheed and Rafidain banks**. The authorities intend to speed up the restructuring process of these banks, which has been dragging on since the signing of an MOU between the MOF, CBI, and the Board of Supreme Audit in 2006. The MOF and the CBI recently reviewed the implementation of the MOU, assessed the banks' end-2014 financial stance, and set a timetable to fulfill unimplemented items. Staff recommended a more ambitious approach, which could start with an audit of the banks' balance sheets by an international company, to be conducted in parallel to the legal clean-up of legacy losses. Staff underlined that a revision of the draft law on state-owned banks to ensure arms-length relationship between the MOF and bank management would also support state-owned banks.

33. **Money laundering, terrorist financing and governance issues risk undermining the Iraqi financial system** (Box 3). These threats are very high in Iraq, and are compounded by major vulnerabilities of the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework underlined by the 2012 World Bank assessment report adopted by the Middle East and North Africa Financial Action Task Force (MENAFATF).

Box 3. Strengthening the Anti-money Laundering and Combating the Financing of Terrorism (AML/CFT) and Anti-Corruption Frameworks in Iraq

Iraq faces serious corruption, money laundering (ML) and terrorist financing (FT) risks that may undermine the financial system and the wider economy. Surveys suggest that the perception of corruption is very high in Iraq.[1] Furthermore, the operations of ISIS increase the risks of terrorism financing. ISIS relies on funding from a wide range of sources including the appropriation of cash held at state-owned banks, exploitation of oil fields, and extortion of part of salary payments of Iraqi government employees.[2]

The Financial Action Task Force (FATF) identified Iraq as a jurisdiction with AML/CFT strategic deficiencies. In October 2013, Iraq made a high-level political commitment to work with the FATF and MENAFATF to address these weaknesses based on an agreed action plan, but they remain as of the FATF June 2015 assessment. Due to lack of sufficient progress in improving its AML/CFT regime, Iraq might be subject to countermeasures that could impede its access to global financial markets.

The AML/CFT measures laid out in the action plan are powerful tools in addressing corruption[3] and limiting the ML/FT risks, and will allow Iraq to exit the FATF listing. In light of the security and capacity constraints and the volatile political situation, a risk-based approach to the implementation of these measures would assist in mitigating the main ML/FT risks. The priority is to adopt the draft AML/CFT law—now under consideration by parliament—to bring it in line with the revised standards and allocate resources for its effective implementation. It is also important to develop an AML/CFT comprehensive national strategy and strengthen the existing key stakeholders—including the financial intelligence unit and the CBI AML supervision (including banks having branches under ISIS control). Moreover, targeted financial sanctions in line with the United Nations Security Council resolutions should be used to prevent and suppress terrorism and terrorist financing.

Anti-corruption measures could also be stepped up to improve governance. Measures could include adopting an anticorruption strategy, strengthening the asset declaration regime, and enhancing the transparency of the procurement system.

1/ http://www.transparency.org/country/#IRQ, see Figure 3.

2/ http://www.fatf-gafi.org/topics/methodsandtrends/documents/financing-of-terrorist-organisation-isil.html

3/ The link between AML and anti-corruption has been acknowledged and supported by the G8, the G20, and the General Assembly of the United Nations. See also Financial Action Task Force (2012).

STRUCTURAL REFORM FOR DIVERSIFIED, INCLUSIVE GROWTH

Beyond the emergency, discussions focused also on the actions needed to diversify Iraq's revenues, streamline government spending, and strengthen the management of oil revenues through better public financial management (PFM) and a stronger architecture for buffers. More broadly, Iraq needs to reduce its dependency on oil by promoting private non-oil sector activity, and make growth more inclusive by reducing the scope of public sector employment and improving labor market mechanisms. While this ambitious reform plan will be difficult to implement in the current challenging circumstances, the discussions provided clarity on prioritization and the medium-term reform path.

A. Stronger Institutions to Support Fiscal Discipline and Oil Revenue Management

34. **Weak policy implementation underlines the need to strengthen the fiscal framework**. The impact of the oil price shock highlights the fiscal dependency on oil, while the 2013 government spending boom undermined the capacity to react to the 2014 shocks by ratcheting up expenditures, depleting fiscal buffers and making it more difficult to downsize spending when needed. This experience points to the need for:

- **Introducing non-oil taxation to diversify revenue sources (medium term)**: The non-oil revenue measures undertaken in the context of the 2015 budget, while bringing small yields, are an important first step to strengthen revenue collection. The MOF should build on these measures and consider the introduction of broader-based, simple revenue instruments such as: (i) excises on big-ticket items, such as cars; (ii) a low-rate General Sales Tax (GST), less efficient but simpler to administer than a Value Added Tax; (iii) property tax, e.g., on real estate; (iv) consolidation of stamp taxes and fees (most of these have not been changed in nominal terms and are essentially now "nuisance taxes").

- **Streamlining government spending to improve service delivery (short/medium term)**. The World Bank's 2014 Public Expenditure Review pointed to areas that can generate savings and improve the quality of government spending, such as (i) review of public employment and ghost workers; (ii) reduction of subsidies, in particular in the energy sector and the Public Distribution System (Box and Selected Issues Paper); and (iii) rationalization and prioritization of public investment. The authorities have started work in some of these areas, e.g., by reviewing ghost military personnel and prioritizing investment projects.

Box 4. Subsidy Systems in Iraq

Subsidies in Iraq are concentrated in food, fuel, and electricity. The authorities have raised fuel prices in the past and made some progress reforming food subsidies (the Public Distribution System-PDS), and are now planning to revise electricity tariffs. However, there is further room to streamline subsidies to make them better targeted, more efficient, and less costly—but reform remains politically difficult. While reforming the PDS would help improve governance and targeting of the poor, most savings would come from eliminating energy subsidies, which cost the government ID 33 trillion in 2013 (over 12 percent of GDP). But any reform would have to be accompanied by a broad improvement of social safety nets to alleviate the impact on the poor.

Food subsidies (PDS). The PDS is an in-kind ration card system through which the government provides a list of subsidized commodities to almost one-fifth of the population. The basket included flour, wheat, sugar, vegetables, and children's milk prior to the ISIS insurgency, but the conflict has affected the efficiency of the distribution system, with only wheat—the most subsidized item—reportedly now available. Most commodities are imported and subject to administered prices determined by the Ministry of Agriculture and Cabinet. The government to some extent restricted eligibility in recent years, but the cost of the PDS still stood at 1.8 percent of GDP in 2014. The government previously attempted to replace the PDS with a cash transfer system, but widespread protests forced it to abandon the reform. Better targeting could yield large savings: for example, excluding one-fifth of those currently eligible (an assumption to proxy high-income quintiles in the absence of income distribution data) would bring savings of around 0.5 percent of GDP. Improvement in procurement timing could also save on import costs.

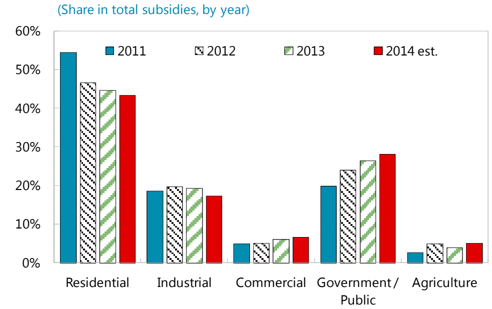
Fuel subsidies. Fuel prices at the pump in Iraq are low compared to other countries in the region, but are relatively high compared to other oil exporters. Gasoline is the most heavily subsidized given that the government must import large quantities at a price not covered by pump prices. The structure of fuel subsidies is complex, spanning the entire chain of production, refinery, and distribution phases. According to the Ministry of Oil, direct costs of energy subsidies for fuel products are roughly ID 5 trillion a year (2.5 percent of GDP). Raising pump prices would bring large savings: an increase of fuel prices to 80 percent of import price would deliver ID 5 trillion (2.5 percent of GDP) in savings. A more comprehensive reform plan could identify structural deficiencies, restructure some companies, and revisit pricing along the energy chain.

Pump Price of Energy Products in Iraq

Diesel	ID 400 / Liter	[$ 0.343]
Kerosene	ID 150 / Liter	[$ 0.129]
Gasoline	ID 450 / Liter	[$ 0.386]

Electricity subsidies. A system of subsidies and cross subsidies governs the sector, benefiting mostly households and the government (pricing is progressive). Subsidization contributes to problems such as limited service hours due to technical losses in distribution, high import content, rigidities in structure of production costs, and intra-agency debts. These factors partly explain the rampant nonpayment by the public, which in turn increases the government electricity subsidy bill, estimated at roughly ID 10 Trillion (5 percent of GDP). The authorities will soon introduce a new, more progressive tariff structure, with much higher rates levied on top end consumers which is estimated to bring savings of ID 5–7 trillion (3–4 percent of GDP). The reform is expected to have minimal effect on lifeline consumption and overall limited social impact as assessed by a distributional analysis prepared by the World Bank, even though the results may be affected by limited data availability. In addition, with World Bank support, the government is implementing a Social Protection Strategic Framework which strengthens social safety nets in parallel to subsidy reform.

Electricity Subsidies by Sector
(Share in total subsidies, by year)



Sources: Iraqi authorities; and IMF staff calculations.

- **Strengthening PFM to contain spending pressures and increase resilience of the economy (short term)**: A weak PFM framework has resulted in lack of fiscal discipline and overly politicized allocation of oil resources. With technical assistance from the Fund and other partners, the government should pursue priority PFM reforms, such as: a stronger role of the MOF in managing the budget process; GFS-consistent budget classification; preparation of monthly cash-flow projections in coordination with the CBI; reconciliation of government financial flows and stocks; establishment of a Treasury Single Account (TSA); and a simple and robust integrated financial management information system (IFMIS).

- **Restoring the DFI architecture to support fiscal buffers accumulation (medium term)**: The fact that central bank resources are being tapped only in an extreme situation bears witness to the robustness of the overall architecture. Staff recommended maintaining the legal framework establishing the independence of the central bank, and, in parallel, restoring a government-owned, CBI-managed DFI when the fiscal situation allows for the reconstitution of fiscal buffers.

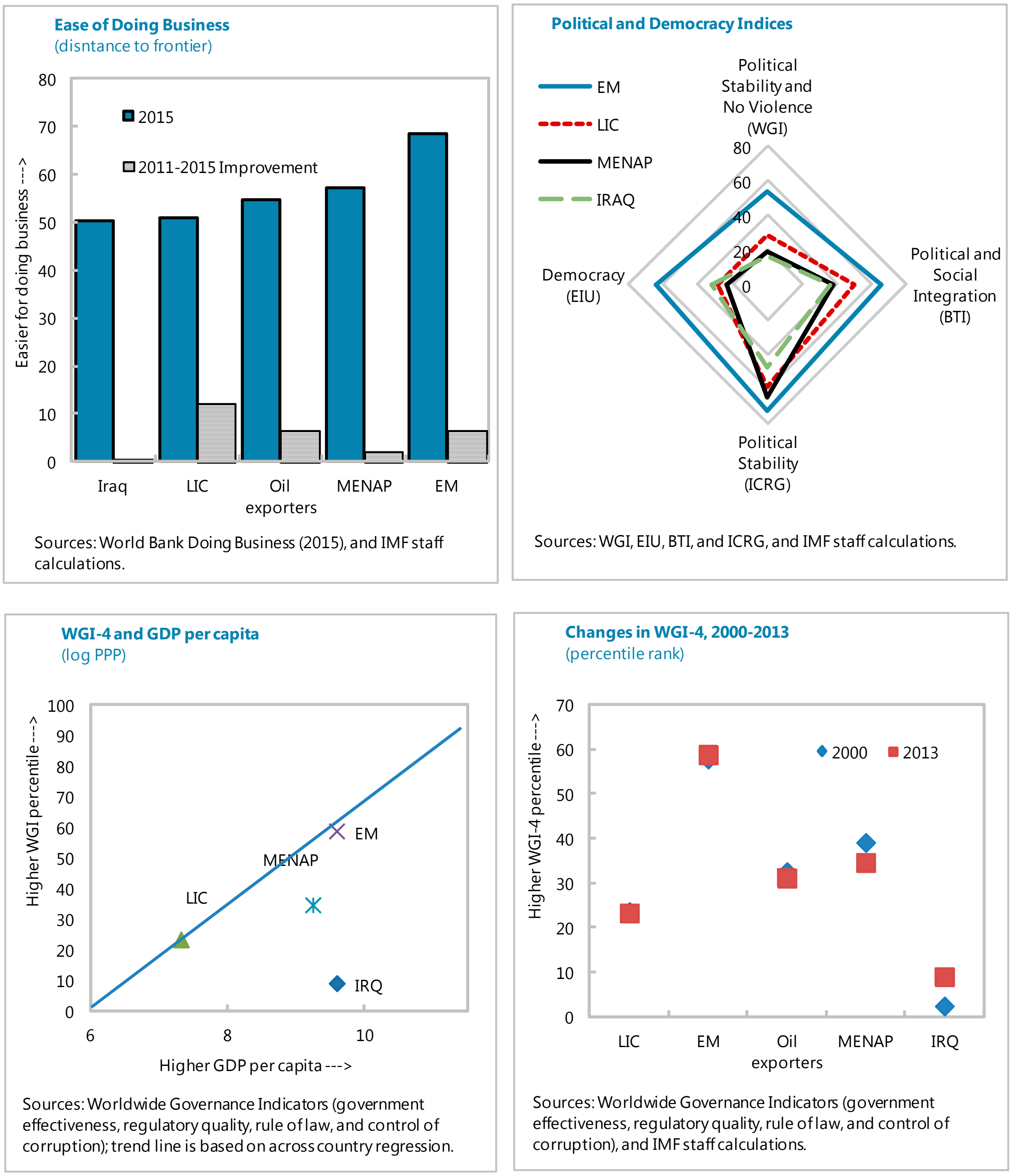
B. A Diversified Economy and a Bigger Role for the Private Sector

35. **Iraq's transition to a market economy is incomplete**. Iraq still presents elements of a transition economy, such as a financial sector dominated by large state-owned banks, pervasive state-owned enterprises (SOEs), and a business environment not conducive to growth. Staff and the authorities agreed on the need to improve on these areas:

- **Leveling the playing field for private banks and strengthening financial infrastructure (short/medium term)**: The restrictions placed on private banks in obtaining government business have put them at a huge disadvantage compared to state-owned banks. The authorities are taking steps to address this issue. Public entities can now accept letters of guarantees and certified checks issued by private banks. The Ministry of Finance is allowed to open letters of credit with private banks up to $10 million ($6 million previously). The threshold to collect state fees by private banks has been increased, and the government is now allowing SOEs to open accounts, make deposits, and pay salaries through private banks, which could however weaken the governance of SOEs and the Ministry of Finance's control over their liquidity. Moreover, the CBI is finalizing regulations to introduce a credit bureau with the assistance of the United States Agency for International Development (USAID), and is considering establishing a deposit insurance scheme. Staff welcomed these steps and noted that the deposit insurance scheme needs to be carefully designed, following best practice, to ensure adequate capitalization and minimize contingent fiscal liabilities.

- **Reforming SOEs (medium term)**: 176 SOEs employing more than 500,000 workers, of which most are inefficient and loss-making, are burdening the public sector. The authorities have prepared a study on their reform, envisaging a systematic cost-benefit assessment of each enterprise with the objective of deciding towards closure, privatization, or maintaining state ownership after proper restructuring. Success of this reform will depend on a rigorous, depoliticized assessment of SOEs including the application of strict, transparent criteria based on international accounting standards. Realistic, but relatively rapid timelines and tight budgets would also be needed to keep to a minimum pre-privatization preparations, including restructuring and recapitalization, and the use of public resources.

Figure 3. Iraq: Business Environment and Governance Indicators



- **Improving the business environment (medium term)**. Iraq does not do well on a number of international indicators which point to the difficulties faced by the private sector (Figure 3). The country ranks 156th out of 189 in the 2015 World Bank cross-country ranking of doing business, down from 151st position in 2014. It ranks particularly low in starting a business, access to credit, trading across borders, enforcement of contracts, and resolving insolvency. The procedures and cost of land registration and constructions permits need to be streamlined. Road networks, communication, and other infrastructure, and particularly production and distribution of electricity should undergo major upgrading. Lastly, Iraq suffers from poor governance in the public sector, and weak rule of law and judicial systems which also hinder the implementation of effective anti-corruption frameworks.

C. More Inclusive Growth

36. **Despite high GDP growth in past years, Iraq has yet to achieve sustainable and inclusive growth**. Job creation has been weak, averaging around 1 percent a year as the oil sector—the main driver of growth—is a capital intensive industry and hence absorbs only about 1 percent of the labor force. At end-2014, the unemployment rate was 11 percent in 2014, and is particularly high among the youth (20 percent) and women (21 percent).[7] Female participation in the labor force, at only 13 percent, is particularly low by international and regional standards. Aggregate labor market indicators mask large geographical disparities, with unemployment of up to 20 percent in some provinces.

37. **Even prior to the conflict, poverty was still relatively high, and most likely it has been rising, especially because of the large refugee population**. The headcount poverty rate declined from 23.6 percent in 2007 to 19.8 percent in 2012, a relatively small gain compared to the cumulative increase in non-oil GDP (50 percent) over the same period, before rising to 23 percent at end-2014. Furthermore, poverty is concentrated in rural areas where it was on average 30 percent at end-2013. The poor suffer from severe shortages of electricity and housing, their school enrollment is low and they have limited access to water and sanitation. Iraq's poor social conditions are reflected in its 120th place in the 2013 Human Development Index. Shortfalls in inclusive growth point to the need for:

- **Creating the conditions to compensate a shrinking role of the government in creating jobs (medium term)**. About 50 percent of the working population is employed by the public sector. But, given its increasingly tight budget constraints, the government will be able to take in much fewer entrants to the labor market, and will have to reduce the generous pay structure in the public sector which has increased the reservation wage and crowded out private employment.

[7] 2014 data exclude the conflict-affected areas. While data are not available, the conflict may have had mixed effects on unemployment. The large number of IDPs may increase unemployment but the increase in security forces may have had the opposite effect.

While economic diversification and non-oil private sector growth will be important, job creation will also require reforms in labor legislation and vocational and education systems with a view to increasing labor force flexibility, creating better working conditions, enhancing protection for private jobs, and matching the skills of the labor force with market demand.

- **Improving social safety nets (short/medium term)**. Iraq will have to start moving away from public sector employment and universal subsidy systems as the main social support for the poor, in favor of supporting private sector-led growth and developing more targeted social safety nets. The authorities are strengthening the social safety nets with the support of the World Bank.

PURCHASE UNDER THE RAPID FINANCING INSTRUMENT

38. **Iraq is facing present and urgent balance of payment and budget needs in 2015**. Under the baseline, which reflects the authorities' adjustment efforts and access to external financing including from the Fund, the ISIS insurgency and a collapse in oil prices are creating a balance of payments deficit, leading to a decline of oil export revenues by 28 percent, budget revenues by 21 percent, and international reserves by 25 percent compared to 2014.

39. **The Iraqi authorities requested Fund financing under the RFI for 50 percent of quota**. Fund financing under the RFI would help address the budgetary impact of the ISIS insurgency and the decline in oil prices. The RFI is designed to assist member countries that face a present and urgent balance of payments need without having an upper-credit tranche quality economic program in place. Therefore, it is appropriate to provide urgent financing to Iraq, which is not in a position to undertake upper credit tranche conditionality at the present time because of limited policy implementation capacity. The purchase of 50 percent of quota (equivalent to SDR 594.2 million, about $839 million) would partly finance the budget, reflecting the fiscal component of the balance of payments need and the need to support central bank independence. Fund financing to the budget—and the borrowing from the markets and international financial institutions that it would facilitate—would smooth the required fiscal adjustment over time and help preserve the independence of the central bank by reducing recourse to indirect central bank financing of the budget. To safeguard Fund resources, a Memorandum of Understanding will be signed between the CBI and the Ministry of Finance, establishing the responsibilities and procedures related to the use of resources provided under the RFI for support of the government of Iraq.[8]

[8] In light of the nature of Iraq's balance of payments problems, the resources provided under the 2010 Stand-By arrangement were also intended for budget support and are being regularly repaid to the Fund.

40. **As described in the Letter of Intent, the purchase under the RFI would help support a comprehensive set of policies, composed of three elements**:

- **Fiscal adjustment**: The measures undertaken and planned by the authorities would contain the deficit already this year. Assuming the full-year impact of some of these measures (e.g., electricity tariff increases, a *prior action*), further rationalizing of the investment budget and deepening of other reforms starting next year, the fiscal position would return to a sustainable path, with decreasing deficits in 2016–18 and a small surplus in 2019.

- **Financing**: Stepped-up engagement with the Fund through RFI financing may facilitate lending from the World Bank and reassure investors, thereby increasing the likelihood of a successful Eurobond issuance. The existence of a residual financing shortfall after taking into account these potential financing sources is consistent with the RFI, which is not a Fund arrangement and as such does not require full financing for the program period.

- **Structural reform**: The authorities see the crisis as an opportunity to lay the ground for a structural reform plan to improve fiscal management, gradually liberalize the foreign exchange market, strengthen the financial system, and diversify the economy.

41. **The authorities are aware of the risks to CBI independence arising from its indirect financial support to the government**. To limit the negative effects on the credibility of the CBI and the exchange rate peg, the authorities commit to draft MOUs to formalize the financial transactions between the MOF and the commercial banks, and between the banks and the CBI, which will lay out the terms and modalities of the operation (*prior action*). In the attached Letter of Intent, the authorities also set a cap of ID 19 trillion to CBI liquidity operations in 2015.

42. **Iraq is expected to be able to repay its obligations to the Fund**. With the proposed purchase, and including the outstanding purchases of the 2010 SBA, the Fund's exposure to Iraq in 2015 will reach $0.9 billion or 1.8 percent of gross international reserves and 1.4 percent of total external debt. Iraq's debt profile will increase mainly due to large domestic borrowing, including related to indirect CBI financing, this year and especially in 2016. Projected medium-term external debt is also higher than in the 2013 Article IV baseline because of the conservative assumption that non-Paris Club debt will not be restructured before 2020, despite the authorities' best efforts to reach an agreement with the non-Paris Club creditors to whom Iraq has incurred sovereign arrears (such debt restructuring operations will be reflected when concluded). The steep increase in debt in 2015–16 and the downside risks in the economic scenario underline the potential debt vulnerabilities. Nevertheless, Iraq's debt is expected to remain sustainable over the medium-term.

43. **The authorities' 2015 adjustment program is subject to a number of risks**:

- **Worsening of the security situation**: A serious military setback could weaken the authorities' economic management and raise social and political tensions, making economic reform even more challenging.

- **Further fall in oil prices**: Given high volatility since last summer, prices could still slide further from current levels during 2015, with adverse consequences for exports and budget revenues.

- **Weak implementation of the program**: The introduction of fiscal measures under the program, most of which are politically and socially sensitive, might proceed more slowly than envisaged. Adoption of a forward-looking framework agreed with staff, ideally under a Staff Monitored Program (SMP), would mitigate this risk.

44. **As Iraq is requesting access under the RFI, the authorities commit to undertake an update Safeguards Assessment in the Letter of Intent**. The most recent assessment of the CBI was completed in 2010. The CBI continues to maintain important safeguards, including the annual external audit by a reputable audit firm and publication of the CBI's audited financial statement. Given the logistical and technical complications of carrying out the Assessment, preparations will start as soon as possible.

STAFF APPRAISAL

45. **Iraq is facing a double shock arising from the ISIS insurgency and the sharp drop in global oil prices**. The shocks are putting the economy under extreme stress and are undermining the authorities' capacity to respond.

46. **The policies put in place by the authorities to deal with the shocks are in the right direction**. In the fiscal area, the authorities are addressing the fall in revenues with a mix of fiscal adjustment and financing to smooth consumption and dampen the impact on the economy. In the external area, the authorities are appropriately maintaining the peg with the U.S. dollar, which provides a key anchor to the economy.

47. **But, risks are very high**. The main risk derives from the stagnation or extension of the conflict. But the outlook is also vulnerable to political tensions, poor policy implementation, and further oil market shocks. To mitigate these risks, staff recommends implementing policies rigorously and front-loading priority reforms to the extent possible.

48. **The 2015 budget represents a sound initial effort to address the pressure from lower oil revenues and higher humanitarian and security spending**. Staff welcomes the introduction of new revenue measures, which should however be implemented swiftly and rigorously. The composition of the fiscal effort is not ideal, as much of the adjustment will come from capital spending rather than current items.

49. **But, insufficient financing will likely require further consolidation**. Even with indirect support from the CBI and financing from the Fund, the World Bank, and the markets, a large residual financing shortfall remains. While it may be possible to obtain more borrowing from domestic and external sources, the authorities may have to consider further fiscal measures to close the gap. The authorities should however avoid the buildup of domestic or external arrears.

50. **Some indirect central bank financing of the government is necessary at this juncture**. As other sources of financing are not immediately available, staff considers the indirect recourse to central bank borrowing—subject to a well-defined limit—as appropriate because domestic adjustment is right now already at its limits. Staff welcomes the cap to CBI support and the authorities' intention to transparently formalize the financial relations between the government, the CBI, and the state-owned banks.

51. **The fixed exchange rate should be supported by the satisfaction of all bona fide demand for foreign currency for current international transactions**. Staff agrees with the authorities' commitment to maintaining the peg. International reserves are at an adequate level and can absorb the projected decline in oil export revenues if the needed fiscal adjustment takes place. Staff welcomes the recent elimination of the advance custom duty and income tax payment applied to foreign exchange transactions and urges the authorities to meet all bona fide demand for foreign currency for current international transactions. The authorities should also strive to minimize volatility in the parallel market to avoid undermining the credibility of the CBI and of the exchange rate regime, and negatively affect Iraq's import-dependent, dollarized economy. Staff does not recommend approval of the three exchange restrictions and the MCP described in paragraph 27 and the Informational Annex, since the authorities have no timetable to remove such measures.

52. **The crisis is increasing tensions in the banking system**. In light of the crisis' impact on private banks and the role of state-owned banks in financing the government, staff welcomes the steps taken by the CBI to strengthen banking supervision and the authorities' commitment to press ahead with the restructuring of Rasheed and Rafidain banks.

53. **The authorities should bring the AML/CFT and anti-corruption frameworks in line with international standards and effectively implement them**. This would prevent illicit financial flows in the financial sector, disrupt the financing of terrorist groups, and enhance the business climate. Making progress in the AML/CFT area—first of all by adopting the draft law under examination by parliament—is also crucial to address the listing of Iraq as a jurisdiction with strategic AML/CFT deficiencies by the Financial Action Task Force.

54. **Staff welcomes the authorities' commitment to maintain momentum on the restructuring of the economy**. The authorities are aware that broad structural reform is needed to improve the resilience and inclusiveness of economic growth. Key elements include strengthening fiscal institutions to support continued consolidation and insulate the economy from shocks; completing the transition to a market economy by pushing ahead with the private banking sector development and SOE restructuring; and improving the business environment, governance, and labor markets institutions. Most of these reforms can be realistically be put in place only in the medium term, but staff urges the authorities to press ahead with the high-priority measures, particularly in the PFM area.

55. **Work on improving the quality and availability of economic data should continue**. Statistics, in particular in the fiscal and balance of payment areas, has serious shortcomings that significantly hamper surveillance. The IMF stands ready to provide further technical assistance in this area.

56. **Staff supports the authorities' request for an RFI with access equivalent to SDR 594.2 million (50 percent of quota)**. The policies laid out in the LOI are adequate to deal with the present and urgent balance of payments and budget needs triggered by the ISIS insurgency and the collapse in oil prices. In the future, staff recommends adopting a forward-looking framework, ideally under an SMP, to be monitored jointly with the authorities, which would help facilitate implementation of the adjustment strategy and allow for building a track record of sound policies. Such framework may be particularly important in light of the persistence of the external financing need at least through 2016 and the large downside risks.

57. **It is proposed that the next Article IV consultation take place on the standard 12-month cycle**.

Table 1. Iraq: Selected Economic and Financial Indicators, 2012–20

(Quota: SDR 1,188.4 million / 0.5 percent of total)
(Population: 33.4 million; 2013)
(Poverty rate: 23 percent, 2014)
(Main export: Crude oil)

	2012 Actual	2013 Actual	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
Economic growth and prices									
Real GDP (percentage change)	13.9	6.6	-2.1	0.5	7.6	8.1	7.6	7.5	7.1
Non-oil real GDP (percentage change)	15.0	10.2	-8.8	-11.2	2.0	3.0	4.0	5.0	5.0
GDP deflator (percentage change)	2.7	0.1	-1.8	-22.4	5.1	3.6	2.6	1.7	1.3
GDP per capita (US$)	6,693	6,957	6,520	4,960	5,470	5,971	6,421	6,843	7,241
GDP (in US$ billion)	218.0	232.5	223.5	174.4	197.3	220.9	243.7	266.4	289.1
Oil production (mbpd) 1/	3.0	3.0	3.1	3.4	3.8	4.3	4.7	5.1	5.5
Oil exports (mbpd) 2/	2.4	2.4	2.5	3.1	3.3	3.6	3.8	4.1	4.4
Iraq oil export prices (US$ pb)	106.7	102.9	97.0	54.7	62.0	67.1	69.9	71.0	71.5
Consumer price inflation (percentage change; end of period)	3.6	3.1	1.6	3.0	3.0	3.0	3.0	3.0	3.0
Consumer price inflation (percentage change; average)	6.1	1.9	2.2	2.1	3.0	3.0	3.0	3.0	3.0
				(In percent of GDP)					
National Accounts									
Gross domestic investment	22.1	27.0	26.1	29.8	27.3	25.8	26.0	25.2	25.9
Of which: public	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Gross domestic consumption	69.4	69.5	74.7	78.5	77.1	73.3	72.0	72.6	72.3
Of which: public	20.7	21.2	19.0	25.9	23.1	21.3	20.2	19.4	18.7
Gross national savings	28.8	28.3	23.3	21.3	20.4	26.4	27.9	27.4	27.8
Of which: public	17.9	11.6	13.7	4.7	9.7	15.7	18.4	19.9	22.9
Saving - Investment balance	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.9	2.2	1.9
				(In percent of GDP, unless otherwise indicated)					
Public Finance									
Government revenue and grants	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Government oil revenue	43.4	39.0	37.8	35.9	38.7	40.0	40.7	40.6	42.4
Government non-oil revenue	4.0	3.6	2.3	4.8	4.6	4.4	4.3	4.2	4.2
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure, *of which:*	42.9	48.4	45.4	57.9	53.5	47.5	46.0	43.7	43.1
Current expenditure	29.7	30.9	26.4	36.4	33.9	28.9	27.0	25.4	24.0
Capital expenditure	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Primary fiscal balance	4.5	-5.5	-5.0	-16.2	-8.9	-1.2	0.8	2.8	5.0
Overall fiscal balance (including grants)	4.1	-5.8	-5.3	-17.2	-10.2	-3.2	-1.0	1.1	3.5
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-66.6	-61.8	-59.0	-58.6	-55.6	-55.4
Memorandum items:									
Tax revenue/non-oil GDP (in percent)	2.1	2.0	1.8	3.6	3.8	3.8	3.8	3.8	3.8
Development Fund of Iraq/MoF US$ account (in US$ billions) 3/	18.1	6.5	0.9	1.0	1.0	1.0	1.0	1.0	6.8
Total government debt (in percent of GDP)	34.7	31.9	38.9	68.5	72.6	67.6	62.3	55.9	48.0
Total government debt (in US$ billion)	75.7	74.3	87.0	119.5	143.2	149.4	151.8	149.0	138.7
External government debt (in percent of GDP)	27.7	25.5	28.8	36.5	35.0	30.8	26.5	22.8	19.8
External government debt (in US$ billion)	60.3	59.2	64.3	63.7	69.1	68.0	64.5	60.7	57.4
				(In percent, unless otherwise indicated)					
Monetary indicators									
Growth in reserve money	8.3	12.6	-9.6	-1.0	-6.5	10.0	10.0	10.0	10.1
Growth in broad money	3.4	16.7	3.6	17.5	8.7	13.5	12.7	11.1	10.3
Policy interest rate (end of period)	6.0	6.0	6.0	…	…	…	…	…	…
				(In percent of GDP, unless otherwise indicated)					
External sector									
Current account	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.9	2.2	1.9
Trade balance	14.3	9.5	6.6	-1.3	2.6	7.1	8.2	8.4	8.4
Exports of goods	43.2	38.5	37.4	35.6	38.3	39.6	40.4	40.2	42.1
Imports of goods	-28.9	-29.0	-30.9	-36.9	-35.8	-32.6	-32.2	-31.9	-33.7
Overall external balance	4.4	-1.3	-7.6	-13.3	-7.9	0.1	1.7	2.8	2.6
Gross reserves (in US$ billion) 4/	69.3	77.8	66.7	50.0	41.0	41.3	45.4	52.7	60.2
In months of imports of goods and services	9.8	10.4	9.9	6.8	5.5	5.1	5.1	5.2	5.2
Exchange rate (dinar per US$; period average)	1,166	1,166	1,166	…	…	…	…	…	…
Real effective exchange rate (percent change, end of period) 5/	-1.7	6.5	4.6	…	…	…	…	…	…

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

1/ Does not reflect KRG production during 2013 and 2014.

2/ Reflects KRG exports through State Organization for Marketing Oil (SOMO).

3/ Reflects the balances of the Development Fund of Iraq which were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

4/ Starting 2014 includes US$ account balances from oil revenues.

5/ Positive means appreciation.

Table 2. Iraq: Central Government Fiscal Accounts, 2012–20
(In trillions of ID; unless otherwise indicated)

	2012 Actual	2013 Actual	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
Revenues and grants	119.4	115.4	104.4	82.9	99.6	114.3	127.9	139.1	157.3
Revenues	119.4	115.4	104.4	82.9	99.6	114.3	127.9	139.1	157.3
Crude oil export revenues	109.4	104.1	97.1	72.1	87.8	101.6	114.2	124.3	141.2
Grants	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	109.0	131.2	118.2	117.8	123.1	122.5	130.8	135.8	145.4
Current expenditures	75.5	83.7	68.8	74.0	77.9	74.5	76.6	78.8	81.0
Salary and pension	34.9	41.1	40.3	41.3	41.8	43.0	44.3	45.6	47.0
Salary	28.5	32.5	31.8	32.6	33.0	34.0	35.0	36.0	37.1
Pension	6.4	8.6	8.4	8.7	8.8	9.0	9.3	9.6	9.9
Goods and services	17.5	16.3	9.1	11.4	11.4	11.7	13.1	14.5	15.9
Transfers	16.3	20.0	13.8	19.3	16.4	14.7	14.0	13.5	13.0
Social safety net (including PDS)	6.7	7.6	7.6	8.0	8.0	8.2	8.5	8.7	9.0
Transfers to SOEs 1/	2.9	1.9	1.5	1.5	1.5	1.5	1.4	1.4	1.3
Other transfers	6.7	10.5	4.8	9.9	7.0	5.0	4.2	3.4	2.7
Interest payments	1.0	1.0	0.7	2.0	3.0	5.0	5.2	5.2	5.0
War reparations 2/	5.5	5.2	4.9	0.0	5.4	0.0	0.0	0.0	0.0
Contingency	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Investment expenditures	33.6	47.6	49.4	43.9	45.2	48.0	54.2	57.0	64.4
Balance (including grants)	10.4	-15.8	-13.8	-34.9	-23.5	-8.1	-2.9	3.3	11.9
Balance (excluding grants)	10.4	-15.9	-13.8	-34.9	-23.5	-8.1	-2.9	3.3	11.9
Statistical discrepancy	-1.1	-0.7	0.8	...	...	...	...	...	...
Financing, *of which:*	-9.3	16.6	13.1	34.9	23.5	8.1	2.9	-3.3	-11.9
External financing	-3.6	12.4	5.5	-9.6	-0.7	-0.4	-3.8	-4.5	-3.8
Assets held abroad	-1.8	13.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	0.0	0.0	0.5	0.6	0.6	0.7	0.7
Amortization	-1.8	-1.1	-2.6	-1.7	-1.2	-1.0	-4.5	-5.2	-4.5
Arrears	0.0	0.0	7.9	-7.9	0.0	0.0	0.0	0.0	0.0
Domestic financing	-5.8	4.2	7.6	26.2	2.2	8.6	6.7	1.2	-8.1
SDR Allocation	0.0	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0
Commercial bank loans	-4.8	6.1	1.1	1.5	0.0	0.0	0.0	0.0	0.0
T-bills	-1.0	-1.9	5.0	26.2	3.0	9.3	7.5	1.9	-7.5
o/w CBI purchases	0.0	0.0	0.0	19.0	0.0	0.0	0.0	0.0	0.0
Arrears	0.0	0.0	2.3	-2.3	0.0	0.0	0.0	0.0	0.0
Amortization	0.0	0.0	-0.9	-0.8	-0.8	-0.8	-0.7	-0.7	-0.6
Financing gap:				18.3	22.0	...	...	...	...
IMF				1.0	0.0	...	...	...	...
World Bank				1.7	0.6	...	...	...	...
Eurobond				2.3	2.3	...	...	...	...
Other unidentified				13.3	19.1	...	...	...	...
Memorandum items:									
Security-related expenditure (military and police equipment and salaries)	16.7	16.4	16.6	19.0	19.2	19.8	20.8	21.9	22.9
Primary fiscal balance	11.4	-14.8	-13.1	-33.0	-20.6	-3.1	2.3	8.6	16.9
Non-oil primary fiscal balance	-81.8	-100.0	-83.7	-85.0	-82.9	-83.9	-89.3	-91.6	-98.8
Development Fund of Iraq (excluding military equipment escrow accounts) 3/	21.1	7.6	...	...	...	...	...	...	...
MOF US$ account at CBI (denominated in IDs) 3/	...	...	1.0	1.2	1.2	1.2	1.2	1.2	7.9
Average Iraq oil export price (US$/bbl)	106.7	102.9	97.0	54.7	62.0	67.1	69.9	71.0	71.5
CBI total financing of the budget deficit	0.0	0.0	0.0	32.3	19.1	0.0	0.0	0.0	0.0

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

1/ For 2012-2014, includes off-budget transfers to SOEs financed by Bank Rafidain.
2/ Five percent of oil exports as mandated by U.N. Security Council Resolution 1483 to finance war reparations to Kuwait until 2016.
3/ Reflects the balances of the Development Fund of Iraq which were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

Table 3. Iraq: Central Government Fiscal Accounts, 2012–20
(In percent of GDP)

	2012 Actual	2013 Actual	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
Revenues and grants	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Revenues	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Crude oil export revenues	43.0	38.4	37.2	35.5	38.2	39.5	40.2	40.0	41.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	42.9	48.4	45.4	57.9	53.5	47.5	46.0	43.7	43.1
Current expenditures	29.7	30.9	26.4	36.4	33.9	28.9	27.0	25.4	24.0
Salary and pension	13.7	15.2	15.5	20.3	18.2	16.7	15.6	14.7	13.9
Salary	11.2	12.0	12.2	16.0	14.3	13.2	12.3	11.6	11.0
Pension	2.5	3.2	3.2	4.3	3.8	3.5	3.3	3.1	2.9
Goods and services	6.9	6.0	3.5	5.6	5.0	4.6	4.6	4.7	4.7
Transfers	6.4	7.4	5.3	9.5	7.1	5.7	4.9	4.3	3.9
Social safety net	2.6	2.8	2.9	3.9	3.5	3.2	3.0	2.8	2.7
Transfers to SOEs 1/	1.1	0.7	0.6	0.7	0.6	0.6	0.5	0.4	0.4
Other transfers	2.7	3.9	1.8	4.9	3.0	2.0	1.5	1.1	0.8
Interest payments	0.4	0.4	0.3	1.0	1.3	1.9	1.8	1.7	1.5
War reparations 2/	2.2	1.9	1.9	0.0	2.3	0.0	0.0	0.0	0.0
Investment expenditures	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Balance (including grants)	4.1	-5.8	-5.3	-17.2	-10.2	-3.2	-1.0	1.1	3.5
Balance (excluding grants)	4.1	-5.9	-5.3	-17.2	-10.2	-3.2	-1.0	1.1	3.5
Statistical discrepancy	-0.4	-0.3	0.3	...	...	...	...	...	...
Financing gap									
Financing, of which:	-3.7	6.1	5.0	17.2	10.2	3.2	1.0	-1.1	-3.5
External financing	-1.4	4.6	2.1	-4.7	-0.3	-0.2	-1.3	-1.5	-1.1
Assets held abroad	-0.7	5.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2	0.2
Amortization	-0.7	-0.4	-1.0	-0.8	-0.5	-0.4	-1.6	-1.7	-1.3
Arrears	0.0	0.0	3.0	-3.9	0.0	0.0	0.0	0.0	0.0
Domestic financing	-2.3	1.5	2.9	12.9	1.0	3.3	2.4	0.4	-2.4
SDR Allocation	0.0	0.0	0.0	0.8	0.0	0.0	0.0	0.0	0.0
Commercial bank loans	-1.9	2.2	0.4	0.7	0.0	0.0	0.0	0.0	0.0
T-bills	-0.4	-0.7	1.9	12.9	1.3	3.6	2.6	0.6	-2.2
o/w CBI purchases	0.0	0.0	0.0	9.3	0.0	0.0	0.0	0.0	0.0
Arrears	0.0	0.0	0.9	-1.1	0.0	0.0	0.0	0.0	0.0
Amortization	0.0	0.0	-0.3	-0.4	-0.3	-0.3	-0.3	-0.2	-0.2
Financing gap:	0.0	0.0	0.0	9.0	9.6	...	...	...	...
IMF				0.5	0.0	...	...	...	...
World Bank				0.9	0.3	...	...	...	...
Eurobond				1.1	1.0	...	...	...	...
Other unidentified				6.5	8.3	...	...	...	...
Memorandum items:									
Security-related expenditure (military and police equipment and salaries)	6.6	6.0	6.4	9.4	8.3	7.7	7.3	7.0	6.8
MOF US$ account at CBI in months of salaries and pensions	...	...	0.3	0.3	0.3	0.3	0.3	0.3	2.0
Primary fiscal balance	4.5	-5.5	-5.0	-16.2	-8.9	-1.2	0.8	2.8	5.0
Current expenditures (percent of non-oil GDP)	59.1	57.5	49.3	58.0	58.1	52.4	50.3	47.8	45.4
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-66.6	-61.8	-59.0	-58.6	-55.6	-55.4
CBI total financing of the budget deficit	0.0	0.0	0.0	15.9	8.3	0.0	0.0	0.0	0.0

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

1/ For 2012-2014, includes off-budget transfers to SOEs financed by Bank Rafidain.

2/ Calculated as 5 percent of oil exports as per U.N. Security Council Resolution 1483 to finance war reparations to Kuwait until 2016.

Table 4. Iraq: Central Bank Balance Sheet, 2012–16
(In billions of Iraqi dinars, unless otherwise indicated)

	2012	2013	2014	2015	2016
	Dec.	Dec.	Dec.	Dec.	Dec.
			Prel.	Proj.	Proj.
Net foreign assets	78,410	88,544	76,563	56,862	46,466
Foreign assets	82,371	92,314	79,273	59,853	49,395
Official reserve assets	80,806	90,742	77,720	58,300	47,842
Gold	1,858	1,902	4,038	4,361	4,710
Other	76,631	86,723	72,545	53,501	42,843
SDR holdings and reserve position in the Fund	2,317	2,117	1,136	438	289
Other foreign assets	1,565	1,572	1,553	1,553	1,553
Foreign liabilities	-3,961	-3,771	-2,709	-2,991	-2,929
Net domestic assets	-13,290	-15,265	-10,311	8,688	14,813
Domestic assets	-3,509	864	600	20,404	20,524
Net claims on general government	-3,622	751	513	20,317	20,437
Loans to central government	3,156	2,756	2,456	3,235	3,123
Holdings of discounted treasury bills	0	0	31	19,023	19,023
Other claims	0	0	0	0	0
Domestic currency deposits	-5,528	-1,895	-1,107	-775	-542
Foreign currency deposits	-1,249	-109	-867	-1,166	-1,166
Monetary policy instruments 1/	-6,902	-10,797	-6,567	-7,374	-3,668
o/w: CBI bills	-745	-943	-853	…	…
Other items net	-2,879	-5,331	-4,343	-4,343	-2,043
Reserve money	65,055	73,259	66,231	65,550	61,279
Currency in circulation	35,785	40,630	39,884	42,849	44,877
Bank reserves	29,270	32,629	26,347	22,701	16,402
Other liquid liabilities	66	20	22	…	…
Memorandum items					
Reserve money (annual growth, in percent)	8.3	12.6	-9.6	-1.0	-6.5
Currency in circulation (annual growth, in percent)	8.1	14.4	3.1	7.4	4.7
Gross foreign exchange assets (in millions of U.S. dollars) 2/	69,302	77,823	66,655	50,000	41,031
Foreign Liabilities (in millions of U.S. dollars)	-3,397	-3,234	-2,324	-2,565	-2,512
Net foreign assets (in millions of U.S. dollars)	65,905	74,589	64,331	47,435	38,519
Exchange rate (end of period)	1,166	1,166	1,166	…	…
Policy interest rate	6.0	6.0	6.0	…	…

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

1/ This mainly represents the ID standing overnight facilities, US$ deposits of commercial banks, domestic currency deposits, and CBI bills.

2/ Starting 2014 reflects the balances of the Development Fund of Iraq were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

Table 5. Iraq: Monetary Survey, 2012–16
(In billions of Iraqi dinars, unless otherwise indicated)

	2012	2013	2014	2015	2016
	Dec.	Dec.	Dec.	Dec.	Dec.
			Prel.	Proj.	Proj.
Net foreign assets	92,454	109,239	102,457	83,016	73,431
Of which: CBI	78,410	88,544	76,563	56,862	46,466
Net domestic assets	-15,312	-19,860	-9,820	25,797	44,836
Domestic claims	-6,019	-5,150	-258	36,358	55,397
Net claims on general government	-25,086	-27,021	-24,576	13,489	30,745
Claims on general government	14,745	11,856	15,892	…	…
less: Liabilities to general government	-39,831	-38,876	-40,468	…	…
Claims on other sectors	19,067	21,871	24,318	22,869	24,652
Other Item Net (OIN)	-9,293	-14,710	-9,562	-10,561	-10,561
Broad money	77,142	89,379	92,638	108,813	118,268
Currency outside banks	30,594	34,995	36,071	40,289	42,566
Transferable deposits	37,059	43,342	41,348	50,089	55,336
Other deposits	9,489	11,041	15,218	18,435	20,366
Memorandum items					
Broad money (percentage growth)	4.1	15.9	3.6	17.5	8.7
Broad money (in percent of GDP)	30.3	33.0	35.5	53.5	51.4
M2 velocity (ratio)	3.3	3.0	2.8	1.9	1.9
Credit to the economy (percentage growth)	71.5	14.7	11.2	-6.0	7.8
Credit to the economy (in percent of non-oil GDP)	14.9	15.0	17.4	17.9	18.4
Private sector credit growth	28.2	15.5	4.5	-2.0	3.0

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

Table 6. Iraq: Balance of Payments, 2012–20
(In billions of U.S. dollars; unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
		Prel.	Est.	Projections					
Trade balance	31.3	22.2	14.7	-2.3	5.0	15.6	20.0	22.3	24.4
(In percent of GDP)	14.3	9.5	6.6	-1.3	2.6	7.1	8.2	8.4	8.4
Exports	94.2	89.5	83.7	62.1	75.6	87.5	98.4	107.2	121.8
Crude oil 1/	93.8	89.3	83.4	61.9	75.3	87.2	97.9	106.6	121.1
Other exports	0.3	0.3	0.2	0.2	0.3	0.4	0.5	0.6	0.7
Imports	-62.9	-67.3	-69.0	-64.4	-70.5	-71.9	-78.4	-84.9	-97.4
Private sector imports	-39.6	-39.8	-37.1	-28.4	-32.6	-33.4	-36.1	-41.4	-45.0
Government imports	-23.3	-27.5	-31.9	-36.0	-38.0	-38.5	-42.3	-43.5	-52.4
Services, net	-12.7	-13.9	-16.4	-12.3	-13.7	-13.8	-15.1	-16.3	-19.1
Receipts	2.8	3.3	4.1	3.8	4.0	4.2	4.5	4.9	5.3
Payments	-15.5	-17.2	-20.5	-16.1	-17.6	-18.0	-19.6	-21.2	-24.3
Income, net	1.1	-0.4	-0.4	-0.5	-0.4	-0.6	-0.4	-0.1	0.3
Transfers, net	-5.1	-4.9	-4.1	0.1	-4.6	0.0	0.0	0.0	0.0
Private, net	-0.4	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Official, net	-4.7	-5.1	-4.2	0.0	-4.6	0.0	0.0	0.0	0.0
Current account	14.5	3.0	-6.2	-15.0	-13.6	1.2	4.5	5.8	5.6
(In percent of GDP)	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.9	2.2	1.9
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-0.1	1.8	-2.3	-8.3	-1.9	-1.0	-0.3	1.5	1.8
Direct and portfolio investment (net) 2/	2.9	5.7	4.6	1.0	2.0	3.0	4.0	4.5	4.6
Other capital, net	-3.0	-4.0	-6.8	-9.3	-3.9	-4.0	-4.3	-3.0	-2.8
Official, net	-0.6	1.5	-1.0	-7.7	-1.0	-0.4	-3.2	-3.5	-3.1
Assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	-0.5	1.5	-1.0	-7.7	-1.0	-0.4	-3.2	-3.5	-3.1
Disbursements 3/	0.3	2.3	0.5	0.0	0.0	0.5	0.5	0.5	0.5
Amortization	-0.8	-0.8	-1.4	-7.7	-1.0	-0.9	-3.7	-4.0	-3.5
Private, net	-2.4	-5.5	-5.9	-1.6	-3.0	-3.6	-1.1	0.6	0.3
Errors and omissions	-4.7	-7.7	-8.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	9.7	-2.9	-16.9	-23.2	-15.5	0.2	4.2	7.4	7.4
(In percent of GDP)	4.4	-1.3	-7.6	-13.3	-7.9	0.1	1.7	2.8	2.6
Financing	-9.7	2.9	16.9	23.2	15.5	-0.2	-4.2	-7.4	-7.4
Development Fund for Iraq (increase -) 4/	-1.6	11.6	5.6	-0.1	...	...	...	...	...
Gross International Reserves (increase -)	-8.1	-8.5	12.0	16.8	9.0	-0.2	-4.1	-7.4	-7.4
Fund credit (net)	0.0	-0.2	-0.8	-0.6	-0.1	0.0	-0.1	0.0	0.0
Financing gap	...	...	...	7.2	6.6	0.0	0.0	0.0	0.0
IMF	...	...	...	0.8	0.0	0.0	0.0	0.0	0.0
World bank	...	...	...	1.5	0.5	0.0	0.0	0.0	0.0
Eurobond	...	...	...	2.0	2.0	0.0	0.0	0.0	0.0
Other (unidentified)	...	...	...	2.8	4.1	0.0	0.0	0.0	0.0
Memorandum items:									
GIR (end of period) 5/	69.3	77.8	66.7	50.0	41.0	41.3	45.4	52.7	60.2
(in months of imports of goods and services)	9.8	10.4	9.9	6.8	5.5	5.1	5.1	5.2	5.2
Reserves net of DFI/MoF US$ account at the CBI	...	...	...	49.0	40.0	40.3	44.4	51.7	53.4
GDP	218.0	232.5	223.5	174.4	197.3	220.9	243.7	266.4	289.1
Of which: Non-oil GDP	109.6	124.8	119.6	109.5	115.0	122.0	130.7	141.3	152.9

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

1/ Reflects KRG exports through the State Oil Marketing Company of Iraq.
2/ Excludes planned issuances of Eurobonds in 2015 and 2016, which are reflected under the financing gap.
3/ Excludes prospective disbursements from the IMF and the WB in 2015 and 2016, which are reflected under the financing gap.
4/ Reflects the transfer of the Development Fund for Iraq from the Federal Reserve Bank of New York to the CBI in May 2014.
5/ Starting 2014 includes US$ balances from oil revenues.

Table 7: Iraq. External Financing Requirements and Sources, 2015–17
(In billions of U.S. dollars, unless otherwise indicated)

	2015	2016	2017
Gross financing requirements	23.2	10.0	-0.4
External current account deficit (excluding official transfers)	15.0	9.0	-1.2
Debt amortization (including Fund repurchases)	8.3	1.0	0.9
Available financing	16.0	3.4	-0.4
Current official transfers	0.0	-4.6	0.0
Financial inflows	-0.6	-1.0	-0.1
Foreign direct investment	1.0	2.0	3.0
Public borrowing	0.0	0.0	0.5
Private inflows	-1.6	-3.0	-3.6
Change in GIR (+ decline)	16.7	9.0	-0.2
Financing gap	7.2	6.6	0.0
IMF	0.8	0.0	0.0
World Bank	1.5	0.5	0.0
Eurobond	2.0	2.0	0.0
other (unidentified)	2.8	4.1	0.0
Memorandum items:			
Fiscal deficit in percent of GDP	17.2	10.2	3.2
Current account deficit	15.0	13.6	-1.2
in percent of GDP	8.6	6.9	-0.6
CBI gross international reserves	50.0	41.0	41.3
in months of prospective imports	6.8	5.5	5.1

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

Table 8. Iraq: Indicators of Fund Credit, 2012–20
(In millions of SDRs, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Disbursements of Fund credit (SBA and RFI)	0.0	0.0	0.0	594.2	0.0	0.0	0.0	0.0	0.0
SBA	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In percent of IMF quota	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RFI	0.0	0.0	0.0	594.2	0.0	0.0	0.0	0.0	0.0
In percent of IMF quota	0.0	0.0	0.0	50.0	0.0	0.0	0.0	0.0	0.0
Obligations (SBA and RFI)	12.0	123.1	506.5	426.7	37.4	0.0	74.3	297.1	222.8
SBA (total)	12.0	123.1	506.5	426.7	37.4	0.0	0.0	0.0	0.0
Repayments of SBA 1/	0.0	111.4	497.6	423.4	37.1	0.0	0.0	0.0	0.0
Total charges and interest	12.0	11.7	8.8	3.3	0.2	0.0	0.0	0.0	0.0
RFI (total)	0.0	0.0	0.0	0.0	0.0	0.0	74.3	297.1	222.8
Repayments of RFI 1/	0.0	0.0	0.0	0.0	0.0	0.0	74.3	297.1	222.8
Total charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations, in percent of:									
Exports of goods and services	0.0	0.2	1.0	0.7	0.1	0.0	0.1	0.5	0.4
External public debt	0.0	0.3	1.2	0.9	0.1	0.0	0.2	0.7	0.6
Gross reserves	0.0	0.2	1.2	1.2	0.1	0.0	0.2	0.8	0.5
GDP	0.0	0.1	0.3	0.3	0.0	0.0	0.0	0.2	0.1
IMF Quota	1.0	10.4	42.6	35.9	3.1	0.0	6.2	25.0	18.8
Outstanding Fund credit (SBA and RFI)	1,069.6	958.2	460.5	631.3	594.2	594.2	519.9	222.8	0.0
SBA	1,069.6	958.2	460.5	37.1	0.0	0.0	0.0	0.0	0.0
RFI	0.0	0.0	0.0	594.2	594.2	594.2	519.9	222.8	0.0
Total outstanding Fund credit, in percent of									
Exports of goods and services	2.1	1.6	0.9	1.0	0.9	1.0	1.0	0.4	0.0
External public debt	2.7	2.5	1.1	1.4	1.2	1.2	1.2	0.5	0.0
Gross reserves	2.4	1.9	1.1	1.8	2.0	2.1	1.6	0.6	0.0
GDP	0.8	0.6	0.3	0.5	0.4	0.4	0.3	0.1	0.0
IMF Quota	90.0	80.6	38.8	53.1	50.0	50.0	43.8	18.8	0.0

Sources: IMF staff estimates and projections.

1/ The SBA and RFI repayments are based on scheduled debt service obligations.

Appendix I. Letter of Intent

July 9, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, DC 20431, USA

Dear Ms. Lagarde,

With this letter, we request financial assistance from the IMF at an utmost difficult time in our country's history. Iraq is facing a mortal terrorist threat, while the economy has been hit by the collapse in oil prices.

1. The terrorist attack by the so-called ISIS has put Iraq in great danger. The Iraqi security forces have made notable progress in the fight against the terrorists, with the help of our international partners. In fact, a significant portion of the territory captured by ISIS after its invasion has been already retaken. However, the war is not likely to end soon and will continue to affect the lives of Iraqis as well as the national economy.

2. The terrorist attack has resulted in the loss of thousands of lives and caused a dramatic humanitarian crisis. More than 3 million people have been displaced in the northern regions since June 2014, in addition to 250 thousand Syrian refugees whom Iraq has been sheltering since the civil war in neighboring Syria. Nearly half of the internally displaced persons are children, forced to live in difficult conditions and to face serious health risks. The refugee crisis is also putting great pressure on Iraq's infrastructure system and public services. Furthermore, the war has destroyed public and private assets and infrastructure, is seriously hampering economic activity in the non-oil sector, and has undermined domestic and external trade.

3. As the ISIS terrorist threat expanded, world oil prices fell by 40 percent in the space of a few months, causing a huge external shock to our balance of payments and our budget revenues, which depend predominantly on oil export receipts. The shock has caused a strong deterioration of the current account balance, drained our international reserves, and boosted the Iraqi government budget deficit.

4. Against this background, we request access of 50 percent of quota (equivalent to SDR 594.2 million, about US$ 828.9 million) through the Rapid Financing Instrument (RFI). We also request that the assistance under the RFI be channeled to the budget. It is our expectation that the IMF financial support will have a catalytic effect in helping generate additional financial resources to close the fiscal gap and ease pressure on our balance of payments for the coming year. In this Letter

of Intent (LOI) we describe our policies for 2015. We believe that the policies set forth in this LOI are adequate to address the present and urgent balance of payments problem.

Economic developments

5. Overall, GDP declined by 2.1 percent in 2014, and is expected to grow modestly by 0.5 percent in 2015. The non-oil economy is suffering from the struggle against the so-called ISIS. Non-oil activity in the four provinces has collapsed in 2014 and remains very low, contributing to a decline in non-oil GDP growth of almost 9 percent in 2014, compared to 10 percent growth in 2013. In 2015, non-oil activity is expected to decline further due to the impact of the conflict, the decline in private sector investment and FDI, and limited government spending, particularly on investment projects, because of the decline in oil prices.

6. The oil sector has continued to expand, despite the exceptionally difficult environment. The main impact of the conflict on the oil sector so far has been the suspension of oil exports through the pipeline to Ceyhan, which is now essentially out of commission because of continued sabotage. In contrast, we have increased production of southern oil fields, which comprise about 90 percent of production. In 2014, oil production rose by 4.5 percent from 2013, reaching 3.11 million barrels per day (mbpd), and exports increased by 5.3 percent to 2.52 mbpd. This year, according to conservative projections production should rise to 3.45 mbpd (11 percent over 2014) and export should hit 3.1 mbpd (23 percent). These results will be possible thanks to the agreement reached in December of last year between the Federal Government and the Kurdistan Regional Government (KRG), envisaging a contribution to exports from northern fields (including Kirkuk) of 550 thousand barrels per day (bpd), on average.

7. Notwithstanding the economic shocks and high uncertainty, inflation has remained low outside ISIS-controlled areas. Inflation at end-2014 was 1.6 percent, declining further to 0.5 percent in April 2015 largely because of deflation in food and commodity prices. However, our estimates exclude inflation for four governorates because of the security situation, although anecdotal evidence suggests that inflation rates are higher in these areas.

8. Despite the good performance in production and export volumes, the collapse in oil prices in the second half of 2014 has dealt a huge blow to our external balance, as revenues from oil exports decreased from $89 billion in 2013 to $83 billion last year and are expected to decline to $62 billion this year. Therefore, the current account balance turned negative in 2014, to a deficit of 2.8 percent of GDP, and is expected to deteriorate further in 2015 with the deficit increasing to almost 8.6 percent of GDP. This decline is expected despite the compression of private sector's imports of goods, a narrowing of the service deficit and the postponement of the final war reparation payment for Kuwait to next year. This year, net capital outflows, largely due to the settlement of arrears with International Oil Companies (IOCs) contracted in 2014, are also forecast to contribute to an increase in the balance of payment deficit.

9. As a result of these external pressures, international reserves (including the DFI) have declined from $84 billion at end-2013 to $67 billion at end-2014, and are expected to fall further to $50 billion by the end of 2015. Reserves, however, continue to be adequate, are not expected to decline below 6 months of imports and 85 percent of the deposit base in 2015. Gross international reserves of the CBI now include the balance of the Development Fund for Iraq, which was closed down as a foreign account in May 2014 and replaced with a government account in dollars at the CBI. Foreign exchange receipts from oil exports are now collected directly in the CBI accounts abroad, with the equivalent amounts credited to the government account in Baghdad.

Fiscal sector

10. Due to the difficult political situation, the 2014 budget was not approved. The government was still able to contain the deficit at slightly above 5 percent of GDP, down from nearly 6 percent of GDP in 2013. The lack of budget approval triggered a fiscal rule that capped monthly outlays to one-twelfth of their annual level during 2013 and blocked new investment projects. In addition, the transfer to the KRG was lower than expected due to a lack of agreement on oil revenue sharing. However, under strong security and humanitarian spending pressures, and the decline in oil prices in the second half of the year, the government was forced to accumulate $6.8 billion in arrears on investment spending and IOCs and ID 2.3 trillion ($2.0 billion) to domestic contractors.

11. Partly due to repressed spending in 2014 and continued needs arising from the struggle with ISIS, the initial draft 2015 budget was expansionary, envisaging a 33 percent expenditure growth. Persistently weak oil prices convinced us of the need to further strengthen the fiscal position. As a result, the government pulled the budget already in parliament and introduced a number of revenue-enhancing and expenditure-reducing measures. Revenues measures include introducing the customs tariffs from the 2010 Customs Law and sales tax on cars, tobacco, alcohol, mobile phone cards and internet usage. The revised budget draft was swiftly approved, with a spending envelope of ID 117.8 trillion (58 percent of GDP) and a deficit of ID 24 trillion (12 percent of GDP).

12. With some delay due to the difficult political situation, the non-oil tax measures have been published in the official gazette at end-May and will be implemented starting on August 1. The full application of the 2010 Custom Law tariff schedule has been delayed by technical difficulties arising from its simultaneous introduction on all national borders. However, the final preparations are about to be completed and we plan to start applying the new tariff schedule on all border posts in August. On a temporary basis, the Cabinet of Ministers asked the MOF to introduce a 5 percent advance custom duty payment and a 3 percent advance income tax applied to the purchase of foreign exchange for import purposes, starting in March in order to compensate for the loss of revenue. However, this measure increased the volatility of the parallel foreign exchange market, and we removed it in June.

13. Partly to address the loss in revenues from these delays, we have instituted an inter-ministerial committee, chaired by a Deputy Prime Minister, to reprioritize investment expenditures leading to the elimination or postponement of less necessary projects that have not been executed to date. The committee is examining project selection and procurement practices, with the objective of improving project selection, implementation capacity and monitoring, while maintaining the rights of contractors and suppliers. This process involves identifying investment priorities based on a number of criteria, such as (i) actual cumulative execution rates of projects, (ii) geographic location, (iii) intersectoral linkages, (iv) national security and foreign exchange considerations, (v) degree of labor intensiveness and resource use, (vi) profits achieved or losses realized as a result of making financing available or withholding it. In this connection, the Ministry of Finance commits to sign an MOU with the Ministry of Planning to execute only high priority investments projects, as early as possible.

14. In the context of our efforts to improve the delivery of electricity to the Iraqi population and contain energy subsidies, the Ministry of Electricity has recently finalized the reform of electricity tariffs, which introduces strongly progressive rates for the largest consumers with minimal impact on the rates for low-income households. The reform, which is expected to bring in annual savings of ID 5–7 trillion, is an important step to advance the reform of the energy sector. Cabinet will soon approve the tariff reform (Prior Action).

15. Over the past years, we have increased domestic fuel prices, which are now among the highest in oil producing countries. The government is planning to take further steps to liberalize the sector and improve its efficiency. In particular, we intend to improve the distribution network for high-octane gasoline in all stable governorates, while encouraging international companies to operate in Iraq, with the objective of establishing additional fueling stations. We are also undertaking steps to lay the ground for the adoption of fuel cards system for gasoline, gasoil, and LNG, which should be rolled out by year-end. We are assessing potential savings from the reduction of gasoline imports which would result from raising gasoline prices to cost-recovery levels.

16. As a result of these additional measures, we expect the deficit to be contained to around ID 35 trillion (17 percent of GDP) this year, including taking into account an additional $10 billion payments to the IOCs. In 2016, the full impact of the fiscal measures introduced this year and the containment of other current spending, together with higher oil revenues thanks to stronger oil exports, should lower the deficit to about 10 percent of GDP.

17. Our strategy to finance the deficit relies on tapping available financing domestically as well as from external sources. We have obtained loans from the Trade Bank of Iraq for $2 billion and placed a total of ID 8.4 trillion of T-bills with state-owned banks Rasheed and Rafidain. Of these T bills, ID 4 trillion were made possible by a recent CBI regulation allowing the substitution of 50 percent of the reserve requirement with government securities. The CBI plans to reverse this measure as soon as market liquidity conditions allow. Furthermore, we are drawing on our 2009 SDR allocation at the IMF. Based on the provisions of the 2015 budget, we have tasked three investment

banks to prepare the issuance of $6 billion. We plan to issue the first tranche of $2 billion in the coming months. The placement of the following tranches will be facilitated by the issuance of a credit rating, which we are actively pursuing. Finally, we are seeking financial support from the international financial institutions, primarily from the IMF (in the form of the RFI purchase, for $0.8 billion) and the World Bank (Development Policy Loan and emergency reconstruction assistance for a total of $2 billion).

18. In light of the already large fiscal effort and the limited available financing, the CBI has started facilitating commercial bank lending to the government by discounting government securities for about ID 5 trillion. In the course of 2015, given the importance of meeting obligations towards the IOCs and in case such support is needed, the CBI may consider discounting up to an additional 14 trillion in the secondary market to facilitate liquidity conditions of commercial banks, possibly through longer-term bonds. This liquidity support will be soon formalized in separate MOUs between (i) the CBI and the state-owned banks and (ii) the state-owned banks and the MOF (Prior Action). The MOUs, as relevant, will lay out (i) terms of repayment of the securities used for the financial support; and (ii) the government's commitment to provide the state-owned banks with the amounts needed to pay principal and interest on the bonds. Additional MOUs could be signed subsequently with other commercial banks as needed. Despite all identified financing, we are left with a residual financing gap of ID 13 trillion, which we expect to fill with domestic and foreign sources.

19. We are pursuing a prudent debt management strategy. We are considering developing and deepening the domestic debt market through the introduction of new instruments, which would diversify our financing sources. In addition, we will step up monitoring of domestic debt to maintain it at sustainable levels. In 2015, additional borrowing will be necessary to mitigate the impact of the oil price shock and the ISIS terrorist attack, but external debt is expected to remain broadly unchanged at about $64 billion in 2015 (37 percent of GDP) thanks to the planned settlement of arrears of US$ 6.8 billion to IOCs this year. We are making progress in negotiations with non-Paris Club creditors, which account for about $40 billion, and we expect to conclude agreements with some creditors in the course of this year for rescheduling at terms comparable to the 2004 Paris Club agreement. Full rescheduling of this debt at these terms would reduce it to $9.3 billion. Given Iraq's fiscal and external sectors' heavy dependence on oil export receipts, we will stay current on external payment obligations to IOCs.

20. We are strengthening our public financial management procedures to support fiscal discipline and efficient use of oil resources. With the support from the World Bank, we are working on the introduction of an integrated financial management and information system (IFMIS). The Shura Council is examining a new public financial management law, to be effective for next fiscal year, which among other measures lays out steps to introduce a Treasury Single Account. We intend to continue relying on technical assistance from the IMF and the World Bank to support these efforts.

Exchange rate and financial sector policies

21. Recognizing that a strong and stable currency provides a key nominal anchor to the economy, we maintained the peg to the U.S. dollar despite the instability created by the ISIS terrorist attack and the balance of payments pressures triggered by the oil price shock. Thanks to the efforts of the CBI to push forward the liberalization of the foreign exchange market, the spread between the official and parallel exchange rates fell from 8 percent in May 2013 to below 1 percent in November 2014, a striking outcome considering the start of the ISIS terrorist attack in June last year. However, the exchange rate spread has increased in the course of 2015, reaching 16 percent in mid-June, partly due to the introduction of the advance customs duty and presumptive income tax, and the CBI's steps to contain dollar cash sales in an effort to shift demand to the wire market and limit illegal cash outflows from the country. Therefore, to reduce the parallel market spread we removed the advance customs duty and presumptive income tax and we reduced the advance deposit requirement to five days in June. These measures had an immediate calming effect on foreign exchange market. We also expect that the rigorous implementation of a circular issued in February this year, which liberalizes further the foreign exchange market, will help reducing the spread.

22. We have intensified our efforts to strengthen the management of the international reserves of the CBI. Based on several years of experience, we have amended 2008 reserve management guidelines to reflect the operational needs of daily reserve management and to align them with the CBI law. We are also working towards our long-term goal to bring active management of international reserves to the CBI in Baghdad. We are greatly benefitting from the technical assistance provided by the IMF in this area.

23. We are closely monitoring the impact of the crisis on the financial sector and stand ready to take measures as needed. The financial sector is suffering as the violence destroys physical assets, daily economic activity is disrupted and trade disruptions affect import financing. Furthermore, contraction in investment spending is greatly affecting the private sector and in turn bank credit. Therefore, growth in credit to private sector fell from 16 percent in 2013 to 5 percent in 2014 but is expected to contract by 2 percent this year. We also expect increase in nonperforming loan (NPL) ratios because of falling business confidence, lower private sector activities, and physical destruction and robberies of some banking institutions at the beginning of the ISIS terrorist attack. In order to better monitor risks to the financial sector, we are stepping up our surveillance, including through the improvement of financial reporting and monetary data with the help of technical assistance from the IMF. In particular, we are working with the IMF to improve our Financial Soundness Indicators to internationally acceptable standards.

24. We are stepping up our efforts to develop the banking sector, a key element in our long-term strategy to strengthen the non-oil economy and private sector activity. To increase public trust in the banking system and deepen financial intermediation, Cabinet is examining the law on the deposit insurance scheme, which will be fully funded by the government and participating commercial banks. We will facilitate the increase in information coverage through the forthcoming

Credit Information Bureau to support commercial banks' credit assessment of clients. To level the playing field between private banks and state-owned banks, we have allowed the public entities to open accounts and pay salaries through private banks starting May this year. These initiatives will create new important opportunities for private banks to provide services and compete with the state-owned sector.

25. We are pressing ahead with the restructuring of the state-owned banks Rasheed and Rafidain. The Executive Committee for Restructuring has made progress, mainly analyzing in detail the impact of inherited debt and war losses on the balance-sheets of the banks and urging the banks to implement the unfulfilled paragraphs of the MOU.

26. We are taking measures to strengthen banking supervision. The CBI has recently extended its contract with Ernst & Young, which assists us in improving an off-site and on-site supervision practices and train our employees. The bank has also hired 35 new contractual staff to strengthen enforcement in the banking supervision department. The CBI is paying increased attention to bank reporting with the aim to detect potential problems at early stage, and intends to enhance and modernize the banking supervision. The banking supervision department is also stepping up the monitoring of state-owned banks Rasheed and Rafidain, which are of systemic importance in line with the CBI's duties of supervising the entire banking sector.

27. To enhance safeguards, we confirm that the CBI remains the exclusive authority in charge of foreign exchange reserves. As we are requesting access under the RFI, we commit to completing an updated safeguards assessment of the CBI. The CBI will provide the Fund staff all the requested information needed for the assessment, including the most recent external audit report and the authorization to speak with its external auditor and stands ready to receive a safeguards mission as soon as needed. We are also committed to prepare and implement an action plan with regard to recommendations that will emerge from the safeguards assessment. We agree to update the Memorandum of Understanding between the CBI and the Ministry of Finance dated February 17, 2011, covering management of foreign exchange reserves and the channeling of IMF budget support under the RFI to the latter.

Conclusion

28. We believe that the policies set forth in the letter are adequate to address the present and urgent balance of payments problem. We will take any further measures that may become appropriate for this purpose.

29. We intend to continue to maintain a close policy dialogue with the Fund in an effort to strengthen Iraq's balance of payments, refrain from measures or policies that would compound Iraq's balance of payments difficulties and maintain macroeconomic stability. The government does not intend to impose new, or intensify existing, restrictions on the making of payments and transfers for current international transactions, introduce new, or intensify existing, trade restrictions for balance of payments purposes, or enter into bilateral payments agreements which are inconsistent with Article VIII of the Fund's Articles of Agreement.

30. The government of Iraq and the CBI authorize the Fund to publish this letter and the staff report relating to this request.

/s/	/s/
Hoshyar Mahmoud Zebari	Ali Mohsen Ismail Al Allaq
Minister of Finance of Iraq	Acting Governor of the CBI

Table 1. Prior Actions for a Purchase under the Rapid Financing Instrument

Measures	Scheduled completion date	Macroeconomic justification
Approval by the Cabinet of Ministers of the new, strongly progressive electricity tariff schedule	Five business days before the Board date	Improve the delivery of electricity to the Iraqi population and contain energy subsidies for annual savings of ID 5–7 trillion
Sign separate MOUs between (i) the CBI and the state-owned banks and (ii) the state-owned banks and the MOF, laying out (i) the terms of repayment of the securities used for CBI financial support to the banks, and (ii) the government's commitment to provide the state-owned banks with the amounts needed to repay principal and interest on the bonds.	Five business days before the Board date	Limit negative effects of indirect CBI financing to the government on the credibility of the CBI and the pegged exchange rate arrangement through formalization of the financial relations between the government, the CBI, and the state-owned banks.

Annex I. Risk Assessment Matrix 1/

Nature/Source of Risk	Likelihood of Realization in the Next Three Years	Expected Economic Impact	Policies to Minimize Impact
Protracted conflict • The baseline assumes the resolution of the conflict with ISIS during 2016–17, but the stalemate could continue. As an additional tail risk, the conflict could extend to the rest of Iraq.	**High**	**High** • The conflict would weigh on the budget, depress confidence, and affect economic activity, particularly in the non-oil sector, and possibly disrupt oil production in the south.	• Pursue implementation of policies agreed under the RFI. • Seek further financial support from international community. • Preserve social spending.
Political fragmentation • The new Iraqi government is inclusive. But the current relative political unity may be undermined by a spike in internal tensions, including on the KRG deal.	**High**	**High** • Disunity within the government would weaken policy implementation and the state's capacity to fight ISIS. • Collapse of the deal with the KRG would lower oil exports.	• Frontload policy and reform implementation to leverage current, relative political stability. • Accelerate diversification of government revenues through non-oil tax instruments.
Poor policy implementation	**High**	**High** • Poor fiscal policies would hinder efforts to fight ISIS and fail to improve the economy's resilience to shocks, particularly from the oil market, and lower medium-term growth. • Intensification of foreign exchange restrictions could cause FX market volatility with negative impact on the economy.	• Adopt forward-looking policy framework to prevent and correct policy slippages. • Maintain peg with the dollar. • Outline timeline to gradually eliminate any new restriction. • Intensify CBI communication with the public and markets.

Annex I. Risk Assessment Matrix (concluded)

Nature/Source of Risk	Likelihood of Realization in the Next Three Years	Expected Economic Impact	Policies to Minimize Impact
Risks to energy prices: • Increased volatility due to uncertainty about the persistence of the oil supply shock and the underlying drivers of the price decline. • Persistently low prices triggered by supply factors reversing only gradually, and weaker demand.	**Medium** **Medium**	**High** • Shortfalls in oil revenues would compress fiscal space and delay the return to fiscal surpluses. • Revenues could also be affected by supply disruptions due to lower-than-expected investment in the oil sector or delays in government payments to the oil companies.	• Strengthen PFM to increase resilience of fiscal policy and the economy to oil market shocks. • Accelerate diversification of government revenues through non-oil tax instruments.
Heightened risk of fragmentation/state failure/security dislocation in the Middle East, leading to a sharp rise in oil prices, with negative global spillovers.	**Medium**	**High** • A regional war would further undermine stability in the country and affect the Iraq economy through refugees and fall in foreign trade.	• Pursue implementation of policies agreed under the RFI. • Seek further financial support from international community. • Preserve social spending.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly.

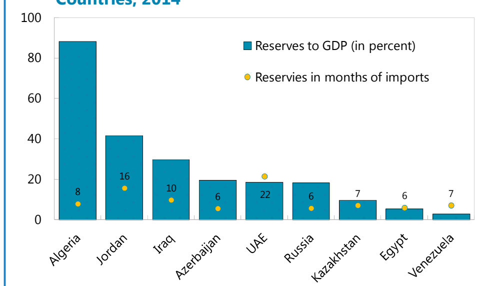
Annex II. External Assessment

1. **The joint assessment of the level of international reserves and the exchange rate shows that Iraq's external position remains sustainable**. Iraq's external position has worsened recently due to the collapse in oil prices but should recover with the planned ramp-up of oil production and the implementation of sound fiscal policies. The fiscal adjustment in 2015 is assumed to continue over the medium term, allowing for the resumption of fiscal surpluses from 2019. This fiscal path would help achieve current account surpluses and attract foreign investment flows, overall strengthening balance of payment outcomes.

Adequacy of international reserves

2. **The current level of international reserves of the CBI seems adequate**. Reserve accumulation was strong during 2010–2013, before starting to decline from 2014.[1] Nevertheless, reserves continue to exceed conventional measures of reserve adequacy and reserve buffers are projected to remain adequate over the medium run. A cross-county comparison indicates that the current level of the CBI reserves as a percentage of GDP is comparable to that of other oil exporting countries.

Reserve Adequacy Indicators for Selected Countries, 2014



Sources: Iraqi authorities; IMF WEO Database; and IMF staff calculations.

Reserve Adequacy, 2013–20
(In units indicated)

	2013	2014	2015	2016	2017	2018	2019	2020
Reserves in USD billion 1/	77.8	66.7	50.0	41.0	41.3	45.4	52.7	60.2
Reserves in months of imports of goods and services	10.4	9.9	6.8	5.5	5.1	5.1	5.2	5.2
Reserves in percent of debt service coming due	2,790	756	2,656	1,955	821	823	1,107	2,847
Reserves in percent of reserve money	123.9	117.3	88.9	78.1	71.4	71.4	75.4	78.2
Reserves in percent of broad money	101.5	83.9	53.6	40.5	35.8	35.0	36.6	37.8
Reserves as a percent of the new IMF ARA metric 2/	262.9	226.8	175.0	…	…	…	…	…

Sources: Iraq authorities; and Fund staff estimates and projections.

1/ Starting 2014 includes US$ account balances from oil revenues.

2/ Reserves within 100–150 percent of the new ARA metric are considered adequate.

[1] In May 2014, the Development Fund for Iraq was closed and its dollar balances transferred to the international reserves of the CBI. From end-2014 onwards CBI international reserves also reflect foreign assets related to foreign currency earned through oil exports.

Exchange rate assessment

3. **Iraq's real and nominal effective exchange rates (REER and NEER) have appreciated over the past two years**. From end 2012 until April 2015, the NEER appreciated by 27 percent on a cumulative basis, in line with the appreciation of the U.S. dollar vis-à-vis Iraq's trade partner currencies. Negative inflation differentials have persisted between Iraq and its main trade partners, with differentials declining over the years. As a result, the REER appreciated by 16 percent over the same period. Falling oil prices have translated into a large negative terms of trade shock over the medium term.

4. **The External Balance Assessment (EBA-Lite) for Iraq suggests that the REER is broadly in line with the fundamentals**. The current account in 2015 is projected to record a deficit of 8.6 percent of GDP, compared to a fitted value of 11.6 percent. The widening of the current account deficit is driven by lower oil prices which also hurt the fiscal position, thus creating a fiscal policy gap of –3.8 percent of GDP. Together with the fitted current account deficit derived from the model, this policy gap results in a current account gap of –0.8 percent of GDP, implying a slight overvaluation of Iraq's REER by 3.5 percent. This result should however be treated with caution due to uncertainties arising from Iraq's dependence on oil export revenues, limitations of estimates of the fitted current account, and sensitivity of the model to underlying assumptions.

Assessing Real Exchange Rate Misalignment in Iraq: 2015

EBA-lite methodology

Projected current account balance (in percent of GDP)	-8.6
Estimated current account norm (in percent of GDP)	-7.8
Current account gap	-0.8
REER gap (misalignment)	3.5

Sources: Iraqi authorities; and IMF staff calculations.

Annex III. Public and External Debt Sustainability Analysis (DSA)

The collapse of international oil prices and the ISIS insurgency have exerted fiscal pressures and are expected to significantly increase the fiscal deficit in 2015 despite consolidation efforts. As a result, public debt is projected to increase significantly more than anticipated in the 2013 Article IV, mainly because of additional borrowing required to finance the large fiscal deficits projected for 2015 and 2016 and more conservative assumptions about the rescheduling of non-Paris Club debt. The domestic debt stock is expected to more than double in 2015, raising total public debt to 69 percent of GDP in 2015, and to reach a peak at around 73 percent of GDP in 2016. But the debt remains sustainable over the medium-term, given the projected fiscal path envisaging fiscal consolidation and improved growth prospects, supporting a reduction of public debt to 48 percent of GDP by end 2020.

1. **Iraq's public debt has averaged around 35 percent of GDP in recent years but is projected to rise sharply in 2015 and 2016 to finance large fiscal deficits before embarking on a downward trend in 2017**. The increase in the debt ratio in 2015 to 69 percent of GDP is explained by new borrowing necessary to finance the large projected fiscal deficit, a sharp nominal GDP contraction and a negative GDP deflator of 22 percent resulting from oil price declines. Funds will mainly be raised from the domestic banking system. State-owned banks in particular are expected to buy government securities which will be discounted by the Central Bank of Iraq. The stock of domestic debt is estimated to increase from 10 percent of GDP in 2014 to 33 percent of GDP in 2015. The planned issuance of Eurobonds, funding from the IMF and the World Bank and unidentified external financing assumed to fill part of the fiscal financing gap would increase external debt to about 37 percent of GDP, up from 29 percent of GDP in 2014. As progress in negotiations of non-Paris Club debt is expected to be slow, staff conservatively assumes that non-Paris Club debt will not be rescheduled over the projection period (even though the authorities are exercising their best efforts to reach agreement on rescheduling with non-Paris Club creditors) and that external debt will decline only gradually until 2020. Debt as a share of GDP is forecast to breach the critical threshold of 70 percent of GDP in 2016 mainly as a result of additional domestic borrowing to fill the fiscal financing gap, before embarking on a downward trend in line with projected improvements in the fiscal stance and faster economic growth. Public debt is projected to fall to about 48 percent of GDP by 2020, mainly due to a reduction in domestic debt.

2. **An assessment of the realism of baseline assumptions for Iraq (forecast track record compared to other countries) is hampered by severe data weaknesses**. Available data point to optimism in historic forecasts for real GDP and the primary balance, while the inflation forecast error—on average—has only recently been in line with the inter-quartile range of other countries. Since growth is mainly driven by the oil sector, GDP forecasts change with underlying assumptions about oil price developments. Staff projects slow growth in 2015 due to the negative impact of the ISIS insurgency and lower oil prices, and a rebound in 2016 on the back of base effects and improvements in the outlook for oil revenues. Over the medium-term, growth is expected to average 7-8 percent, a downward revision from the 2013 Article IV projections which assumed significantly higher oil prices. It is important to note that Iraq continues to be highly dependent on

oil export receipts, making it vulnerable to further oil price volatility, and thereby to macroeconomic imbalances which raise risks to longer-term public debt sustainability.

Shocks and Stress Tests:

3. **Standardized stress tests indicate that Iraq's debt level and financing needs are sensitive to shocks**. Iraq is particularly vulnerable to GDP growth shocks (which could materialize in case of a deterioration of the security situation or delays in the ramp-up of oil production) and shocks to the primary balance which would raise the debt ratio significantly over the medium run. Permanently higher interest rates would raise debt levels particularly towards the end of the projection period. Large gross financing needs which arise from high rollover requirements of debt owed to the central bank present a risk under all stress scenarios.

- **Growth shock**. Under this scenario, the baseline real GDP growth profile is reduced by one standard deviation calculated over the recent 9-year period (based on available data). This corresponds to an average growth rate of 5.8 percent of GDP over 2016–20, compared with baseline average growth of 7.6 percent. Under this scenario, the public debt ratio increases by 6 percentage points of GDP in 2016 and 15 percentage points of GDP in 2017, bringing the debt ratio to 61 percent of GDP by 2020. On average, the debt path is 13 percentage points of GDP higher than in the baseline over the period 2016-2020.

- **Primary balance shock**. This scenario increases the noninterest expenditure to GDP by about 4 percent of GDP in 2016 and 2017 (excluding any effect on revenues). The scenario further assumes an interest rate increase of 25 bps for each 1 percent of GDP deterioration in the primary balance. This shock would increase public debt to GDP by 4 percentage points of GDP in 2016 with the incremental annual debt increase widening over the medium term compared to the baseline, raising total public debt to 58 percent of GDP by 2020.

- **Interest rate shock**. This scenario examines the implications of a large increase in nominal interest rates relative to the baseline throughout the projection period. The shock would slow the process of debt reduction down and would bring the public debt ratio to 68 percent of GDP in 2020.

- **Real exchange rate shock**. The scenario assumes a one-time 4 percent depreciation in the real exchange rate. Given the relatively small stock of external debt, the shock would increase the total debt-to-GDP ratio by 1 percentage point of GDP on average over the medium term. Gross financing would be correspondingly higher.

- **Combined shock**. The combined shock for Iraq leads to a notably higher public debt path to GDP, reflecting: (a) lower GDP growth by 4.5 percentage points in 2016 and 2017, (b) higher nominal interest rates (by around 20 percent on average), (c) a 4 percent real exchange rate depreciation, and (d) increases in the noninterest expenditure to GDP by about 4 percent of GDP. Under this scenario, the debt-to-GDP ratio is pushed up to 81 percent of GDP in 2016 and rises to 94 percent of GDP in 2020, with gross financing needs increasing accordingly.

4. **Oil price shock**. This scenario models the effect of a decline in real GDP growth as a consequence of a sharp oil price shock in 2016. Oil prices are assumed to fall by 20 percent in 2016 and to converge only gradually to the baseline over the medium run. Real GDP growth would drop by more than 5 percentage points in 2016 but the effect of the shock would gradually phase out in the following years. The path of government revenues, the fiscal balance and financing needs would also be altered. Debt to GDP in this scenario would increase to around 86 percent of GDP in 2016-2018 and then fall to 71 percent of GDP towards the end of the forecast period.

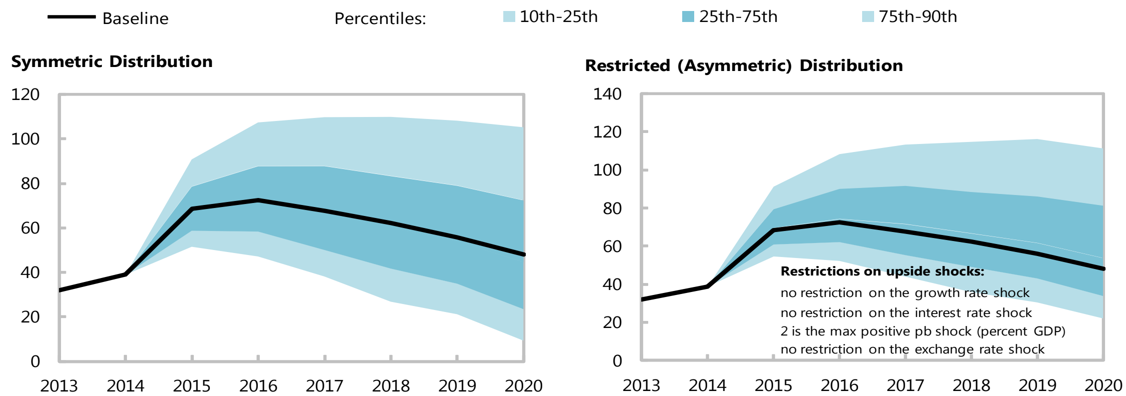
Figure 1. Iraq: Public Sector Debt Sustainability Analysis(DSA)—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

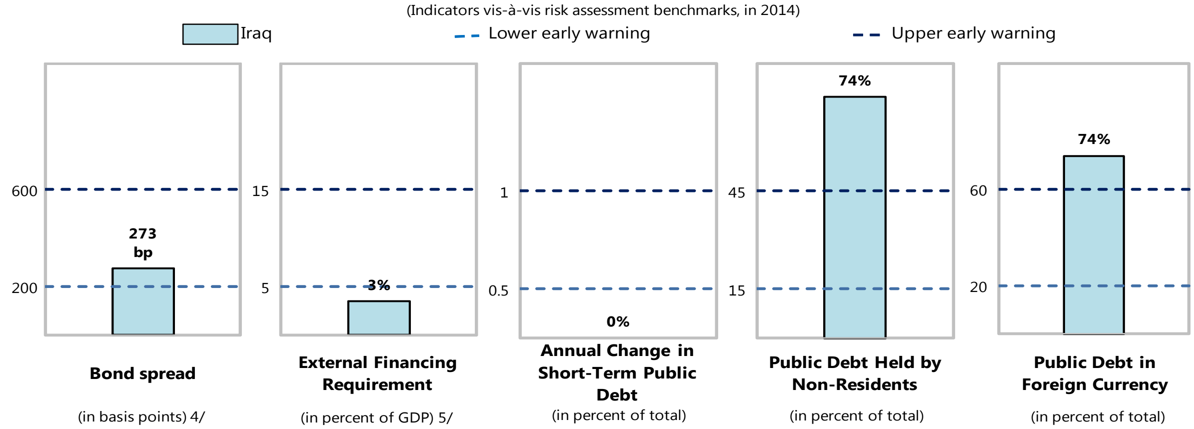
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

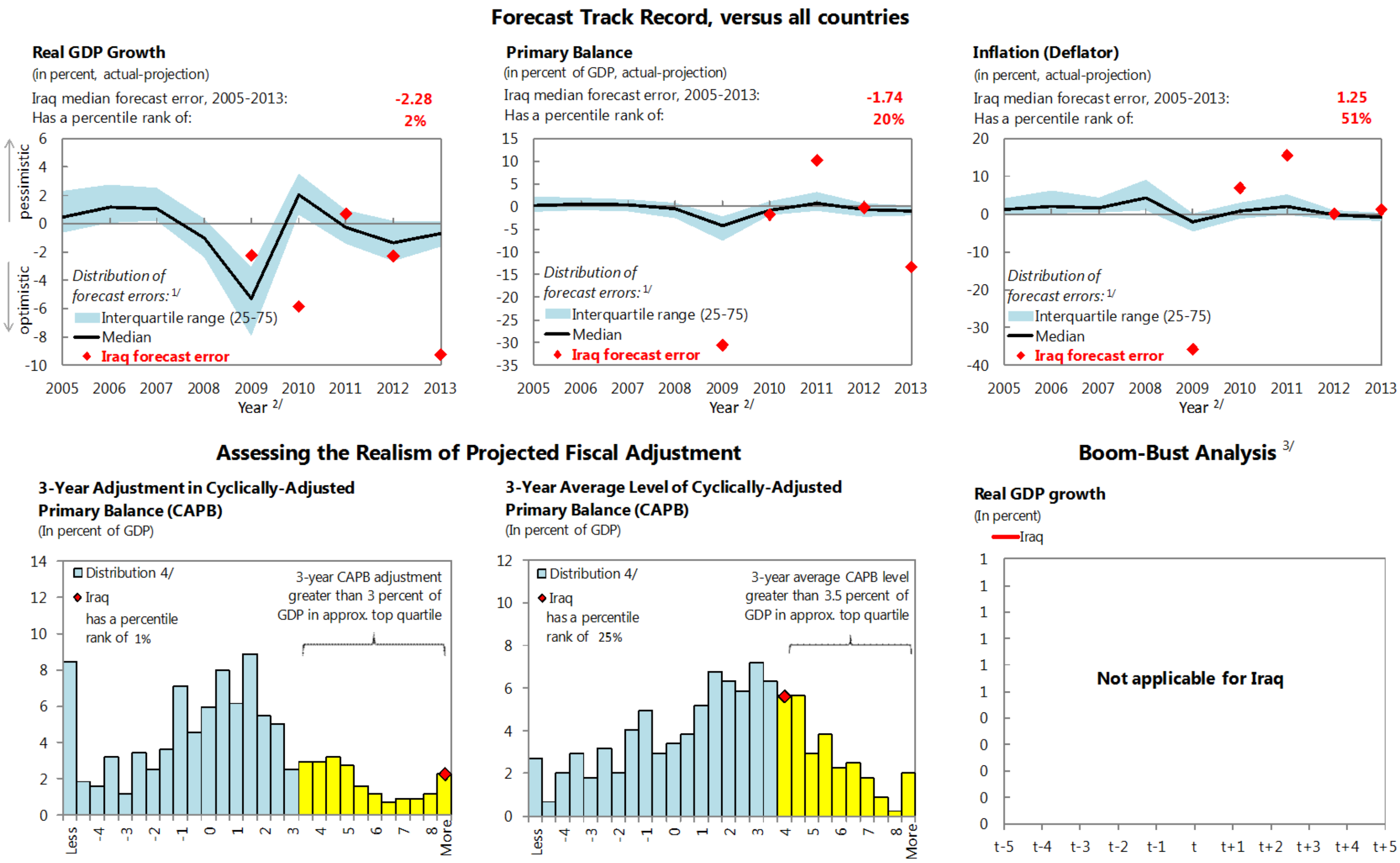
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG (bp), an average over the last 3 months, 10-Feb-15 through 11-May-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Iraq: Public Debt Sustainability Analysis—Realism of Baseline Assumptions



Source: IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Iraq, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Table 1. Iraq: Public Debt Sustainability Analysis—Baseline Scenario

(In percent of GDP unless otherwise indicated)

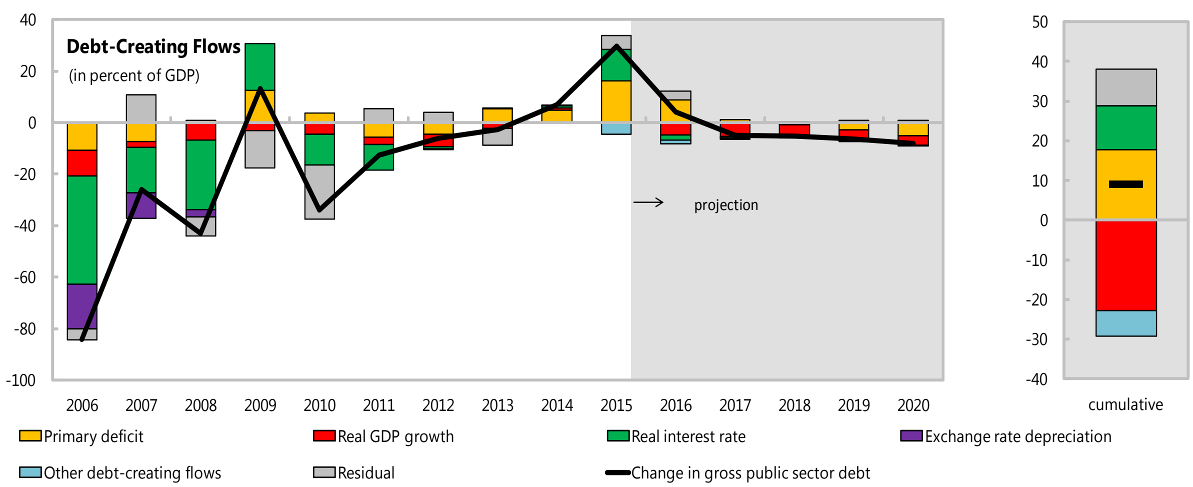
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	86.5	31.9	38.9	68.5	72.6	67.6	62.3	55.9	48.0
Public gross financing needs	-1.1	5.4	4.3	22.3	23.9	18.3	22.8	26.1	21.8
Real GDP growth (in percent)	11.3	6.6	-2.1	0.5	7.6	8.1	7.6	7.5	7.1
Inflation (GDP deflator, in percent)	16.0	0.1	-1.8	-22.4	5.1	3.6	2.6	1.7	1.3
Nominal GDP growth (in percent)	29.1	6.6	-3.9	-22.0	13.1	12.0	10.3	9.3	8.5
Effective interest rate (in percent) [4/]	0.7	1.2	0.8	2.0	2.1	3.0	3.0	3.0	2.9

As of May 11, 2015		
Sovereign Spreads		
Bond Spread (bp) 3/		589
5Y CDS (bp)		347
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-27.5	-2.8	7.0	29.6	4.0	-4.9	-5.4	-6.4	-8.0	9.0	
Identified debt-creating flows	-23.7	3.7	6.6	24.1	0.8	-4.8	-5.5	-6.6	-8.1	-0.2	
Primary deficit	-1.5	5.5	5.0	16.2	8.9	1.2	-0.8	-2.8	-5.0	17.8	-3.1
Primary (noninterest) revenue and grants	50.8	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6	264.9	
Primary (noninterest) expenditure	49.3	48.0	45.1	57.0	52.2	45.6	44.2	42.0	41.6	282.7	
Automatic debt dynamics [5/]	-22.2	-1.8	1.6	11.9	-6.7	-5.8	-4.5	-3.6	-2.9	-11.6	
Interest rate/growth differential [6/]	-17.9	-1.8	1.6	11.9	-6.7	-5.8	-4.5	-3.6	-2.9	-11.6	
Of which: real interest rate	-13.0	0.4	0.9	12.2	-2.0	-0.6	0.1	0.7	0.8	11.1	
Of which: real GDP growth	-4.9	-2.1	0.7	-0.3	-4.6	-5.2	-4.6	-4.3	-3.7	-22.7	
Exchange rate depreciation [7/]	-4.3	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	-4.1	-1.5	-0.2	-0.2	-0.2	-0.2	-6.4	
Other flows (+ reduces financing needs) (negative)	0.0	0.0	0.0	-4.1	-1.5	-0.2	-0.2	-0.2	-0.2	-6.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., other debt flows) (+ increas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-3.8	-6.5	0.4	5.5	3.2	-0.1	0.2	0.2	0.2	9.2	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG (bp).

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ) times previous period debt ratio, with r = effective nominal interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

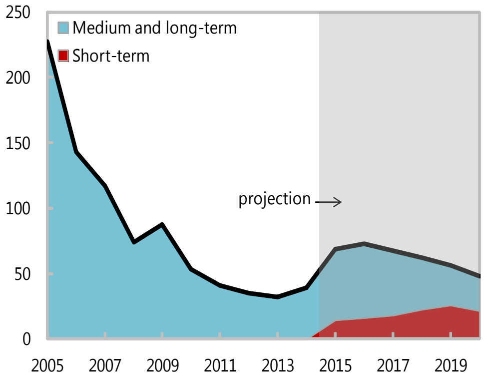
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Iraq: Public Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

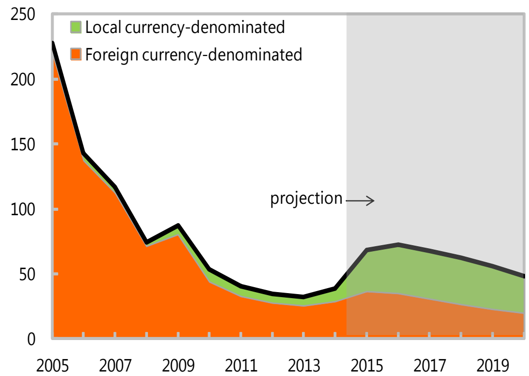
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

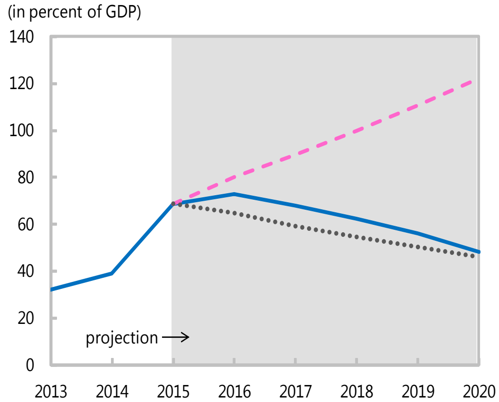


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

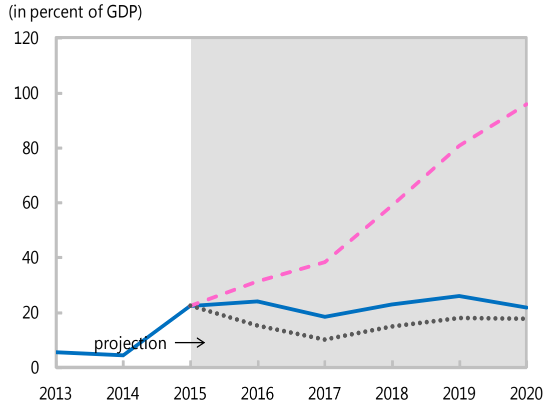
Gross Nominal Public Debt [1/]

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

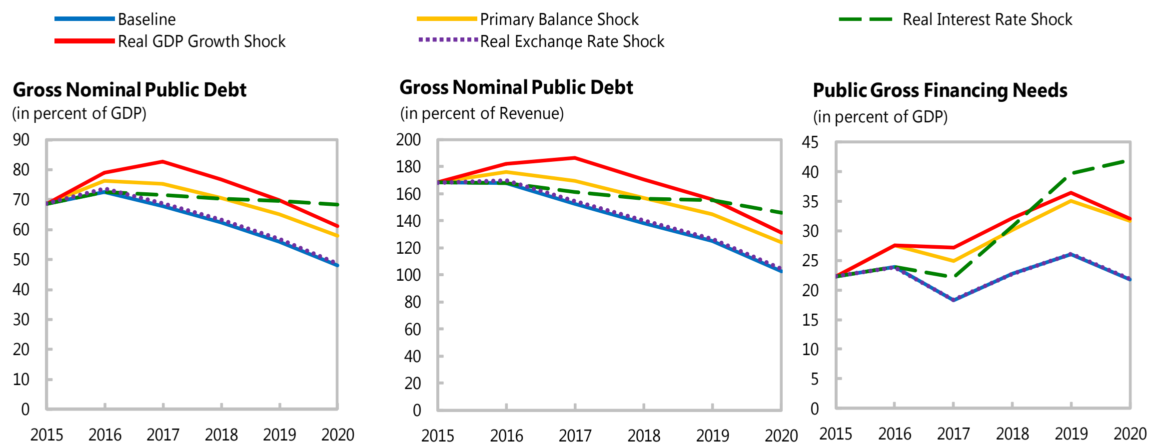
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.5	7.6	8.1	7.6	7.5	7.1
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary Balance	-16.2	-8.9	-1.2	0.8	2.8	5.0
Effective interest rate	2.0	2.1	3.0	3.0	3.0	2.9
Constant Primary Balance Scenario						
Real GDP growth	0.5	7.6	8.1	7.6	7.5	7.1
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary Balance	-16.2	-16.2	-16.2	-16.2	-16.2	-16.2
Effective interest rate	2.0	2.1	3.1	3.2	3.4	3.7

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.5	5.7	5.7	5.7	5.7	5.7
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary Balance	-16.2	0.0	0.0	0.0	0.0	0.0
Effective interest rate	2.0	2.1	0.4	0.3	-1.0	-1.5

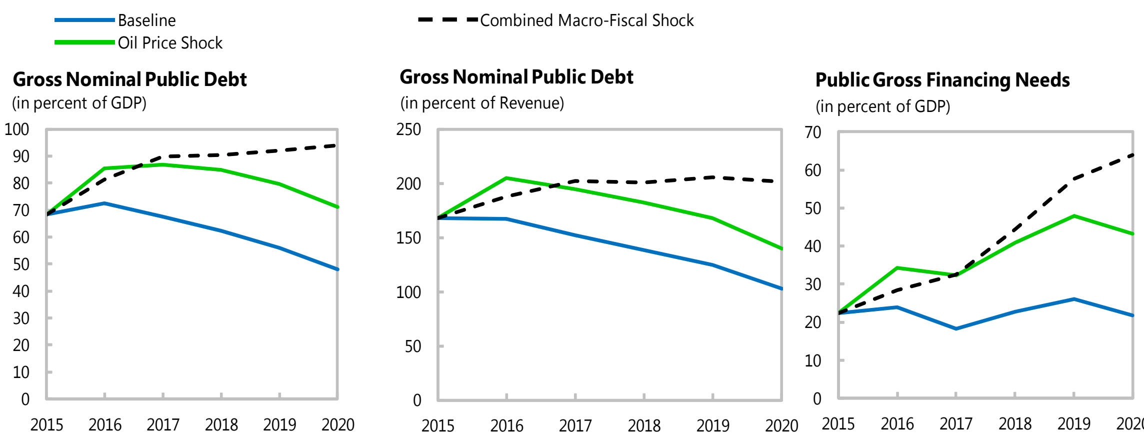
Source: IMF staff.

Figure 4. Iraq: Public Sector Debt Sustainability Analysis (DSA)—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	0.5	7.6	8.1	7.6	7.5	7.1
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary balance	-16.2	-12.6	-5.1	-0.2	1.8	3.9
Effective interest rate	2.0	2.1	3.4	3.5	3.3	3.2
Real Interest Rate Shock						
Real GDP growth	0.5	7.6	8.1	7.6	7.5	7.1
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary balance	-16.2	-8.9	-1.2	0.8	2.8	5.0
Effective interest rate	2.0	2.1	8.8	9.9	12.5	14.1
Combined Shock						
Real GDP growth	0.5	3.2	3.6	7.6	7.5	7.1
Inflation	-22.4	4.0	2.5	2.6	1.7	1.3
Primary balance	-16.2	-12.6	-6.3	-0.2	1.8	3.9
Effective interest rate	2.0	2.2	9.3	10.9	13.5	15.4

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	0.5	3.2	3.6	7.6	7.5	7.1
Inflation	-22.4	4.0	2.5	2.6	1.7	1.3
Primary balance	-16.2	-11.8	-6.3	0.8	2.8	5.0
Effective interest rate	2.0	2.1	3.3	3.5	3.1	3.1
Real Exchange Rate Shock						
Real GDP growth	0.5	7.6	8.1	7.6	7.5	7.1
Inflation	-22.4	6.3	3.6	2.6	1.7	1.3
Primary balance	-16.2	-8.9	-1.2	0.8	2.8	5.0
Effective interest rate	2.0	2.2	3.0	3.0	2.9	2.9
Oil Price Shock						
Real GDP growth	0.5	2.2	7.4	7.3	7.3	7.1
Inflation	-22.4	5.1	3.6	2.6	1.7	1.3
Primary balance	-16.2	-18.4	-7.9	-3.6	0.6	4.9
Effective interest rate	2.0	2.1	3.1	3.2	3.2	3.3

Source: IMF staff.

Table 2. Iraq: External Debt Sustainability Framework, 2010–20
(In percent of GDP; unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014	10-Year Historical Average	10-Year Standard Deviation	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
Baseline: External debt	43.9	32.8	27.7	25.5	28.8			**36.5**	**35.0**	**30.8**	**26.5**	**22.8**	**19.8**	**-2.9**
Change in external debt	-36.5	-11.2	-5.1	-2.2	3.3			7.7	-1.5	-4.2	-4.3	-3.7	-2.9	
Identified external debt-creating flows (4+8+9)	-19.5	-24.2	-12.8	-5.5	1.8			7.8	3.4	-4.4	-5.6	-5.7	-5.0	
Current account deficit, excluding interest payments	-3.2	-12.4	-7.0	-1.6	2.5			8.3	6.5	-1.1	-2.3	-2.6	-2.3	
Deficit in balance of goods and services	-0.7	-13.3	-8.5	-3.6	0.8			8.4	4.4	-0.8	-2.0	-2.2	-1.9	
Exports	39.2	44.4	44.5	39.9	39.3			37.8	40.3	41.5	42.2	42.1	44.0	
Imports	38.4	31.1	36.0	36.4	40.0			46.1	44.7	40.7	40.2	39.8	42.1	
Net non-debt creating capital inflows (negative)	-1.0	-1.0	-1.3	-2.5	-2.0			-0.6	-1.0	-1.4	-1.6	-1.7	-1.6	
Automatic debt dynamics 1/	-15.3	-10.8	-4.5	-1.5	1.3			0.1	-2.0	-2.0	-1.6	-1.4	-1.2	
Contribution from nominal interest rate	0.2	0.4	0.3	0.3	0.3			0.3	0.4	0.6	0.5	0.4	0.3	
Contribution from real GDP growth	-4.1	-2.5	-3.9	-1.7	0.6			-0.2	-2.5	-2.5	-2.1	-1.8	-1.5	
Contribution from price and exchange rate changes 2/	-11.4	-8.7	-1.0	0.0	0.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-17.0	13.0	7.7	3.3	1.5			-0.1	-4.9	0.2	1.3	2.0	2.1	
External debt-to-exports ratio (in percent)	112.1	73.8	62.2	63.8	73.2			96.7	86.8	74.1	62.7	54.2	45.1	
Gross external financing need (in billions of US dollars) 4/	-4.0	-21.9	-13.7	-2.0	8.4			23.2	14.6	-0.4	-0.7	-1.4	-1.8	
in percent of GDP	-2.9	-11.8	-6.3	-0.9	3.8			13.3	7.4	-0.2	-0.3	-0.5	-0.6	
Scenario with key variables at their historical averages 5/								**36.5**	**21.0**	**12.2**	**5.5**	**-0.1**	**-4.9**	**-0.4**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	6.4	7.5	13.9	6.6	-2.1	5.3	4.4	0.5	7.6	8.1	7.6	7.5	7.1	
GDP deflator in US dollars (change in percent)	16.6	24.7	3.0	0.1	-1.8	15.3	18.6	-22.4	5.1	3.6	2.6	1.7	1.3	
Nominal external interest rate (in percent)	0.4	1.1	1.1	1.0	1.0	0.5	0.5	0.9	1.4	1.8	1.8	1.6	1.5	
Growth of exports (US dollar terms, in percent)	33.5	52.0	17.7	-4.3	-5.4	21.5	29.7	-25.0	20.7	15.3	12.2	8.9	13.4	
Growth of imports (US dollar terms, in percent)	2.6	8.5	35.8	7.8	5.9	16.8	13.1	-10.1	9.6	1.9	9.0	8.3	14.7	
Current account balance, excluding interest payments	3.2	12.4	7.0	1.6	-2.5	5.0	7.1	-8.3	-6.5	1.1	2.3	2.6	2.3	
Net non-debt creating capital inflows	1.0	1.0	1.3	2.5	2.0	1.3	0.6	0.6	1.0	1.4	1.6	1.7	1.6	

Sources: International Monetary Fund, Country desk data, and staff estimates.

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

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

3/ For projection, line includes the impact of price and exchange rate changes.

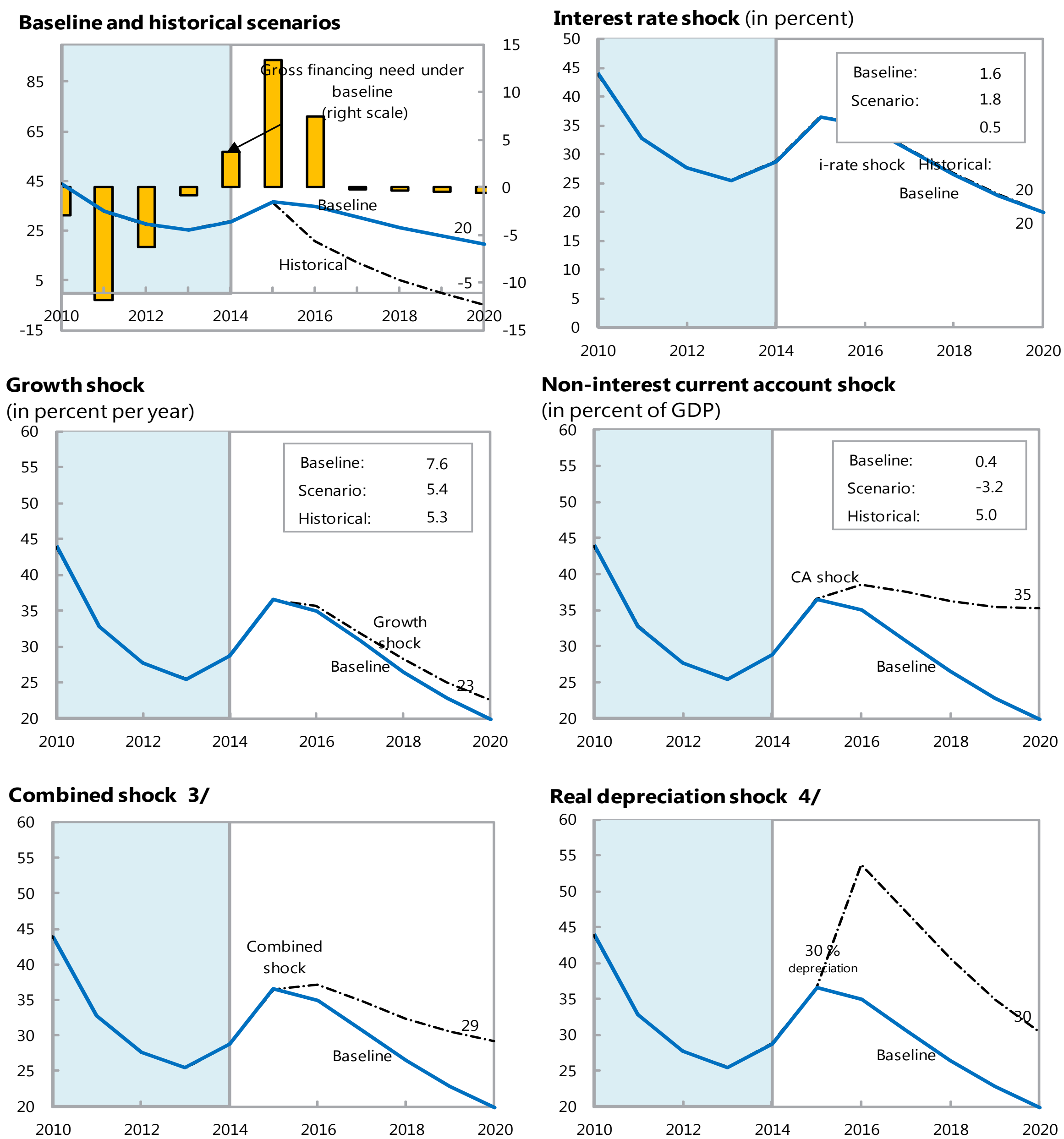
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Figure 5. Iraq: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2016.

INTERNATIONAL MONETARY FUND

IRAQ

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION AND REQUEST FOR PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—INFORMATIONAL ANNEX

July 10, 2015

Prepared By

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

CONTENTS

RELATIONS WITH THE FUND

(As of May 31, 2015)

Membership Status:

Date of membership: December 27, 1945
Status: Article XIV

General Resources Account	**SDR Million**	**Percent Quota**
Quota	1,188.40	100.00
Fund Holdings of Currency	1,284.70	108.10
Reserve Tranche Position	171.10	14.40

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	1,134.50	100.00
Holdings	306.14	26.98

Outstanding Purchases and Loans	**SDR Million**	**Percent of Quota**
Stand-by Arrangements	267.39	22.50

Latest Financial Arrangements

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	Feb 24, 2010	Feb 23, 2013	2,376.80	1,069.56
Stand-by	Dec 19, 2007	Mar 18, 2009	475.36	0.00
Stand-by	Dec 23, 2005	Dec 18, 2007	475.36	0.00

Projected Payments to the Fund[1]
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2015	2016	2017	2018	2019
Principal	230.25	37.14			
Charges/Interest	1.19	0.64	0.43	0.43	0.43
Total	**231.44**	**37.78**	**0.43**	**0.43**	**0.43**

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

Safeguards Assessments

The most recent safeguards assessment of the Central Bank of Iraq (CBI) was completed in 2010 under the SBA that expired in February 2013. While the assessment concluded that significant safeguards risks remain, it noted that the CBI maintains important safeguards recommended by previous assessments, including annual external audits by reputable audit firms and publication of the CBI's audited financial statements.

Exchange Arrangement

Iraq's de jure and de facto exchange rate arrangements have been retroactively reclassified to a conventional peg arrangement, effective January 15, 2012. The Central Bank Law provides the Board of the CBI with power to formulate exchange rate policy, and the Board has maintained its policy to keep the official exchange rate at 1,166 per U.S. dollar since January 15, 2012. The CBI stands ready to provide foreign exchange at the official exchange rate plus commissions for permissible transactions through its daily auctions (allocations), establishing a peg. However, because certain transactions are excluded from the access to the CBI auctions, many transactions take place at parallel market exchange rates. The CBI publishes the daily volume of the auction allocation on its website.

Iraq continues to avail itself of the transitional arrangements under Article XIV, Section 2 but no longer maintains any exchange restrictions or multiple currency practices subject to Article XIV, Section 2, and currently maintains three exchange restrictions and one multiple currency practice (MCP) subject to Fund approval under Article VIII, Sections 2(a) and 3. Two of four exchange restrictions identified in 2009 have been removed, with two remaining. All exchange restrictions identified in 2012 have now been removed. Although the various measures limiting the availability of foreign exchange, which gave rise to the MCP identified in 2012, have evolved and changed over the last three years, the MCP remains in place. One new exchange restriction has been identified in 2015.

The foreign exchange system in Iraq has been constantly modified over the last few years. Until March 2009, Iraq maintained a generally open current and capital accounts. However, access to foreign exchange from the official auction organized by the Central Bank of Iraq (CBI) became subject to various limits starting in 2009. The limits were modified several times, in part reflecting the authorities' efforts to liberalize the system while keeping speculative demand for foreign exchange cash under control, as well as volatile security conditions and pressure on official reserves from fluctuations in global oil prices.

In 2009, the Fund identified four exchange restrictions, two of which have now been removed. The two exchange restrictions that have been removed were based upon CBI circulars that have now been nullified. These restrictions arose from (i) the requirement to submit a tax certificate and a letter of nonobjection stating that the companies do not owe any taxes to the government before non-Iraqi companies may transfer proceeds of current international transactions out of the country; and (ii) the requirement that before non-Iraqis may transfer proceeds in excess of ID 15 million out of Iraq, the banks are required to give due consideration of legal obligations of these persons with respect to official entities, which must be settled before allowing any transfer. The exchange restrictions that remain in place arise from (i) the requirement to pay all obligations and debts to the government before proceeds of investments of investors, and salaries and other compensation of non-Iraqi employees may be transferred out of Iraq; and (ii) an Iraqi balance owed to Jordan under an inoperative bilateral payments agreement.

All exchange restrictions identified in 2012 have now been removed. In 2012, the Fund identified five additional exchange restrictions and a multiple currency practice (MCP). In 2013, four of these five exchange restrictions were removed as the relevant circulars were nullified. These measures were: (i) the requirement to submit a tax clearance certificate that all taxes (even unrelated to the transaction) have been paid before foreign exchange for payment and transfer of certain current international transactions can be purchased in the auction; (ii) the limitation that corporates can purchase foreign exchange in the auction for import transactions only; (iii) a limit of US$75,000 a week on the availability of foreign exchange cash in the auction for money transfer companies (MTCs) and money exchange bureaus (MEBs); and (iv) a limit of US$4 million a week on the availability of foreign exchange cash in the auction for banks. In 2015, the final exchange restriction identified in 2012, arising from the limit on individual purchases of cash foreign exchange, was also removed. This exchange restriction originally arose from the US$5,000 limit on individual purchases of cash foreign exchange, imposed by Circular No. 19 of October 1, 2012. The CBI reports that this limit is now only indicative, due to the repeal of previous circulars, and therefore this measure no longer gives rise to an exchange restriction. However, this has been communicated to banks only by informal electronic message. Therefore, this measure no longer gives rise to an exchange restriction as the limit is now only indicative.[10]

The 2015 Article IV mission identified one new exchange restriction arising from weekly limits on purchases of cash by financial institutions from the CBI.[11] Recently these limits have been raised to $300,000 per week for banks with capital of at least ID 250 billion, $150,000 per week for MTCs, and $50,000 per week for MEBs. Similar limits on the availability of foreign exchange in the CBI auction

[10] The advance deposit requirement for purchase of foreign exchange, originally identified in 2014, no longer gives rise to an exchange restriction given that the authorities assert that it is for purposes of assessing the bona fide of exchange transactions within the now "normal" 5-day limit. This measure was originally imposed by Circular No. 2/24 (Jan. 25, 2014); however, most provisions of this circular were nullified by Circular No. 9/3/26 of February 2015. The advance deposit requirement continues in force by virtue of paragraphs b (wire sales) and h (cash sales) of the February 2015 circular. The original requirement was that banks wishing to purchase foreign exchange must deposit with the CBI the Iraqi dinar equivalent of the amount requested for purchase "one week prior to the date of actual purchase." The period was subsequently changed to 15 days by the February 2015 circular, then to 10 days on May 25, 2015 by a verbal instruction of the CBI, and to five days in June 2015.

[11] The mission also discussed another new exchange restriction arising from a requirement for importers to pay a portion of custom duties and income tax that will be due on imports at the time of purchase of foreign exchange necessary for such imports. The requirement was cancelled in June 2015, and hence the exchange restriction was also removed.

for banks, MTCs, and MEBs were originally imposed beginning in 2010 and found to give rise to exchange restrictions. Later these measures were removed, and thus the exchange restrictions were also removed).

The MCP was originally identified by the Fund in 2012 and continues to remain in place, even though the various measures limiting the availability of foreign exchange have evolved and changed. The MCP arises from the official action to limit the purchase of foreign exchange, with no mechanism to ensure that exchange rates in the official auction and in the market do not deviate from each other by more than two percent. The average spread between the official and market rates was around 10 percent in May 2015.

In addition, one exchange restriction maintained for security reasons should be notified to the IMF under the framework of Decision 144–(52/51).

Article IV Consultation

Iraq is on the standard 12-month consultation cycle. The last Article IV consultation was concluded on May 13, 2013. The staff report (IMF Country Report No. 13/217) was published on July 19, 2013, and is available on the internet at http://www.imf.org/external/pubs/cat/longres.aspx?sk=40802.0.

IRAQ: RECENT TECHNICAL ASSISTANCE, 2005–15

Department	Date	Purpose
FAD	February 2005	Public Financial Management (Joint FAD-World Bank Mission)
FAD	April 2005	Budget Classification Reform
FAD	November 2006	Financial Management Information System
FAD	December 2006	Oil sector management and fiscal federalism
FAD	May 2007	Tax policy workshop
FAD	March 2008	Public Financial Management
FAD	August 2008	Oil sector—Pricing and Financial Flows
FAD	March 2008	Oil sector—Taxation
FAD	October 2009	Public Financial Management
FAD	May 2010	Public Financial Management
FAD	March 2012	Public Financial Management
FAD	May 2012	Public Financial Management
FAD	December 2012	Public Financial Management
LEG	August 2008	AML/CFT raising awareness workshop
LEG	October 2008	Article VIII acceptance
LEG	February 2009	Workshop for financial intelligence unit and criminal justice officials on AML/CFT measures

IRAQ: RECENT TECHNICAL ASSISTANCE, 2005–15

Department	Date	Purpose
LEG	April 2010	Phase One of the Three-Phase AML/CFT Capacity Enhancement and Sustainability Training Program
LEG	July 2010	Phase Two of the Three-Phase AML/CFT Capacity Enhancement and Sustainability Training Program
LEG	October 2012	Article VIII acceptance and AML/CFT assessment
MCM	March 2007	Banking restructuring
MCM	March 2007	Banking supervision
MCM	September 2007	Banking restructuring
MCM	March 2008	Liquidity forecasting and management
MCM	April 2008	Bank restructuring workshop
MCM	July 2008	Reserve management
MCM	August 2008	Bank restructuring workshop
MCM	October 2008	Article VIII acceptance
MCM	December 2008	Reserve management
MCM	January 2009	Bank supervision workshop
MCM	March 2009	Banking supervision workshop
MCM	July 2009	TA coordination summit
MCM	November 2009	Reserve management
MCM	November 2009	Banking supervision workshop-reporting forms
MCM	April 2010	Islamic banking workshop
MCM	August 2010	Reserve management
MCM	August 2010	Remote assistance on liquidity management and treasury market development
MCM	December 2010	Government Securities/Monetary Operations
MCM	January 2011	Government Securities/Monetary Operations
MCM	January 2011	Training on New Developed Regulations and Call Reports (METAC)
MCM	January 2011	Training on Off-Site Supervision and Report Development (METAC)
MCM	April 2011	Risk management workshop (stress testing)
MCM	May 2011	Bank restructuring
MCM	May 2011	Reserve management
MCM	July 2011	Reserve management
MCM	September 2011	Reserve management workshop
MCM	March 2012	Bank restructuring
MCM	October 2012	Article VIII acceptance

IRAQ: RECENT TECHNICAL ASSISTANCE, 2005–15 (concluded)

Department	Date	Purpose
MCM	March 2014	Assessment of Banking Needs (METAC)
MCM	April 2014	Central Bank Reserve Management
MCM	May 2015	Asset Management
STA	January 2006	Balance of Payments Statistics
STA	March 2006	Monetary and Financial Statistics
STA	November 2006	Balance of Payments Statistics
STA	January 2007	Monetary and Financial Statistics
STA	January 2007	Consumer Price Statistics
STA	April 2007	Monetary and Financial Statistics
STA	February 2007	National Accounts Statistics
STA	November 2007	Consumer Price Statistics
STA	February 2008	External Sector Statistics
STA	February 2008	National Accounts Statistics
STA	January 2009	External Sector Statistics
STA	November 2009	National Accounts Statistics
STA	April 2010	External Sector Statistics
STA	July 2010	Monetary and Financial Statistics
STA	February 2012	External Sector Statistics
STA	March 2012	National Accounts Statistics
STA	May 2012	Monetary and Financial Statistics
STA	April 2013	National Accounts Statistics
STA	December 2013	Balance of Payments Statistics
STA	December 2014	Balance of Payments Statistics (METAC)
STA	March 2015	Government Finance Statistics (ArabStat)
STA	May 2015	Government Finance Statistics
INS	February 2006	Financial Programming and Policies
INS	February 2007	External Sector Issues
INS	March 2008	Financial Programming and Policies
INS	January 2009	Financial Programming and Policies
INS	January 2010	Financial Programming and Policies

RELATIONS WITH THE WORLD BANK GROUP

(As of June 30, 2015)

Title	Products	Provisional and Actual Timing of Missions	Expected and Actual Delivery Date
A. Mutual Information on Relevant Work Program			
The World Bank work program in the next 12 months[1]	**Economic Policy Analysis and Advice** **WB:** - Systematic Country Diagnostic (SCD) - Iraq Public Expenditure Review, Wages and Subsidies - (KRG-RAS) Growth Diagnostic Analysis	Sept. 2015 July 2015 Nov. 2014	July 2016 June 2016 June 2016
	Technical Assistance **WB:** - Public Financial Management - Social Protection - Extractive Industries Transparency Initiative - Pension Reform - Doing Business Reforms - Poverty TA - (Baghdad RAS) Gas value chain in Iraq - (KRG-RAS) Procurement reform - (KRG-RAS) Social safety Nets and pension - (KRG-RAS) Support to Choura Council **IFC:** - Infrastructure PPPs - Strengthening financial infrastructure - Improving banks' corporate governance	July 2015 July 2015 March 2015 July 2015 July 2015 April 2015 July 2015 Nov. 2013 Nov. 2013 Nov. 2013	June 2016 June 2016 Dec. 2015 June 2016 June 2017 June 2016 Feb. 2017 June 2016 Jan. 2016 Jan. 2016 Ongoing

[1] Not including infrastructure investments.

	and risk management systems - Providing SME training under Business Edge, especially to women owned enterprises		
The Fund work program in the next 12 months	**Macroeconomic Policy Analysis and Advice** - Staff visit - Article IV consultation - Continuous policy advice	Sept. 2013 March 2014	May 2014
	Technical Assistance - Statistical capacity: national accounts - Public Financial Management - Statistical capacity: CPI - Reserves management - FX new regulations - AML/CFT	April 2013 Mayo 2013 Spring 2013 Continuous Continuous	May 2013
B. Requests for Work Program Inputs			
Fund request to Bank	- Macroeconomic and financial data to be shared regularly - Logistical support on missions to Iraq	Ongoing basis	
Bank request to Fund	- Fiscal data to be shared regularly - Coordination on macroeconomic policy and management training - Macroeconomic and financial data to be shared regularly, including any restriction on foreign exchange transactions - Sector-specific data - Consultations outcomes to be shared	Ongoing basis	
C. Agreement on Joint Products and Missions			
Joint products in the next 12 months	n/a		

STATISTICAL ISSUES

(As of June 30, 2015)

I. Assessment of Data Adequacy for Surveillance

General

Data provided to the Fund have serious shortcomings that significantly hamper surveillance. Macroeconomic statistics have suffered from years of neglect and recent turmoil has added to the difficulties. While the Central Statistics Organization (CSO) remained in place, it lacks adequate technical expertise and resources to address the requirements for a modern statistical system. At the Central Bank of Iraq (CBI), statistical capacity is slightly better, but issues of interagency data sharing and data collection responsibilities are hampering progress on external sector statistics.

Since 2003, the Statistics Department (STA) has provided considerable technical assistance (TA) in all major datasets, including on dissemination standards.

National Accounts

CSO compiles annual and quarterly national accounts at current and constant (2007) prices. Annual data of GDP by activity are available on the website of CSO for 2003–13, and quarterly GDP data up to the third quarter of 2014.

The national accounts follow the 1968 System of National Accounts (SNA), however, with technical assistance from STA, CSO is moving towards implementing the concepts of the 1993 SNA. The quality of the national accounts compiled is poor due to the lack of comprehensive source data for estimating value added by activity and for GDP by expenditure. A Household Budget Survey (HBS) was conducted during 2007 and the results have been incorporated. CSO still includes the Kurdistan Territory's contribution to GDP by economic activities as percentages for each activity based on results obtained from previous estimates dating back to 1990. Other activities that started in the Kurdistan Territory after 1990 are not included. There are limited price and volume data for deriving volume measures of GDP. The base year was recently updated to 2007

There is a shortage of quarterly and monthly indicators of economic activity and a lack of timely data for services. Quarterly GDP estimates are based on a limited number of indicators—crude oil output, electricity, rent of dwellings, and government expenditure.

Price Statistics

Based on the HBS 2007, CSO compiles and disseminates a monthly CPI for all-Iraq (including Kurdistan) and for each governorate. However, the CPI only covers the urban areas in all governorates and resources are insufficient to expand coverage. Starting June 2014 official data on CPI do not include the four conflict-affected provinces. A quarterly PPI is also compiled and disseminated within two months of the reference quarter. The index is based in 2007 which needs to be updated, and capacity building is needed to implement improvements to methodology.

Government Finance Statistics

Despite the difficult security situation, which has a direct impact on data compilation and analysis, the provision of fiscal data for program monitoring purposes has been satisfactory. Infrequent submission delays occur, and coverage of the Kurdish region remains sketchy. However, the authorities are taking measures to address these shortcomings.

In March 2015, an STA mission—overlapped with the Article IV mission—discussed a work plan aimed at improving the frequency and timeliness of fiscal reporting data and setting a migration plan to improve fiscal statistics based on Government Finance Statistics Manual 2014 (GFSM 2014). Iraq resumed reporting government finance statistics for publication in the Government Finance Statistics Yearbook (GFSY). Currently there are no fiscal statistics published by the government beyond the summary of central government budgetary estimates and outturn.

Monetary and Financial Statistics

Notable progress has been made in developing the components and structure for compiling a depository corporations survey, but the quality and timeliness of the data continue to be hampered by the lack of staff capacity, particularly at the commercial bank level. While most banks, including state-owned banks are using the new report forms, which were developed based on the IMF's Monetary and Financial Statistics Manual, some banks continue to have data reporting problems (e.g., missing data, reporting errors, and reporting delay). Therefore, the old report forms are still used to compile data for other depository corporations (ODCs). Monetary statistics does not cover the northern region (Kurdistan) due to problems with data collection from that region. As a result, the CBI reports data for publication in the IMF's International Financial Statistics with a lag of more than three months and the latest reported data for ODCs are marked "preliminary," indicating that there are problems with their data collection and compilation.

Financial sector surveillance

Iraq has not yet compiled financial soundness indicators (FSIs) as set out in the IMF's *FSI Compilation Guide*. Following a discussion with the IMF (STA) during the 2015 Spring Meetings in Washington, D.C., the CBI requested technical assistance in compiling FSIs. STA will decide on the tasks, dates, and alternative location for a technical assistance mission upon receiving adequate information, including source data for commercial banks from the CBI.

External Sector Statistics

Balance of Payments and IIP Statistics

Balance of payments statistics are available to the Fund for 2005–2013 in the IMF's Balance of Payments Manual, sixth edition (BPM6) format. The CBI also compiles and disseminates an annual international investment position (IIP) statement. The quality of the information for recent years has marginally improved but timeliness remains a key concern. Further, the presentation is still limited due to coverage problems and some deviations from the internationally acceptable methodologies. Issues regarding the full recording of external debt data continue to impact the coverage and timeliness of balance of payments and IIP statistics. International reserves are compiled consistent with international methodologies and published in the IFS since end-2006.

The quality of the information remains hampered by the lack of data submission to the CBI from other government institutions and the private sector, which is evidenced by large and growing errors and omissions with persistent negative sign. The paucity of data exists particularly in the areas of external trade in goods and services and foreign direct investment. To help address these and other issues, a February 2012 mission proposed several recommendations, including improved interagency cooperation on direct investment statistics.

External Trade Statistics

External trade data have serious problems of timeliness and are of poor quality. A new customs form for imports is available but it is not being used at the customs border due to the security situation and the lack of Customs Department resources at the border outlets.

Coverage of private sector imports is constrained by data sources. Only goods that are paid for through the Iraqi banking system are captured. Thus goods that are imported under external payments arrangements (for example, imports for direct investment projects) are not recorded in the balance of payments. The coverage of the external trade statistics excludes the northern region of the country (Kurdistan), and no estimates for smuggling are made.

Export data from the oil sector are received from the BOPSD at the CBI. The nonoil export data, which amounts to the equivalent of 3–5 percent of total exports, are compiled based on information from the customs export form. Nonoil export data are provided to the CBI on a monthly basis for crosschecking purposes.

II. Data Standards and Quality

The country is a GDDS participant. However, most of its metadata, with the exception of the real sector and socio-demographic metadata, have not been updated since October 2002. At the authorities' request, STA has conducted an SDDS assessment, providing a draft action plan that could lead to SDDS subscription.	No data ROSC is available.

APPENDIX I. TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of June 2015)

	Date of latest observation (For all dates in table) dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality–Methodological soundness[9]	Data Quality–Accuracy and reliability
Exchange Rates	24/6/2014	24/6/2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	23/4/2014	4/2015	M	M	M, 4-6 week lag		
Reserve/Base Money	31/12/2014	4/2015	M	M	M, 4-6 week lag		
Broad Money	31/12/2014	4/2015	M	M	M, 4-6 week lag		
Central Bank Balance Sheet	31/12/2014	4/2015	M	M	M, 4-6 week lag		
Consolidated Balance Sheet of the Banking System	31/12/2014	1/4/2015	M	M	Q 4-6 week lag		
Interest Rates[2]	23/4/2014	4/2015	M	M	M, 4-6 week lag		
Consumer Price Index	30/4/2014	29/5/2015	M	M	M, 3 week lag		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	03/2015	26/5/2015	M	M	N/A		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	03/2015	26/5/2015	M	M	N/A		

APPENDIX I. TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE (concluded)

(As of June 2015)

	Date of latest observation (For all dates in table) dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality – Methodological soundness[9]	Data Quality– Accuracy and reliability
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/2014	1/6/2015	N/A	N/A	N/A		
External Current Account Balance	12/2014	1/6/2015	Q	Q	Q 9 month lag		
Exports and Imports of Goods and Services	12/2014	1/6/2015	Q	Q	Q 9 month lag		
GDP/GNP	3/2014	5/2014	Q	Q	Q 3 month lag		
Gross External Debt	12/2014	1/6/2015	N/A	N/A	N/A		
International Investment Position[6]	12/2014	6/1/2015	Q	Q	Q 9 month lag		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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

[3] Foreign, domestic bank, and domestic nonbank financing.

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

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.

[9] Iraq has not had the data ROSC or the Substantive Update.

INTERNATIONAL MONETARY FUND

IRAQ

July 24, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION AND REQUEST FOR PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—SUPPLEMENTARY INFORMATION AND SUPPLEMENTARY LETTER OF INTENT

Approved By
Aasim M. Husain and Taline Koranchelian

Prepared By
Middle East and Central Asia Department

1. **The authorities have requested increased financing under the Rapid Financing Instrument, in line with the recent change in Fund policy**. In the attached Supplementary Letter of Intent, the authorities request a purchase of 75 percent of quota (SDR 891.3 million, $1.242 billion) under the Rapid Financing Instrument (RFI), to be channeled to the budget (see attached revised Decision). Higher access compared to the 50 percent of quota (SDR 594.2 million, $828.9 million) requested in the Letter of Intent dated July 9, 2015 would be in line with the increase in RFI access limits recently endorsed by the Board in the context of the Fund's efforts to enhance the financial safety nets for developing countries.

2. **Higher access under the RFI would strengthen Fund financial support to Iraq, but would still not close either the balance of payments or the budget gaps**. The revised macroeconomic framework (see attached tables) includes additional Fund financing of about $413 million (0.2 percent of GDP) compared to the staff report.

Prior actions

3. **The prior action on signing MOUs between the state-owned banks, the Central Bank of Iraq and the Ministry of Finance has been completed**. Both the MOUs between the state-owned banks and the ministry of finance, and those between the state-owned banks and the Central Bank of Iraq (CBI) have been signed (prior action, see Letter of Intent, Table 1).

4. **The prior action on Cabinet approval of the new electricity tariff schedule will not be implemented before the Board meeting**. The Iraqi authorities have informed staff that the Cabinet will not be able to prepare and fully implement the tariff increase in the foreseeable future, due to the authorities' increasingly strained capacity to overcome the political and social difficulties in the context of the recent setbacks in the conflict with ISIS. The new tariff reform was expected to deliver about 2.4 percent of fiscal savings on an annual basis, or 1.2 percent of GDP for 2015. In a worst-case scenario in which the tariff reform is not implemented this year, the government deficit would be 18.4 percent of GDP compared to 17.2 percent of GDP under the staff report baseline, and the unidentified financing gap would reach 7.5 percent of GDP compared to 6.3 percent of GDP under the baseline (adjusted to reflect a purchase of 75 percent of quota). In this scenario, end-2015 public debt would reach 70 percent of GDP, compared to from 68.5 percent of GDP under the baseline, because of higher financing needs. Staff expects the reform to be implemented, or compensating measures to be introduced. Therefore, projections for 2016 and the medium term are affected only marginally.

5. **The authorities remain committed to implement the tariff reform as soon as possible (see attached Supplementary Letter of Intent)**. The authorities see the introduction of the new electricity tariff schedule as important to provide fiscal savings and to accelerate the reform of the energy sector, and intend to proceed with the tariff increase as soon as possible, which may be after the summer when the high demand for electricity, causing more frequent outages, subsides. However, the delay underlines the high risk that the tariff increase may not be approved in 2015, in which case the authorities commit to find compensatory fiscal measures. In this regard, Cabinet has approved this week a 40–50 percent cut in salaries for the high-level government officials, ranging from the Prime Minister to department directors, and a reduction in salaries for members of parliament. The measure is not expected to bring significant savings but has a high symbolic value.

External Sector

6. **The CBI has informed staff that international reserves of the CBI were $65.5 billion at end-June 2015**. The update is in line with staff's projection of $50.4 billion at end-2015 (taking into account increased Fund financing).

7. **The foreign exchange market has stabilized.** The parallel market spread has remained stable at about 4 percent as of July 21st.

Staff Appraisal

8. **Staff supports the request of a purchase of 75 percent of quota under the RFI**. Increased financing from the Fund would better contribute to address the present and urgent balance of payments problem, helping reduce the gap arising from unidentified domestic and external financing. The increased access does not significantly alter staff's assessment of Iraq's capacity to repay the Fund.

9. **Staff urges the authorities to quickly implement the agreed tariff reform (or equivalent contingency measures) given the large financing gap**. The delay in raising electricity tariffs increases the fiscal deficit and the financing gap, thus increasing the need for further fiscal adjustment in 2015-16. However, the tariff reform—while still macrocritical given the large residual financing gap and the current low level of tariffs in Iraq compared to other countries in the region—has turned out to be more challenging than expected. Ultimately, the delay reflects the authorities' weaker than previously envisaged policy capacity, further undermined by the government's focus on the ISIS conflict and the increasingly tense social and political situation. In light of this capacity issue, in accordance with the Fund's Guidelines on Conditionality, staff recommends that the electricity tariff reform not be a prior action for the purchase under the RFI, thus giving the authorities more time to implement this measure.

Table 1. Iraq: Selected Economic and Financial Indicators, 2012–20

(Quota: SDR 1,188.4 million / 0.5 percent of total)

(Population: 33.4 million; 2013)

(Poverty rate: 23 percent, 2014)

(Main export: Crude oil)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Actual	Actual	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Economic growth and prices									
Real GDP (percentage change)	13.9	6.6	-2.1	0.5	7.6	8.1	7.6	7.5	7.1
Non-oil real GDP (percentage change)	15.0	10.2	-8.8	-11.2	2.0	3.0	4.0	5.0	5.0
GDP deflator (percentage change)	2.7	0.1	-1.8	-22.4	5.1	3.6	2.6	1.7	1.3
GDP per capita (US$)	6,693	6,957	6,520	4,960	5,470	5,971	6,421	6,843	7,241
GDP (in US$ billion)	218.0	232.5	223.5	174.4	197.3	220.9	243.7	266.4	289.1
Oil production (mbpd) 1/	3.0	3.0	3.1	3.4	3.8	4.3	4.7	5.1	5.5
Oil exports (mbpd) 2/	2.4	2.4	2.5	3.1	3.3	3.6	3.8	4.1	4.4
Iraq oil export prices (US$ pb)	106.7	102.9	97.0	54.7	62.0	67.1	69.9	71.0	71.5
Consumer price inflation (percentage change; end of period)	3.6	3.1	1.6	3.0	3.0	3.0	3.0	3.0	3.0
Consumer price inflation (percentage change; average)	6.1	1.9	2.2	2.1	3.0	3.0	3.0	3.0	3.0
				(In percent of GDP)					
National Accounts									
Gross domestic investment	22.1	27.0	26.1	29.8	27.3	25.8	26.0	25.2	25.9
Of which: public	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Gross domestic consumption	69.4	69.5	74.7	78.5	77.1	73.3	72.0	72.6	72.3
Of which: public	20.7	21.2	19.0	25.9	23.1	21.3	20.2	19.4	18.7
Gross national savings	28.8	28.3	23.3	21.3	20.4	26.4	27.9	27.4	27.8
Of which: public	17.9	11.6	13.7	3.4	9.6	15.7	18.3	19.9	22.9
Saving - Investment balance	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.8	2.2	1.9
				(In percent of GDP, unless otherwise indicated)					
Public Finance									
Government revenue and grants	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Government oil revenue	43.4	39.0	37.8	35.9	38.7	40.0	40.7	40.6	42.4
Government non-oil revenue	4.0	3.6	2.3	4.8	4.6	4.4	4.3	4.2	4.2
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure, *of which:*	42.9	48.4	45.4	59.2	53.6	47.6	46.1	43.8	43.2
Current expenditure	29.7	30.9	26.4	37.6	33.9	29.0	27.0	25.4	24.1
Capital expenditure	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Primary fiscal balance	4.5	-5.5	-5.0	-17.4	-8.9	-1.2	0.8	2.8	5.0
Overall fiscal balance (including grants)	4.1	-5.8	-5.3	-18.4	-10.3	-3.2	-1.1	1.0	3.5
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-68.6	-61.8	-59.0	-58.6	-55.6	-55.4
Memorandum items:									
Tax revenue/non-oil GDP (in percent)	2.1	2.0	1.8	3.6	3.8	3.8	3.8	3.8	3.8
Development Fund of Iraq/MoF US$ account (in US$ billions) 3/	18.1	6.5	0.9	1.0	1.0	1.0	1.0	1.0	6.3
Total government debt (in percent of GDP)	34.7	31.9	38.9	70.0	74.0	68.7	63.3	57.0	49.1
Total government debt (in US$ billion)	75.7	74.3	87.0	122.1	145.9	151.8	154.4	151.9	141.9
External government debt (in percent of GDP)	27.7	25.5	28.8	37.0	35.5	31.0	26.6	22.8	19.8
External government debt (in US$ billion)	60.3	59.2	64.3	64.5	69.9	68.4	64.9	60.9	57.4
				(In percent, unless otherwise indicated)					
Monetary indicators									
Growth in reserve money	8.3	12.6	-9.6	-1.0	-6.5	10.0	10.0	10.0	10.1
Growth in broad money	3.4	16.7	3.6	17.5	8.7	13.5	12.7	11.1	10.3
Policy interest rate (end of period)	6.0	6.0	6.0	…	…	…	…	…	…
				(In percent of GDP, unless otherwise indicated)					
External sector									
Current account	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.8	2.2	1.9
Trade balance	14.3	9.5	6.6	-1.3	2.6	7.1	8.2	8.4	8.4
Exports of goods	43.2	38.5	37.4	35.6	38.3	39.6	40.4	40.2	42.1
Imports of goods	-28.9	-29.0	-30.9	-36.9	-35.8	-32.6	-32.2	-31.9	-33.7
Overall external balance	4.4	-1.3	-7.6	-13.6	-7.9	0.1	1.7	2.7	2.5
Gross reserves (in US$ billion) 4/	69.3	77.8	66.7	50.4	41.5	41.7	45.6	52.8	60.0
In months of imports of goods and services	9.8	10.4	9.9	6.9	5.5	5.1	5.2	5.2	5.2
Exchange rate (dinar per US$; period average)	1,166	1,166	1,166	…	…	…	…	…	…
Real effective exchange rate (percent change, end of period) 5/	-1.7	6.5	4.6	…	…	…	…	…	…

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

1/ Does not reflect KRG production during 2013 and 2014.

2/ Reflects KRG exports through State Organization for Marketing Oil (SOMO).

3/ Reflects the balances of the Development Fund of Iraq which were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

4/ Starting 2014 includes US$ account balances from oil revenues.

5/ Positive means appreciation.

Table 2. Iraq: Central Government Fiscal Accounts, 2012–20
(In trillions of Iraqi dinars; unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Actual	Actual	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenues and grants	119.4	115.4	104.4	82.9	99.6	114.3	127.9	139.1	157.3
Revenues	119.4	115.4	104.4	82.9	99.6	114.3	127.9	139.1	157.3
Crude oil export revenues	109.4	104.1	97.1	72.1	87.8	101.6	114.2	124.3	141.2
Grants	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	109.0	131.2	118.2	120.3	123.3	122.6	130.9	136.0	145.5
Current expenditures	75.5	83.7	68.8	76.5	78.0	74.6	76.7	79.0	81.1
Salary and pension	34.9	41.1	40.3	41.3	41.8	43.0	44.3	45.6	47.0
Salary	28.5	32.5	31.8	32.6	33.0	34.0	35.0	36.0	37.1
Pension	6.4	8.6	8.4	8.7	8.8	9.0	9.3	9.6	9.9
Goods and services	17.5	16.3	9.1	11.4	11.4	11.7	13.1	14.5	15.9
Transfers	16.3	20.0	13.8	21.8	16.4	14.7	14.0	13.5	13.0
Social safety net (including PDS)	6.7	7.6	7.6	8.0	8.0	8.2	8.5	8.7	9.0
Transfers to SOEs 1/	2.9	1.9	1.5	1.5	1.5	1.5	1.4	1.4	1.3
Other transfers	6.7	10.5	4.8	12.4	7.0	5.0	4.2	3.4	2.7
Interest payments	1.0	1.0	0.7	2.0	3.1	5.1	5.3	5.4	5.2
War reparations 2/	5.5	5.2	4.9	0.0	5.4	0.0	0.0	0.0	0.0
Contingency	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Investment expenditures	33.6	47.6	49.4	43.9	45.2	48.0	54.2	57.0	64.4
Balance (including grants)	10.4	-15.8	-13.8	-37.4	-23.7	-8.3	-3.0	3.2	11.7
Balance (excluding grants)	10.4	-15.9	-13.8	-37.4	-23.7	-8.3	-3.0	3.2	11.7
Statistical discrepancy	-1.1	-0.7	0.8	...	...	...	...	...	...
Financing, *of which:*	-9.3	16.6	13.1	37.4	23.7	8.3	3.0	-3.2	-11.7
External financing	-3.6	12.4	5.5	-9.6	-0.7	-0.4	-4.1	-4.9	-4.1
Assets held abroad	-1.8	13.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	0.0	0.0	0.5	0.6	0.6	0.7	0.7
Amortization	-1.8	-1.1	-2.6	-1.7	-1.2	-1.0	-4.7	-5.6	-4.9
Arrears	0.0	0.0	7.9	-7.9	0.0	0.0	0.0	0.0	0.0
Domestic financing	-5.8	4.2	7.6	26.2	2.2	8.7	7.1	1.8	-7.6
SDR Allocation	0.0	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0
Commercial bank loans	-4.8	6.1	1.1	1.5	0.0	0.0	0.0	0.0	0.0
T-bills	-1.0	-1.9	5.0	26.2	3.0	9.5	7.8	2.4	-6.9
o/w CBI purchases	0.0	0.0	0.0	19.0	0.0	0.0	0.0	0.0	0.0
Arrears	0.0	0.0	2.3	-2.3	0.0	0.0	0.0	0.0	0.0
Amortization	0.0	0.0	-0.9	-0.8	-0.8	-0.8	-0.7	-0.7	-0.6
Financing gap:				20.8	22.1	...	...	...	...
IMF				1.4	0.0	...	...	...	...
World Bank				1.7	0.6	...	...	...	...
Eurobond				2.3	2.3	...	...	...	...
Other unidentified				15.3	19.2	...	...	...	...
Memorandum items:									
Security-related expenditure (military and police equipment and salaries)	16.7	16.4	16.6	19.0	19.2	19.8	20.8	21.9	22.9
Primary fiscal balance	11.4	-14.8	-13.1	-35.5	-20.6	-3.1	2.3	8.6	16.9
Non-oil primary fiscal balance	-81.8	-100.0	-83.7	-87.5	-82.9	-83.9	-89.3	-91.6	-98.8
Development Fund of Iraq (excluding military equipment escrow accounts) 3/	21.1	7.6	...	...	...	...	...	...	...
MOF US$ account at CBI (denominated in IDs) 3/	...	...	1.0	1.2	1.2	1.2	1.2	1.2	7.4
Average Iraq oil export price (US$/bbl)	106.7	102.9	97.0	54.7	62.0	67.1	69.9	71.0	71.5
CBI total financing of the budget deficit	0.0	0.0	0.0	34.3	19.2	0.0	0.0	0.0	0.0

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

1/ For 2012-2014, includes off-budget transfers to SOEs financed by Bank Rafidain.

2/ Five percent of oil exports as mandated by U.N. Security Council Resolution 1483 to finance war reparations to Kuwait until 2016.

3/ Reflects the balances of the Development Fund of Iraq which were moved from the Federal Reserve Bank of New York to the CBI as a US$ account (US$ balances from oil revenues) in May 2014.

Table 3. Iraq: Central Government Fiscal Accounts, 2012–20
(In percent of GDP)

	2012 Actual	2013 Actual	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
Revenues and grants	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Revenues	47.0	42.6	40.1	40.8	43.3	44.4	45.0	44.8	46.6
Crude oil export revenues	43.0	38.4	37.2	35.5	38.2	39.5	40.2	40.0	41.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	42.9	48.4	45.4	59.2	53.6	47.6	46.1	43.8	43.2
Current expenditures	29.7	30.9	26.4	37.6	33.9	29.0	27.0	25.4	24.1
Salary and pension	13.7	15.2	15.5	20.3	18.2	16.7	15.6	14.7	13.9
Salary	11.2	12.0	12.2	16.0	14.3	13.2	12.3	11.6	11.0
Pension	2.5	3.2	3.2	4.3	3.8	3.5	3.3	3.1	2.9
Goods and services	6.9	6.0	3.5	5.6	5.0	4.6	4.6	4.7	4.7
Transfers	6.4	7.4	5.3	10.7	7.1	5.7	4.9	4.3	3.9
Social safety net	2.6	2.8	2.9	3.9	3.5	3.2	3.0	2.8	2.7
Transfers to SOEs 1/	1.1	0.7	0.6	0.7	0.6	0.6	0.5	0.4	0.4
Other transfers	2.7	3.9	1.8	6.1	3.0	2.0	1.5	1.1	0.8
Interest payments	0.4	0.4	0.3	1.0	1.3	2.0	1.9	1.7	1.5
War reparations 2/	2.2	1.9	1.9	0.0	2.3	0.0	0.0	0.0	0.0
Investment expenditures	13.2	17.6	19.0	21.6	19.7	18.6	19.1	18.3	19.1
Balance (including grants)	4.1	-5.8	-5.3	-18.4	-10.3	-3.2	-1.1	1.0	3.5
Balance (excluding grants)	4.1	-5.9	-5.3	-18.4	-10.3	-3.2	-1.1	1.0	3.5
Statistical discrepancy	-0.4	-0.3	0.3	...	...	...	...	...	...
Financing gap									
Financing, of which:	-3.7	6.1	5.0	18.4	10.3	3.2	1.1	-1.0	-3.5
External financing	-1.4	4.6	2.1	-4.7	-0.3	-0.2	-1.4	-1.6	-1.2
Assets held abroad	-0.7	5.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project financing	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2	0.2
Amortization	-0.7	-0.4	-1.0	-0.8	-0.5	-0.4	-1.7	-1.8	-1.4
Arrears	0.0	0.0	3.0	-3.9	0.0	0.0	0.0	0.0	0.0
Domestic financing	-2.3	1.5	2.9	12.9	1.0	3.4	2.5	0.6	-2.2
SDR Allocation	0.0	0.0	0.0	0.8	0.0	0.0	0.0	0.0	0.0
Commercial bank loans	-1.9	2.2	0.4	0.7	0.0	0.0	0.0	0.0	0.0
T-bills	-0.4	-0.7	1.9	12.9	1.3	3.7	2.8	0.8	-2.1
o/w CBI purchases	0.0	0.0	0.0	9.3	0.0	0.0	0.0	0.0	0.0
Arrears	0.0	0.0	0.9	-1.1	0.0	0.0	0.0	0.0	0.0
Amortization	0.0	0.0	-0.3	-0.4	-0.3	-0.3	-0.3	-0.2	-0.2
Financing gap:	0.0	0.0	0.0	10.2	9.6	...	...	...	...
IMF				0.7	0.0	...	...	...	...
World Bank				0.9	0.3	...	...	...	...
Eurobond				1.1	1.0	...	...	...	...
Other unidentified				7.5	8.4	...	...	...	...
Memorandum items:									
Security-related expenditure (military and police equipment and salaries)	6.6	6.0	6.4	9.4	8.3	7.7	7.3	7.0	6.8
MOF US$ account at CBI in months of salaries and pensions	...	...	0.3	0.3	0.3	0.3	0.3	0.3	1.9
Primary fiscal balance	4.5	-5.5	-5.0	-17.4	-8.9	-1.2	0.8	2.8	5.0
Current expenditures (percent of non-oil GDP)	59.1	57.5	49.3	59.9	58.2	52.5	50.4	47.9	45.5
Non-oil primary fiscal balance (percent of non-oil GDP)	-64.0	-68.7	-60.0	-68.6	-61.8	-59.0	-58.6	-55.6	-55.4
CBI total financing of the budget deficit	0.0	0.0	0.0	16.9	8.4	0.0	0.0	0.0	0.0

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

1/ For 2012-2014, includes off-budget transfers to SOEs financed by Bank Rafidain.

2/ Calculated as 5 percent of oil exports as per U.N. Security Council Resolution 1483 to finance war reparations to Kuwait until 2016.

Table 4. Iraq: Central Bank Balance Sheet, 2012–16
(In billions of Iraqi dinars; unless otherwise indicated)

	2012 Dec.	2013 Dec.	2014 Dec. Prel.	2015 Dec. Proj.	2016 Dec. Proj.
Net foreign assets	78,410	88,544	76,563	56,899	46,507
Foreign assets	82,371	92,314	79,273	60,359	49,906
Official reserve assets	80,806	90,742	77,720	58,806	48,353
Gold	1,858	1,902	4,038	4,361	4,710
Other	76,631	86,723	72,545	54,007	43,354
SDR holdings and reserve position in the Fund	2,317	2,117	1,136	438	289
Other foreign assets	1,565	1,572	1,553	1,553	1,553
Foreign liabilities	-3,961	-3,771	-2,709	-3,460	-3,399
Net domestic assets	-13,290	-15,265	-10,311	8,651	14,772
Domestic assets	-3,509	864	600	20,874	20,994
Net claims on general government	-3,622	751	513	20,787	20,907
Loans to central government	3,156	2,756	2,456	3,705	3,592
Holdings of discounted treasury bills	0	0	31	19,023	19,023
Other claims	0	0	0	0	0
Domestic currency deposits	-5,528	-1,895	-1,107	-775	-542
Foreign currency deposits	-1,249	-109	-867	-1,166	-1,166
Monetary policy instruments 1/	-6,902	-10,797	-6,567	-7,880	-4,180
o/w: CBI bills	-745	-943	-853	…	…
Other items net	-2,879	-5,331	-4,343	-4,343	-2,043
Reserve money	65,055	73,259	66,231	65,550	61,279
Currency in circulation	35,785	40,630	39,884	42,849	44,877
Bank reserves	29,270	32,629	26,347	22,701	16,402
Other liquid liabilities	66	20	22	…	…
Memorandum items					
Reserve money (annual growth, in percent)	8.3	12.6	-9.6	-1.0	-6.5
Currency in circulation (annual growth, in percent)	8.1	14.4	3.1	7.4	4.7
Gross foreign exchange assets (in millions of U.S. dollars) 2/	69,302	77,823	66,655	50,434	41,469
Foreign Liabilities (in millions of U.S. dollars)	-3,397	-3,234	-2,324	-2,968	-2,915
Net foreign assets (in millions of U.S. dollars)	65,905	74,589	64,331	47,467	38,554
Exchange rate (end of period)	1,166	1,166	1,166	…	…
Policy interest rate	6.0	6.0	6.0	…	…

Sources: Iraqi authorities; and Fund staff estimates and projections.
1/ This mainly represents the ID standing overnight facilities, US$ deposits of commercial banks, domestic currency deposits, and CBI bills.
2/ Starting 2014 reflects the balances of the Development Fund of Iraq were moved from the Federal Reserve Bank of New York to the CBI

Table 5. Iraq: Monetary Survey, 2012–16
(In billions of Iraqi dinars; unless otherwise indicated)

	2012	2013	2014	2015	2016
	Dec.	Dec.	Dec.	Dec.	Dec.
			Prel.	Proj.	Proj.
Net foreign assets	92,454	109,239	102,457	83,052	73,473
Of which: CBI	78,410	88,544	76,563	56,899	46,507
Net domestic assets	-15,312	-19,860	-9,820	25,761	44,795
Domestic claims	-6,019	-5,150	-258	36,322	55,356
Net claims on general government	-25,086	-27,021	-24,576	15,477	32,825
Claims on general government	14,745	11,856	15,892	...	...
less: Liabilities to general government	-39,831	-38,876	-40,468	...	...
Claims on other sectors	19,067	21,871	24,318	20,844	22,531
Other Item Net (OIN)	-9,293	-14,710	-9,562	-10,561	-10,561
Broad money	77,142	89,379	92,638	108,813	118,268
Currency outside banks	30,594	34,995	36,071	40,289	42,566
Transferable deposits	37,059	43,342	41,348	50,089	55,336
Other deposits	9,489	11,041	15,218	18,435	20,366
Memorandum items					
Broad money (percentage growth)	4.1	15.9	3.6	17.5	8.7
Broad money (in percent of GDP)	30.3	33.0	35.5	53.5	51.4
M2 velocity (ratio)	3.3	3.0	2.8	1.9	1.9
Credit to the economy (percentage growth)	71.5	14.7	11.2	-14.3	8.1
Credit to the economy (in percent of non-oil GDP)	14.9	15.0	17.4	16.3	16.8
Private sector credit growth	28.2	15.5	4.5	-2.0	3.0

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

Table 6. Iraq: Balance of Payments, 2012–20

(In billions of U.S. dollars; unless otherwise indicated)

	2012	2013 Prel.	2014 Est.	2015	2016	2017	2018	2019	2020
				Projections					
Trade balance	31.3	22.2	14.7	-2.3	5.0	15.6	20.0	22.3	24.4
(In percent of GDP)	14.3	9.5	6.6	-1.3	2.6	7.1	8.2	8.4	8.4
Exports	94.2	89.5	83.7	62.1	75.6	87.5	98.4	107.2	121.8
Crude oil 1/	93.8	89.3	83.4	61.9	75.3	87.2	97.9	106.6	121.1
Other exports	0.3	0.3	0.2	0.2	0.3	0.4	0.5	0.6	0.7
Imports	-62.9	-67.3	-69.0	-64.4	-70.5	-71.9	-78.4	-84.9	-97.4
Private sector imports	-39.6	-39.8	-37.1	-28.4	-32.6	-33.4	-36.1	-41.4	-45.0
Government imports	-23.3	-27.5	-31.9	-36.0	-38.0	-38.5	-42.3	-43.5	-52.4
Services, net	-12.7	-13.9	-16.4	-12.3	-13.7	-13.8	-15.1	-16.3	-19.1
Receipts	2.8	3.3	4.1	3.8	4.0	4.2	4.5	4.9	5.3
Payments	-15.5	-17.2	-20.5	-16.1	-17.6	-18.0	-19.6	-21.2	-24.3
Income, net	1.1	-0.4	-0.4	-0.5	-0.4	-0.6	-0.4	-0.1	0.3
Transfers, net	-5.1	-4.9	-4.1	0.1	-4.6	0.0	0.0	0.0	0.0
Private, net	-0.4	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Official, net	-4.7	-5.1	-4.2	0.0	-4.6	0.0	0.0	0.0	0.0
Current account	14.5	3.0	-6.2	-15.0	-13.6	1.2	4.5	5.8	5.6
(In percent of GDP)	6.7	1.3	-2.8	-8.6	-6.9	0.6	1.8	2.2	1.9
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-0.1	1.8	-2.3	-8.7	-1.9	-1.0	-0.4	1.4	1.6
Direct and portfolio investment (net) 2/	2.9	5.7	4.6	1.0	2.0	3.0	4.0	4.5	4.6
Other capital, net	-3.0	-4.0	-6.8	-9.7	-3.9	-4.0	-4.4	-3.1	-3.0
Official, net	-0.6	1.5	-1.0	-7.6	-1.0	-0.4	-3.4	-3.7	-3.2
Assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	-0.5	1.5	-1.0	-7.6	-1.0	-0.4	-3.4	-3.7	-3.2
Disbursements 3/	0.3	2.3	0.5	0.0	0.0	0.5	0.5	0.5	0.5
Amortization	-0.8	-0.8	-1.4	-7.6	-1.0	-0.9	-3.9	-4.2	-3.7
Private, net	-2.4	-5.5	-5.9	-2.0	-3.0	-3.6	-1.1	0.6	0.3
Errors and omissions	-4.7	-7.7	-8.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	9.7	-2.9	-16.9	-23.7	-15.5	0.2	4.1	7.2	7.3
(In percent of GDP)	4.4	-1.3	-7.6	-13.6	-7.9	0.1	1.7	2.7	2.5
Financing	-9.7	2.9	16.9	23.7	15.5	-0.2	-4.1	-7.2	-7.3
Development Fund for Iraq (increase -) 4/	-1.6	11.6	5.6	-0.1	...	...	...	...	...
Gross International Reserves (increase -)	-8.1	-8.5	12.0	16.4	9.0	-0.2	-3.9	-7.2	-7.3
Fund credit (net)	0.0	-0.2	-0.8	-0.6	-0.1	0.0	-0.2	0.0	0.0
Financing gap	...	...	...	8.0	6.6	0.0	0.0	0.0	0.0
IMF	...	...	...	1.2	0.0	0.0	0.0	0.0	0.0
World bank	...	...	...	1.5	0.5	0.0	0.0	0.0	0.0
Eurobond	...	...	...	2.0	2.0	0.0	0.0	0.0	0.0
Other (unidentified)	...	...	...	3.3	4.1	0.0	0.0	0.0	0.0
Memorandum items:									
GIR (end of period) 5/	69.3	77.8	66.7	50.4	41.5	41.7	45.6	52.8	60.0
(in months of imports of goods and services)	9.8	10.4	9.9	6.9	5.5	5.1	5.2	5.2	5.2
Reserves net of DFI/MoF US$ account at the CBI	...	...	...	49.4	40.5	40.7	44.6	51.8	53.7
GDP	218.0	232.5	223.5	174.4	197.3	220.9	243.7	266.4	289.1
Of which: Non-oil GDP	109.6	124.8	119.6	109.5	115.0	122.0	130.7	141.3	152.9

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

1/ Reflects KRG exports through the State Oil Marketing Company of Iraq.
2/ Excludes planned issuances of Eurobonds in 2015 and 2016, which are reflected under the financing gap.
3/ Excludes prospective disbursements from the IMF and the WB in 2015 and 2016, which are reflected under the financing gap.
4/ Reflects the transfer of the Development Fund for Iraq from the Federal Reserve Bank of New York to the CBI in May 2014.
5/ Starting 2014 includes US$ balances from oil revenues.

Table 7: Iraq. External Financing Requirements and Sources, 2015–17

(In billions of U.S. dollars; unless otherwise indicated)

	2015	2016	2017
Gross financing requirements	23.2	10.0	-0.4
External current account deficit (excluding official transfers)	15.0	9.0	-1.2
Debt amortization (including Fund repurchases)	8.2	1.0	0.9
Available financing	15.2	3.4	-0.4
Current official transfers	0.0	-4.6	0.0
Financial inflows	-1.0	-1.0	-0.1
Foreign direct investment	1.0	2.0	3.0
Public borrowing	0.0	0.0	0.5
Private inflows	-2.0	-3.0	-3.6
Change in GIR (+ decline)	16.2	9.0	-0.2
Financing gap	8.0	6.6	0.0
IMF	1.2	0.0	0.0
World Bank	1.5	0.5	0.0
Eurobond	2.0	2.0	0.0
other (unidentified)	3.3	4.1	0.0
Memorandum items:			
Fiscal deficit in percent of GDP	18.4	10.3	3.2
Current account deficit	15.0	13.6	-1.2
in percent of GDP	8.6	6.9	-0.6
CBI gross international reserves	50.4	41.5	41.7
in months of prospective imports	6.9	5.5	5.1

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

Table 8. Iraq: Indicators of Fund Credit, 2012–20

(In millions of SDRs; unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Disbursements of Fund credit (SBA and RFI)	0.0	0.0	0.0	891.3	0.0	0.0	0.0	0.0	0.0
SBA	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In percent of IMF quota	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RFI	0.0	0.0	0.0	891.3	0.0	0.0	0.0	0.0	0.0
In percent of IMF quota	0.0	0.0	0.0	75.0	0.0	0.0	0.0	0.0	0.0
Obligations (SBA and RFI)	12.0	123.1	506.5	426.7	37.4	0.0	111.4	445.7	334.2
SBA (total)	12.0	123.1	506.5	426.7	37.4	0.0	0.0	0.0	0.0
Repayments of SBA 1/	0.0	111.4	497.6	423.4	37.1	0.0	0.0	0.0	0.0
Total charges and interest	12.0	11.7	8.8	3.3	0.2	0.0	0.0	0.0	0.0
RFI (total)	0.0	0.0	0.0	0.0	0.0	0.0	111.4	445.7	334.2
Repayments of RFI 1/	0.0	0.0	0.0	0.0	0.0	0.0	111.4	445.7	334.2
Total charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations, in percent of:									
Exports of goods and services	0.0	0.2	1.0	0.7	0.1	0.0	0.2	0.8	0.5
External public debt	0.0	0.3	1.2	0.9	0.1	0.0	0.2	1.1	0.9
Gross reserves	0.0	0.2	1.2	1.2	0.1	0.0	0.4	1.2	0.8
GDP	0.0	0.1	0.3	0.3	0.0	0.0	0.1	0.2	0.2
IMF Quota	1.0	10.4	42.6	35.9	3.1	0.0	9.4	37.5	28.1
Outstanding Fund credit (SBA and RFI)	1,069.6	958.2	460.5	928.4	891.3	891.3	779.9	334.2	0.0
SBA	1,069.6	958.2	460.5	37.1	0.0	0.0	0.0	0.0	0.0
RFI	0.0	0.0	0.0	891.3	891.3	891.3	779.9	334.2	0.0
Total outstanding Fund credit, in percent of									
Exports of goods and services	2.1	1.6	0.9	1.4	1.4	1.5	1.4	0.6	0.0
External public debt	2.7	2.5	1.1	2.0	1.8	1.9	1.7	0.8	0.0
Gross reserves	2.4	1.9	1.0	2.6	3.0	3.0	2.5	0.9	0.0
GDP	0.8	0.6	0.3	0.8	0.6	0.6	0.5	0.2	0.0
IMF Quota	90.0	80.6	38.8	78.1	75.0	75.0	65.6	28.1	0.0

Sources: IMF staff estimates and projections.

1/ The SBA and RFI repayments are based on scheduled debt service obligations.

Supplementary Letter of Intent

July 24, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, DC 20431, USA

Dear Ms. Lagarde,

This letter complements the Letter of Intent dated July 9, 2015. We understand that the Executive Board of the IMF has recently adopted policies to enhance the financial safety nets for developing countries, including by raising the annual access limits of the Rapid Financing Instrument (RFI) from 50 percent of quota to 75 percent of quota. We therefore request access of 75 percent of quota (equivalent to SDR891.3 million, or about US$1.242 billion) under the RFI. The additional financing from the Fund would help us address the present and urgent balance of payments need caused by the conflict with ISIS and the collapse in oil prices. We also request that the assistance under the RFI be channeled to the budget to reduce the residual fiscal financing gap.

Cabinet approval of the new electricity tariff reform is not possible at the moment, but we commit to implement this measure as soon as possible or find compensatory fiscal measures.

/s/	/s/
Fadhil Nabi Othman	Ali Mohsen Ismail Al Allaq
Deputy Minister of Finance of Iraq	Acting Governor of the CBI

Table 1. Prior Action for a Purchase under the Rapid Financing Instrument

Measure	Scheduled completion date	Macroeconomic justification
Sign separate MOUs between (i) the CBI and the state-owned banks and (ii) the state-owned banks and the MOF, laying out (i) the terms of repayment of the securities used for CBI financial support to the banks, and (ii) the government's commitment to provide the state-owned banks with the amounts needed to repay principal and interest on the bonds.	Five business days before the Board date.	Limit negative effects of indirect CBI financing to the government on the credibility of the CBI and the pegged exchange rate arrangement through formalization of the financial relations between the government, the CBI, and the state-owned banks.

Statement by Hazem Beblawi, Executive Director and Maya Choueiri, Senior Advisor to Executive Director
July 29, 2015

1. Iraq is facing a double shock resulting from the Islamic State of Iraq and Syria (ISIS) conflict and the sharp drop in global oil prices, which compounds very challenging security and political conditions that have been prevailing for several years. The armed conflict has created a humanitarian tragedy, causing over three million people to be displaced internally, one of the highest numbers in the world, at a time when a quarter of a million Syrian refugees have sought shelter in Iraq. Living conditions across the country have markedly deteriorated since the onset of the conflict and the government's ability to provide basic public goods and services is severely hampered. The violence has also caused extensive damage to infrastructure and productive assets, disrupted internal and external trade, and deteriorated investor confidence. The two shocks have severely affected the Iraqi economy, which contracted by about 2 percent in 2014 despite solid growth in the oil sector and is projected to achieve only a modest recovery this year. At the same time, the fiscal and external positions are expected to weaken considerably in 2015 relative to 2014, as reflected in a 21 percent drop of budget revenues and 25 percent decline in international reserves.

2. The authorities strongly appreciate the support provided by the international community in response to the country's difficult situation, particularly the United Nations' humanitarian support plan for Iraq and the generous contribution by the State of Kuwait. They are implementing several policy measures in response to the crisis, including large-scale fiscal adjustment and financing to address the fall in revenues, while maintaining the peg to the U.S. dollar, which provides a key anchor to the economy. Despite very difficult circumstances, the authorities have successfully implemented many of the 2013 Article IV recommendations. They are seeking assistance from the Fund under the Rapid Financing Instrument (RFI) in support of their efforts to help address the impact on the balance of payments resulting from the ISIS conflict and the decline in oil prices. They believe that the RFI would also help generate additional resources by facilitating the planned borrowing from the markets and financing by other international financing organizations.

Fiscal Policies and Reforms

3. The revised 2015 budget aimed at addressing the fiscal pressures from low oil revenues and the ISIS conflict. It introduced wide-ranging revenue-enhancing and expenditure-reducing measures which reduced the deficit by 13 percent of GDP. Revenue measures, which aimed at introducing non-oil taxation to diversify revenue sources, consisted of introducing a higher custom tariff schedule and sales taxes on cars, tobacco, alcohol, mobile telephony and internet usage, while large expenditure cuts were agreed with line ministries.

4. Moreover, the authorities are in the process of introducing additional measures which would result in budgetary savings of about 5 percent of GDP consisting of the rationalization of the capital budget through a rigorous prioritization process. In this connection, an inter-ministerial committee chaired by the Deputy Prime Minister has been established to examine project selection and procurement practices, with the objective of improving project selection based on objective criteria (LOI ¶13) and enhancing implementation capacity and monitoring.

5. The authorities had planned the introduction of a more progressive electricity tariff structure, with much higher rates levied on the largest consumers and minimal effect on lifeline consumption and an overall limited social impact. The reform was expected to deliver about 2.4 percent of fiscal savings on an annual basis. Nonetheless, Cabinet approval of the new electricity tariff reform is not possible at the moment, given the increasingly difficult political and social context resulting from the conflict with ISIS. The authorities commit to implement the electricity tariff measure as soon as possible or to find compensatory fiscal measures. In this connection, the Cabinet decided in its meeting of July 21, 2015, to reduce significantly the salaries and allocations of high-level government officials. This includes a 50 percent reduction for the Prime Minister and his deputies and a 40 percent reduction for Ministers. While the reductions, which will be effective on August 1st, 2015, are not expected to bring significant savings, they carry a high symbolic value.

6. Notwithstanding the aforementioned consolidation efforts, a large fiscal deficit would remain, largely reflecting continued acute spending pressures to respond to the country's considerable security and humanitarian needs. The authorities' view is that these categories of spending cannot be easily compressed at this juncture, given the difficult environment. The

remaining deficit also reflects arrears on investment spending and international oil companies accumulated the previous year. In light of the above, the authorities stepped up their efforts to identify financing sources. They have secured loans from the state-owned banks financing, which will be supported in turn by the Central Bank of Iraq (CBI) via the discount of government bonds for about 9 percent of GDP in 2015. They have also strived to find other financing sources, including Fund financing through the drawdown of the SDR allocation and the RFI purchase, a $6 billion Eurobonds issuance over two years, with an issuance this year of at least $2 billion, as well as possible World Bank financing in urgent reconstruction financing and a potential Development Policy Loan. The authorities plan to fill any remaining financing gap with domestic and foreign sources.

7. The authorities are pursuing a prudent debt management strategy. They are considering developing and deepening the domestic debt market through the introduction of new instruments, which would diversify their financing sources. In addition, they will strengthen the monitoring of their public debt to maintain it at sustainable levels. They are making progress in negotiations with non-Paris Club creditors and expect to conclude agreements with some creditors in the course of this year on terms that are consistent with the 2004 Paris Club agreement.

8. The authorities have launched an initiative to reform state-owned enterprises to help alleviate the burden on the public sector. They have prepared a study envisaging a systematic cost-benefit assessment of each enterprise that would assess its viability and enable decisions towards closure, privatization, or maintaining state ownership after proper restructuring.

9. The authorities are also strengthening their public financial management procedures to support fiscal discipline and efficient use of oil resources. With support from the World Bank, they are continuing to work on the introduction of an integrated financial management and information system. In addition, the Shura Council is examining a new public financial management law which paves the way for the introduction of a Treasury Single Account. They will continue to rely on Fund and the World Bank technical assistance in support of their efforts in these areas.

Monetary, Exchange Rate and Financial Sector Policies and Reforms

10. The stability of the exchange rate provides a key nominal anchor to the economy in an uncertain environment. The authorities are therefore committed to maintaining the peg to the U.S. dollar despite the deteriorating external position. In an effort to address concerns related to illegal cash outflows from the country, the CBI reduced the volumes of cash currency sales and imposed a 15-day advance deposit requirement for foreign currency transactions in early 2015. In addition, the government introduced a 5 percent customs duty advance payment and a 3 percent presumptive income tax to be paid at the time of request for foreign exchange to finance imports. However, the authorities soon removed the latter measures and shortened the advance deposit requirement to five days in June, given the rise in the spread between the official and parallel exchange rates. As a result, the spread quickly narrowed to about 6 percent by end-June. They are committed to removing the weekly limits on cash transactions once external conditions allow.

11. The CBI intensified its efforts to strengthen the management of international reserves, which despite a recent decline, continue to exceed conventional adequacy indicators. With the support of Fund technical assistance, it updated the 2008 guidelines for reserve management to bring them in line with the CBI Law and address quantitatively all key reserve management strategic objectives, including the strategic asset allocation, credit risk limits, and liquidity needs. The CBI is working towards a long-term goal to bring active management of its international reserves to Baghdad.

12. The shocks affecting the economy are adversely impacting the financial sector and the authorities expect nonperforming loans to rise as a result of falling business confidence, lower private sector activity, physical destruction and the robbery of some banking institutions at the beginning of the conflict with ISIS. Accordingly, the authorities are stepping up the monitoring and supervision of the banking sector, including through the improvement of financial reporting and monetary data. They are also working with the IMF to improve their financial soundness indicators to internationally acceptable standards. The CBI has recently extended its contract with Ernst & Young, which helps improve off-site and on-site supervision practices and co-train inspectors. The CBI has also hired 35 new staff in the banking supervision department. The banking supervision department is also stepping up the monitoring of state-owned banks

Rasheed and Rafidain, which are of systemic importance. The authorities intend to speed up the restructuring of the two banks (LOI ¶25).

13. The authorities are stepping up their efforts to develop the banking sector, a key element in their long-term strategy to strengthen the non-oil economy and private sector activity. In order to level the playing field between private banks and state-owned banks, they have allowed public entities to accept letters of guarantees and certified checks issued by private banks. The Ministry of Finance can open letters of credit with private banks up to $10 million ($6 million previously). The threshold to collect state fees by private banks has been increased, and the government is now allowing SOEs to open accounts, make deposits, and pay salaries through private banks. It is hoped that these initiatives will create new opportunities for private banks to provide services and compete with the state-owned sector. With the support of USAID, the CBI is finalizing regulations to introduce a credit bureau and is considering establishing a deposit insurance scheme.

14. The CBI continues to maintain important safeguards, including the annual external audit by a reputable audit firm and publication of its audited financial statement. As the authorities are requesting access under the RFI, they commit to completing an updated safeguards assessment of the CBI (LOI ¶27).

Conclusion

15. Iraq is facing a particularly difficult time in its history, which is putting the economy under extreme stress. The authorities are doing their utmost to address the situation. In support of their effort, they are seeking Fund assistance under the RFI. They will maintain a close dialogue with the Fund to preserve macroeconomic stability. They would like to express their appreciation for the Fund's Executive Board, Management, and staff, for their support under difficult circumstances.