

Iraq: First and Second Reviews Under the Stand-By Arrangement, Financing Assurances Review, and Request for Waiver of Nonobservance and Applicability of Performance Criteria—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iraq

In the context of the first and second reviews under the Stand-By Arrangement, financing assurances review, and request for waiver of nonobservance and applicability of performance criteria, the following documents have been released and are included in this package:

- the staff paper for the First and Second Reviews Under the Stand-By Arrangement, Financing Assurances Review, and Request for Waiver of Nonobservance and Applicability of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on June 11, 2006, 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 17, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a supplement to the staff report of July 31, 2006 updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its August 2, 2006 discussion of the staff report that completed the request and reviews.
- a statement by the Executive Director for Iraq.

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

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

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

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

INTERNATIONAL MONETARY FUND

IRAQ

**First and Second Reviews Under the Stand-By Arrangement,
Financing Assurances Review, and Request for Waiver of Nonobservance
and Applicability of Performance Criteria**

Prepared by Middle East and Central Asia Department

(In consultation with other departments)

Approved by Lorenzo Pérez and Adrienne Cheasty

July 17, 2006

- A 15-month Stand-By Arrangement (SBA) for Iraq in an amount equivalent to SDR 475.4 million, or 40 percent of quota, was approved on December 23, 2005. The authorities continue to treat the arrangement as precautionary.
- The first review, due after February 27, 2006, was delayed because the formation of the government took longer than expected. Accordingly, the first and the second review (due after May 14, 2006) are being conducted together.
- The new government has affirmed its commitment to the program supported by the SBA. In the attached Supplementary Memorandum of Economic and Financial Policies, the Iraqi authorities outline their plans to bring the program back on track.

Contents	Page
I. Introduction	3
II. Political and Economic Background.....	3
III. Policy Discussions	6
A. Fiscal Policy and Related Measures.....	6
B. Monetary and Exchange Rate Policy	8
C. Other Structural Issues	9
IV. Program Monitoring and Fund Relations	11
V. Vulnerabilities and Risks	12
VI. Staff Appraisal.....	12
 Tables	
1. Selected Economic and Financial Indicators	14
2. Fiscal and Oil Sector Accounts, 2004–06.....	15
3. Fiscal and Oil Sector Accounts, 2004-06	16
4. Central Bank Survey, 2003–06.....	17
5. Depository Corporations (Monetary) Survey, 2004–05	18
6. Balance of Payments, 2004–06.....	19
7. Oil Product Prices (SBA).....	20
8. 2005–06 Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement (SBA).....	21
9. Prior Actions, Structural Performance Criteria, and Structural Benchmarks Under the Stand-By Arrangement	22
10. Proposed Availability of Purchases Under the Stand-By Arrangement, 2005–07	23
11. Indicators of Fund Credit, 2004–11	24
Appendix – Medium-Term Prospects and External Debt Outlook.....	25
Letter of Intent	33
Supplementary Memorandum on Economic and Financial Policies	35

I. INTRODUCTION

1. **The 15-month Stand-By Arrangement (SBA) for Iraq in an amount equivalent to SDR 475.4 million, or 40 percent of quota, was approved on December 23, 2005.** The authorities continue to treat the arrangement as precautionary and have not made any purchase. Discussions on the first and second reviews were held with representatives of the new Iraqi government in Amman during June 7-11, 2006.
2. **Approval of the SBA unlocked the second stage of the Paris Club debt reduction agreement.** The first stage of the agreement (effective in November 2004) involved a 30 percent debt reduction. The second stage (effective December 2005) involved a further 30 percent debt reduction. The final stage, involving 20 percent debt reduction, depends upon the successful conclusion of the final review of the third year of (one or more successive) upper credit tranche arrangements, expected by end-December 2008.
3. **The first review of the SBA was delayed because the formation of the new Iraqi government, following elections in December 2005, took much longer than anticipated.** The first review was scheduled to be completed on or after February 27, 2006. The new government was not approved by the Council of Representatives (successor to the National Assembly) until May 20, 2006. This was after the scheduled date for the second review (May 14, 2006), so the first and second reviews are being conducted together.
4. **The new government has affirmed its commitment to the program supported by the SBA.** The new government, which has a four year mandate under the constitution, replaces the transitional government that agreed to the SBA. The government has sought to bring those elements of the program (mainly structural) that were off-track back on track.

II. POLITICAL AND ECONOMIC BACKGROUND

5. **Iraq's constitutional government is now in place.** The government is headed by President Jalal Talibani (as before), with Tariq al Hashami and Adil Abd al Mahdi (who remains in his post) as deputies. The cabinet is led by prime minister Nuri Maliki, with Barham Salih (former minister of planning) and Salam Zaubai as deputies. The minister of finance is Baqir Jabr al Zubaydi (former minister of interior), and the minister of oil is Hussain al Shahrastani. The governor of the Central Bank of Iraq (CBI), Sinan Shabibi, remains in his position.
6. **The security situation remains very difficult.** The political hiatus during the first five months of 2006 was exploited by insurgents, who continued to attack Iraqi and coalition forces, as well as holy sites in an effort to incite further sectarian violence. The death of the major terrorist Zarqawi raised hopes that the insurgency could be brought under control, but the violence has unfortunately continued.

7. **Economic growth continues to be below target.** Overall economic growth in 2005 is estimated to have slowed to around 4 percent, from nearly 50 percent in 2004. Economic growth in 2006 is also expected to be around 4 percent (Table 1). In both 2005 and 2006, the source of growth is expected to derive from non-oil economic activity, with oil production remaining flat at an average of 2.0 million barrels per day (mbpd).¹ The lack of progress in raising oil output reflects a combination of low investment (with project implementation impeded, inter alia, by the continuing violence), and technical problems with the existing infrastructure.

8. **Inflation has recently begun to accelerate.** The twelve-month rate of inflation ended 2005 at 31.7 percent, largely unchanged from end-2004 and higher than the 20 percent targeted under the SBA. Inflation has since accelerated, with twelve-month inflation reaching 58 percent by May 2006. The factors driving inflation have been changing over the past two years (Box 1), but the ongoing insurgency, and the resulting acute shortages of certain goods (especially gasoline and other fuel products), continues to play a major role. It is also possible that rising international crude oil prices and growing spending power in the economy are pushing up Iraq's equilibrium real exchange rate. With the nominal exchange rate fixed, the real exchange rate adjustment is reflected in a rising domestic price level.

9. **The fiscal balance remains in surplus** (Tables 2 and 3). Mainly due to lower investment and higher than expected oil revenues, the fiscal balance ended 2005 in a surplus equivalent to 10 percent of GDP, against a programmed deficit of 10 percent of GDP. A part of this surplus was used to place deposits toward letters of credit (equivalent to 5.8 percent of GDP). Resources available in the Development Fund for Iraq (DFI) ended the year at \$5.4 billion, substantially higher than programmed. The fiscal balance remained in surplus in the first quarter. Oil export volumes averaged 1.4 mbpd in the first five months of 2006, below the program assumption of 1.65 mbpd, but this was offset by higher than programmed oil export prices. As before, investment continued below budgeted levels.

10. **The exchange rate remains stable and reserves continue to grow.** The exchange of the Iraqi dinar to the US dollar has remained close to 1,475 at the daily auctions, which have been conducted free of any restrictions. The (net) international reserves of the CBI, which reached \$11.5 billion at end-2005, grew further to \$12.7 billion by end-April, above projected levels under the SBA and comfortably above the program floor (performance criterion) of \$7.5 billion. Currency in circulation grew by 27.9 percent in 2005, and by a further 6.1 percent in the first quarter of 2006 (Table 4). The economy remains predominantly cash-based, with cash comprising nearly two thirds of total broad money, which is growing more slowly (Table 5).

¹ Non-oil economic activity is estimated have increased by 12 percent in 2005, based on economic indicators (e.g., cement production, electricity output), and is projected to grow by 10 percent in 2006.

Box 1: Inflation in Iraq

Price stability in Iraq has been one important area where the aspirations of the government's economic program have not yet been met. To a large extent, this reflects the ongoing insurgency, which has caused acute shortages of certain goods (especially gasoline) and slowed the growth of the non-oil sector, impeding its ability to satisfy the rise in spending power in the economy. In 2004, the main contribution to the rate of inflation was from rents (whose end-2003 effective weight was 31 percent), which explained nearly all the increase during the year (Table 1). This reflects the recovery in purchasing power, including as a result of aid flows. Spending power has continued to grow. In 2005, the wage and pensions bill doubled, and is projected to rise by a further 50 percent in the 2006 budget. This is putting rising pressure on the relatively small non-oil economy, which is not believed to have grown as fast. In 2005, inflation increasingly derived from a combination of price hikes in food, fuel and electricity, and transportation and communications (with end-2004 effective weights of 29, 13, and 4 percent respectively), reflecting growing shortages in these commodities and the knock on effects on services. By 2006, these factors (especially fuel and electricity) explain over two thirds of inflation. Most of the increase in prices of fuel and electricity, and of the majority of the other inflation components, occurred early in 2006 (Table 2). However, upward pressure on prices appears now to be fanning out to all items. The year on year change in the different components was subject to wide variation in 2004, but became more consistent in 2005. By May 2006, prices of all items were growing in the range of 15–30 percent, although fuel and electricity prices were still growing much faster, resulting in a year on year increase of 58 percent (Table 3).

Table 1: Iraq -- Consumer Price Index / Cumulative Contributions

	Food Items	Tobacco & Drinks	Clothing	Household Goods	Fuel & Electricity	Transport, Communications	Medicine & Medical Services	Misc. Goods & Services	Rent	Total
Dec-04	0.8	(0.1)	(0.4)	(0.1)	1.7	0.8	0.5	0.1	28.4	31.7
Dec-05	7.4	0.0	0.6	0.1	4.9	2.9	0.7	0.1	14.8	31.6
Jan-06	1.7	0.0	0.1	0.0	1.8	0.5	0.2	0.0	1.5	5.8
Feb-06	2.1	0.0	0.0	0.0	11.1	1.3	0.5	0.0	4.5	19.7
Mar-06	2.8	0.0	0.1	0.0	11.0	2.0	0.5	0.0	5.1	21.7
Apr-06	4.6	0.0	0.1	0.0	6.4	2.3	0.2	0.0	6.7	20.2
May-06	3.7	0.0	0.0	0.0	11.9	2.1	0.2	0.0	7.6	25.7

Table 2: Iraq -- Consumer Price Index / Cumulative Percentage Change

	Food Items	Tobacco & Drinks	Clothing	Household Goods	Fuel & Electricity	Transport, Communications	Medicine & Medical Services	Misc. Goods & Services	Rent	Index
Dec-04	2.1	-17.4	-8.9	-6.5	11.3	17.7	9.7	14.5	90.7	31.7
Dec-05	25.8	12.8	19.1	14.8	38.6	69.7	16.1	32.5	32.6	31.6
Jan-06	6.3	1.7	3.2	1.3	13.5	8.7	4.7	2.3	3.3	5.8
Feb-06	7.8	10.3	1.6	3.1	83.1	25.2	12.0	6.2	9.9	19.7
Mar-06	10.3	8.1	4.9	3.6	82.9	36.7	13.8	8.8	11.1	21.7
Apr-06	16.6	4.2	2.7	3.9	47.9	42.6	5.0	7.7	14.6	20.2
May-06	13.4	9.6	0.6	5.7	89.6	39.6	4.6	10.7	16.6	25.7

Table 3: Iraq -- Consumer Price Index, Year-Over-Year Percentage Change

	Food Items	Tobacco & Drinks	Clothing	Household Goods	Fuel & Electricity	Transport, Communications	Medicine & Medical Services	Misc. Goods & Services	Rent	Index
Dec-04	2.1	-17.4	-8.9	-6.5	11.3	17.7	9.7	14.5	90.7	31.7
Dec-05	25.8	12.8	19.1	14.8	38.6	69.7	16.1	32.5	32.6	31.6
Jan-06	26.4	1.8	27.0	15.3	-12.7	83.4	15.6	33.1	31.8	22.3
Feb-06	23.2	13.2	19.1	16.9	82.7	107.1	22.9	33.4	37.5	41.9
Mar-06	21.3	17.0	26.4	17.0	243.2	130.5	23.5	36.6	37.6	53.4
Apr-06	20.2	19.2	22.5	12.7	226.5	133.9	10.6	23.3	38.2	48.1
May-06	26.6	18.4	15.1	16.6	371.5	119.4	12.2	32.6	37.5	58.0

11. **Structural reform has been slowed by the delay in forming a government.** High profile actions, such as adjustments in oil product prices, were delayed because the caretaker government had insufficient authority to implement controversial measures. Two structural performance criteria (adoption of budget classification and chart of accounts, and the finalization of the audit of the CBI) missed their target dates, as did two structural benchmarks (establishment of an audit oversight committee for the DFI, and a census of public service employees). On the other hand, progress toward developing a payments system (three structural benchmarks) is running ahead of schedule.

III. POLICY DISCUSSIONS

12. **The discussions focused on the measures needed to bring the program back on track.** The key issues discussed concerned the resumption of domestic fuel price adjustments, the liberalization of private imports of gasoline, the containment of budgetary pressures (especially from pensions), the control of inflation and dollarization, and the resolution of external claims (especially non-Paris Club and Gulf countries). The authorities acknowledged that the delay in forming a government had slowed the reform process, but committed to promptly get to grips with all these issues. Broad agreement was reached on budgetary prospects and priorities for 2006, as well as on the implementation of related measures. In addition, there was a consensus that action needed to be taken to tackle inflation, including through monetary tightening, and allowing the exchange rate to strengthen (as conditions permit).

A. Fiscal Policy and Related Measures

13. **The government intends to keep to the approved budget for 2006.** The authorities are of the view that the introduction of a supplementary budget would risk a flood of requests for additional spending. With crude oil export revenues projected to be slightly higher than assumed in the budget, it should be possible to implement the existing spending allocations within the existing fiscal deficit target.² The minister committed to resist calls for an increase in the wage bill (from additional hiring), and will resist the practice of granting large Eid bonuses.³ The greatest threat to the budget, however, derives from the pension law.⁴ The need

² Projected crude oil export volumes for 2006 were revised down from 1.65 mbpd to 1.5, while the average Iraqi oil export price was revised up from \$46.6 to \$53.3 per barrel. This revised projection was based on the latest WEO oil price forecast, less a \$10.6 quality differential (as in the SBA) and an additional \$4.5 risk discount for the second half of the year (as in the SBA, in case the WEO projection may turn out too high).

³ The government remains interested in conducting a census of public employees, but the delay in getting this going has required a postponement of the target date for the census to end-2006.

⁴ The delay in forming a government has delayed the process in preparing a budget for 2007. The outline of the 2007 budget will be a focus of the third review, scheduled after August 14, 2006. The reconstruction levy was supposed to increase to 10 from 5 percent in April 2006, but this did not happen. The government intends to effect this change later this year and in time for the 2007 budget.

to contain recurrent spending has taken on added importance in view of the persistence of inflation, and the possibility that at least some of this derives from the small non-oil economy being overwhelmed by domestic demand.⁵

14. **The government is committed to reform the pension law before it goes into effect.** The new pension law that was passed in November 2005 (against the wishes of the then minister of finance) and gazetted in January 2006, was not accommodated in the 2006 budget and is unsustainable over the medium term. The full year effect at the outset is estimated to likely add some ID 2 trillion (about 3 percent of GDP) to the pension bill). This could be expected to grow over the medium term. The government intends to continue to delay implementation of the law, and develop (in consultation with the World Bank) an amended version prior to its implementation.⁶ The revised law will need to be approved by the Council of Ministers and then by the Council of Representatives. A target date of end-September 2006 has been set for the reform of the law as a (new) structural benchmark.

15. **The authorities agreed to restore domestic fuel price adjustments according to schedule.**⁷ On June 17, 2006, the price of kerosene was raised from ID 25 to ID 75 per liter, and the price of diesel was raised to ID 125 from ID 90 per liter. These are in line with the price levels expected for end-June under the SBA (Table 7). The price of liquefied petroleum gas (LPG) was raised to ID 1000 per cylinder (the level projected for end-December). On July 1, the price of regular (octane 82) gasoline was raised from ID 100 to ID 175 per liter (the price scheduled for end-September), and of premium (octane 92) gasoline from ID 250 to ID 350 per liter (the price scheduled for end-June). Blended gasoline (octane 87), a roughly equal mixture of regular and premium gasoline, will sell at ID 250 per liter (compared to ID 150 per liter before). The authorities intend to continue adjusting prices so as to reach targeted levels either at or ahead of schedule over the remainder of the year.

16. **Private imports of gasoline will be liberalized as soon as possible.** A law designed to liberalize private imports of gasoline was submitted to the National Assembly in November 2005, but was not passed. The draft law contained some elements that need to be removed (specifically, those which subject the resale of such imports to price controls). The Council of Ministers has agreed the necessary amendments to the law, and will (by July 21) have submitted to the Council of Representatives the proposed amendments, and will urge the Council of Representatives to approve the amended law as soon as possible. The law will

⁵ The size of the non-oil economy remains very hard to measure, but is estimated at around 30 percent of total GDP in 2006. But the wage and pension bill, which is projected to increase by nearly 50 percent in 2006, is equivalent to around two thirds of estimated non-oil GDP in 2006.

⁶ Under the plan in the current version of the law, employees can retire at age 50 with 25 years of service. The first 15 years of service earns a pension equal to 50 percent of the final salary, increasing by 1.75 percent per annum up to a maximum of 80 percent of final salary. Neither pensions nor contributions are taxable in Iraq.

⁷ The last increase in domestic fuel prices was on December 18, 2005, as a prior action for the Board's approval of the SBA. A second stage of increases was scheduled for end-March, 2006, but did not take place.

retain an exemption for such imports from the reconstruction levy, but only for two years. The law should help alleviate domestic fuel shortages and eventually reduce black market prices to international levels. A target date of end-September 2006 has been set for the liberalization of private imports of gasoline as a (new) structural benchmark.

17. **The new social protection program is moving forward.** In addition to the existing Public Distribution System (which supplies monthly packages of basic goods to all Iraqis), the government introduced (at the end of 2005) a separate means tested program of cash support for poor Iraqi families (those earning less than about \$2 per day). By June, some 430,000 families were covered. The aim is to cover 1 million of the poorest families in Iraq by end-2006.⁸

18. **The ministry of finance will resume bi-weekly treasury bill auctions.** The last auction was held in April 2006. The ministry of finance had been reluctant to continue with the auctions because it was already very liquid (reflecting the budget surplus in 2005). However, the ministry accepts the importance of keeping the treasury bill market alive in order to (i) maintain a potential market for new borrowing in case circumstances change (e.g., if oil revenues were to fall), and (ii) preserve a market reference point for interest rates.

B. Monetary and Exchange Rate Policy

19. **In view of the persistence of inflation, the CBI has raised interest rates further.** The CBI's policy rate was raised from 7.0 to 8.0 percent in April, following this with parallel adjustments in lending rates (but not the deposit rate) in early May. At the moment, the only effective rate is the deposit rate, reflecting the banks' high level of liquidity. Banks held ID 2.5 trillion in the CBI's dinar deposit facility as of end-March 2006. These deposits do not count toward satisfying reserve requirements. The CBI raised its policy rate further to 10.0 percent on July 4, with parallel movements in its other rates, and will move rates up to 12.0 percent in July if inflationary trends warrant further tightening. In future, deposit rates will be expected to adjust automatically in line with changes in the policy rate. The monetary transmission mechanism, however, is weak. The effectiveness of interest rate changes in influencing inflation is thus very limited.⁹ Economic activity is dominated by cash transactions, and the banking system is largely inert. Few loans are extended and the deposit base is not very active. Raising interest rates will nonetheless signal the authorities' determination to deal with inflation.

⁸ It is possible that the budgetary allocation for social protection programs could be exceeded, but this can be met out of the contingency allowance. The new program has been allocated ID 500 billion. The authorities intend to reform the more expensive Public Distribution System over the medium term (with the help of the World Bank). Savings under this scheme are already been sought through better procurement programs.

⁹ The ability of the CBI to influence monetary conditions will be enhanced when it is able to conduct open market operations, allowing the CBI to reduce the money supply other than by selling dollars at auction. However, progress in establishing marketable instruments and developing a secondary market remains slow.

C. Other Structural Issues

20. **Implementing the Financial Management Information System (FMIS) is proceeding slowly.** As a result the assessment of the software is overdue. The authorities confirmed their interest in FAD technical assistance to review the operations of the FMIS jointly with ministry of finance staff and consultants. FAD has been reviewing draft budget classifications and chart of accounts submitted by the ministry of finance. FAD will field a mission later in the year to review the new budget classification, chart of accounts and the FMIS. The related performance criterion has been postponed to December 2006.
21. **The ministry of oil is focusing its efforts on combating corruption.**¹⁰ The new minister of oil reported that he had already cancelled some suspicious contracts related to the transportation of fuel products, and intended to follow up on other leads. The minister noted that corruption related to the production and distribution of refined fuel products was rampant, but he doubted that there was any large scale smuggling of crude oil. Oil metering projects are underway, but the repair of metering systems at the Basra oil export terminal has suffered from delays in receiving parts. International oil companies are advising on installing metering systems for upstream and downstream production, but it will be some time before such systems are operational.
22. **Progress is being made in setting up a successor to the International Advisory and Monitoring Board (IAMB).** The IAMB, whose mandate expires at the end of 2006, has oversight over external audits of Iraq's oil revenues deposited in the Development Fund for Iraq. The IAMB met with representatives of the Iraqi government during May 30–31, 2006, to discuss successor arrangements for an independent, competent and professional body to ensure continued oversight of Iraq's oil revenue accounts. IAMB recommendations for such an oversight body were sent on June 9, 2006 to Prime Minister Maliki for his consideration.
23. **Good progress has been made in setting up a payments system in Iraq.** The Real Time Gross Settlement System between the CBI and headquarters of commercial banks should be operational very soon and well ahead of schedule. Development of a payments clearing system through the Automatic Clearing House (with a target date of completion of November 2006) looks likely to be also completed ahead of schedule. Payments system regulations (targeted for end-June) have already been adopted.

¹⁰ In addition to comments in the press, allegations of corruption have been made in the quarterly report to the U.S. Congress of the Special Inspector General for Iraq Reconstruction, as well as in the report of the Iraqi Oil Ministry's Inspector general. Hard evidence is, however, difficult to come by. In April, the Iraqi authorities broke up a smuggling operation that involved a convoy of 1,200 trucks attempting to carry a total of about 500,000 barrels (equivalent) of semi-refined heavy fuel oil across the Syrian border. Iraq's oil facilities produce an excess of heavy fuel oil, much of which is pumped back into the ground.

24. The CBI has established a committee to address the shortcomings in its accounting arrangements that were identified in Ernst and Young's 2004 audit report.

Ernst & Young completed the audit of the 2005 financial statements on July 13, 2006. As expected at this stage, the auditors were not able to confirm the reliability of the balances reported in the financial statements due to accounting weaknesses and inadequate or incomplete information on some balance sheet items.¹¹ Detailed areas for improvement have been flagged in the audit report. The CBI plans to retain Ernst and Young as auditor for its 2006 financial statement.

25. The CBI and ministry of finance are coordinating their strategy toward restructuring the state-owned banks. The CBI has established a bank restructuring unit, tasked with advising on bank restructuring plans. The ministry of finance intends to appoint an international auditor to conduct a financial and operational audit of the banks. The ministry aims to have devised a comprehensive restructuring plan by the end of 2006.

26. The government expects to initiate negotiations on resolving non-Paris Club official claims very soon. While most Paris Club official creditors have now signed bilateral agreements, progress has been slow in resolving non-Paris Club official claims, especially those of Gulf countries. This has been held up by the delay in forming the constitutionally-based government. Now that the new government is in place, negotiations can begin with a view to resolving these claims in a timely manner. Contacts have already been made with Saudi Arabia at the ministerial level regarding the resolution of these claims, and a technical working committee is being set up to begin the process of reconciliation.

27. The authorities continue to make good faith efforts to resolve the remaining arrears to private creditors. By May 2006, Iraq had resolved almost \$18 billion of claims submitted by private creditors through debt and cash exchanges, and submitted almost \$1 billion of claims arbitration.¹² While the process of debt reconciliation is ongoing, the authorities will continue the current strategy of resolving the remaining arrears of about \$2 billion through debt or cash exchange offers, including the arbitration process, through July 2006. The authorities plan to develop a follow-up strategy regarding commercial claims still outstanding after July 2006. Since the amount of the remaining private arrears is relatively small, about 4 percent of the total external debt in 2006, they are unlikely to pose significant risk to the program.

¹¹ This does not affect program monitoring, as the relevant data used for this purpose are derived from elements of the balance sheet that are not in question.

¹² In June 2006, the authorities reported the conclusion of the arbitration process of unreconciled claims of large creditors, resulting in an issuance of additional dollar-denominated bonds and multicurrency loans of \$143 million. The arbitration process of small creditors' unreconciled claims is ongoing.

IV. PROGRAM MONITORING AND FUND RELATIONS

28. **Some performance criteria have been missed.** Iraq met all quantitative performance criteria set for end-March, except for that applying to revenue of oil related state-owned enterprises which was slightly below target, reflecting lower than expected oil production and interruptions of refinery operations. Three other performance criteria were also missed: (i) payments arrears arose with Turkey in December 2005 (but these have since been regularized); (ii) the budget classification in line with GFSM 2001 was not adopted on June 30, 2006; (iii) the audit report of the Central Bank of Iraq's (CBI) 2005 financial statement, was not finalized by mid-May (but instead on July 13, 2006).

29. **The authorities are seeking waivers for the missed performance criteria.** In view of the relatively small size of the deviation and in light of the change in the underlying production assumptions, the authorities request a waiver for the missed performance criterion on revenue of oil related state-owned enterprises. On the basis of corrective actions specified in the attached Supplementary Memorandum of Economic and Financial Policies (SMEFP), the authorities request waivers for the three other missed performance criteria noted in paragraph 29. As the IMF Executive Board will be considering the First and Second Review of the SBA after end-June, 2006, but before the outcome for end-June quantitative performance criteria will be known, the authorities request that the applicability of these performance criteria be waived. Staff have no reason to believe that any of these performance criteria would have been missed on the basis of preliminary data.

30. **The authorities also request establishment of the quantitative performance criteria proposed in the SMEFP for end-September and end-December 2006.** The performance criteria for the second half of the program period are the same as the indicative targets set for this period in the SBA, except that (i) revenues of oil-related state-owned enterprises have been adjusted down to reflect lower projected crude and refined oil production¹³, and (ii) the ceiling on contracting external debt with a grant element less than 50 percent now provides a window for loans with a grant element exceeding 35 percent (to accommodate pending loans from the Japanese government which are to finance projects designed to improve Iraq's productive capacity). Staff do not believe that these loans would risk Iraq's debt sustainability. The SBA currently defines lending as concessional lending if it has a grant element greater than 50 percent.

31. **Staff aim to finalize an interim safeguards assessment for Iraq by the time of the next review taking into account the results of the recent audit of the CBI by Ernst & Young.** A safeguards assessment should normally be completed before the completion of the first review of the program. However, the security situation in Iraq did not allow this to be done. As explained to the Board at the time of the approval of the SBA, a phased approach

¹³ Lower crude oil production implies lower compensation (revenue) for the expense (also lower) of lifting oil from the ground, while lower refinery output means lower sales revenue. The target applies to gross revenues.

has been adopted for the safeguards assessment, similar to that for post-conflict cases, where the security situation or the state of development of the central bank does not allow a full on-site assessment.

V. VULNERABILITIES AND RISKS

32. **Iraq's medium term economic prospects look reasonably favorable, but are subject to considerable risk.** A medium term scenario is presented in the Appendix. This scenario updates the projections made in the staff report for the SBA in light of higher oil prices and a slower than expected recovery in oil production. As before, it is assumed that security improves sufficiently to allow the authorities to implement the investment program needed to generate growth. The scenario shows that, provided Iraq exercises due restraint on recurrent spending, the budget should be able to accommodate Iraq's investment needs without generating financing gaps (and thereby large scale borrowing needs). However, this prognosis depends heavily on the assumption that the wage and pension bill can be kept under control, which in turn makes it imperative that the new pension plan that is expected to go into effect later this year is sustainable and that inflation is contained before triggering a wage price spiral. The scenario is also vulnerable to declines in oil prices relative to present projections, as well as to lower than programmed oil production. The economy remains extremely vulnerable to the country's ongoing security problems, which impede investment and inhibit private economic activity, and to corruption, which damages Iraq's ability to manage its oil resources effectively and siphons off much needed wealth to improper ends.

VI. STAFF APPRAISAL

33. **The new government has taken important and decisive measures to bring the program back on track.** The adjustment of fuel prices in line with the original schedule, within weeks of the new government's installation, provides strong evidence of the new government's commitment to the program. The determination to contain recurrent spending, and particularly wages and pensions, to the original budget allocations, is an important signal of the government's respect for fiscal discipline.

34. **The momentum of action and reform must be strengthened.** It is essential that the government reform the pension plan to make it a fiscally sustainable system, before it goes into effect. The government must also secure early passage of the law liberalizing private imports of gasoline, if it is to succeed in bringing to an end the acute shortages of fuel products in Iraq.

35. **The impact of reform on the poor should be kept in sharp focus.** The government is strongly encouraged to pursue its social protection programs, in parallel with the reduction of subsidies, and seek ways to better target support toward the poor.

36. **Institution building remains a cornerstone of the reconstruction process.** It is encouraging that preparations for establishing an operational payments system are well

advanced. This will support reform in many other areas, including by introducing better transparency in the government's payroll, in redirecting financial transactions away from cash and back into the banking system, and in laying the groundwork for a successor to the PDS.

37. **Inflation remains a serious source of concern.** The ongoing insurgency and shortages of goods, as well as supply disruptions generally in the non-oil economy, will continue to put upward pressure on prices. But it remains important that the CBI take decisive measures to contain it before inflationary expectations become entrenched, either by an effective tightening of monetary conditions and/or by exchange rate action. The CBI will need to tighten monetary conditions further if inflation does not start to come down soon. The government can help by keeping public sector wages and pensions in line with the absorptive capacity of the small, albeit growing, non-oil economy, and by making every effort to prevent supply bottlenecks (especially in the petroleum product market) from destabilizing prices further.

38. **For the program to be implemented effectively, corruption must be tackled and security brought under control.** Corruption is damaging the credibility of the government's reform program, and undermining its effectiveness, especially in the petroleum and petroleum product sector. The continuing lack of security meanwhile remains Iraq's biggest obstacle to its recovery and reconstruction program, and presents the greatest risk of all to its future prosperity.

39. **The staff recommends that the first and second reviews under the SBA be completed.** In view of the government's commitment to the program, and in light of the policies and measures described in their SMEFP, the staff believe that the program is on track. The staff recommend approval of the waivers requested by the authorities for the missed performance criteria, and of the applicability of end-June targets. Based on the authorities' intentions to accelerate its efforts to address its arrears to non-Paris Club creditors, and on the staff's judgment that their strategy to resolve the remaining arrears to private creditors remains consistent with the Fund's policy on lending into arrears, staff also supports the completion of financing assurances review.

Table 1. Iraq: Selected Economic and Financial Indicators

	2004	2005		2006	
		SBA	Est.	SBA	Proj.
Economic growth and prices					
Real GDP (percentage change)	46.5	2.6	3.7	10.4	4.0
Non-oil GDP (percentage change)	14.9	8.0	12.0	8.0	10.0
GDP per capita (US\$)	949	1,189	1,237	1,452	1,635
GDP (US\$ million)	25,706	33,182	34,541	41,741	47,008
Oil production (In mbpd)	2.0	2.0	2.0	2.3	2.0
Oil exports (In mbpd)	1.4	1.4	1.4	1.65	1.5
Iraq oil export prices (US\$ pb)	31.6	43.0	43.9	46.6	53.7
Population growth	3.0	3.0	3.0	3.0	3.0
Consumer Price Inflation (end of period)	31.7	20.0	31.6	15.0	30.0
National Accounts (In percent of GDP)					
Gross domestic investment	26.5	29.1	20.5	29.0	31.1
<i>Of which: public</i>	22.2	25.6	17.6	26.6	26.8
Gross domestic consumption	97.8	95.4	89.5	87.1	83.8
<i>Of which: public</i>	56.4	59.6	54.1	57.2	49.9
Gross national savings	-7.9	14.7	25.7	26.1	29.2
<i>Of which: public</i>	-36.5	14.6	27.7	17.6	20.6
Public Finance (In percent of GDP, unless otherwise indicated)					
Government revenue and grants	80.0	93.6	97.3	96.3	87.0
Government oil revenue	69.6	67.8	69.4	72.9	66.9
Government non oil revenue	1.3	2.6	2.6	3.0	2.5
Grants	9.1	23.2	25.3	20.4	17.6
Expenditure	120.6	104.5	87.4	105.3	93.1
Recurrent expenditure	98.4	78.9	69.9	80.0	66.8
Capital expenditure	22.2	25.6	17.6	25.3	26.3
Overall fiscal balance (including grants)	-40.6	-10.9	9.8	-9.0	-6.1
Primary fiscal balance	-39.6	-10.8	10.0	-8.2	-5.2
Gross borrowing/use of external assets	43.1	11.9	5.8	9.3	7.1
Amortization	1.8	0.6	0.5	0.3	2.5
Financing gap/Surplus	0.7	0.0	0.1	0.0	0.0
Memorandum item:					
Tax revenue/non oil GDP (In percent)	1.3	2.4	2.8	4.2	1.8
Monetary Indicators (In percent)					
Growth in reserve money	116.9	12.9	12.0	20.6	28.1
Gross CBI foreign exchange assets/Reserve money	94.4	98.8	129.4	99.2	105.7
Gross reserves (In US\$ million)	7,902	9,311	11,984	11,013	13,791
In months of goods and services	3.2	3.1	3.9	3.6	4.4
Balance of payments (in percent of GDP)					
Current account	-34.4	-14.4	5.2	-2.7	-1.9
Trade balance	-7.6	-4.9	8.3	1.1	0.7
Exports of goods	69.2	68.7	66.7	68.9	63.9
Imports of goods	-76.8	-73.6	-58.3	-67.7	-63.3
Income and services	-34.5	-30.8	-26.8	-22.4	-18.4
Transfers	7.7	21.4	23.6	18.5	15.8
Financial account	42.5	18.6	4.8	6.8	7.3
Direct investment	0.8	0.9	1.2	0.7	1.1
Gross borrowing/use of external assets	41.8	23.2	15.5	14.3	11.2
Amortization	0.0	-0.6	-0.5	-0.3	-2.5
Overall external balance	8.8	4.2	10.0	4.0	5.4
Central bank reserves (increase -)	-26.3	-4.2	-11.8	-4.0	-3.8
Change in arrears	-122.1	-84.3	-83.7	-2.9	-35.5
Financing gap/Surplus	0.7	0.0	0.1	0.0	0.0

Sources: Iraqi authorities and staff estimates and projections.

Table 2. Iraq: Fiscal and Oil Sector Accounts, 2004–06
(In billions of ID; unless otherwise indicated)

	2004		2005		2006	
	Est.	SBA	Est.	SBA	Budget	Proj.
Revenues and Grants	30,019	45,490	49,568	60,316	59,979	60,327
Revenues	26,595	34,211	36,664	47,531	47,392	48,094
Crude oil export revenues 1/	25,326	31,919	33,905	42,109	42,106	43,326
Revenues of oil-related state owned enterprises	799	1,020	1,456	3,513	3,375	3,066
Of which, revenues from reduction in price subsidy on petroleum products	0	0	0	1,513	1,375	1,350
Tax revenues	160	372	495	821	822	449
Direct taxes	78	119	207	222	222	222
Indirect taxes	81	252	288	599	600	227
Non-tax revenues	201	755	614	1,016	1,016	1,016
Interest on assets held abroad	109	145	195	71	73	238
Grants	3,425	11,279	12,904	12,787	12,587	12,233
Expenditures	45,246	50,797	44,552	65,935	65,170	64,543
Operating expenditures (ex. reconstruction)	36,921	38,368	35,599	47,698	45,269	45,329
Salaries and pensions	4,532	8,591	9,282	12,899	12,871	12,871
Salaries	3,482	6,039	6,542	8,403	8,375	8,375
Defense/Interior	...	2,025	2,213	3,574	3,574	3,574
Others	...	4,014	4,329	4,829	4,801	4,801
Pensions	1,050	2,552	2,740	4,496	4,496	4,496
Goods and Services (non-oil sector)	11,018	13,600	13,058	15,265	15,382	15,241
Budgeted goods and services 2/	6,985	4,094	3,135	6,802	6,919	6,919
OFFP financed (other than social safety net)	1,624	1,429	760	0	0	0
Overhead costs for donor financed projects 3/	864	2,867	3,526	3,539	3,539	3,480
Security costs for project implementation 4/	1,546	5,210	5,636	4,925	4,925	4,842
Goods and Services (oil sector)	5,612	6,788	5,212	6,090	5,806	5,806
Oil derivative imports	4,823	5,768	4,128	4,090	4,090	4,090
Operating expenditures of oil-related state-owned enterprises (including refineries)	790	1,020	1,085	2,000	1,716	1,716
Transfers	14,085	7,724	6,232	10,858	8,618	8,618
Social safety net	5,956	4,500	3,751	5,000	5,000	5,000
Transfers to SOEs	1,237	1,160	900	1,260	1,428	1,428
Other transfers 5/	6,893	2,064	1,581	4,597	2,190	2,190
Interest payments	369	69	86	481	486	626
Domestic interest payments	369	69	86	244	...	370
External interest payments	...	0	0	237	...	256
War reparations 6/	1,304	1,596	1,730	2,105	2,105	2,166
Investment expenditures	8,324	12,430	8,953	15,862	18,910	18,224
Non-oil investment expenditures	6,136	8,800	6,602	10,530	13,692	13,006
Domestically financed reconstruction expenditure	4,087	3,049	2,189	6,050	9,266	9,266
US utilization of DFI	0	1,689	473	0	0	0
OFFP financed reconstruction expenditure	1,084	1,070	478	0	0	0
Grant financed reconstruction expenditure	965	2,992	3,462	4,068	4,013	3,658
Loan financed reconstruction expenditure	0	0	0	413	413	81
Oil investment expenditures	2,188	3,630	2,351	5,331	5,219	5,218
Contingency	...	...	...	2,375	990	990
Balance (including grants)	-15,226	-5,308	5,016	-5,619	-5,190	-4,216
Balance (excluding grants)	-18,651	-16,587	-7,888	-18,404	-17,777	-16,449
Change in outstanding LCs [+ increase] 7/	...	...	2,947	...	...	...
Unexplained residual or financing gap [+]/surplus [-]	260	0	30	0	0	0
Total financing	14,966	5,308	-2,099	5,619	5,190	4,216
External financing	15,499	5,484	2,717	5,619	5,190	3,216
Assets held abroad	10,177	2,528	1,467	5,411	5,247	4,858
Project financing	0	0	0	413	413	81
Other financing (OFFP)	5,992	3,249	1,486	0	0	0
Amortization	670	293	236	205	470	1,723
Domestic financing	-533	-176	-4,816	0	0	1,000
Direct bank lending	-333	0	-5,124	0	0	1,000
T-bills	-200	-176	308	0	0	0
Memorandum items						
Assets held in the Development Fund for Iraq 8/	6,683	5,848	9,144	...	3,896	4,286
Exchange rate (ID/US dollar)	1,460	1,465	1,474	1,500	1,475	1,475
Government primary fiscal deficit/surplus	-14,857	-5,239	5,102	-5,136	-4,704	-3,590
Government primary fiscal deficit (in US dollars)	-10,176	-3,576	3,461	-3,424	-3,189	-2,434
Salaries and pensions (excluding Defense/Interior)	...	6,566	7,069	9,325	9,297	9,297
Nominal GDP	37,531	48,611	50,948	62,611	62,611	69,337

1/ 2006 projections assume WEO crude oil price less the quality differential of \$10.6/barrel for H1, but WEO less quality differential of \$10.6/barrel and less a \$4.5/barrel discount for H2.

2/ Includes spending by the U.S. from seized and vested assets in 2004.

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

4/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.

5/ 2006 data includes ID270 billion allocated toward government's share of capital in new regional commercial banks. ID 1,500 formerly recorded under this item

were re-classified as non-oil investment expenditures in 2006 budget presentation. Finally, ID265 billion were re-classified as debt repayment.

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

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

8/ Includes balances on the DFI sub-account (PCO), which are assumed constant throughout 2006.

Table 3. Iraq: Fiscal and Oil Sector Accounts, 2004–06
(In percent of GDP)

	2005			2006		
	Est.	SBA	Est.	SBA	Budget	Proj.
Revenues and Grants	80.0	93.6	97.3	96.3	95.8	87.0
Revenues	70.9	70.4	72.0	75.9	75.7	69.4
Crude oil export revenues 1/	67.5	65.7	66.5	67.3	67.3	62.5
Revenues of oil-related state owned enterprises	2.1	2.1	2.9	5.6	5.4	4.4
Of which, revenues from reduction in price subsidy on petroleum products	0.0	0.0	0.0	2.4	2.2	1.9
Tax revenues	0.4	0.8	1.0	1.3	1.3	0.6
Direct taxes	0.2	0.2	0.4	0.4	0.4	0.3
Indirect taxes	0.2	0.5	0.6	1.0	1.0	0.3
Customs revenues on private oil imports	0.0	0.0	0.0	0.5	0.5	0.0
Other indirect taxes	0.2	0.5	0.6	0.4	0.4	0.3
Non-tax revenues	0.5	1.6	1.2	1.6	1.6	1.5
Interest on assets held abroad	0.3	0.3	0.4	0.1	0.1	0.3
Grants	9.1	23.2	25.3	20.4	20.1	17.6
Expenditures	120.6	104.5	87.4	105.3	104.1	93.1
Operating expenditures (ex. reconstruction)	98.4	78.9	69.9	76.2	72.3	65.4
Salaries and pensions	12.1	17.7	18.2	20.6	20.6	18.6
Salaries	9.3	12.4	12.8	13.4	13.4	12.1
Defense/Interior	...	4.2	4.3	5.7	5.7	5.2
Others	...	8.3	8.5	7.7	7.7	6.9
Pensions	2.8	5.3	5.4	7.2	7.2	6.5
Goods and Services (non-oil sector)	29.4	28.0	25.6	24.4	24.6	22.0
Budgeted goods and services 2/	18.6	8.4	6.2	10.9	11.1	10.0
OFFP financed (other than social safety net)	4.3	2.9	1.5	0.0	0.0	0.0
Overhead costs for donor financed projects 3/	2.3	5.9	6.9	5.7	5.7	5.0
Security costs for project implementation 4/	4.1	10.7	11.1	7.9	7.9	7.0
Goods and Services (oil sector)	15.0	14.0	10.2	9.7	9.3	8.4
Oil derivative imports	12.8	11.9	8.1	6.5	6.5	5.9
Operating expenditures of oil-related state-owned enterprises (including refineries)	2.1	2.1	2.1	3.2	2.7	2.5
Transfers	37.5	15.9	12.2	17.3	13.8	12.4
Social safety net	15.9	9.3	7.4	8.0	8.0	7.2
Budgeted social safety net	10.2	0.0	7.4	8.0	8.0	7.2
Social safety net financed by OFFP	5.7	0.0	0.0	0.0	0.0	0.0
Transfers to SOEs	3.3	2.4	1.8	2.0	2.3	2.1
Other transfers 5/	18.4	4.2	3.1	7.3	3.5	3.2
Interest payments	1.0	0.1	0.2	0.8	0.8	0.9
Domestic interest payments	1.0	0.1	0.2	0.4	...	0.5
External interest payments	0.0	0.0	0.0	0.4	...	0.4
War reparations 6/	3.5	3.3	3.4	3.4	3.4	3.1
Investment expenditures	22.2	25.6	17.6	25.3	30.2	26.3
Non-oil investment expenditures	16.3	18.1	13.0	16.8	21.9	18.8
Domestically financed reconstruction expenditure	10.9	6.3	4.3	9.7	14.8	13.4
Defense/Interior	...	1.1	0.4	2.8	2.8	2.5
Others	...	5.2	3.9	6.9	12.0	10.9
US utilization of DFI	0.0	3.5	0.9	0.0	0.0	0.0
OFFP financed reconstruction expenditure	2.9	2.2	0.9	0.0	0.0	0.0
Grant financed reconstruction expenditure	2.6	6.2	6.8	6.5	6.4	5.3
Grant financed reconstruction expenditure (US)	2.2	5.5	6.4	5.2	5.2	4.7
Grant financed reconstruction expenditure (other donors)	0.4	0.7	0.4	1.3	1.3	0.6
Loan financed reconstruction expenditure	0.0	0.0	0.0	0.7	0.7	0.1
Oil investment expenditures	5.8	7.5	4.6	8.5	8.3	7.5
Budget financed oil investment	2.6	5.5	3.6	8.5	8.3	7.5
Of which advance payments for letters of credit for execution in subsequent years	0.0	0.0	0.0	3.0	0.0	2.7
OFFP financed oil investment	3.1	1.5	0.5	0.0	0.0	0.0
Grant financed oil investment (US)	0.1	0.4	0.5	0.0	0.0	0.0
Contingency	...	...	...	3.8	1.6	1.4
Balance (including grants)	-40.6	-10.9	9.8	-9.0	-8.3	-6.1
Balance (excluding grants)	-49.7	-34.1	-15.5	-29.4	-28.4	-23.7
Change in outstanding LCs [+ increase] 7/	...	...	5.8	...	...	...
Unexplained residual or financing gap [+]/surplus [-]	0.7	0.0	0.1	0.0	0.0	0.0
Total financing	39.9	10.9	-4.1	9.0	8.3	6.1
External financing	41.3	11.3	5.3	9.0	8.3	4.6
Assets held abroad	27.1	5.2	2.9	8.6	8.4	7.0
Project financing	0.0	0.0	0.0	0.7	0.7	0.1
Other financing (OFFP)	16.0	6.7	2.9	0.0	0.0	0.0
Amortization	1.8	0.6	0.5	0.3	0.8	2.5
Domestic financing	-1.4	-0.4	-9.5	0.0	0.0	1.4
Direct bank lending	-0.9	0.0	-10.1	0.0	0.0	1.4
T-bills	-0.5	-0.4	0.6	0.0	0.0	0.0

1/ 2006 projections assume WEO crude oil price less the quality differential of \$10.6/barrel for H1, but WEO less quality differential of \$10.6/barrel and less a \$4.5/barrel discount for H2.

2/ Includes spending by the U.S. from seized and vested assets in 2004.

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

4/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.

5/ 2006 data includes ID270 billion allocated toward government's share of capital in new regional commercial banks. ID 1,500 formerly recorded under this item were re-classified as non-oil investment expenditures in 2006 budget presentation. Finally, ID265 billion were re-classified as debt repayment.

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

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

Table 4. Iraq: Central Bank Survey, 2003–06
(In billions of Iraqi dinars, unless otherwise indicated)

	2003	2004	2005		2006		
	Actual	Actual	Actual	SBA	Actual	SBA	Proj.
	Dec.	Dec.	Dec.		Mar.		
Net foreign exchange assets 1/	1,600	10,743	17,078	12,993	17,864	15,869	19,909
Foreign exchange assets	1,916	11,538	17,724	13,639	18,510	16,515	20,555
Gold 2/	114	115	143	119	162	119	143
Other	1,803	11,422	17,581	13,520	18,348	16,397	20,413
CBI vaults	1,803	10,361	16,600	12,521	17,360	15,353	19,421
Fx claims on state banks	0	0	0	0	0	0	0
SDR Account	0	1,061	982	999	988	1,044	992
Foreign exchange liabilities	-316	-795	-646	-646	-646	-646	-646
<i>Of which</i> : IMF liabilities	...	-637	-637	-637	0	-637	-637
Net domestic assets	4,038	1,485	-3,380	811	-3,352	777	-2,363
Domestic assets	3,698	4,345	138	3,161	531	3,161	757
Net claims on general government	3,698	4,336	128	3,152	520	3,152	748
Holdings of treasury bills	2,874	2,589	2,560	2,528	2,866	2,528	4,707
Holdings of discounted treasury bills	206	709	707	707	707	707	0
Overdrafts	909	1,637	1,821	1,821	1,821	1,821	0
Domestic currency deposits	-15	-596	-3,577	-596	-4,302	-596	-3,577
Foreign currency deposits	-276	-3	-1,382	-1,307	-571	-1,307	-382
Claims on nonbank public institutions	0	0	0	0	0	0	0
Claims on commercial banks	0	8.7	9.4	8.7	10.6	8.7	9.4
Monetary policy instruments 3/	0	0	-3,731	-3,316	-3,746	-3,350	-2,996
Other items net	339	-2,859	214	966	-137	966	-125
Reserve money	5,638	12,228	13,698	13,804	14,926	16,646	17,546
Currency outside banks	2,606	7,163	9,110	8,815	9,621	10,949	11,838
Currency issued	4,586	8,021	10,257	9,679	10,881	12,022	13,327
<i>less cash in vaults of commercial banks</i>	1,980	858	1,146	864	1,260	1,073	1,489
Banks reserves	1,052	4,208	3,442	4,124	4,044	4,624	4,219
Required	717	2,287	2,596	3,329	3,251	3,829	3,374
Excess	335	1,921	845	795	793	795	845
Memorandum items:							
Reserve money (annual growth, in percent)	...	116.9	12.0	12.9	9.0	20.6	28.1
Currency issued (annual growth, in percent)	...	74.9	27.9	20.7	6.1	24.2	29.9
Gross foreign exchange assets (in millions of U.S. dollars)	1,134	7,902	11,984	9,311	12,507	11012.2	13790.7
Gold	67	79	96	82	109	81	106
CBI vault + DFI sub-account	1,067	7,097	11,223	8,547	11,730	10,235	12,947
Deposits at state banks	0	0	0	0	0	0	0
SDR Account	0	727	664	682	668	696	737
Foreign exchange liabilities (in millions of U.S. dollars)	-187	-544	-443	-441	-431	-431	-480
Net foreign exchange assets (in millions of U.S. dollars)	947	7,358	11,541	8,870	12,076	10581	13310
Exchange rate (end-of-period) 4/	1,690	1,460	1,479	1,465	1,480	1500	1345
Exchange rate (program) 4/	1,690	1,460	1,460	1,465	1,500	1500	1500
Inflation (12-month)	36.3	31.7	31.6	20.0	53.4	15.0	30.0
Non-oil real GDP growth (in percent)	-3.4	14.9	12.0	8.0	10.0	8.0	10.0
Real GDP growth (in percent)	-41.4	46.5	3.7	2.6	4.0	3.7	4.0
Gross foreign exchange assets/reserve money (in percent)	34.0	94.4	129.4	98.8	124.0	99.2	105.7
Claims on banks/reserve money (in percent)	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Reserve money coverage (in percent)	28.4	87.9	124.6	94.1	119.7	95.4	102.0
Currency in circulation /reserve money (in percent)	46.2	58.6	66.5	63.9	64.5	65.8	67.5
Ratio of Currency outside banks to GDP	10.6	19.1	17.9	17.3	14.1	17.6	19.5
Ratio of Reserve money to GDP	15.2	32.6	26.9	27.1	21.8	32.7	25.7

Sources: Iraqi authorities, and staff estimates and projections.

1/ Valued at market exchange rates.

2/ For 2005, valued at market prices.

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

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

Table 5. Iraq: Depository Corporations (Monetary) Survey, 2004–05 1/
(In billions of Iraqi dinars)

	2004		2005		
	Dec.	Mar.	Jun.	Sep.	Dec.
Nonresident claims	4,043	-1,493	13,490	21,923	13,080
Net foreign assets of depository corporations 2/	-5,944	-4,640	-4,001	-3,922	-580
Government claims on nonresidents on balance sheet of CBI (DFI/OFF) 3/	9,987	3,147	17,490	25,844	13,660
Domestic claims	-1,324	176	-373	-815	-3,750
Net claims on central government	-2,118	-707	-1,375	-1,931	-5,081
CBI liabilities to government (DFI/MOU)	-294	6,442	-7,448	-19,281	-7,001
Other net claims on central government	-2,118	-707	-1,375	-1,931	-5,081
Claims on other sectors	794	883	1,002	1,116	1,330
Public nonfinancial corporations	120	151	153	156	161
Other nonfinancial corporations	63	121	140	208	294
Other resident sectors	611	612	709	752	875
Broad money liabilities	14,351	14,393	13,856	14,024	14,963
Currency outside depository corporations	6,730	8,330	8,260	8,334	9,081
Transferable deposits	6,287	4,472	3,934	3,873	3,984
Other financial corporations	252	332	504	347	213
Public nonfinancial corporations	1,426	1,132	1,048	1,006	1,095
Other nonfinancial corporations	2,958	1,444	967	1,004	971
Other resident sectors	1,650	1,564	1,414	1,516	1,705
Other deposits	1,334	1,591	1,663	1,816	1,898
Other financial corporations	20	25	25	23	21
Public nonfinancial corporations	43	47	47	123	123
Other nonfinancial corporations	69	36	20	19	29
Other resident sectors	1,202	1,483	1,571	1,651	1,725
Deposits excluded from broad money	17	37	67	93	93
Shares and other equity	-9,865	-7,648	-8,874	-12,159	-11,116
Other items (net)	1,071	-1,808	469	-283	-1,758

Source: Central Bank of Iraq.

1/ The Depository Corporations Survey is a consolidation of the asset and liability positions of the depository corporations relative to all other economic *Manual*, depository corporations comprise all institutions that issue liabilities included in

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

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

Table 6. Iraq: Balance of Payments, 2004–06 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2004		2005		2006	
	Est.	SBA	Est.	SBA	Proj.	
Trade balance	-1,949	-1,636	2,878	476	306	
(In percent of GDP)	-7.6	-4.9	8.3	1.1	0.7	
Exports	17,782	22,781	23,032	28,745	30,052	
Crude oil	17,329	22,176	22,443	28,073	29,373	
Other exports	452	605	589	672	679	
Imports 2/	-19,730	-24,416	-20,154	-28,269	-29,746	
Government imports	-13,922	-14,596	-11,304	-14,456	-14,933	
UN Oil for Food Program (OFFP)	-3,489	-1,929	-880	0	0	
Other consumption imports (non-OFFP)	-3,843	-3,528	-2,909	-5,089	-4,877	
Other non-oil related capital imports (non-OFFP)	-2,353	-3,450	-2,828	-4,882	-5,791	
Oil-related capital imports	-1,429	-2,261	-2,252	-2,113	-1,852	
Refined oil products	-2,808	-3,428	-2,435	-2,372	-2,412	
Private sector imports	-5,809	-9,820	-8,850	-13,813	-14,813	
<i>Of which: refined oil products</i>	0	0	0	-2,429	-2,040	
Income, net 3/	-4,587	-3,741	-2,904	-2,237	-1,320	
Services, net 2/	-4,286	-6,477	-6,342	-7,093	-7,316	
Transfers, net	1,979	7,090	8,163	7,721	7,425	
Private, net (incl. NGOs)	500	500	500	600	600	
Official	1,479	6,590	7,663	7,121	6,825	
Receipts	2,346	7,699	8,786	8,525	8,293	
Payments	-866	-1,109	-1,122	-1,404	-1,469	
Current account	-8,842	-4,763	1,796	-1,133	-905	
(In percent of GDP)	-34.4	-14.4	5.2	-2.7	-1.9	
Capital account	0	0	0	0	0	
Financial account	10,937	6,172	1,651	2,821	3,444	
Direct investment	200	300	400	300	500	
Other capital, net	10,737	5,872	1,251	2,521	2,944	
Official, net	10,835	7,504	5,244	5,839	4,828	
Assets 4/	10,835	3,943	2,011	3,607	3,293	
Liabilities	0	3,561	3,233	2,232	1,535	
Loan disbursements	0	0	0	275	55	
Amortization 5/ 6/	0	-200	-121	-136	-436	
Capitalized interest payment 5/	0	3,761	3,354	2,093	1,915	
Financial corporations, net 7/	0	0	-2,007	-1,247	-1,278	
Private, net	-98	-1,632	-1,986	-2,071	-606	
Errors and omissions	178	0	21	0	0	
Overall balance	2,273	1,409	3,468	1,688	2,539	
(In percent of GDP)	8.8	4.2	10.0	4.0	5.4	
Financing	-2,273	-1,409	-3,468	-1,688	-2,539	
Central bank (increase -)	-6,768	-1,409	-4,081	-1,688	-1,807	
Reserves (net; increase -)	-6,332	-1,409	-4,081	-1,688	-1,807	
Liabilities (increase +)	436	0	0	0	0	
Fund credit (net)	436	0	0	0	0	
Disbursement	436	0	0	0	0	
Repayments	0	0	0	0	0	
Deferred accrued interest 8/	4,680	0	0	0	0	
Change in arrears (net, decrease -) 9/	-31,392	-27,987	-28,894	-1,195	-16,666	
Debt forgiveness 10/	31,207	27,987	29,508	1,195	15,934	
Memorandum items:						
Central bank reserves	7,902	9,311	11,984	11,013	13,791	
Central bank reserves (in months of imports of goods and service)	3.2	3.1	3.9	3.6	4.3	
GDP	25,706	33,182	34,541	41,741	47,008	
Non-oil GDP	8,277	10,716	11,805	12,999	16,882	

Sources: Iraqi authorities and staff estimates and projections.

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

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

3/ Includes interest accrued, deferred, and capitalized.

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

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

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

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

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

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

10/ The notional debt forgiveness reflects: (i) the first stage of debt reduction (30 percent) at end 2004; (ii) the second stage reduction (30 percent) at end-2005; and (iii) the settlement of debt owed to private creditors through cash and debt exchanges. Assumes debt reduction comparable to the Paris Club agreement on other debt to official creditors.

Table 7. Iraq: Oil Product Prices (SBA)

	LPG 1/	Gasoline		Kerosene	Diesel
		Regular	Premium		
Official price, ID per liter/cylinder					
September 2005	250	20 2/	50	5	10
Proposed price increases:					
December 2005 (prior action) 3/	600	100	250	25	90
March 31, 2006 3/	700	130	300	50	110
June 30, 2006 3/	800	155	350	75	125
September 30, 2006 3/	900	175	400	90	155
December 31, 2006 4/	1000	200	450	115	175
Average price 2006	750	140	325	40	120
Price in US\$ (average of 2006) 5/	0.50	0.09	0.22	0.03	0.08
Price in US\$ (end-September 2006) 5/	0.60	0.12	0.27	0.06	0.10
Price in US\$ (end-December 2006) 5/	0.67	0.13	0.30	0.08	0.12
Average price for Gulf countries in US\$ 6/	...	0.24	0.27	0.17	0.18

Sources: Iraqi authorities and MCD database.

1/ Priced at ID per 12 kg cylinder.

2/ ID 50 in Baghdad.

3/ Approved by cabinet decree, and as committed in the Stand-by Arrangement.

4/ Indicative.

5/ Exchange rate \$1 = ID 1500.

6/ As of June 2005, average prices for Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Prices for regular gasoline in the Gulf are typically for octane levels of at least 87, whereas current octane for regular gasoline sold in Iraq is about 82, and it is of significantly lower quality.

Table 8. Iraq: 2005–06 Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement (SBA) 1/
(In billions of Iraqi dinars, unless otherwise indicated)

	2005	Performance Criteria				
	9/30/05	12/31/05	3/31/06	6/30/06	9/30/06	12/31/06
<i>Cumulative change from September 2005</i>						
Net international reserves of the CBI (floor) (in millions of U.S. dollars) (Actual)	8,500 2/	-1,000 +3,041	-1,000 +3,576	-1,000	-1,000	-1,000
Lending to the government and the private sector by the CBI (ceiling) 3/ (Actual)	5,100 2/	0 0	0 0	0	0	0
<i>Cumulative flow from beginning of calendar year</i>						
Government primary fiscal deficit (in billions; ceiling; deficit [+]/surplus[-]) 4/ (Actual)	...	5,400 -5,102	1,950 -873	3,600	4,850	5,300
Government wage and pension bill (ceiling) 4/ 5/ (Actual)	...	6,650 7,069	2,400 2,051	4,750	7,100	9,500
Revenue of oil related enterprises, including those remitted to the budget (floor) 4/ (Actual)	...	900 1,456	700 509	1,500	2,100	2,800
New medium-and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 4/ 7/ (Actual)	...	500 0	500 0	500	500	500
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 6/ (Actual)	...	0 653	0 0	0	0	0
<i>Indicative target</i>						
Government imports of petroleum products (ceiling) 4/ (Actual)		6,000 4,128	1,700 1,152	3,400	4,000	4,200

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

2/ Estimated.

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

4/ Flows for 12/31/05 are cumulative for 2005. Flows for 2006 are cumulative starting 1/1/2006.

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

6/ This will be monitored on a continuous basis.

7/ This ceiling excludes loans with grant element of 35 percent or more of up to Yen 200 billions for reconstruction projects to be contracted with the government of Japan in 2006.

Table 9. Iraq: Prior Actions, Structural Performance Criteria, and Structural Benchmarks
Under the Stand-By Arrangement

	Date	Status
I. Prior Actions for Completion of the First and Second Review		
Submission by the Council of Ministers to the Council of Representatives the amendments to the draft law for the liberalization of private imports of gasoline after removing articles 7 and 8.		
II. Structural Performance Criteria		
Avoid administrative measures limiting participation or bids in the CBI's regular auction of foreign exchange other than screening related to anti-money laundering or counter-terrorism.	Continuous	Met so far
Adoption of fully detailed budget classification and chart of accounts in line with the IMF's Government Financial Statistics Manual (GFSM) 2001, within a cash accounting framework. ^{1/}	June 30, 2006	Rescheduled to December 31, 2006. Work is underway.
Final audit of CBI 2005 Financial operations and statements.	May 15, 2006	Original date of May 15 was missed. Audit finalized on July 13, 2006.
III. Structural Benchmarks		
Implementation of payment system regulations.	June 30, 2006	Met on May 15, 2006.
Establishment of an audit oversight committee, to become effective on or before December 31, 2006, including the participation of independent international audit experts, to continue the work of the International Advisory and Monitoring Board (upon its dissolution) in overseeing and making public audits of the Development Fund for Iraq and oil export sales.	June 30, 2006	Rescheduled to September 30, 2006.
Reform of pension law in line with sustainable pension system	September 30, 2006	
Approval by Council of Representatives of law liberalizing private gasoline imports	September 30, 2006	
Completion of census of all public service employees (including military).	June 30, 2006	Rescheduled to December 31, 2006
Commencement of operation of Real Time Gross Settlement system (RTGS) linking headquarters of commercial banks to the CBI.	August 31, 2006	Running ahead of schedule
Commencement of payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House (ACH).	November 30, 2006	Running ahead of schedule
Full capitalization of CBI to the stipulated ID 100 billion, based on the 2005 audited financial statements and taking into account the restructuring of outstanding claims on the central government that are on the December 31, 2005 balance sheet of the CBI.	December 31, 2006	CBI claims on government have been rescheduled. Capitalization awaits the audit of the CBI 2005 accounts.

^{1/} The budget classification and chart of accounts will be deemed in line with the IMF GFSM 2001 if it is consistent with the methodology and high level classification defined in the technical assistance report of the IMF's Fiscal Affairs Department entitled "Iraq Budget Classification Reform" (July 2005).

Table 10. Iraq: Proposed Availability of Purchases Under the Stand-by Arrangement, 2005–07

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

Source: Fund staff projections.

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

	2004	2005	2006	2007	2008	2009	2010	2011
Disbursements of Fund credit								
EPCA	297.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Prospective SBA 1/ In percent of IMF quota	0.0	0.0	396.1	79.2	0.0	0.0	0.0	0.0
	0.0	0.0	33.3	6.7	0.0	0.0	0.0	0.0
Obligations								
Clearance of arrears	55.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments of EPCA	0.0	0.0	0.0	0.0	148.6	148.6	0.0	0.0
Repayments of prospective SBA	0.0	0.0	0.0	0.0	0.0	69.3	227.8	168.4
Total charges and interest	0.7	10.5	15.9	37.9	35.5	27.6	16.7	5.3
Total obligations	56.0	10.5	15.9	37.9	184.0	245.5	244.5	173.6
Total obligations, in percent of:								
Exports of goods and services	0.5	0.1	0.1	0.2	0.6	0.7	0.7	0.4
External public debt	0.1	0.0	0.0	0.1	0.5	0.7	0.6	0.5
Gross reserves	1.0	0.1	0.2	0.3	1.5	1.9	1.8	1.2
GDP	0.3	0.0	0.0	0.1	0.4	0.4	0.4	0.3
IMF Quota	4.7	0.9	1.3	3.2	15.5	20.7	20.6	14.6
Outstanding Fund credit								
EPCA	297.1	297.1	297.1	297.1	148.6	0.0	0.0	0.0
Prospective SBA	0.0	0.0	396.1	475.4	475.4	406.0	178.3	9.9
Total outstanding Fund credit	297.1	297.1	693.2	772.5	623.9	406.0	178.3	9.9
Total outstanding Fund credit, in percent of								
Exports of goods and services	2.6	1.9	3.3	3.1	2.1	1.2	0.5	0.0
External public debt	0.5	0.7	2.1	2.3	1.7	1.1	0.5	0.0
Gross reserves	5.6	3.7	7.4	7.1	5.1	3.1	1.3	0.1
GDP	1.7	1.3	2.2	1.9	1.3	0.7	0.3	0.0
IMF Quota	25.0	25.0	58.3	65.0	52.5	34.2	15.0	0.8

Sources: Fund staff estimates and projections.

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

APPENDIX— IRAQ: MEDIUM-TERM PROSPECTS AND EXTERNAL DEBT OUTLOOK

1. Iraq's medium term prospects have improved since the Stand-By Arrangement (SBA) was approved in December 2005, mainly on account of higher oil prices (see Appendix, Table 1–4). Staff projections suggest that, on current WEO forecasts for oil prices, Iraq should be able to meet its first major amortization payment (in 2011) on its rescheduled debt without difficulty. These projections incorporate a downward “risk” discount of one standard deviation in oil prices (\$4.5 per barrel) to the existing forecast, in addition to the usual quality differential for Iraqi oil. Nevertheless, the simulations below show that Iraq remains vulnerable to further downward shocks to oil prices and/or to a renewed stalling of oil production. This suggests that Iraq has little room for fiscal expansion beyond what is projected in these scenarios, and that the government would be wise to retain positive precautionary balances in the Development Fund for Iraq (or its future equivalent) throughout the scenario (rather than run balances to zero in 2007).

2. Iraq has made significant progress in resolving claims of private creditors through cash and debt exchange offers. Through the cash-exchanges in August 2005, September 2005, and March 2006, Iraq settled about \$3.5 billion of claims submitted by small private creditors. In January 2006, Iraq converted claims of large private creditors totaling almost \$14 billion into \$2.66 billion dollar denominated bonds and \$0.18 billion multicurrency loans.

3. ¹ The bonds have been traded in the market since January 23, 2006. By May 2006, Iraq has settled almost \$18 billion of the total claims of about \$21 billion submitted by private creditors. Most of the remaining claims are being reconciled or have been submitted to the arbitration process.

4. Despite the substantial debt reduction received from Paris Club and private creditors, however, the amount of external debt remains large. By end-2005, Iraq had received 60 percent debt reduction from the Paris Club creditors. In addition, by May 2006 Iraq had settled about 85 percent of debt to private creditors, and received overall (private) debt reduction of more than 80 percent. The latest estimates of external debt indicate that the stock of debt was \$63 billion (183 percent of GDP) at end 2005, and is expected to decline to about \$48 billion (102 percent of GDP) by end 2006. Without the third stage of debt reduction, external debt would increase to about \$57 billion (about 57 percent of GDP) by 2011. The

¹ The bond was exchanged at a ratio of 20 percent. The bonds will mature in 2028 and pay a fixed rate of 5.8 percent semi-annually starting July 2006. The multicurrency loan has the terms that closely replicate the financial terms of the Paris Club agreement, and was exchanged at a ratio of 40 percent. Consistent with the terms of Iraq's Paris Club agreement, upon the completion of the final review of a three-year implementation of one (or more) upper credit tranche arrangement(s) with the Fund, the outstanding principal of the loan will at that time be reduced by a further 50 percent (resulting in a final exchange ratio of about 20 percent).

third stage reduction (expected in 2008) would further reduce Iraq's external debt to about \$33 billion (33 percent of GDP) by 2011 (see Appendix, Table 5).^{2 3}

5. Iraq's external debt also remains vulnerable to a negative oil shock, particularly in 2011 when Iraq will start repaying the debt to official creditors. Based on the Paris Club agreement in 2004, the repayment of the remaining debt stock would start in 2011, while the interest payments accrued during 2005–2010 are mostly capitalized. The debt service would be relatively small until 2010 before it increased to about 5 percent of GDP in 2011. Simulations for two oil shocks—a production shock that keeps oil production constant at 2.7 mbpd over 2008–11, and a price shock that lowers oil export price by \$4.5 per barrel (equivalent to one standard deviation) during 2007–11—show that Iraq would require significant borrowing from the international markets to close the financing gaps (see Appendix, Table 6).

² The third stage of debt reduction would be contingent on Iraq completing the final review of the third year of upper credit tranche arrangements.

³ The medium term projections assume that new debt disbursement is mostly from multilateral creditors and Japan.

Table 1. Iraq: Selected Economic and Financial Indicators

	2004	2005	2006	2007	2008	2009	2010	2011
		Est.	Proj.					
Economic growth and prices								
Real GDP (percentage change)	46.5	3.7	4.0	14.4	12.9	12.7	9.6	7.1
Non-oil GDP (percentage change)	14.9	12.0	10.0	10.0	10.0	9.5	9.5	9.0
GDP per capita (US\$)	949	1,237	1,635	2,060	2,319	2,608	2,861	3,029
GDP (US\$ million)	25,706	34,541	47,008	60,948	70,534	81,471	91,691	99,486
Oil production (In mbpd)	2.0	2.0	2.0	2.4	2.7	3.1	3.4	3.6
Oil exports (In mbpd)	1.4	1.4	1.5	1.8	2.1	2.5	2.7	3.0
Iraq oil export prices (US\$ pb)	31.6	43.9	53.7	56.0	55.5	55.0	54.8	54.5
Population growth	3.0	3.0	3.0	2.9	2.8	2.7	2.6	2.5
Consumer Price Inflation (end of period)	31.7	31.6	30.0	17.0	10.0	7.0	5.0	4.0
National Accounts (In percent of GDP)								
Gross domestic investment	26.5	20.5	31.1	29.2	29.4	29.9	29.7	28.8
<i>Of which: public</i>	22.2	17.6	26.8	25.0	24.6	24.3	23.4	22.3
Gross domestic consumption	97.8	89.5	83.8	70.2	69.0	68.0	67.5	68.0
<i>Of which: public</i>	56.4	54.1	49.9	32.9	32.6	33.0	33.1	33.5
Gross national savings	-7.9	25.7	29.2	27.8	27.7	28.6	29.0	28.5
<i>Of which: public</i>	-36.5	27.7	20.6	22.9	23.8	24.8	24.2	22.6
Public Finance (In percent of GDP, unless otherwise indicated)								
Government revenue and grants	80.0	97.3	87.0	71.1	71.1	72.2	71.9	71.7
Government oil revenue	69.6	69.4	66.9	66.5	67.4	68.7	68.6	68.3
Government non oil revenue	1.3	2.6	2.5	2.4	3.5	3.3	3.3	3.4
Grants	9.1	25.3	17.6	2.2	0.2	0.2	0.0	0.0
Expenditure	120.6	87.4	93.1	73.2	71.9	71.7	71.1	71.4
Recurrent expenditure	98.4	69.9	66.8	49.0	48.0	47.9	48.2	49.5
Capital expenditure	22.2	17.6	26.3	24.1	23.9	23.7	22.9	21.8
Overall fiscal balance (including grants)	-40.6	9.8	-6.1	-2.1	-0.8	0.5	0.8	0.3
Primary fiscal balance	-39.6	10.0	-5.2	-1.4	0.1	1.7	2.6	3.2
Gross borrowing/use of external assets	43.1	5.8	7.1	1.1	0.8	-0.5	-0.8	2.4
Amortization	1.8	0.5	2.5	0.1	0.0	0.0	0.0	2.8
Financing gap/Surplus	0.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:								
Tax revenue/non oil GDP (In percent)	1.3	2.8	1.8	2.3	4.1	3.8	3.8	3.8
Monetary Indicators (In percent)								
Growth in reserve money	116.9	12.0	28.1	31.5	...	...	...	...
Gross CBI foreign exchange assets/Reserve money	94.4	129.4	105.7	94.2	...	...	...	...
Gross reserves (In US\$ million)	7,902	11,984	13,791	16,166	18,196	19,419	20,769	21,967
In months of goods and services	3.2	3.9	4.4	4.6	4.5	4.4	4.4	4.4
Balance of payments (in percent of GDP)								
Current account	-34.4	5.2	-1.9	-1.4	-1.7	-1.3	-0.7	-0.3
Trade balance	-7.6	8.3	0.7	7.0	7.3	7.8	8.5	8.6
Exports of goods	69.2	66.7	63.9	62.0	61.5	61.7	60.7	59.9
Imports of goods	-76.8	-58.3	-63.3	-55.0	-54.2	-53.9	-52.2	-51.2
Income and services	-34.5	-26.8	-18.4	-8.8	-7.8	-7.8	-7.8	-7.6
Transfers	7.7	23.6	15.8	0.4	-1.2	-1.3	-1.3	-1.4
Financial account	42.5	4.8	7.3	5.4	4.6	2.8	2.1	1.5
Direct investment	0.8	1.2	1.1	1.1	1.2	1.3	1.8	1.9
Gross borrowing/use of external assets	41.8	15.5	11.2	4.4	3.4	1.5	0.4	2.4
Amortization	0.0	-0.5	-2.5	-0.1	0.0	0.0	0.0	-2.8
Overall external balance	8.8	10.0	5.4	4.0	2.9	1.5	1.5	1.2
Central bank reserves (increase -)	-26.3	-11.8	-3.8	-3.9	-2.9	-1.5	-1.5	-1.2
Change in arrears	-122.1	-83.7	-35.5	-0.1	0.0	0.0	0.0	0.0
Financing gap/Surplus	0.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Iraqi authorities and staff estimates and projections.

Table 2. Iraq: Fiscal and Oil Sector Accounts, 2004–11
(In billions of ID, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011
		Est.			Revised projections			
Revenues and Grants	30,019	49,568	60,327	63,905	79,739	97,907	112,924	124,373
Revenues	26,595	36,664	48,094	61,970	79,488	97,695	112,870	124,336
Crude oil export revenues	25,326	33,905	43,326	54,616	67,603	82,526	93,852	102,376
Revenues of oil-related state owned enterprises	799	1,456	3,066	5,185	7,995	10,731	13,893	16,181
Of which revenues from reduction in price subsidy on petroleum products	0	0	1,350	2,850	5,012	7,072	9,736	11,718
Tax revenues	160	495	449	745	1,599	1,738	1,997	2,237
Direct taxes	78	207	222	291	363	451	550	648
Indirect taxes 1/	81	288	227	453	1,236	1,287	1,447	1,589
Non-tax revenues	310	809	1,254	1,424	2,291	2,700	3,128	3,542
Grants	3,425	12,904	12,233	1,935	251	212	55	37
Expenditures	45,246	44,552	64,543	65,775	80,599	97,249	111,687	123,836
Operating expenditures	36,921	35,599	45,329	41,770	51,536	62,752	73,425	83,659
Salary and pension	4,532	9,282	12,871	14,605	18,209	22,042	25,512	28,196
Goods and Services (non-oil sector) 2/	11,018	13,058	15,241	11,063	13,842	17,517	20,745	24,010
Budgeted goods and services 3/	6,985	3,135	6,919	10,087	13,842	17,517	20,745	24,010
Financed by oil-for-food program (OFFP) (other than social safety net)	1,624	760	0	0	0	0	0	0
Overhead costs for donors' financed projects 4/	864	3,526	3,480	408	0	0	0	0
Other goods and services financed by donors 5/	1,546	5,636	4,842	568	0	0	0	0
Goods and Services (oil sector)	5,612	5,212	5,806	2,335	2,984	3,659	4,157	4,463
Oil derivative imports	4,823	4,128	4,090	0	0	0	0	0
Operating expenditures of oil-related state-owned enterprises (including refineries)	790	1,085	1,716	2,335	2,984	3,659	4,157	4,463
Transfers	14,085	6,232	8,618	10,435	12,136	13,729	15,497	16,985
Social safety net (excluding OFFP)	3,829	3,751	5,000	6,020	7,079	8,091	9,152	10,244
Social safety net (financed by OFFP)	2,126	0	0	0	0	0	0	0
Transfers to SOEs	1,237	900	1,428	1,528	1,457	1,150	1,150	1,000
Other transfers 6/	6,893	1,581	2,190	2,887	3,600	4,488	5,195	5,741
Interest payments	369	86	626	602	985	1,679	2,822	4,886
Domestic interest payments	369	86	370	334	298	262	226	190
External interest payments	0	0	256	268	687	1,417	2,596	4,696
War reparations 7/	1,304	1,730	2,166	2,731	3,380	4,126	4,693	5,119
Investment expenditures	8,324	8,953	18,224	21,705	26,763	32,197	35,962	37,876
Non-oil investment expenditures	6,136	6,602	13,006	15,588	20,197	24,669	28,058	28,543
Domestic financed reconstruction expenditure	4,087	2,663	9,266	13,864	17,983	21,967	25,228	26,857
OFFP financed reconstruction expenditure	1,084	478	0	0	0	0	0	0
Grant financed reconstruction expenditure	965	3,462	3,658	930	251	212	55	37
Loan financed reconstruction expenditure	0	0	81	794	1,963	2,491	2,775	1,649
Oil investment expenditures (including on refineries)	2,188	2,351	5,218	6,117	6,566	7,528	7,904	9,333
Contingency	0	0	990	2,300	2,300	2,300	2,300	2,300
Balance (including grants)	-15,226	5,016	-4,216	-1,869	-860	658	1,237	537
Balance (excluding grants)	-18,651	-7,888	-16,449	-3,804	-1,111	446	1,183	500
Change in outstanding LCs [+ increase] 8/	...	2,947	...	...	...	...	...	...
External financing	15,499	2,718	3,216	869	860	-658	-1,237	-537
Assets held abroad	10,177	1,467	4,858	164	-1,103	-3,148	-4,013	2,600
Project financing	0	0	81	794	1,963	2,491	2,775	1,649
Other financing 9/	5,992	1,486	0	0	0	0	0	0
Amortization	670	235	1,723	88	0	0	0	4,785
Domestic financing	-533	-4,816	1,000	1,000	0	0	0	0
Bank financing	-333	-5,124	1,000	1,000	0	0	0	0
Non bank financing	-200	308	0	0	0	0	0	0
Residual or Financing gap[+]/surplus [-]	260	30	0	0	0	0	0	0
Memorandum items:								
Security-related expenditure	...	2,405	8,018	11,624	14,527	17,773	20,707	23,040
Primary fiscal balance	-14,857	5,102	-3,590	-1,267	125	2,337	4,060	5,424
Non-oil primary fiscal balance	-33,182	-22,696	-38,958	-52,617	-65,923	-79,734	-91,624	-99,337
Tax revenue in percent of non-oil GDP	1.3	2.8	1.8	2.3	4.1	3.8	3.8	3.8
Nominal GDP	37,531	50,948	69,337	89,899	112,087	135,681	157,038	173,560

Sources: Iraqi authorities, and staff estimates and projections.

1/ Projections for 2007-2011 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.

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

3/ Includes spending by the U.S. from seized and vested assets in 2004.

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

5/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.

6/ 2006 data includes ID270 billion allocated toward government's share of capital in new regional commercial banks. ID 1,500 formerly recorded under this item were re-classified as non-oil investment expenditures in 2006 budget presentation. Finally, ID265 billion were reclassified as debt repayment.

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

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

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

Table 3. Iraq: Fiscal and Oil Sector Accounts, 2004–11
(In percent of GDP)

	2004	2006	2007	2008	2009	2010	2011	
		Est.	Revised projections					
Revenues and Grants	80.0	97.3	87.0	71.1	71.1	72.2	71.9	71.7
Revenues	70.9	72.0	69.4	68.9	70.9	72.0	71.9	71.6
Crude oil export revenues	67.5	66.5	62.5	60.8	60.3	60.8	59.8	59.0
Revenues of oil-related state owned enterprises	2.1	2.9	4.4	5.8	7.1	7.9	8.8	9.3
<i>Of which</i> revenues from reduction in price subsidy on petroleum products	0.0	0.0	1.9	3.2	4.5	5.2	6.2	6.8
Tax revenues	0.4	1.0	0.6	0.8	1.4	1.3	1.3	1.3
Direct taxes	0.2	0.4	0.3	0.3	0.3	0.3	0.4	0.4
Indirect taxes 1/	0.2	0.6	0.3	0.5	1.1	0.9	0.9	0.9
Non-tax revenues	0.8	1.6	1.8	1.6	2.0	2.0	2.0	2.0
Grants	9.1	25.3	17.6	2.2	0.2	0.2	0.0	0.0
Expenditures	120.6	87.4	93.1	73.2	71.9	71.7	71.1	71.4
Operating expenditures	98.4	69.9	65.4	46.5	46.0	46.2	46.8	48.2
Salary and pension	12.1	18.2	18.6	16.2	16.2	16.2	16.2	16.2
Goods and services (non-oil sector) 2/	29.4	25.6	22.0	12.3	12.3	12.9	13.2	13.8
Budgeted goods and services 3/	18.6	6.2	10.0	11.2	12.3	12.9	13.2	13.8
Financed by oil-for-food program (OFFP) (other than social safety net)	4.3	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Overhead costs for donors' financed projects 4/	2.3	6.9	5.0	0.5	0.0	0.0	0.0	0.0
Other goods and services financed by donors 5/	4.1	11.1	7.0	0.6	0.0	0.0	0.0	0.0
Goods and services (oil sector)	15.0	10.2	8.4	2.6	2.7	2.7	2.6	2.6
Oil derivative imports	12.8	8.1	5.9	0.0	0.0	0.0	0.0	0.0
Operating expenditures of oil-related state-owned enterprises (including refineries)	2.1	2.1	2.5	2.6	2.7	2.7	2.6	2.6
Transfers	37.5	12.2	12.4	11.6	10.8	10.1	9.9	9.8
Social safety net (excl. OFFP)	10.2	7.4	7.2	6.7	6.3	6.0	5.8	5.9
Social safety net (financed by OFFP)	5.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers to SOEs	3.3	1.8	2.1	1.7	1.3	0.8	0.7	0.6
Other transfers 6/	18.4	3.1	3.2	3.2	3.2	3.3	3.3	3.3
Interest payments	1.0	0.2	0.9	0.7	0.9	1.2	1.8	2.8
Domestic interest payments	1.0	0.2	0.5	0.4	0.3	0.2	0.1	0.1
External interest payments	0.0	0.0	0.4	0.3	0.6	1.0	1.7	2.7
External interest payments on loans other than to finance the financing gap	0.0	0.0	0.4	0.3	0.6	1.0	1.7	2.7
External interest payments on loans to finance the financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
War reparations 7/	3.5	3.4	3.1	3.0	3.0	3.0	3.0	2.9
Investment expenditures	22.2	17.6	26.3	24.1	23.9	23.7	22.9	21.8
Non-oil investment expenditures	16.3	13.0	18.8	17.3	18.0	18.2	17.9	16.4
Domestic financed reconstruction expenditure	10.9	5.2	13.4	15.4	16.0	16.2	16.1	15.5
OFFP financed reconstruction expenditure	2.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Grant financed reconstruction expenditure	2.6	6.8	5.3	1.0	0.2	0.2	0.0	0.0
Loan financed reconstruction expenditure	0.0	0.0	0.1	0.9	1.8	1.8	1.8	0.9
Oil investment expenditures (including on refineries)	5.8	4.6	7.5	6.8	5.9	5.5	5.0	5.4
Contingency	0.0	0.0	1.4	2.6	2.1	1.7	1.5	1.3
Balance (including grants)	-40.6	9.8	-6.1	-2.1	-0.8	0.5	0.8	0.3
Balance (excluding grants)	-49.7	-15.5	-23.7	-4.2	-1.0	0.3	0.8	0.3
Change in outstanding LCs [+ increase] 8/	...	5.8	...	...	...	...	...	...
External financing	41.3	5.3	4.6	1.0	0.8	-0.5	-0.8	-0.3
Assets held abroad	27.1	2.9	7.0	0.2	-1.0	-2.3	-2.6	1.5
Project financing	0.0	0.0	0.1	0.9	1.8	1.8	1.8	0.9
Other financing 9/	16.0	2.9	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	1.8	0.5	2.5	0.1	0.0	0.0	0.0	2.8
Domestic financing	-1.4	-9.5	1.4	1.1	0.0	0.0	0.0	0.0
Bank financing	-0.9	-10.1	1.4	1.1	0.0	0.0	0.0	0.0
Non bank financing	-0.5	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Residual or financing gap[+]/surplus [-]	0.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Security-related expenditure	...	4.7	11.6	12.9	13.0	13.1	13.2	13.3
Primary fiscal balance	-39.6	10.0	-5.2	-1.4	0.1	1.7	2.6	3.1
Non-oil primary fiscal balance	-88.4	-44.5	-56.2	-58.5	-58.8	-58.8	-58.3	-57.2

Sources: Iraqi authorities and staff estimates and projections.

1/ Projections for 2007-2011 assume that the private sector will start importing petroleum products, thereby increasing substantially the base for import duties.

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

3/ Includes spending by the U.S. from seized and vested assets in 2004.

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

5/ Other goods and services financed by donors include security spending associated with the implementation of reconstruction projects. No firm figures were received from donors to date.

6/ 2006 data includes ID270 billion allocated toward government's share of capital in new regional commercial banks. ID 1,500 formerly recorded under this item were reclassified as non-oil investment expenditures in 2006 budget presentation. Finally, ID265 billion were reclassified as debt repayment.

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

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

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

Table 4. Iraq: Balance of Payments, 2004–11 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2004		2006	2007	2008	2009	2010	2011
	Est.	Est.	Proj.					
Trade balance	-1,949	2,878	306	4,247	5,161	6,354	7,767	8,601
(In percent of GDP)	-7.6	8.3	0.7	7.0	7.3	7.8	8.5	8.6
Exports	17,782	23,032	30,052	37,784	43,359	50,299	55,623	59,556
Crude oil	17,329	22,443	29,373	37,028	42,541	49,554	54,798	58,683
Other exports	452	589	679	756	818	745	826	873
Imports 2/	-19,730	-20,154	-29,746	-33,537	-38,198	-43,945	-47,856	-50,956
Government imports	-13,922	-11,304	-14,933	-17,265	-19,291	-21,912	-23,948	-25,589
UN Oil for Food Program (OFFP)	-3,489	-880	0	0	0	0	0	0
Other consumption imports (non-OFFP)	-3,843	-2,909	-4,877	-6,699	-7,633	-8,625	-9,598	-10,671
Other non-oil related capital imports (non-OFFP)	-2,353	-2,828	-5,791	-7,020	-8,311	-9,626	-10,612	-10,585
Oil-related capital imports	-1,429	-2,252	-1,852	-3,546	-3,347	-3,661	-3,738	-4,333
Refined oil products	-2,808	-2,435	-2,412	0	0	0	0	0
Private sector imports	-5,809	-8,850	-14,813	-16,273	-18,907	-22,033	-23,908	-25,367
Of which: refined oil products	0	0	-2,040	-4,094	-3,799	-3,270	-3,362	-3,421
Income, net 3/	-4,587	-2,904	-1,320	-1,457	-1,441	-1,673	-2,036	-2,054
Services, net 2/	-4,286	-6,342	-7,316	-3,926	-4,082	-4,713	-5,139	-5,474
Transfers, net	1,979	8,163	7,425	261	-869	-1,050	-1,208	-1,412
Private, net (incl. NGOs)	500	500	600	800	1,100	1,300	1,500	1,501
Official, net	1,479	7,663	6,825	-539	-1,969	-2,350	-2,708	-2,913
Receipts	2,346	8,786	8,293	1,312	158	127	32	21
Payments	-866	-1,122	-1,469	-1,851	-2,127	-2,478	-2,740	-2,934
Current account	-8,842	1,796	-905	-875	-1,231	-1,082	-616	-339
(In percent of GDP)	-34.4	5.2	-1.9	-1.4	-1.7	-1.3	-0.7	-0.3
Capital account	0	0	0	0	0	0	0	0
Financial account	10,937	1,651	3,444	3,310	3,262	2,305	1,966	1,537
Direct investment	200	400	500	650	829	1,092	1,617	1,872
Other capital, net	10,737	1,251	2,944	2,660	2,433	1,213	348	-336
Official, net	10,835	5,244	4,828	2,660	2,433	1,213	348	-336
Assets 4/	10,835	2,011	3,293	111	-694	-1,892	-2,346	1,462
Liabilities	0	3,233	1,535	2,549	3,127	3,105	2,694	-1,798
Loan disbursements	0	0	55	538	1,235	1,496	1,621	945
Amortization 5/ 6/	0	-121	-436	0	0	0	0	-2,743
Capitalized interest payment 5/	0	3,354	1,915	2,011	1,892	1,610	1,074	0
Financial corporations, net 7/	0	-2,007	-1,278	0	0	0	0	0
Private, net	-98	-1,986	-606	0	0	0	0	0
Errors and omissions	178	21	0	0	0	0	0	0
Overall balance	2,273	3,468	2,539	2,435	2,031	1,223	1,350	1,198
(In percent of GDP)	8.8	10.0	5.4	4.0	2.9	1.5	1.5	1.2
Financing	-2,273	-3,468	-2,539	-2,435	-2,031	-1,223	-1,350	-1,198
Central bank (increase -)	-6,768	-4,081	-1,807	-2,375	-2,031	-1,223	-1,350	-1,198
Reserves (net; increase -)	-6,332	-4,081	-1,807	-2,375	-2,252	-1,444	-1,350	-1,198
Liabilities (increase +)	436	0	0	0	-221	-222	0	0
Fund credit (net)	436	0	0	0	-221	-222	0	0
Disbursement	436	0	0	0	0	0	0	0
Repayments	0	0	0	0	-221	-222	0	0
Deferred accrued interest 8/	4,680	0	0	0	0	0	0	0
Change in arrears (net, decrease -) 9/	-31,392	-28,894	-16,666	-60	0	0	0	0
Debt forgiveness 10/	31,207	29,508	15,934	0	0	0	0	0
Memorandum items:								
Central bank reserves	7,902	11,984	13,791	16,166	18,196	19,419	20,769	21,967
Central bank reserves (in months of imports of goods and service):	3.2	3.9	4.4	4.6	4.5	4.4	4.4	4.4
GDP	25,706	34,541	47,008	60,948	70,534	81,471	91,691	99,486
Non-oil GDP	8,277	11,805	16,882	21,727	24,401	27,281	30,500	33,320

Sources: Iraqi authorities and staff estimates and projections.

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

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

3/Includes interest accrued, deferred, and capitalized.

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

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

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

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

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

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

10/The notional debt forgiveness reflects: (i) the first stage of debt reduction (30 percent) at end 2004; (ii) the second stage reduction (30 percent) at end-2005; and (iii) the settlement of debt owed to private creditors through cash and debt exchanges. Assumes debt reduction comparable to the Paris Club agreement on other debt to official creditors.

Table 5. Iraq: Estimated External Debt Stock, 2004–11
(In billions of U.S. dollars) 1/

	2004 before debt reduction	2004 after debt reduction	2005	2006	2007	2008	2009	2010	2011
Without the third stage of debt reduction in 2008 (baseline) 4/									
Paris Club official creditors	36.2	23.6	15.9	16.5	17.1	17.7	18.2	18.6	17.7
Non-Paris Club official creditors 2/	62.1	43.5	26.1	27.4	28.8	30.1	31.2	31.9	30.0
Private creditors 3/	20.7	20.7	19.5	3.1	3.2	3.2	3.2	3.2	3.2
Multilateral creditors and others 4/	0.8	1.0	1.7	1.0	1.5	2.5	3.8	5.4	6.3
Total debt	119.8	88.8	63.2	48.0	50.5	53.4	56.3	59.0	57.2
In percent of GDP	465.9	345.5	182.8	102.2	82.9	75.8	69.1	64.4	57.5
Total debt service 5/	...	0.2	0.2	1.4	0.3	0.7	1.1	1.5	5.4
With the third stage of debt reduction in 2008 6/									
Total debt	119.8	88.8	63.2	48.0	50.5	29.5	31.5	33.7	33.3
In percent of GDP	465.9	345.5	182.8	102.2	82.9	41.8	38.7	36.7	33.4
Total debt service 5/	...	0.2	0.2	1.4	0.3	0.7	0.8	0.9	2.9

Sources: The Paris Club and staff estimates.

1/ The assumptions made in this table are for purposes of illustration and discussion only. While the process of Iraq's debt reconciliation is ongoing, the IMF has had to base its analysis on information that may include as yet unreconciled data. Such use of data by the IMF does not amount to a recognition or denial of any particular claims. The estimates of the debt stock are different from those in IMF Country Report No. 06/15 to incorporate the latest results of debt reconciliation and the settlements of debt to private creditors.

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

3/ Assumes that by end 2006 all debt to private creditors would be settled by debt and cash exchanges, and the total amount new bonds and loans issued may be less than projected if the reconciliation rate is less than 100 percent.

4/ Includes new debt and arrears related to fuel imports from Turkey.

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

6/ Assumes precautionary SBA during 2005–08.

Table 6. Iraq: External Debt Sustainability Framework, 2004–11
(In percent of GDP, unless otherwise indicated)

	Est.		Projections					
	2004	2005	2006	2007	2008	2009	2010	2011
External debt	345.5	182.8	102.2	82.9	75.8	69.1	64.4	57.5
Change in external debt (1)	-594.7	-162.7	-80.6	-19.3	-7.1	-6.6	-4.8	-6.9
Identified external debt-creating flows (2)	-483.1	-89.0	-50.6	-23.2	-9.7	-7.9	-6.2	-8.1
Current account deficit, excluding interest payments	16.2	-14.9	-2.6	-2.2	-1.6	-1.7	-2.2	-2.4
Deficit in balance of goods and services	24.3	10.0	14.9	-0.5	-1.5	-2.0	-2.9	-3.1
Exports	69.2	67.1	64.2	62.2	61.7	61.9	60.9	60.1
Imports	93.4	77.1	79.2	61.7	60.2	59.9	58.0	56.9
Net non-debt creating capital inflows (negative) 1/	-43.2	4.5	-4.1	-1.2	-0.2	1.0	0.8	-3.4
Automatic debt dynamics 2/	-456.0	-78.6	-44.0	-19.7	-8.0	-7.1	-4.9	-2.3
Contribution from nominal interest rate	18.2	9.7	4.5	3.6	3.3	3.0	2.8	2.7
Contribution from real GDP growth	-216.8	-9.5	-5.3	-11.3	-9.3	-8.4	-5.9	-4.2
Contribution from price and exchange rate changes 3/	-257.5	-78.8	-43.2	-12.1	-2.0	-1.8	-1.8	-0.9
Residual, incl. change in gross foreign assets (1-2)	-111.6	-73.6	-30.0	3.9	2.6	1.2	1.5	1.2
Of which: change in official reserves (increase = positive)	26.3	11.8	3.8	3.9	2.9	1.5	1.5	1.2
External debt-to-exports ratio (in percent)	499.5	272.6	159.1	133.2	122.8	111.6	105.8	95.8
Gross external financing need (in billions of US dollars) 4/ in percent of GDP	9.0 35.1	-1.7 -4.8	1.3 2.9	0.9 1.4	1.2 1.7	1.1 1.3	0.6 0.7	3.1 3.1
External debt service in percent of exports 5/	26.3	15.0	8.4	5.8	5.4	4.9	4.6	9.1
Debt-stabilizing non-interest current account (positive = surplus) 6/	-610.9	-147.7	-78.1	-17.1	-5.6	-4.9	-2.6	-4.5
Key Macroeconomic Assumptions								
Real GDP growth (in percent)	46.5	3.7	4.0	14.4	12.9	12.7	9.6	7.1
GDP deflator in U.S. dollars (change in percent)	37.7	29.6	30.9	13.4	2.5	2.5	2.7	1.3
Nominal external interest rate (in percent)	3.9	3.8	3.3	4.6	4.6	4.6	4.6	4.6
Growth of exports (U.S. dollar terms, in percent)	91.7	30.3	30.3	25.6	14.7	16.0	10.6	7.1
Growth of imports (U.S. dollar terms, in percent)	200.4	10.9	39.7	1.1	12.8	15.0	8.9	6.5
Stress Tests for External Debt Ratio								
Limited oil production 7/		182.8	102.2	82.9	75.8	76.5	80.4	87.0
Lower oil price in 2007–11 8/		182.8	102.2	87.5	81.2	75.3	70.9	68.6
Stress Tests for External Debt Service-to-Exports Ratio 5/								
Limited oil production 7/		15.2	10.8	6.0	5.4	5.8	6.2	15.4
Lower oil price in 2007–11 8/		15.2	10.8	6.5	5.8	5.8	6.0	11.3
Memorandum items:								
Real GDP growth under stress scenarios (in percent)								
Limited oil production 7/		3.7	4.0	14.4	12.9	3.7	3.9	3.9
Lower oil price in 2007–11 8/		3.7	4.0	14.4	12.9	12.7	9.6	7.1
Non-interest current account deficit under stress scenarios (in percent of GDP)								
Limited oil production 7/		-14.9	-2.6	-2.2	-1.7	4.7	8.1	10.2
Lower oil price in 2007–11 8/		-14.9	-2.6	0.3	0.9	0.7	0.2	0.0

Source: Fund staff estimates.

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

2/ Derived as $[r - g - \rho(1+g) + \epsilon\alpha(1+r)] / (1+g + \rho + g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ϵ = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

5/ Debt service is total accrued amount.

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

7/ Assumes that oil production reaches its peak by 2008 at 2.7 mbpd.

8/ Assumes that oil price in 2007–11 is US\$4.5 lower than in the baseline, equivalent to one standard-deviation shock.

Baghdad, July 15, 2006

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

Dear Mr. de Rato:

1. The Board of the IMF approved a request for a Stand-By Arrangement (SBA) for Iraq on December 23, 2005, in support of an economic program for 2006. Despite the challenging security and political environment, good progress has been made in implementing this program, and macroeconomic stability has been broadly secured so far. We would like to confirm that the new government, which assumed power on May 20, 2006, remains committed to the program, and to the goals of the SBA. We will take whatever steps are necessary to ensure that the program remains on track.
2. Iraq has met all quantitative performance criteria set for end-March, except for that applying to revenue of oil related state-owned enterprises which was slightly below target, reflecting lower than expected oil production and interruptions of refinery operations. Three other performance criteria were also missed: (i) payments arrears arose with Turkey in December 2005 (but these have since been regularized); (ii) the budget classification in line with GFSM 2001 was not adopted on June 30, 2006; (iii) the audit report of the Central Bank of Iraq's (CBI) 2005 financial statement, was not finalized by mid-May (but instead on July 13, 2006).
3. In light of the change in the underlying production assumptions, we would like to request a waiver for the missed performance criterion on revenue of oil related state-owned enterprises. On the basis of corrective actions specified in the attached Supplementary Memorandum of Economic and Financial Policies (SMEFP), we would also like to request waivers for the three other missed performance criteria noted in paragraph 2. As the IMF Executive Board will be considering the First and Second Review of the SBA after end-June, 2006, but before the outcome for end-June quantitative performance criteria will be known, we request that the applicability of these performance criteria be waived. We also request establishment of the quantitative performance criteria proposed in the SMEFP for end-September and end-December 2006.
4. Looking forward, we shall strive to continue to maintain macroeconomic stability, in particular to lower inflation, maintain a prudent fiscal stance, and continue reforms that put Iraq on a path of sustainable growth. A cornerstone of this strategy continues to be the reduction of subsidies on oil derivative products. The program of adjusting prices of oil derivative products was resumed in June, in line with our commitments under the program. We will continue our strategy of gradual price adjustments in the remainder of the program.

By July 21, 2006, we will have submitted to the National Assembly proposed amendments of the draft law to allow private sector imports of petroleum products for domestic resale at market prices, and will urge the Assembly to approve the amended law as soon as possible.

Sincerely yours,

/s/

Dr. Sinan Shabibi
Governor of the Central Bank of Iraq

/s/

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

IRAQ**Supplementary Memorandum on Economic and Financial Policies for 2006****July 15, 2006****I. INTRODUCTION**

1. This memorandum supplements our Memorandum on Economic and Financial Policies for 2005–06 (MEFP) annexed to our letter dated December 6, 2005. It describes additional economic objectives and policies agreed in the context of the first and second reviews under the Stand-By Arrangement (SBA). Policies and unfulfilled commitments specified in the original MEFP continue to be part of the program.
2. A new Government of Iraq (GoI) was approved by the Council of Representatives on May 20, 2006. The GoI is committed to adhere to the program that was approved by its predecessor, the Transitional Government, and which forms the basis for the SBA.

II. RECENT DEVELOPMENTS UNDER THE STAND BY ARRANGEMENT

3. Macroeconomic stability was preserved, despite political uncertainty and difficult security conditions. The GoI has been able to resist unwarranted spending pressures, maintain a stable exchange rate, while enabling continued economic growth. Inflation, however, remains high and volatile. Twelve month consumer price inflation was 58 percent in May.
4. The growth of real GDP is projected to be 4 percent in 2006. This is lower than the 10.6 percent projected at the outset of the program, because oil production has not increased as expected. Oil production has been constrained mainly by exportation problems, mostly of a technical nature, and by difficulties in undertaking the necessary investment. Non-oil activity is projected to grow 10 percent this year.
5. Fiscal policy has remained on track. The fiscal outturn for 2005 showed a large fiscal surplus, reflecting higher than expected oil revenues and lower than programmed investment. A small fiscal surplus was also recorded in the first quarter of 2006, which allowed the GoI to continue to build up financial reserves in the Development Fund for Iraq (DFI). Revenues overall were broadly as budgeted in the first quarter, as lower oil export volumes were offset by higher than expected oil prices. Recurrent spending was also in line with the budget. Investment expenditure was below budget, mainly due to continuing security problems affecting implementation as well as the delay in forming a government, which hindered approval of investment projects.

6. The GoI has used monetary policy to maintain a fixed rate of exchange of the Iraqi dinar. Daily auctions of foreign exchange were held at rates close to ID 1,475 per U.S. dollar. Net international reserves continued to grow to \$12.2 billion at end April 2006. The Central Bank of Iraq (CBI) raised its policy interest rate to 8 percent on April 18, 2006.

7. All but one of the quantitative performance criteria set for end-March were met. Revenue of oil related state-owned enterprises was slightly below the target, reflecting lower than expected oil production (and therefore compensation for associated costs), and interruptions to refinery operations (and lower sales of domestic fuel products). The GoI has regularized the arrears to Turkey (subject to a continuous performance criterion) which arose in December. A copy of the memorandum of understanding with Turkey has been submitted to IMF staff. The new budget classification in line with the IMF's *Government Financial Statistics Manual 2001* (GFSM 2001) has not yet been adopted (a structural performance criterion for end June 2006). The Ernst and Young audit report of the CBI's 2005 financial statement, due by mid-May (performance criterion), was finalized on July 13, 2006.

III. ECONOMIC AND FINANCIAL POLICIES IN 2006

8. For the remainder of 2006 the GoI's main macroeconomic policy objective will be maintain fiscal sustainability, lower inflation and continue reforms that put Iraq on a path to sustainable growth.

9. The main parameters of the 2006 budget remain in place. Higher international oil prices will compensate most of the losses from lower production and exports. Revenues of oil related enterprises (a performance criterion¹) will be slightly lower than previously programmed due to lower oil production and lower domestic sales of refined products. Indirect taxes will turn out lower than budgeted due to a delay in the increase of the reconstruction levy from 5 to 10 percent. The draft law to increase the reconstruction levy has been prepared and is scheduled to be discussed by cabinet and submitted to the Council of Representatives by September, 2006.

10. The GoI intends to keep spending within current allocations. Unbudgeted new hiring and unplanned bonuses will be resisted. Minor budget overruns might also be possible for the new social protection program under which we aim to have enrolled one million families by year-end. The Public Distribution System will remain in place, but will not be expanded.

11. These policies should contain the overall government deficit to 6.3 percent of (revised) GDP. The primary deficit for 2006 will continue to be subject to a performance criterion measured in ID billion as envisaged at the time of the SBA approval. By the end of 2006, we aim to hold the equivalent of at least ID 3.3 trillion in assets in the DFI. To keep the

¹ See Table 1 for (revised) performance criteria under the SBA.

option of domestic financing open and to maintain a market indicator for interest rates, we will continue the regular bi-weekly issuance of treasury bills.

12. The GoI is committed to reforming the new pension law prior to its implementation. Law 27/2005 will be reformed to make it fiscally sustainable in the medium term. We will aim to have the law reformed by end-September, 2006 (as a structural benchmark).

13. The GoI remains committed to adjust fuel prices to close to the level of neighboring countries. Oil derivative products will be adjusted gradually to reach the targets specified under the program. In June we increased prices to reach the program targets for end-June.² We will continue this policy of gradual price adjustment in the coming months to reach price levels slated for September either by, or ahead of schedule. Popular understanding of the price adjustments will be supported by providing sufficient supply of premium gasoline where it is sold, although the premium product will not be available at all gas stations.

14. The GoI will continue to push forward legislation to liberalize private gasoline imports. Liberalizing private gasoline imports is a key element of our policy to contain domestic price inflation and improve the sustainability and quality of the budget. The Council of Ministers has approved the revised draft law for the liberalization of private gasoline imports after removing articles 7 and 8. The revised draft law will be sent to the Council of Representatives by July 21, 2006 (as a prior action for the first and second review). We will continue to push for consideration of the amended law by the Council of Representatives and aim to have it passed by September, 2006 (as a structural benchmark).

15. To help fight inflation the Central Bank of Iraq (CBI) will strengthen monetary policy. The CBI's policy interest rate was raised on July 4 to 10 percent, and CBI lending and deposit rates will be adjusted in line with the policy rate. The policy rate will be adjusted further to 12 percent by mid-July, if inflationary trends warrant further tightening.

16. The CBI approved the Ernst and Young audit of the CBI's 2005 financial statement on July 13, 2006. The GoI is committed to develop plans for the restructuring of the state-owned banking sector. The GoI will keep the IMF closely informed, and its plans for the state-owned banks will be subject to IMF review.

17. The GoI is in the process of finalizing the modalities for the formation of a successor oversight board, in light of the expected expiration of the IAMB mandate in December 2006.

18. The GoI will step-up its efforts to negotiate a debt settlement with non-Paris Club official creditors and continue to resolve the remaining claims of private creditors. Contacts have been made at the ministerial level with Saudi Arabia, and agreement was reached to hold technical meetings at the level of deputy ministers. Arrangements for these meetings are

² Table 2 shows the indicative path proposed for oil derivative prices during 2006.

well underway. Iraq recently signed agreements with Czech Republic and Hungary, and the negotiations with other non-Gulf countries continue. Iraq has resolved about \$18 billion claims submitted by private creditors and submitted almost \$1 billion claims to the panel arbitration. The process of reconciliation and resolution of the remaining claims of about \$2 billion is ongoing.

19. The GoI remains committed to enhance the effectiveness and transparency of budgetary management. We will step-up our efforts to implement a Financial Management Information System (FMIS) in time for the 2007 budget, which will also help improve the timeliness of budget reporting. An assessment of the Free Balance software will be completed by end-September 2006, and by end-December a report on any changes necessary to adapt it adequately to the needs of Iraq. The GoI will adopt a budget classification in line with the IMF's *GFSM 2001* as soon as possible, but no later than end-December 2006.

20. Development of a market oriented and transparent oil sector remains one of the top priorities of the GoI. We will prepare a draft petroleum law by end-December 2006. In this regard, we intend to take advantage of IMF technical expertise to ensure that the law is consistent with international best practices. The GoI will combat corruption vigorously. We will closely monitor the quality assessments of crude oil and continue to work with the PCO contractor to install a metering system by end-2006.

IV. PROGRAM MONITORING

21. Monitoring of the program will remain unchanged and indicative targets specified for end-September and end-December 2006 in the MEFP will be converted into performance criteria except for those applicable to revenue of oil related enterprises and the contracting of external debt. Two structural benchmarks and a structural performance criterion will be rescheduled³. The performance criterion on revenue from oil enterprises for end-September and end-December 2006 will be adjusted downward from the specified indicative targets in the MEFP to reflect lower projected oil production and lower domestic sales of refined products in 2006. The performance criterion on non-concessional external debt will be modified to accommodate loans with a grant element of 35 percent or more of up to Yen 200 billion from the government of Japan. A census of all public service employees (including military personnel) will be completed by end-December (structural benchmark). Establishment of an audit oversight committee to oversee and audit the Development Fund of Iraq will be based on a proposal that the GoI has received from the IAMB and be completed by end-September 2006 (structural benchmark). A budget classification and chart of accounts in line with *GFSM 2001* will be adopted by end-December 2006. In addition, reform of the pension law in line with a sustainable pension system will be completed by end-September,

³ See Table 1 for the modified quantitative performance criteria under the SBA and Table 3 for the modified structural performance criteria and benchmarks.

2006 (new structural benchmark), and the effective liberalization of private gasoline imports shall also be completed by end-September, 2006 (new structural benchmark). The formulation of the 2007 budget will be the focus of the third review, in addition to further adjustments of fuel prices.

22. The Technical Memorandum of Understanding is modified in the manner described in the attached Addendum.

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

	2005	Performance Criteria				
	9/30/05	12/31/05	3/31/06	6/30/06	9/30/06	12/31/06
<i>Cumulative change from September 2005</i>						
Net international reserves of the CBI (floor) (in millions of U.S. dollars) (Actual)	8,500 2/	-1,000 +3,041	-1,000 +3,576	-1,000	-1,000	-1,000
Lending to the government and the private sector by the CBI (ceiling) 3/ (Actual)	5,100 2/	0 0	0 0	0	0	0
<i>Cumulative flow from beginning of calendar year</i>						
Government primary fiscal deficit (in billions; ceiling; deficit [+]/surplus[-]) 4/ (Actual)	...	5,400 -5,102	1,950 -873	3,600	4,850	5,300
Government wage and pension bill (ceiling) 4/ 5/ (Actual)	...	6,650 7,069	2,400 2,051	4,750	7,100	9,500
Revenue of oil related enterprises, including those remitted to the budget (floor) 4/ (Actual)	...	900 1,456	700 509	1,500	2,100	2,800
New medium-and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 4/ 7/ (Actual)	...	500 0	500 0	500	500	500
External arrears on new borrowing (in millions of U.S. dollars; ceiling) 6/ (Actual)	...	0 653	0 0	0	0	0
<i>Indicative target</i>						
Government imports of petroleum products (ceiling) 4/ (Actual)		6,000 4,128	1,700 1,152	3,400	4,000	4,200

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

2/ Estimated.

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

4/ Flows for 12/31/05 are cumulative for 2005. Flows for 2006 are cumulative starting 1/1/2006.

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

6/ This will be monitored on a continuous basis.

7/ This ceiling excludes loans with grant element of 35 percent or more of up to Yen 200 billions for reconstruction projects to be contracted with the government of Japan in 2006.

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

	September 2005	Prior Action	03/31/06	06/30/06	09/30/06	12/31/06
Official domestic price of petroleum products (equal to or above, by specified dates)						
LPG (in Iraqi dinars per 12 kg cylinder)	250	600	700	800	900	1,000
Regular gasoline	20	100	130	155	175	200
Premium gasoline	50	250	300	350	400	450
Kerosene	5	25	50	75	90	115
Diesel	10	90	110	125	155	175

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

	Date	Status
I. Prior Actions for Completion of the First and Second Review		
Submission by the Council of Ministers to the Council of Representatives the amendments to the draft law for the liberalization of private imports of gasoline after removing articles 7 and 8.		
II. Structural Performance Criteria		
Avoid administrative measures limiting participation or bids in the CBI's regular auction of foreign exchange other than screening related to anti-money laundering or counter-terrorism.	Continuous	
Adoption of fully detailed budget classification and chart of accounts in line with the IMF's Government Financial Statistics Manual (GFSM) 2001, within a cash accounting framework. ^{1/}	December 31, 2006	
Final audit of CBI 2005 Financial operations and statements.	May 15, 2006	Met July 13, 2006
III. Structural Benchmarks		
Implementation of payment system regulations.	June 30, 2006	Met
Establishment of an audit oversight committee, to become effective on or before December 31, 2006, including the participation of independent international audit experts, to continue the work of the International Advisory and Monitoring Board (upon its dissolution) in overseeing and making public audits of the Development Fund for Iraq and oil export sales.	September 30, 2006	
Reform of pension law in line with sustainable pension system	September 30, 2006	
Approval by Council of Representatives of law liberalizing private gasoline imports	September 30, 2006	
Completion of census of all public service employees (including military).	December 31, 2006	
Commencement of operation of Real Time Gross Settlement system (RTGS) linking headquarters of commercial banks to the CBI.	August 31, 2006	
Commencement of payments clearing system between the headquarters of commercial banks and the CBI through the Automatic Clearing House (ACH).	November 30, 2006	
Full capitalization of CBI to the stipulated ID 100 billion, based on the 2005 audited financial statements and taking into account the restructuring of outstanding claims on the central government that are on the December 31, 2005 balance sheet of the CBI.	December 31, 2006	

^{1/} The budget classification and chart of accounts will be deemed in line with the IMF GFSM 2001 if it is consistent with the methodology and high level classification defined in the technical assistance report of the IMF's Fiscal Affairs Department entitled "Iraq Budget Classification Reform" (July 2005).

IRAQ**Addendum to the Technical Memorandum of Understanding**

July 15, 2006

1. This Addendum describes changes to the Technical Memorandum of Understanding (TMU) of December 6, 2005.
2. The limits on medium- and long-term external debt (specified in paragraph 14 of the TMU) excludes loans with grant element of 35 percent or more of up to Yen 200 billions for reconstruction projects to be contracted with the government of Japan in 2006.
3. To facilitate regular monitoring under the SBA the following items are added to the list of information to be provided to the Fund (paragraph 18 of the TMU):
 - The balance sheet of the Trade Bank of Iraq (TBI), with no more than 8 weeks lag.
 - The amount of loans contracted from the Japanese government, and grant element, on a quarterly basis, with no more than eight weeks lag.
4. Review of the structural reforms (paragraph 19 of the TMU) refers to reforms specified in the memorandum of economic and financial policies and its supplement.

INTERNATIONAL MONETARY FUND

IRAQ

**Supplementary Information for First and Second Reviews
Under the Stand-By Arrangement, Financing Assurances Review, and Request for
Waivers of Nonobservance and Applicability of Performance Criteria**

Prepared by Middle East and Central Asia Department

Approved by Lorenzo Pérez and Adrienne Cheasty

July 31, 2006

1. This supplement provides an update on developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged.
2. **Inflation remains high.** Consumer prices increased by 0.7 percent in June, bringing the cumulative increase in prices since the beginning of the year to 22.5 percent, while the 12 month inflation rate was 52.5 percent.¹ This does not significantly alter the inflation outlook described in the staff report. Consumer prices for most goods and services increased by between 1 to 5 percent in June, with the exception of transportation and communication services (which increased by 24.6 percent) and fuel and electricity prices (which declined by 11.3 percent).
3. **The Central Bank of Iraq (CBI) raised its interest rates again on July 14.** The CBI increased its policy interest rate from 10 to 12 percent on July 14, and raised deposit rates by similar amounts. This follows the increase in the policy rate from 8 to 10 percent on July 4. Including the catch up with the April increase in the policy rate, deposit rates have been increased by 5 percentage points since the beginning of July. This is in line with the policy described in the staff report.
4. **The prior action on submission of amendments to the draft law for liberalization of private imports of gasoline has been fulfilled.** The amended law was approved by cabinet and submitted to the office of the Council of Representatives on June 25, 2006, with articles 7 and 8 removed to eliminate price controls on resale of private imports of gasoline. A parliamentary select committee has reviewed the amended law, and is expected to soon table the law for a first reading by the Council of Representatives.

¹ The CPI increase for May was revised down by 3.3 percentage points to 1.2 percent, and the year on year increase was reduced from 58.0 percent to 53.0 percent.

5. **Crude oil production and exports continue to climb.** Oil production in June increased to 2.36 million barrel per day (mbpd), the highest level since the invasion in 2003. Exports increased to 1.68 mbpd in June and benefited from the sale of oil that had been stored in Turkey from the northern fields. Crude oil sales from the north have continued in July on a sporadic basis. For the time being, the staff are maintaining the projection of an average of 1.5 mbpd of crude oil exports in 2006.
6. **Coverage of the new social safety net system continues to expand.** As of mid-July, some 550,000 families were covered, in line with the target coverage of one million families by year-end.
7. **Bilateral debt agreements with all Paris Club Creditors except Russia have now been signed.** Russia has concluded a bilateral agreement with Iraq, and is expected to sign the agreement in September. The new Iraqi government has also made contact with the Saudi Arabian authorities and with China (two of the biggest non-Paris Club creditors) to start negotiations on a debt agreement.
8. **Through July 31, 2006 Iraq had settled about 96 percent of commercial claims through the debt and cash exchanges, including the arbitration process.** The total amount of claims settled (including those under arbitration) has risen to \$19.7 billion. The total amount of claims subject to settlement has been revised to \$20.5 billion.



Press Release No. 06/175
FOR IMMEDIATE RELEASE
August 3, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First and Second Reviews Under the Stand-By Arrangement with Iraq

The Executive Board of the International Monetary Fund (IMF) has completed the first and second review of Iraq's performance and a review of financing assurances under the 15 months Stand-By Arrangement. The arrangement is being treated as precautionary by the Iraqi authorities.

The Stand-By Arrangement in an amount equivalent to SDR 475.4 million (about US\$705.6 million) was approved on December 23, 2005 (see [Press Release No. 05/307](#)).

In completing the reviews, the Board approved the authorities' requests for waivers of applicability of six end-June 2006 quantitative performance criteria as well as waivers for the nonobservance of the quantitative performance criterion on the revenue of oil-related state enterprises for March 31, 2006, the May 15, 2006 structural performance criterion on completing the final audit of the Central Bank of Iraq's 2005 financial operations, the structural performance criterion on adopting a fully detailed budget classification and chart of accounts by June 30, 2006, and the continuous performance criterion on external arrears on new borrowings.

Following the Executive Board's discussion of Iraq, on Wednesday, August 2, 2006, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

“The Iraqi authorities have taken important and decisive measures to bring their economic program back on track, although continued progress in the authorities' reform efforts will remain critically dependent on an improvement in the security situation. Substantial efforts have been made to maintain fiscal discipline and control recurrent spending, despite the difficult environment, and the Central Bank of Iraq's tightening of monetary conditions constitutes an important step in the right direction. The timely adjustment of fuel prices is welcome, and the submission to the Council of Representatives of the revised draft law to liberalize private imports of fuel products restores to the agenda a key component of the authorities' program, and its early passage into law and implementation will be key to prevent supply bottlenecks in the market for petroleum products.

“Inflation remains, however, a serious source of concern. The ongoing violence and supply disruptions in the non-oil economy will undoubtedly continue to put pressure on prices. In this context, it is commendable that the Central Bank of Iraq stands ready to further tighten monetary

and exchange rate policy to prevent high inflation from becoming entrenched. Fiscal policy should be supportive by keeping public sector wages and pensions in check.

“Structural reforms and institution-building will remain the cornerstone of the reconstruction process. It is encouraging that preparations for establishing an operational payments system are well advanced. However, much work remains to be done in other areas. A top priority is the reform of the pension law to ensure that Iraq’s public sector pension system is sustainable over the medium term. Other key areas of reform include improvements in transparency in the government’s payroll, improvements in public expenditure management, and work towards a successor to the Public Distribution System. There has been a welcome increase in targeted support for the poor, and reforms in this area will continue to be of central importance, including the development of a better targeted social safety net that will go hand in hand with the reduction in general subsidies.

“The completion of bilateral negotiations with Paris Club creditors is welcome and progress has to be made toward resolving non-Paris Club official claims. The excellent progress in settling arrears with private creditors is also noteworthy. Good faith efforts to resolve the remaining arrears should continue.

“Governance and transparency are essential for the authorities’ program to succeed. The government’s efforts to tackle corruption in the petroleum sector are therefore welcome,” Mr. Kato said.

Statement by Shakour Shaalan, Executive Director for Iraq
August 2, 2006

1. The Iraqi authorities would like to thank the Fund's Executive Board, Management and Staff, for their continued support throughout these momentous times. They appreciate in particular the cooperative spirit of the staff and their useful contributions to the formulation of sound policies in Iraq under difficult circumstances. The current SBA, which has been approved by the Board in December 2005, has played a significant role in anchoring and furthering the progress made in achieving macroeconomic stability under the EPCA that preceded it; As importantly, the program offers a coherent context for the elaboration of a consistent set of policies to establish the basis for a viable open economy. While the unexpected delay in the formation of the new cabinet has caused the postponement of the first review—initially scheduled for February—and led to some elements of the program to go off-track, the new government in place since May has acted swiftly to bring the overall program back in line. In this respect, the authorities would like to express their vigorous commitment to the SBA, whose objectives they view as clearly beneficial to Iraq.
2. The first parliamentary elections under the framework of the new constitution was successfully held on December 15, 2005 with a high voters' participation rate from across the various segments of the population, resulting in a more representative parliament. Given the desire to establish a well balanced and inclusive cabinet, a protracted and difficult negotiation process for the formation of a new government followed the elections. This resulted in the delayed confirmation of the current government headed by Prime Minister Al-Maliki. However, given its stronger legitimacy and its four year mandate, the new government—the first non-transitional government of Iraq since the onset of the war—has the opportunity to contemplate the possibility of a longer-term horizon in which to formulate its strategic choices and elaborate its policies. In this respect, the authorities look forward to develop further their fruitful collaboration with the Fund.
3. Notwithstanding this improved institutional context, the security situation remains tragically out of control and keeps undermining the prospects of rapid improvements of economic outcomes. With unabating violence affecting the daily lives of Iraqi citizens, the implementation of critical measures often remain subject to the influence of events outside the control of the authorities. Improvement on the security front is a clear prerequisite for the ability of the government to effectively implement its policies and for the private sector to develop its productive capacity. One evident adverse impact of the security situation on economic activity is the inability to implement budgeted investment projects, which are essential for the provision of critical infrastructure, and to increase the export capacity in the oil sector. The latter, still constrained by sabotage activities and the threats to necessary qualified personnel have led to a stagnation of oil production levels at an average of 2.0 mbpd (and export levels at 1.5 mbpd) so far in 2006. Hence, notwithstanding an overall growth of the non-oil economy estimated to around 12 and 10 percent for 2005 and 2006 respectively, overall growth performance is expected to remain at around 4 percent, well below the staff projections in December. The authorities are hopeful, however, that with

more focused attention to the security of the pipeline infrastructure especially in the north, export capacity should grow significantly next year and oil production can resume its upward trend.

4. The authorities have made the improvement of security their overarching objective, while being at the same time committed to accelerate the economic agenda. They recognize that the provision of basic services and the improvement in standards of living have a role in reducing social tensions. The new government has consequently been decisive in addressing the daunting economic challenges it faces in this respect. This is evidenced by the measures undertaken in the short time span since taking office, to broadly realign the program. These actions stand in sharp contrast with the expectations that were being formed earlier about the prospects of the new government, such as those related by staff during their informal briefing to Directors in May. The main areas of potential risks were identified as (1) a possible inability of the new government to commit to the schedule of fuel price increases (2) the likely emergence of strong pressures on the wage bill resulting from additional civil service hiring (in particular to reward political groups that supported the government in the elections) (3) the emergence of cost pressures from the new pension law which the then minister of finance was unable to withdraw, (4) and the likely revision of the 2006 budget with a supplementary budget.

5. The new government has responded resolutely to these concerns and ruled out the introduction of a supplementary budget, to avoid encouraging requests for additional spending which they could see arising from many quarters. The authorities have furthermore committed to resist any increase in additional hiring and bonuses and, importantly, to reform the pension law. They agree with staff that in its current form, the pension law—which has already been approved by the previous parliament and would therefore be very difficult to repeal—will have unsustainable fiscal consequences in the medium to long term. Accordingly, they have decided to further delay its implementation to allow an amended version of the pension plan that ensures its sustainability, to be developed in consultation with the World Bank. The approval of the reformed law by the cabinet and Parliament by September 2006 has been set as a new structural benchmark.

6. While the previous caretaker government was unable to carry out the second stage of price increase scheduled for end-March 2006 in the SBA, the new government has moved promptly to restore the original schedule, and even accelerate it for some products. Indeed, prices for some fuels have been brought in line with their end-June targets (kerosene, diesel, premium gasoline) while for others, prices have been increased to the target for end-September (regular gasoline) or even end-December (liquefied petroleum gas). These increases have been accompanied by clearer public communication as to their critical necessity for the welfare of the country. In parallel, improvement in the social protection program that includes a cash support for poor families, has been progressing steadily. More than 40 percent of the one million household objective have been enrolled in the program so far. This program will complement the popular Public Distribution System already in place, which will be rationalized to improve its targeting.

7. Another key measure for the government in the oil sector will be the passing of the law to allow the liberalization of private gasoline imports. The law has been amended to remove the possibility of price interference and has been already sent to Parliament this week, thus satisfying a prior action for the current review. The government is hoping for swift approval of the law, which should have an important impact on alleviating domestic fuel shortages and reduce black market activities. Moreover, the combined effects of removing fuel subsidies and increasing imports will help with efforts to combat corruption, a key issue for the current government's objective of developing a transparent and open oil sector, and strengthen the credibility of policies in this regard. The government furthermore, plans to enhance significantly its monitoring of oil production and transportation and aims to install an oil metering system by end-2006. Finally the government will follow-up on the recommendations of the IAMB, which is set to dissolve by end-2006, for the creation of an oversight committee to replace it in monitoring and auditing the Development Fund for Iraq (DFI).

8. The reduction of shortages following from the liberalization of gasoline import is expected to contribute to lower inflation, as increasing black market gasoline prices have a major impact on the cost of living indices. The high and increasing rate of inflation, whose dynamics is still quite uncertain as the staff reports, is a key issue for the government. It aims at containing it through structural policies aimed at reducing shortages and monetary policy tightening. Indeed the Central Bank of Iraq (CBI), faced with a surging inflation rate has raised the policy rates by two percentage points to 10 percent at the beginning of July, and by another two percentage points more recently, in an effort to slow the inflationary cycle. While the monetary transmission channel is relatively weak, the CBI agrees with staff that strong moves in interest rate will signal the clear determination of the monetary authorities to control inflation dynamics and prevent the consolidation of inflationary expectations. Furthermore, the authorities aim to strengthen the effectiveness of monetary policy through linking deposit rates to the policy rates in the future. Finally, the CBI will consider the possibility of a gradual appreciation of the Iraqi dinar if needed, which could have a positive effect on both inflation and the process of dedollarization.

9. The measures enacted by the new government so far, attest to their resolve in facing squarely the challenges they face in establishing a functioning economy under very adverse circumstances. The authorities remain committed to a strong implementation of the program. They have met all quantitative performance criteria (PC) except with regard to the transferred revenues from the oil-related state owned enterprises, due to lower-than-projected oil production. They request waivers for this quantitative PC and for the three other missed PC on the basis of the corrective actions specified in the Supplementary Memorandum of Economic and Financial Policies attached to the staff report. They would like also to underscore their appreciation for the Fund's technical assistance in various areas, which has been critical for enhancing their ability to implement the program and enact their policy initiatives. In this respect, they would like to express their gratitude to the member countries that have provided generous financial support to the Technical Assistance Subaccount for Iraq. The Iraqi authorities hope they can continue to rely on the support of the Board in helping them overcome the difficult challenges ahead.