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**Iraq: First Review Under the Stand-By Arrangement and Financing Assurances Review—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iraq**

In the context of Iraq's First Review Under the Stand-By Arrangement and Financing Assurances Review, the following documents have been released and are included in this package:

- The staff report for the First Review Under the Stand-By Arrangement and Financing Assurances Review, prepared by a staff team of the IMF, following discussions that ended on June 15, 2008 with officials of Iraq on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 18, 2008. 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 August 29, 2008 updating information on recent developments.
- A press release summarizing the views of the Executive Board as expressed during its September 3, 2008 discussion of the staff report that completed the review.
- A statement by the Executive Director for Iraq.

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

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INTERNATIONAL MONETARY FUND

IRAQ

**First Review Under the Stand-By Arrangement  
and Financing Assurances Review**

Prepared by the Middle East and Central Asia Department  
(In consultation with other departments)

Approved by Adam Bennett and Mark Allen

August 18, 2008

- This report is based on discussions held during June 10–15, 2008 in Amman. Staff met with Minister of Finance Al-Zubaydi, Minister of Oil Al-Shahristani, Governor of the Central Bank of Iraq (CBI), Al-Shabibi, and other senior officials. The staff team comprised Messrs. De Vrijer (head), Grigorian, Kock, and Ms. George (all MCD), and Ms. Oliva-Armengol (PDR). Mr. Ibrahim, the Fund's resident representative for Iraq, assisted the mission.
- A 15-month Stand-By Arrangement (SBA) in an amount equivalent to SDR 475.36 million (40 percent of quota) was approved by the Executive Board on December 19, 2007. The authorities continue to treat the arrangement as precautionary.
- Iraq has met all quantitative performance criteria set for end-March 2008, except for the performance criterion on government imports of petroleum products which was missed by a small margin due to higher-than-expected import prices for kerosene. All structural performance criteria have been met.

Contents		Page
Executive Summary .....		4
I. Introduction.....		5
II. Recent Economic Developments .....		6
III. Policy Discussions .....		9
A. Macroeconomic Outlook and Risks .....		9
B. Fiscal Policy and Related Measures.....		11
C. Monetary and Exchange Rate Policy .....		13
D. Other Structural Issues .....		14
IV. Program Monitoring and Financing Assurances.....		14
V. Staff Appraisal .....		15
 Box		
1. Recent Developments in Iraq’s Debt Restructuring Process .....		10
 Figures		
1. Violence Indicators, June 2003–June 2008 .....		5
2. Output and Inflation.....		7
3. External and Fiscal Indicators.....		8
4. Official Fuel Prices in Iraq, 2004–07.....		12
5. Real and Nominal Exchange Rates, January 2004–March 2008.....		13
 Tables		
1. Selected Economic and Financial Indicators, 2005–09 .....		17
2. Fiscal and Oil Sector Accounts (in billions of Iraqi dinars), 2005–09 .....		18
3. Fiscal and Oil Sector Accounts (in percent of GDP), 2005–09 .....		19
4. Central Bank Balance Sheet, 2005–09.....		20
5. Summary Balance Sheet of Deposit Money Banks, 2005–09 .....		21
6. Monetary Survey, 2005–09.....		22
7. Balance of Payments, 2005–09.....		23
8. Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2007–08 .....		24
9. Prior Action, Structural Performance Criteria, and Structural Benchmarks Under the Stand-By Arrangement .....		25
10. Availability of Purchases Under the Stand-By Arrangement, 2008–09 .....		26
11. Indicators of Fund Credit, 2004–14.....		27

Appendix

External Debt Outlook .....28

Attachments

I. Letter of Intent .....31  
II. Supplementary Memorandum of Economic and Financial Policies for 2008 .....33

## EXECUTIVE SUMMARY

**Economic activity remained subdued in 2007 but growth prospects have improved in 2008, underpinned by increasing oil production and exports.** Benefiting from better security and improved maintenance, crude oil exports resumed from mid-2007 through the northern pipeline to Turkey. Non-oil activity appears to have picked-up in the latter part of 2007 and in early 2008, except for the drought-hit agriculture sector.

**Inflation has slowed down and monetary and exchange rate policies have been adjusted in response.** Annual consumer price inflation has been in the low single digits since December 2007. However, core inflation (excluding fuel and transportation) remained in double digits (about 12½ percent in June), in part because of higher food prices. The Central Bank of Iraq (CBI) slowed the pace of appreciation and reduced its policy interest rate to 16 percent.

For the remainder of 2008, key elements of the authorities' program include the following:

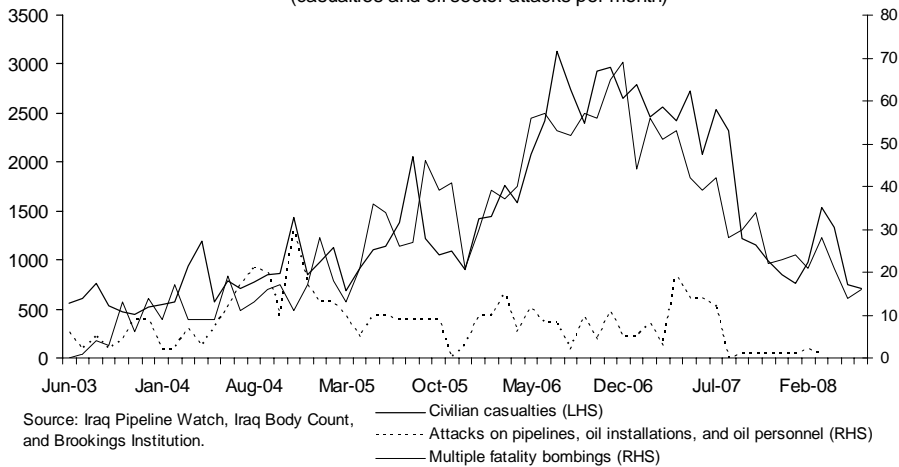
- **The supplementary budget for 2008 provides for a sizable increase in current and capital spending.** The impact on inflation is expected to be modest because of the high import content of the additional outlays. A significant civil service salary increase—to partially compensate for the significant erosion of real wages in recent years—will be implemented gradually in 2008 and 2009.
- **Domestic retail prices of LPG and jet fuel have been increased and the government will continue to refrain from providing direct fuel subsidies,** except for a small subsidy on kerosene. Gasoline and diesel prices are planned to be adjusted again in early 2009.
- **The CBI will increase the pace of appreciation of the dinar and keep the policy interest rate positive in real terms** to keep inflation under control.
- **Priority structural reforms will continue.** Work is underway to improve public financial management (PFM), including by adopting a comprehensive PFM action plan. The CBI will further improve its accounting and reporting practices and adopt new reserve management guidelines. Restructuring plans for the two largest state-owned banks will be developed on the basis of their finalized financial and operational audits, and work will proceed to complete the full set of prudential regulations for commercial banks.

## I. INTRODUCTION

1. **The current SBA for Iraq was approved in December 2007 in support of the authorities' economic program for 2008.** The main objectives of the program are to maintain macroeconomic stability, facilitate higher investment and growth, and move forward with key structural reforms. The arrangement runs through March 18, 2009.

2. **The security situation has improved, but is still precarious and full political reconciliation within the government remains to be achieved.** Despite a reduction in violence since early 2007, periodic flare-ups continue to hamper the pace of economic recovery. During March/April 2008, an offensive was launched by Iraqi security forces against the Mahdi Army (loyal to Shia cleric Muqtada Al-Sadr), followed by a campaign against Al-Qaeda in Mosul. In this period, there were also two bomb attacks on southern pipelines, temporarily interrupting oil exports. The various offensives appear to have ended in May. Since April 2007, ministers from the (secular) Iraqi National List, the (Sunni) National Accord Front, and the Al-Sadr block have withdrawn from the government. In mid-July 2008, the National Accord Front rejoined the government.

Figure 1: Violence Indicators, June 2003–June 2008  
(casualties and oil sector attacks per month)



3. **The Paris Club agreed on November 21, 2004 to a debt reduction for Iraq, equivalent to 80 percent in net present value (NPV) terms, to be achieved in three stages.** The first and second stages, each comprising a 30 percent debt reduction in NPV terms, went into effect in November 2004 and in December 2005 (following approval of the first SBA), respectively. The final stage will comprise an additional 20 percent debt reduction, and depends on completion by end-December 2008 of the second and last review under the current SBA.

4. **The first annual review conference of the International Compact with Iraq (ICI) was held in Stockholm on May 29, 2008.** The international community affirmed its support for Iraq's political, security, and economic reform program. The Fund's main contribution to



the ICI consists of the medium-term macroeconomic policy framework of the SBA-supported program.

## II. RECENT ECONOMIC DEVELOPMENTS

5. **Economic activity remained subdued in 2007 but growth prospects have improved in 2008, underpinned by increasing oil production and exports.** Real GDP growth is estimated to have been only about 1½ percent in 2007, reflecting a decline in agricultural and industrial production. However, crude oil exports began to pick up in the second half of the year, benefiting from better security and improved maintenance, and the resumption of exports through the northern pipeline to Turkey. In January–May 2008, crude oil production averaged 2.3 million barrels per day (mbpd), compared to just above 2.0 mbpd in 2007. There are also indications of a pick-up in non-oil activity in the latter part of 2007 and in early 2008, except for agriculture which is being hit by drought.

6. **Inflation was brought down to 5 percent during 2007,** from 65 percent at end-2006. The overall consumer price level in June fell by some 6 percent relative to a year earlier, reflecting better availability of fuel products and lower black-market fuel prices. Core inflation (excluding fuel and transportation costs) remained at about 12½ percent in June, year-on-year, in part because of increasing food prices.<sup>1</sup>

7. **Higher oil revenues and below-budget investment spending resulted in an overall budget surplus of 13½ percent of GDP in 2007** (the program projected a surplus of 1.5 percent of GDP). The balance of the Development Fund for Iraq (DFI) grew to \$12.6 billion at end-2007. In the first six months of 2008, higher oil exports increased the balance of the DFI by a further \$4.6 billion. There are indications that the measures to improve investment execution have begun to bear fruit.

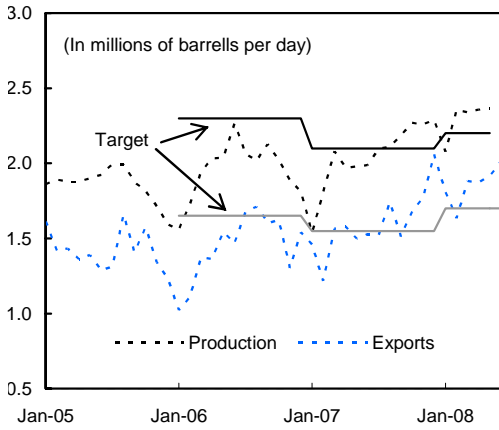
8. **Monetary and exchange rate policies have been adjusted in response to the slowdown in inflation.** The policy interest rate was reduced in three steps from 20 percent at end-2007 to 16 percent as of July 1, 2008, but remained positive in real terms (defined as the policy rate minus core inflation). The appreciation of the dinar has slowed from about ½ percent per month in the second half of 2007, to about ¼ percent per month during January–June 2008. The appreciation helped to bring inflation down and to reduce cash dollarization. The real demand for dinar currency in circulation expanded by 23 percent in 2007. Gross international reserves increased to \$38.3 billion at end-April 2008, equivalent to about 10 months of imports of goods and services.

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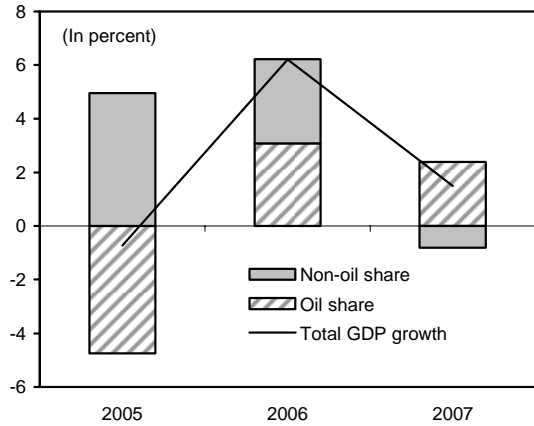
<sup>1</sup> The definition of core inflation in Iraq excludes fuel and transportation (with an end-2006 effective weight of 35 percent) because these components explain most of the volatility in the CPI. Core inflation excluding food prices was 15.3 percent, year-on-year, in June 2008.

Figure 2. Iraq: Output and Inflation

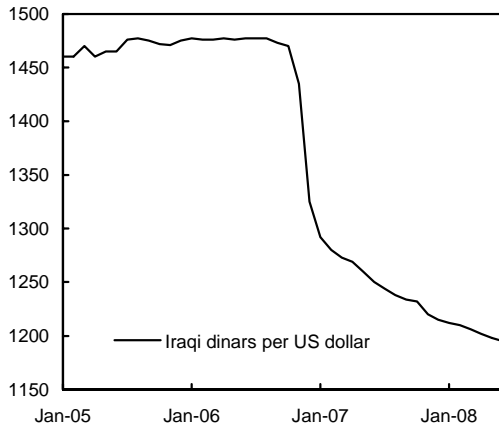
**Oil production and exports have gradually increased...**



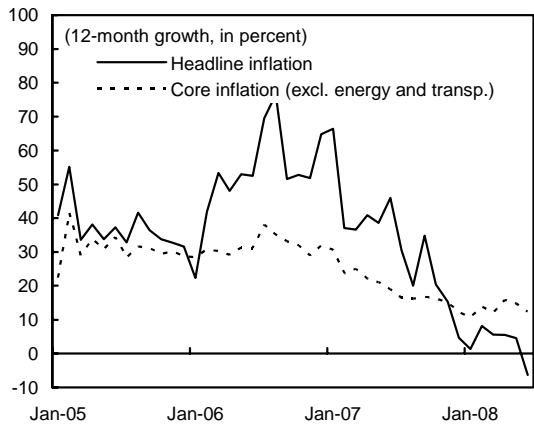
**...but overall output growth remained low.**



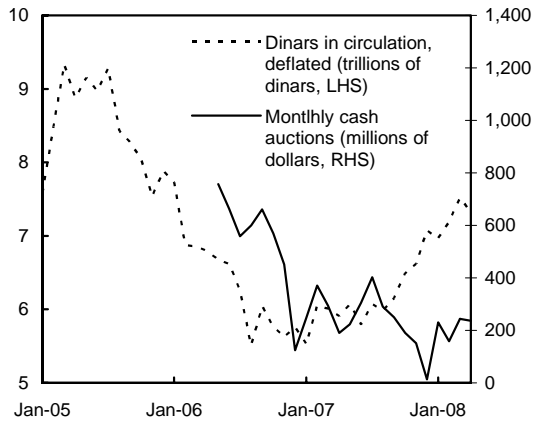
**Appreciation of the dinar...**



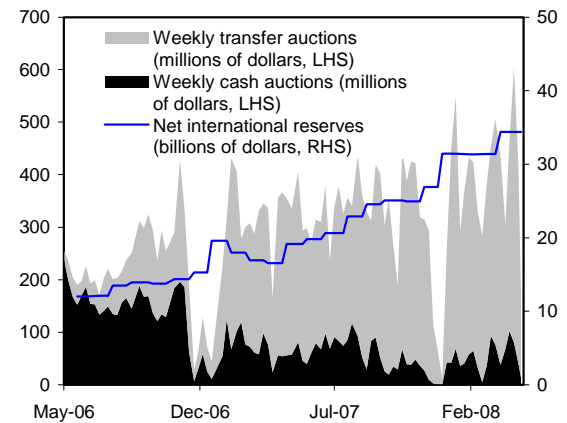
**...has helped bring down consumer price inflation...**



**...and reduce cash dollarization...**



**...while the CBI was able to satisfy market demand for dollars and build up reserves.**



Source: Iraqi authorities and Fund staff calculations.

































































































