



IRAQ

SELECTED ISSUES

July 2019

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July 3, 2019

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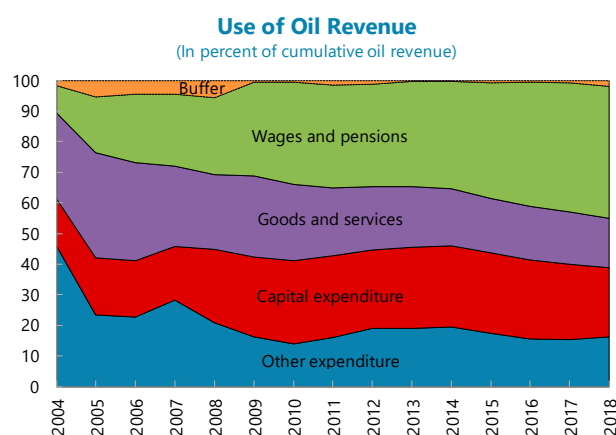
A RISK AND RULES-BASED APPROACH TO FISCAL POLICY¹

Building fiscal buffers for precautionary purposes and introducing fiscal rules as part of broader fiscal reforms to strengthen fiscal institutions can help Iraq address the challenges from oil revenue volatility. The paper discusses the choice and design of rules for Iraq, guided by fiscal policy priorities and the country's institutional capacity. A ceiling on current spending is proposed as a fiscal rule that would be simple and easy to monitor and support efforts to create space for scaling up capital expenditure, build fiscal buffers to reduce fiscal policy procyclicality, and also help secure debt sustainability.

A. Context

1. Iraq's oil sector has generated substantial revenue since 2003 but institutional weaknesses have hindered effective allocation of these resources.

The proceeds from the sale of oil exceeded \$850 billion between 2003–18, a period of steadily rising production and generally favorable international prices. However, poor governance, public financial management (PFM) weaknesses, and capacity limitations have diverted these windfalls away from essential investment in human and physical capital towards current spending, notably the public sector wage bill, and little has been saved in financial assets. As a result, Iraq's development needs remain large, with wide infrastructure gaps, and difficult social conditions, highlighted by unrest last summer over the poor quality of water and electricity, and high unemployment.



2. The challenges for fiscal policy are set to increase in the context of highly volatile oil prices. Spending pressures are mounting in the aftermath of the war with ISIS not only due to the large reconstruction needs (an estimated \$46 billion of damage to infrastructure and property²) but also demands to expand public employment and the social safety net in war-affected areas. While the recent recovery in oil prices provides some fiscal space, increased oil price volatility and the projected reversal in prices over the medium term—to well below the levels needed to balance the budget—highlight the risks involved in basing expenditure decisions on current revenue levels.

3. Iraq therefore needs a stronger fiscal policy framework to deal with oil price risks and ensure resources are directed towards much needed reconstruction and development spending. Elements of the proposed framework include well identified objectives and risk-based

¹ Prepared by Gazi Shbaikat.

² See [Iraq: Reconstruction and Investment](#).

anchors for fiscal policy, robust budget processes and PFM, and multi-year fiscal planning supported by fiscal rules. This paper focuses on the latter aspect, discusses different rules and international experience, and considers how to select and calibrate a fiscal rule that would help mitigate the risks of oil price volatility, reduce procyclicality, and create space for higher capital spending. Establishing and implementing such a framework will also require a strong resolve to overcome potential political objections.

B. Fiscal Policy in Iraq: What Is the Challenge?

4. **Iraq has one of the most undiversified revenue bases of oil exporters in the MENA region, and is correspondingly more vulnerable than most to oil price movements (Figure 1).**

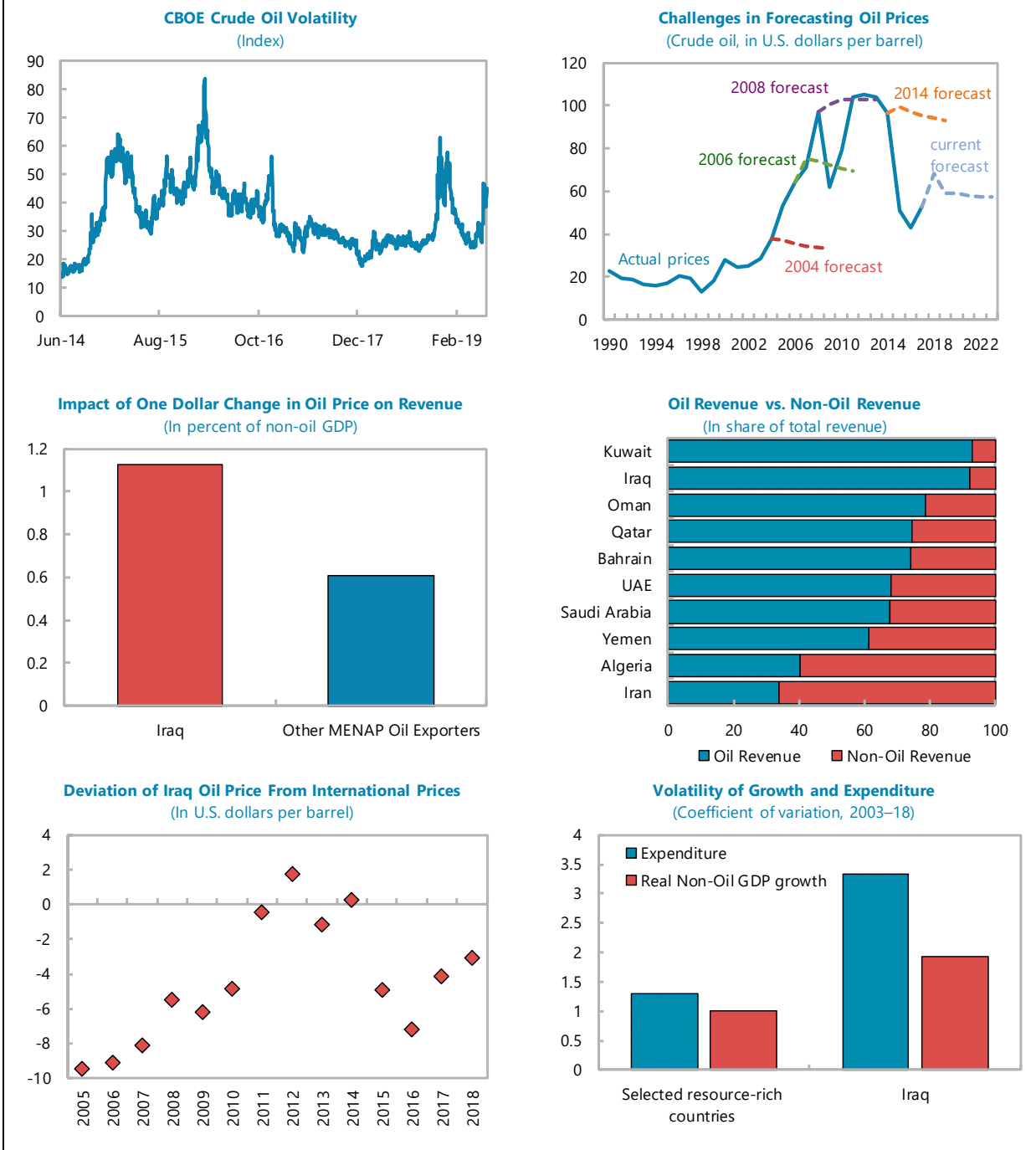
In 2018, oil revenue accounted for about 92 percent of total budget revenue. Rising oil production has magnified this dependence—for instance at current production levels, every dollar change in oil price results in a change in total revenue by 1.1 percent of non-oil GDP (\$1.5 billion), compared with 0.6 percent in other oil-exporting countries in the MENA region. On the other hand, the non-oil tax base is narrow and has been eroded by weak compliance; in 2018 non-oil revenue represented less than 5 percent of non-oil GDP.

5. Volatility and unpredictability of oil prices have increased in recent years, posing significant challenges to policymakers (Figure 1). Oil price shocks are often large and persistent, with booms and busts involving prices moving by as much as 40–80 percent for as long as a decade. Oil price volatility has increased sharply especially during the 2014–15 commodity price shock, and has shown renewed volatility since the fourth quarter of 2018. Hence, forecasting commodity prices has proved exceptionally difficult in recent years (IMF, 2015 and 2019). An added factor of volatility for Iraq is the differential with international prices, which fluctuated between +1 and -10 since 2004, reflecting security-related changes in the freight cost, mixture of light and heavy crude, and delivery risks.

6. Iraq's policy frameworks and institutions are ill-equipped to deal with these challenges. Fiscal policy is short-term oriented—largely conducted in the context of the annual budget, while medium to long-term fiscal planning supported by a policy to build adequate buffers has been lacking. Revenue projections generally reflect the oil prices prevailing at the time of budget preparation, while expenditure allocations usually follow a bottom up approach, leading to incremental trends without adequate consideration of changing government priorities or fiscal sustainability. Moreover, weaknesses in the legal framework have allowed spending to be approved outside budget procedures, and inadequate commitment control and cash management processes have undermined the integrity of the annual budget, which has become a poor predictor of fiscal outcomes.³

³ The recently adopted General Financial Management Law (GFML) offers an opportunity to address many of these issues (see ¶113).

Figure 1. Iraq: Vulnerability to Oil Prices, 1990–2022 1/



Sources: Bloomberg LP; WEO; Market projections; and IMF staff estimates and calculations.

1/ The Chicago Board Options Exchange (CBOE) Crude Oil Volatility Index measures the market's expectation of 30-day volatility of crude oil prices. Deviation of Iraq oil price from international prices equals Iraq export prices minus WEO crude oil prices.

7. These factors have together led to a highly procyclical fiscal policy and unbalanced expenditure structure, adversely affecting growth and development. Government expenditure has been closely associated with oil price changes—the correlation between growth in government spending and oil prices was 0.7 during 2003–18. The adverse impact of expenditure fluctuations on

long-term growth is well documented, and is exacerbated by asymmetrical fiscal policy responses to changes in oil prices. Current spending, notably the wage bill, has been ramped up during booms, while abrupt cuts in capital spending and an accumulation of arrears have been the first line of defense when oil prices have declined. This asymmetry has skewed the structure of expenditure towards current spending—non-oil capital expenditure represented only 4 percent of total expenditure in 2018, and led to severe expenditure rigidities and limited buffers. As a result, Iraq has experienced greater economic volatility than comparator countries, and lower investment rates, which have translated over time into lower human and physical capital accumulation (Figure 1).

C. A Proposed Fiscal Policy Framework to Address These Challenges

Defining Fiscal Policy Objectives

8. The long-term goal of fiscal policy in most oil-producing countries is to leverage depleting oil wealth to promote sustainable economic development. This involves making strategic choices about the share of oil revenues to be converted into other forms of assets (real or financial) or consumed, subject to long-term fiscal sustainability and intergenerational equity considerations.⁴ The choices should reflect the government’s economic and social priorities, its capacity to spend efficiently, as well as the rate of return and risks associated with each form of asset.

9. Iraq’s short- to medium-term objective—which is the focus of this paper—is to meet pressing post-conflict demands and address infrastructure gaps while maintaining macroeconomic stability. The space for investment is constrained by volatile international oil prices and the lack of fiscal buffers, while a modest debt-carrying capacity and imperfect access to capital markets limit the scope for financing spending through borrowing. Fiscal policy should therefore aim at:

- Creating space within the budget, through tight control on current spending and increasing tax revenue, to scale up the needed infrastructure and social spending, reflecting the availability of significant pledged donor support (\$30 billion).
- Managing oil revenue volatility and avoiding procyclical fiscal policy by building adequate fiscal buffers (which can be used to protect capital expenditure during downturns).

Medium-Term Budget Planning

10. Developing a medium-term orientation to budget planning would help dampen procyclicality and ensure that oil revenues are spent in a sustainable manner. Fiscal planning over a medium-term horizon helps prevent volatile annual revenues from translating into expenditure fluctuations that may destabilize the economy and reduce the quality of spending.

⁴ At projected production rates, Iraq’s oil reserves will last over 100 years. Extraction of oil and export proceeds are projected to rise over the medium term, albeit subject to large risks on account of constraints on export capacity, OPEC quotas, and the path of international oil prices.

Setting and adhering to medium-term spending plans will lower the risk of short-term spending pressures jeopardizing longer-term strategic fiscal objectives. Key components are:

- *Medium-term fiscal framework (MTFF).* The budget should be underpinned by an MTFF with forecasts for broad fiscal aggregates for revenues and expenditures, formulated in line with the fiscal anchor.
- *Medium-term budget and expenditure frameworks.* Such aggregate expenditure forecasts should be translated into disaggregated expenditure ceilings, including for the investment program. Initially, this would focus only on larger expenditure categories, but over time it would be implemented with greater granularity, based on component programs.
- *Strengthening macroeconomic forecasting.* Reliable forecasts are essential for formulating fiscal policy decisions and assessing their impact on the economy. This underscores the importance of a strong analytical capacity supported by proper national accounts, reliable methodologies and well-qualified staff. In many countries, the establishment of a macro-fiscal unit at the Ministry of Finance has supported moves to a medium-term fiscal framework.

11. Iraq could build on the progress already made in preparing medium-term projections.

The Ministry of Finance has recently started preparing indicative three-year projections for individual expenditure items as part of its budget submission. To make these targets meaningful, ministries would be expected to commit to these ceilings as part of the budget preparation process and develop medium-term plans on this basis. This can be further supported by a medium-term fiscal framework that sets the overall parameters of fiscal policy and guides the formulation of these projections. Such a medium-term framework is a prerequisite for the authorities' planned move towards program and performance-based budgeting.

Robust Annual Budget and Supporting Fiscal Institutions

12. The budget process and public financial management frameworks can be significantly improved.

Extending the budgeting horizon over multiple years would improve fiscal policy outcomes only if there is a credible annual budget and robust systems to ensure fiscal discipline and spending efficiency at all levels of government. In this regard, the following are priority areas:

- The budget process needs to be unified and comprehensive, requiring appropriate levels of coverage of government operations and fiscal reporting. Practices or legislation that allow spending to be approved outside budget processes should be eliminated.
- The budget should be based on the best possible forecasts, which requires a sound understanding of how parameters drive annual expenditure, as well as making repeated comparisons between the adopted budget and the budget execution outturn—both in-year and soon after the end of the fiscal year.
- Adherence to the expenditure envelope in the adopted budget even if oil prices exceed budget projections; in this regard, while the use of lower than actual/expected oil prices in budget

preparations gives policymakers a buffer, using more realistic oil price assumptions would enhance policy planning and budget transparency.

- Fiscal reporting that reflects international reporting standards, timely and frequent, and includes within-year reporting.

13. Parliament adopted a new General Financial Management Law (GFML) in 2019 that strengthens the legal framework for public financial management. The law defines general government for the first time, establishes the need for a medium-term fiscal framework and enshrines fiscal transparency requirements. It also limits parliament’s capacity to amend the budget, as well as the scope for spending to be authorized outside budget processes. It will be important for the authorities to develop subsidiary legislation and/or adopt decisions at the council of ministers so that the law is implemented, and remaining gaps relating to guarantees and commitment controls are addressed.

14. The medium-term fiscal frameworks can be reinforced by robust fiscal institutions. Fiscal rules, stabilization funds, fiscal responsibility laws, and independent fiscal agencies or fiscal councils are example of such institutions. They seek to increase commitment and accountability of policy makers and set binding boundaries to guide the formulation of medium-term fiscal framework. They all require a strong political commitment and adequate administrative capacities and should be introduced gradually and flexibly in the case of Iraq given the fragilities. This paper focuses on fiscal rules and stabilization buffers as complementary instruments that could help improve fiscal policy outcomes in Iraq—about one quarter of oil-exporting countries have combined fiscal rules with stabilization funds. However, adopting a numeric rule should be seen as a complement to, rather than a substitute for, a strong medium-term budget framework.

Targeting the Right Fiscal Indicators

15. The fiscal framework should include a set of fiscal indicators to help assess the macro-fiscal stance and fiscal sustainability. The overall (primary) fiscal balance is the main conventional indicator for resource and non-resource rich countries, given its direct link to financing needs and public debt. However, changes in the overall balance could be cyclical rather than a reflection of changes in the underlying fiscal position. Many countries, therefore, augment fiscal analysis with measures of structural balances that strip the cyclical components of revenue and expenditure out of the overall balance.

16. As a resource-rich country, Iraq should focus on alternative set of fiscal indicators that exclude (or smooth) the volatile oil revenue. The non-oil primary balance and overall balances that uses smoothed oil prices are often used in countries where natural resource revenues represent a significant part of total revenue. The primary current balance and current expenditure are particularly informative in Iraq’s case, as they help track the use of oil revenue and focus attention on fiscal risks and adequacy of resources for public investment (Box 1). It would be useful for Iraq to provide in the policy frameworks such indicators and report them in the annual budget.

Box 1. Which Fiscal Indicators to Target and Monitor

Policy makers rely on a range of indicators to assess various features of fiscal policy such as the fiscal stance, fiscal risks and sustainability, and quality of fiscal adjustment. For resource rich countries, the traditional fiscal indicators do not accurately capture these aspects. For instance, the large impact of externally driven changes on the oil prices on the *overall balance* means that it could mask large fiscal risks and could give misleading signals about the underlying fiscal position. Conventional debt measures also do not adequately capture debt and fiscal sustainability considerations or intergenerational equity, as they exclude other financial and under-the ground resources. However, the traditional indicators remain relevant and serve important objectives—for instance, the overall balance is directly linked to government gross financing requirements and changes in net financial assets, while debt indicators are important to monitor rollover risks and debt service burden. The financing of the overall balance (and its main domestic and external components) can shed light on liquidity constraints and the impact of government demand on private sector credit.

Measures that exclude oil revenue—such as the non-oil primary balance (NOPB)—are more suitable for assessing fiscal risks and long-term sustainability in resource rich countries. They measure the degree of dependency on oil and the fiscal risks involved, and when assessed against long-term benchmarks, can serve as an indicator of long-term sustainability. These measures also indicate the direction of fiscal policy, with an increase in the non-oil primary deficit indicating a loosening of fiscal policy arising either through higher expenditure or a relaxation of non-oil revenue collection. A reduction in the non-oil primary deficit would signal fiscal consolidation. The short-run macroeconomic impact of a loosening/tightening in the NOPB is similar to an externally-financed increase/decrease in the overall deficit in a conventional economy (Medas and others. 2009).

To focus on the underlying fiscal stance and the medium term, the overall balance based on price-smoothing is another useful indicator that excludes cyclical components in the fiscal position. It is usually used as a complement to the non-resource balances in resource-rich countries with long reserve horizons. Oil revenues can be decomposed into a structural and a cyclical component using various approaches, including a price-based smoothing rule. The structural primary balance is equal to the non-resource balance plus the structural component of resource revenues. In this manner, the structural primary balance target could be set to ensure a sustainable fiscal policy framework, and the smoothing rule would delink expenditures from externally-driven volatility in commodity prices. A key decision is the reference price used to calculate structural resource revenues. The reference or benchmark commodity price could be set by using an automatic price smoothing formula such as backward and/or forward looking moving averages of oil prices, or by an independent committee (IMF, 2012).

If the government is focusing on the composition of expenditures and aims at protecting capital expenditure, the primary current balances/spending should feature prominently in the formation of fiscal policy. For Iraq, this is particularly important and would improve the fiscal policy outcome in two ways. First, it will help control the extent to which transitory oil revenue increases lead to permanent increases in current outlays, thus reducing fiscal risks. Second, containing current spending growth would help create space for capital spending. However, changes in aggregate measures of public expenditure should be monitored to assess the impact of fiscal policy on aggregate demand and guard against creative accounting; a practical drawback of focusing on current spending is that it ignores difficulties in classifying current and capital expenditure.

Indicators such as the NOPB should be normalized by non-oil GDP to avoid the fluctuation in the indicators caused by oil price changes and to better reflect the domestic economy.

D. Fiscal Rules

17. Fiscal rules can promote fiscal discipline in three main ways:⁵ (i) *Commitment device*, tying the hands of the government and limiting the scope for fiscal discretion; (ii) *Signaling effect*, by increasing transparency in a context of imperfect information, and revealing the government's priorities and plans; and (iii) *Political function*, by imposing numerical limits, rules may serve as a focal point for politicians, facilitating the formation and stability of political coalitions, and enhancing coordination (Eyraud and others, 2018).

18. Fiscal rules can help control expenditure, and limit deficit and procyclicality biases. Economic theory and empirical evidence points to a tendency for government expenditure to rise over time (*expenditure creep*), whereas taxes tend to grow more slowly, leading to higher deficits and the accumulation of public debt.⁶ The tendency of procyclical policies is also well documented, as the fiscal position is loosened during good times (when resources are abundant), with contractionary measures to reduce the deficit enacted in the downswing. Fiscal rules help correct these biases by constraining the scope for fiscal discretion (Eyraud and others, 2018).

19. These tendencies are particularly pronounced in Iraq, pointing to the benefits of rules in the short and long terms. As shown in Section B, the high dependence on oil revenue creates high expenditure volatility in Iraq, but there are also a number of structural factors that will continue to exert pressure on spending in the longer term. These include a demographic and labor structure that will exert increasing demand on public employment and public services, a large fiscal burden and contingent liabilities from a large and inefficient SOE sector, as well as inefficiencies in public spending.

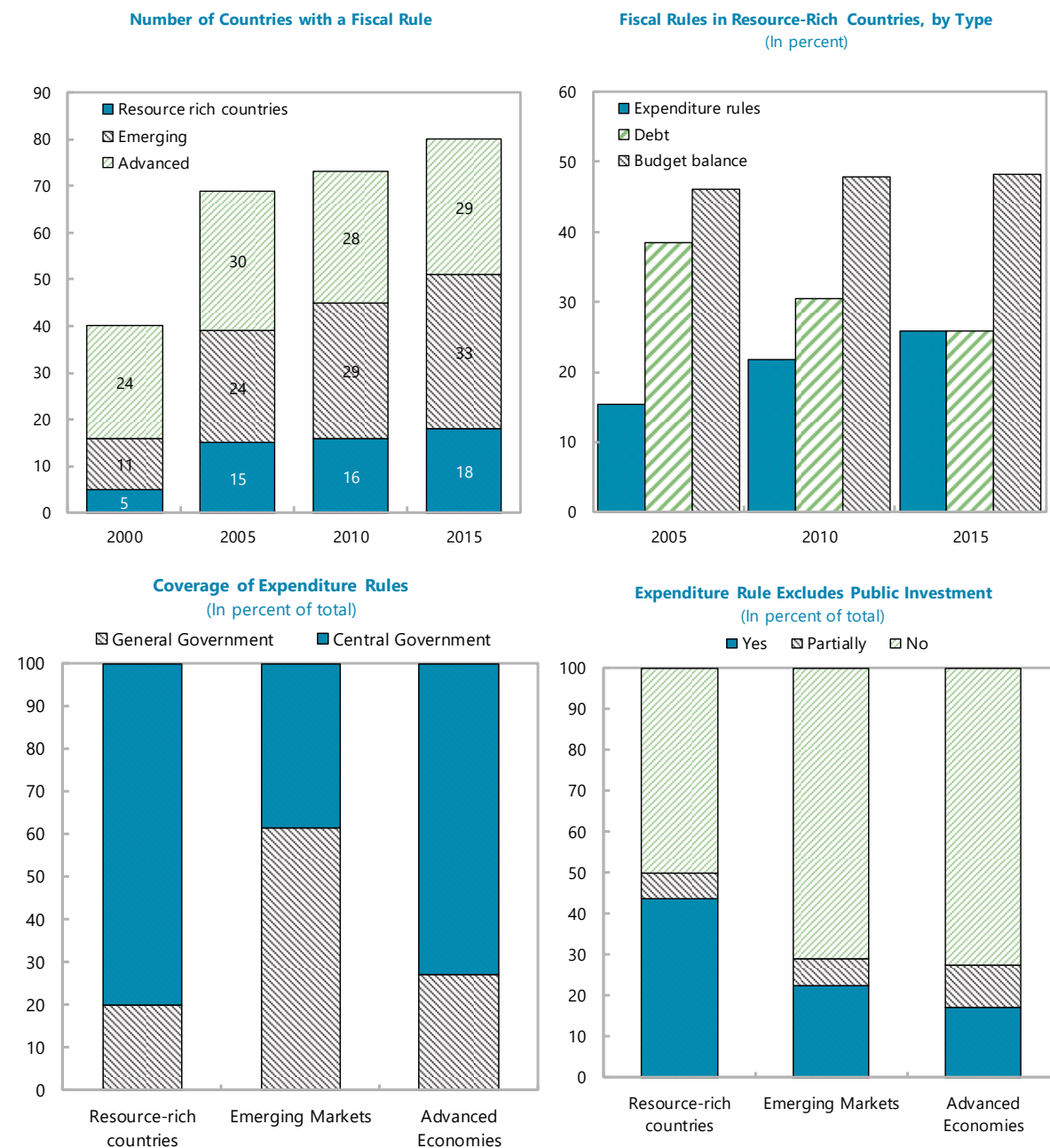
International Experience with Fiscal Rules

20. Fiscal rules have become common in resource-rich countries. The number of resource-rich countries with fiscal rules increased from five in 2000 to 18 by 2015, and such countries are increasingly using two rules as a combination. Rules targeting the budget balance are the most common, combined in many countries with a public debt rule. Expenditure rules are gaining popularity among resource-rich countries (Figure 2). In most resource-rich countries, standard fiscal rules are modified to take into account fiscal sustainability and commodity price volatility. While some such countries target traditional fiscal aggregates such as the overall balance and debt (e.g., Canada, Nigeria, Indonesia, and Russia before 2010, and Peru before 2013), non-resource balance and structural balance rules are more common among resource-rich countries.

⁵ Fiscal rules are defined as constraints on fiscal policy through a simple numerical target on fiscal aggregates such as expenditure, revenue, the budget balance, cyclically adjusted balance, and debt. Rules are often enshrined in legislation, signaling the importance attached by the government to fiscal consolidation, and detail the circumstances under which the rule can be amended.

⁶ As income levels increase, both the demand for public goods and services ("Wagner's law") and the cost of providing them ("Baumol's cost disease") increase relative to other goods and services produced in the country, leading to a rising expenditure-to-GDP ratio (IMF Fiscal Monitor, 2015).

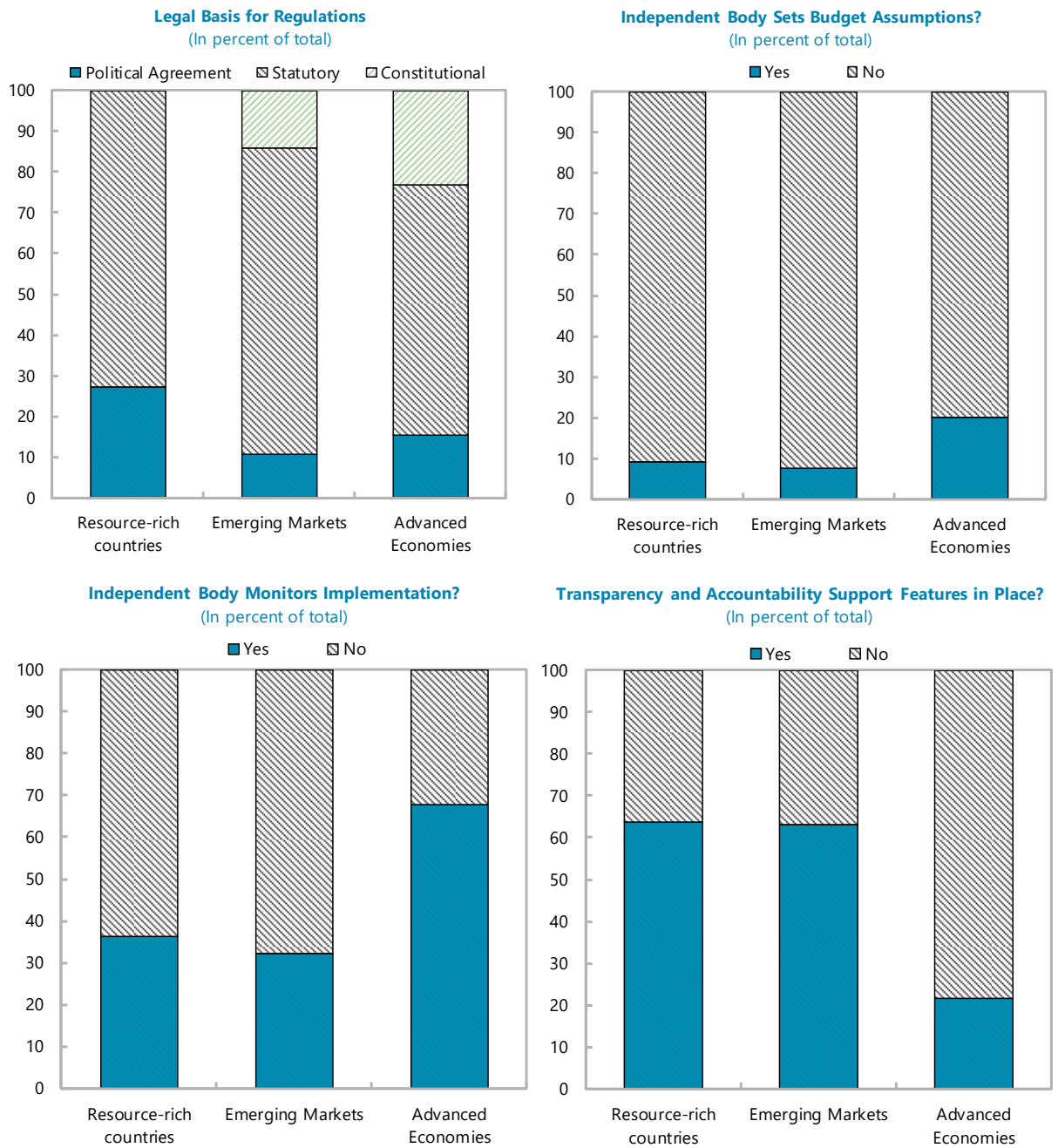
Figure 2. Selected Resource-Rich Countries: Fiscal Rules, 2000–15 1/



Sources: IMF Fiscal Rules Dataset, 2015; Budina and others (2012); and IMF staff calculations.

1/ Resource-rich countries: Botswana, Cameroon, Canada, Chad, Chile, Colombia, Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Liberia, Namibia, Niger, Nigeria, Norway, Peru, and Russia.

Figure 2. Selected Resource-Rich Countries: Fiscal Rules, 2000–15 (concluded) 1/



Sources: IMF Fiscal Rules Dataset, 2015; Budina and others (2012); and IMF staff calculations.

1/ Resource-rich countries: Botswana, Cameroon, Canada, Chad, Chile, Colombia, Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Liberia, Namibia, Niger, Nigeria, Norway, Peru, and Russia.

21. The performance of fiscal rules in resource-rich countries has been mixed owing to design flaws and weak institutional arrangements. Designing and implementing fiscal rules for such countries is challenging for two reasons; the technical difficulties of designing a rule that can withstand large and unpredictable swings in resource prices, and the political difficulties associated with resisting spending pressures during booms. There are a few examples of rules that have been successfully implemented (Botswana, Chile, and Norway); for instance, the presence of the fiscal rule in Chile has reduced the procyclical fiscal bias, increased the credibility of fiscal policy and contributed to a 20 percentage point of GDP reduction in net public debt before the global financial crisis (IMF 2015). In many oil-resource countries rules have been subject to frequent modification and suspension during both down and upswings in resource prices, although rules are more likely to be breached in bad times.

22. International experience highlights a number of lessons for the successful implementation of rules in resource-rich countries:

- *Political commitment*, as exemplified by the Chilean and Norwegian cases.
- *Supporting institutions*. Robust budget planning and monitoring, adequate PFM capacity and fiscal transparency are examples of institutional frameworks that support rules. Moreover, the creation of institutions such as fiscal responsibility laws and fiscal councils have been instrumental in enforcing and enhancing the credibility of fiscal accounts and mitigated the complexities inherent to certain rules (for example in Chile the fiscal council provides estimates of the structural balance) (IMF, 2015). By contrast, Mongolia's fiscal rule was undermined by off-budget spending, while excessive revenue earmarking was an adverse factor in Ecuador's case.
- *Design matters* for rule's effectiveness (see next section), such as incorporating sufficient flexibility and appropriate escape clauses to deal with various shocks. In Norway, temporary deviations from the effect of the automatic non-oil stabilizers are permitted over the nonoil economic cycle, while Chile's structural balance rule provides room for countercyclical policy.⁷
- *Timing matters* for commitment to the rule and successful implementation, as it is preferable to introduce rules in stable conditions. Evidence has shown that rules have helped countries preserve fiscal consolidation gains when conditions changed and are more credible and successful if introduced following a period of adjustment. Mexico and Spain, for example, adopted fiscal rules toward the end of large fiscal consolidations, using this to lock in the achievements (IMF, 2009). By contrast, Argentina's attempt in 1999 to introduce fiscal rules in the context of extreme economic volatility was ineffective, with the rules later reversed.

⁷ The rule combines a commitment at the end of the mandate with flexibility in terms of adjusting the path of spending to both the end-of-mandate target and the position in the business and commodity cycles.

Selecting Fiscal Rules: The Case for an Expenditure Rule for Iraq

23. Effective fiscal rules generally have a number of desirable features. Rules are selected mainly based on their effectiveness in achieving stabilization and/or fiscal sustainability. The choice also depends on a number of operational aspects:

- *Simplicity*; the rule should be easily understood by decision makers and the public, and it should be possible to translate the implications of the rule into clear operational guidance in the annual budget process.
- *Controllability*; budget aggregates targeted by the rule should be largely under the control of the policymaker.
- *Resilience*; a rule should be in place for a sustained period to build credibility, and should not be easily abandoned after a temporary shock.
- *Ease of monitoring and enforcement*; it should be easy to verify compliance, and policy makers should be held accountable for deviations from the rule.
- *Flexibility*; the rule should be flexible enough that it can be modified in case of permanent economic shocks. Some instruments such as debt brakes and escape clauses can provide adequate flexibility, but they should be introduced with pre-established rules to trigger them, and to the extent possible, understandings about how best to distinguish temporary from permanent shocks.

24. Each type of fiscal rule varies in relation to these properties and the choice should reflect Iraq's circumstances (see Text Table). No single rule is likely to fulfil all the above criteria simultaneously. For example, rules based on specifying ceilings for the overall balance and debt encourage debt sustainability, but at the cost of incentivizing procyclicality. Rule design could also entail trade-offs between these features. For example, increasing flexibility by including more escape clauses to allow the rule threshold to adjust in specific circumstances could come at the expense of simplicity. Using multiple rules is a global trend that emerged after the financial crisis, as countries sought to address shortcomings and trade-offs involved in single rules (what is referred to as second generation rules). It has a drawback, however, of increasing the complexity of the framework and potential inconsistencies and overlap between the rules (see Eyraud and others, 2018) for further discussion).

Assessment of Fiscal Rules	
Overall Balance Rules	Debt Rules
+ Closely linked to debt sustainability	+ Directly linked to debt sustainability
+ Easy to communicate/monitor	+ Easy to communicate/ monitor
+ Clear operational guidance	– Do not provide operational guidance
– Not under the direct control of policy makers	– Not under the direct control of policy makers
– Can lead to procyclicality	– Can lead to procyclicality
– Could adversely affect quality of adjustment	– Could adversely affect quality of adjustment
Golden Rules (Current Balance)	Structural/Price Smoothing Rules
+ Protect public investment	+ Foster economic stabilization
+ Intergenerational equity	+ Help achieve long-term sustainability
– Weak link to debt sustainability	– Difficult to compute and monitor
– Creative Accounting	
Expenditure Rules	Non-Resource Primary Balance Rules
+ Easy to communicate, monitor, and control	+ Easy to monitor and control
+ Reduce volatility/allow countercyclical fiscal policy	+ Could encourage non-resource revenue generation
+ Encourage PFM reforms	– Difficult to communicate: balance always in deficit
+ Can Improve expenditure composition	– Narrow coverage and weaker link to financing needs and debt
+ Clear operational guidance	
– Narrow coverage and weaker link to financing needs and debt	
– May reduce incentive to raise revenue	

25. For Iraq, the following should be taken into account in rule selection:

- Solvency is not currently the main concern, notwithstanding Iraq’s limited debt carrying capacity, while volatility is a major policy challenge given the high dependency on oil revenue. The latter also makes controllability of the targeted aggregate and flexibility in the design of the rule to allow it to withstand large shocks, key considerations. More importance should, therefore, be assigned to rules that promote stability such as structural balance or rules based on price smoothing, and rules that are under the direct control of the government such as expenditure rules and non-oil balance rules. The incorporation and use of escape clauses should be carefully examined to ensure robustness of the rule.
- The composition of adjustment should feature highly in rule selection and design. Rules on the overall, non-oil, and structural balances, public debt, or total expenditure are silent on the composition of the fiscal adjustment needed to comply with the rule. This is a crucial issue in Iraq given the recent pattern where capital expenditure has borne the brunt of adjustment and, looking forward, the need to create space for large development spending in the coming years.

- Capacity limitations call for simplicity in the selection of the rule. The technical and institutional capabilities to adopt more complex rules such as structural, cyclically adjusted rules or rules based on oil price smoothing are lacking in Iraq's context. Fiscal reporting systems are also not in line with international standards, and many key indicators such as the structural and non-resource balances are not publicly used or included in fiscal policy analysis.

26. Based on the above, expenditure rules have a number of features that are particularly appropriate for Iraq. First, they have been shown to be more effective in reducing expenditure volatility (IMF, 2015), which is a policy priority in Iraq. Expenditure is the part of the budget causing procyclicality of fiscal policy (driven by the close link to oil price), and fiscal consolidation episodes in Iraq have historically been expenditure-based.⁸ Unlike deficit caps, expenditure rules also help create buffers in good times, when revenue windfalls can make spending pressures difficult to resist (Ayuso-i-Casals, 2012). As such, expenditure rules promote stabilization more directly than, for example, structural balance or price smoothing rules, which mitigate but do not fully remove volatility. At the same time, expenditure is the budget component that the government controls most directly, which helps increase the compliance rate with the rule, as shown by empirical studies (Cordes and others, 2015). For Iraq this is a clear advantage over rules targeting both sides of the budget given that revenue movements are almost entirely due to factors outside the government's control, in particular externally driven changes in oil revenue.

27. Expenditure rules could support efforts to improve the quality of spending and encourage public financial management reform. If well designed, expenditure rules can be instrumental in improving the composition of government expenditure in Iraq and shifting resources away from outlays such as the wage bill to social and productive spending. This can be achieved by excluding certain items from the ceiling, or by breaking down the overall spending ceiling into separate thresholds for each of the main expenditure areas, which in turn provides clear policy guidelines and priorities for policymakers. Moreover, multi-year expenditure ceilings are by definition a top-down approach to budgeting and as such form the basis for well-designed medium-term budgetary frameworks. When translated into procedural spending rules, they can also foster strong spending commitment and control practices by spending units. In this regard, there is strong empirical evidence that expenditure rules have fostered complementary public financial management reforms and strengthened budget procedures, such as the adoption of top-down budgeting, and their introduction has often been accompanied by a strengthening of medium-term fiscal frameworks (Ayuso-i-Casals, 2012 and IMF, 2015).

28. While a rule on the non-resource balance (NRB) shares similar features, for Iraq it would add little value compared with an expenditure rule. A NRB rule includes the non-oil component of revenue, thus has a broader coverage than an expenditure rule. Targeting the non-resource balance would help reduce volatility and facilitate an explicit link to long-term sustainability and intergenerational equity. A rule on the NRB is generally recommended for countries with shorter reserve horizons where issues of exhaustibility should figure more prominently (IMF, 2012). Moreover, non-oil revenue in Iraq is limited (3 percent of GDP in 2018), and

⁸ Similar to evidence in other countries including in the GCC (IMF 2017).

thus expenditure is the dominant factor in non-oil balance movements. An expenditure rule would therefore play a similar role to the non-oil balance, but with the added advantages of simplicity and ease of monitoring. Expenditure rules are also more directly linked to absorptive capacity (IMF, 2015), which would support macroeconomic management (e.g., avoiding overheating and large current account deficits) and reduce spending inefficiencies. As the share of non-oil revenue becomes more important in the future and intergenerational equity becomes a policy priority, Iraq could consider moving to a non-oil revenue rule anchored on long-term benchmarks.

29. Expenditure rules have some potential shortcomings that can be addressed in their design and by combining them with other rules. As they cover only one side of the budget, other rules are required to ensure that the overall balance is consistent with macroeconomic stabilization and sustainability. Empirical evidence has shown that combining expenditure rules with other rules is associated with higher primary balances and lower primary spending (IMF, 2015). For example, an expenditure rule combined with a debt rule, a common combination in emerging market economies, would assist policymakers with short to medium-term operational decisions and provide a link to debt sustainability. A number of resource-rich countries have combined expenditure rules with structural balance rules (for example Colombia, Peru, and Mongolia).

Design and Implementation Issues

30. The coverage of the expenditure rule should be determined based on policy priorities. This involves layers of the government and the expenditure categories to be included in the expenditure ceiling. In most countries—and especially in resource-rich countries (Figure 2)—the coverage of the rule is limited to central government for operational feasibility reasons. Many countries also exclude certain expenditure items such as interest payments, cyclically-sensitive expenditure, capital expenditure, and security-related spending. For instance, in the EU countries, expenditure rules coverage ranges between 20 to 80 percent of general government expenditure (Ayuso-i-Casals, 2012). More comprehensive coverage is better from a fiscal sustainability viewpoint, but other considerations such as improving the composition of spending to promote long-term growth or the difficulty of controlling some outlays may argue for excluding certain items.

31. In Iraq's case, setting the ceiling on current primary spending at the central government level would support efforts to scale up and protect public investment. Excluding capital expenditure from the rule would help allocate adequate resource to rebuild the country after the war and close infrastructure gaps. It would also prevent the buildup of fiscal risks during oil price booms—by controlling the growth of current spending, which is difficult to reverse during shocks. In this regard, more than a third of the resource-rich countries with expenditure rules protect public investment by excluding it from the rule, while some of these countries include capital expenditure but establish limits for capital expenditure growth that are higher than those for current spending (Figure 2). To be effective, a current expenditure rule should be supported by measures to strengthen public expenditure management to ensure efficiency of capital spending and prevent creative accounting (reclassification of spending items) to circumvent the rule. Iraq can expand the rule coverage in the future to general government as capacity to monitor and control other public

spending improves, and to include capital expenditure once the country's capital stock has been built.

32. A multi-year horizon for the expenditure rule seems preferable to a one-year target, and would support efforts to move to a medium-term fiscal framework. A longer horizon supports the management of public expenditure by allowing prioritization, taking into account the future impact of current spending policies over the next years, and setting targets consistent with the expected macroeconomic outlook and sustainability issues. A multi-year horizon would also limit the potential circumvention of the rule by postponing the recording of expenditures or the implementation of structural adjustments. Longer planning, however, may be associated with lower compliance when macroeconomic conditions change, which are frequent in the context of Iraq's high exposure to large swings in oil prices. Regardless of the time horizon, targets should be adopted before the outset of the annual budget process to ensure that the spending rule guides the preparation and execution of the budget.

33. Setting the rule's target as a ceiling on expenditure *in nominal terms* would be easier to implement and more effective in controlling expenditure in Iraq. Targets for expenditure rules could be a ceiling either on (i) nominal expenditure (in levels or growth terms); (ii) growth of expenditure in real terms; or (iii) expenditure as share of GDP (or non-resource GDP in resource rich countries). The latter may be preferred over a longer planning horizon, or if the goal were to control the overall size of the public sector, but it is difficult to control and is associated with lower compliance rates than ceilings on nominal expenditure or expenditure growth (Cordes and others, 2015). For Iraq, oil price-driven fluctuations in nominal GDP would destabilize expenditure if the rule is expressed in relation to GDP, which would result in procyclicality. It could also increase expenditure during oil price booms to unsustainable levels. Therefore, from a stabilization point of view and other considerations including transparency and simplicity, targets expressed in nominal terms would be preferred to those expressed in relation to GDP or non-oil GDP.

34. Developing procedures to adjust the expenditure target to structural changes in non-oil revenue would be useful for Iraq.⁹ It would create incentives to diversify revenues, and thus reduce vulnerability to oil prices. The additional expenditure would not increase fiscal risks or a deterioration in the non-oil primary balance, making the expenditure rule more closely linked to long-term fiscal sustainability. In this regard, adjustment to the rule should be symmetrical and apply only to permanent increases/decreases in non-oil revenue.

35. The rule should have a clear institutional mechanism to deal with large oil price shocks and correct past deviations from the numerical target. Large oil price drops could result in excessive headline deficits and a sharp rise in public debt. While in the case of a rule on current spending, capital expenditure can be adjusted to absorb the shock, the rule should identify the size of the overall deficit that would trigger adjustment to the current expenditure ceiling. On correcting past deviations, this is important to increase compliance and can be achieved by including in the

⁹ Linking the expenditure targets to revenue changes is practiced in a number of countries. For example, under the expenditure benchmark rule in the EU, public spending is not allowed to increase faster than medium-term potential GDP growth, unless it is matched by adequate revenues.

rule a mechanism that defines under which circumstances past deviations should be corrected and establishes over what period this should be carried out, with an explicit enforcement procedure. This correction mechanism can be applied at the aggregate level or at the spending unit level.

36. The rule could initially be formalized through a cabinet decree, but ultimately needs to be supported by legislation. Most fiscal rules are backed by legal provisions, especially in emerging countries where rules are more commonly supported by fiscal responsibility laws and transparency and accountability features than in advanced countries (Figure 2). However, rules can also be established through political commitments and coalition agreements: in advanced economies, expenditure rules tend to be more closely integrated into Medium-Term Expenditure Frameworks, which are sometimes part of coalition agreements (IMF, 2015). For Iraq, the rule can be introduced as a policy guideline for the medium-term budget framework and later, after building capacity and a successful implementation in a learning period, can be supported by a law.

Calibrating the Rule

This section presents an exercise of how the rule can be put into practice in Iraq. The calibration is carried out in three steps, starting from identifying and calibrating the rule's anchor—in order to quantify the fiscal objectives—to deriving the operational rule (the ceiling on current expenditure).

Step 1. Identifying and Calibrating the Rule's Anchor

37. The first step in calibrating the rule is to define and specify a numerical target to anchor the medium-term framework, which in Iraq's case is best done through a risk-based approach (IMF 2012, 2018).¹⁰ Specifically, given oil revenue volatility and uncertainty, this approach entails building fiscal buffers to mitigate the impact of oil price shocks on spending. Most resource-rich countries have established funds for this purpose and specified rules for accumulation and withdrawals from these funds (Box 2). Several methods exist to calculate the level of financial saving that countries should maintain as a precautionary buffer that can be tapped to support spending when resource revenues fall short.

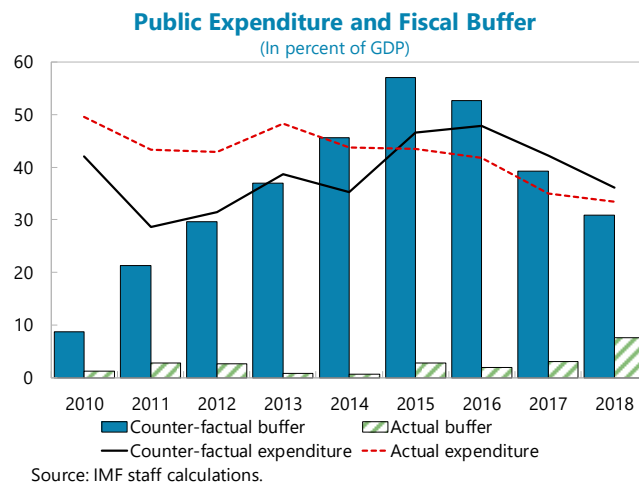
- For Iraq, maintaining a buffer that covers part of the revenue loss from a potential permanent shock to oil prices could be an appropriate benchmark to help calibrate the expenditure rule. The shock can be estimated based on one standard deviation (SD) of the forecast errors as a proxy for volatility. The potential revenue loss is the sum of the differences between oil revenue under the central forecast of oil prices (R_b) and oil revenue at one SD below the central forecast

¹⁰ Ceilings on gross debt, expressed in percent of GDP, is another common long-term anchor for fiscal policy; in 2015, about 70 countries had an explicit cap on public debt. In resource-rich countries, the concept of net debt or net wealth is more appropriate than gross debt, as some of these countries have large financial savings in addition to substantial underground assets. A standard anchor for these countries is to maintain net wealth to achieve intergenerational equity based on permanent income hypothesis (PIH) benchmarks, which entails sustaining a smoothed level of consumption out of the oil wealth across generations. Versions of this rule were modified for low income countries to allow frontloading of spending to support development. For countries with a long resource horizon like Iraq, however, fiscal policy may be better anchored in a medium-term framework that focuses on delinking expenditure from oil revenue changes, which would help address pro-cyclicality and sustainability issues (IMF, 2015).

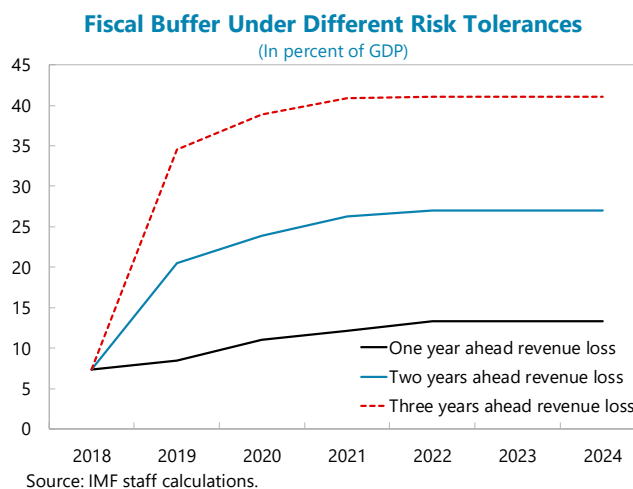
(Rs). The government’s decision as to how large a buffer it builds to cover such a potential loss depends on its risk tolerance, captured by (δ) in the following equation:

$$FB_t^* = FB_{t-1} + \delta \sum_{t+1}^N (Rb - Rs) \tag{1}$$

- To illustrate how this rule of thumb would have anchored fiscal policy in the past, a simulation for 2010–18 is applied based on maintaining a buffer equivalent to the one year ahead revenue loss resulting from an oil price shock. It shows that the government could have built a buffer of over \$104 billion (45 percent of GDP) by 2014, which would have been sufficient to cover the entirety of the oil price shock in 2015–16 and still remained large by 2018. It would also have supported a more countercyclical fiscal policy compared with actual policy in the 2010–14 upturn as well as the downturn in 2015–17.¹¹



- Looking ahead, applying the same methodology to WEO oil price projections, a negative oil price shock equivalent to one standard deviation, implies an annual revenue loss of about 28 percent of Iraq oil export proceeds in one year ahead. The loss is much higher in the longer term reaching 40 percent by 2024 as forecast uncertainties rise. The buffer target could be set at a level equivalent to the potential revenue loss in one year ahead (about 12 percent of GDP on average over 2019–24).¹²



- Modifying/changing the anchor in the future.* In the transition period, the adequacy of the buffer to absorb a larger shock can be increased if (i) oil prices increased above current projections and/or (ii) capital expenditures are underexecuted. If, on the other hand, the oil price shock materializes and turns to be persistent, the government would use this buffer to protect

¹¹ Government expenditure at year t was reduced by the same amount of the buffer build up. The buffer was used in 2015–17 to maintain the level of expenditure in 2014. The simulation is based on a 1 standard deviation shock-equivalent buffer.

¹² This size of the buffer is in line with the methodology used for calculating reserves adequacy metric for oil exporting countries that augments the standard metric with a buffer based on the gap between current oil prices and futures prices one year ahead one standard deviation below the central futures forecast.

expenditure under the rule. Once Iraq has accumulated large buffers, beyond precautionary levels, the rule's anchor can be revisited.

Step 2. From the Buffer Target to the Overall Fiscal Balance Path

38. The second step is to derive the budget balance consistent with the buffer target identified above (of 12 percent of GDP), taking into account below-the-line financing items.

The initial transition period, in which the level of buffer gradually converges to its target, should be determined based on a feasible fiscal adjustment path. The overall balances over this period should lead to a gradual buildup of the buffer and their sum should result in reaching the target by a specific date. In the steady state, the fiscal balance should remain at a level consistent with the buffer target every year. Financing below the line will affect the level of the implied overall balance (OB), derived according to the following accounting identity:

$$OB^* = \Delta \text{ Fiscal Buffer} + \Delta \text{ financing} \quad (2)$$

39. **The build-up of the buffer should not be achieved through excessive or overly expensive borrowing that would put gross debt on an unsustainable path.** When feasible, the buffer should be accumulated from actual budget surpluses. However, as part of an asset-liability management, the government may decide to borrow to build the fiscal buffer for a number of reasons.¹³ Provided that the fiscal positions is not changed, the net debt (debt-buffer) will not be affected, and decline as share of GDP. Excessive recourse to borrowing to accumulate assets could, however, increase gross debt and financing needs to unsustainable levels. Importantly, without controlling for debt, the buffer target would no longer provide a meaningful anchor for the rule and for the adjustment in the fiscal balance. To avoid the risk of circumventing the rule, the medium-term fiscal framework should be formulated with a view to ensuring that debt remains within sustainable levels. The frameworks could explicitly set, within the overall debt limit, restrictions on specific financing items, for example borrowing from the central bank or to allow certain external borrowing such as project financing.

Starting from an initial path for the overall balance (OB^i) that is consistent with debt sustainability, the targeted overall balance OB^* required to increase the buffer from its initial level (FB_0) to a targeted level (FB^*), can be derived as follows (lower case indicates percent of GDP):

$$ob^* = (ob^i) + (fb^* - \eta fb_0) \quad (3)$$

where $\eta = \frac{1}{1+g}$ and g is invariant nominal GDP growth.

The second term of Equation 3 is the additional adjustment in the overall balance to achieve the targeted buffer.

¹³ The government may decide to maintain a certain level of readily available funds as a self-insurance mechanism against oil price shocks or tightening financing conditions. Other factors that may prompt the government to borrow to build assets include the initial debt level, relative cost of borrowing versus return on buffer, and other policy objective such as developing domestic financial markets.

40. Convergence to the buffer target could be gradual over the medium term in view of the current outlook. The pace of fiscal adjustment needed to reach the target depends on a number of factors including the distance to the target (from the projected level of 6.7 of GDP in 2019 to the targeted 12 percent of GDP) and macroeconomic projections, especially the projected path for oil prices. Should oil revenue surprise on the upside, convergence can be accelerated. Below is an illustration of different speeds to reaching the buffer target and the corresponding overall balance in each case. Equation 3 can be modified to allow different time horizon for the convergence to the buffer target as follows:

$$ob^* = ob^i + \frac{\lambda}{(1+\lambda)^n - 1} [fb^* - (1+\lambda)^n fb_0] \quad (4)$$

$$\text{where } \lambda = \frac{-g}{1+g}$$

Assumptions:

Nominal GDP growth and public debt levels over the medium terms are derived from a proposed adjustment scenario in the accompanying staff report—a debt to GDP ratio of 49.9 percent on average over 2020–24 and nominal GDP growth is 7 percent annually on average. After 2024 the long-term GDP growth is assumed to be 6 percent, and debt to remain at its level in 2024 (49.2 percent of GDP).

1. *Achieving the target over the medium term:* to achieve the target gradually over five years (by 2024), the overall balance should not exceed -1 percent of GDP during the convergence period (derived as -2.6 percent of GDP as the initial level consistent with the debt path and 1.6 percent of GDP additional adjustment to build the buffer) (Figure 3).
2. *Converging over a longer time horizon to allow scaling up of capital expenditure (recommended).* The authorities may wish to build the buffer more gradually over the medium term and accelerate it once a desired level of capital spending has been reached (see Step 3). If the time horizon is set at 10 years, the overall balance over the medium term, 2020–24 can be relaxed to -2 percent of GDP, and tightened thereafter to -1.3 percent of GDP over 2025–29 to ensure the buffer targeted is achieved by the end of that period (Figure 3). On current oil price projections, this would strike a reasonable balance between mitigating risks and creating space to scale up capital expenditure in the coming years.

Step 3. From the Overall Fiscal Balance to the Expenditure Ceiling

41. The final step is to calibrate the operational rule for expenditure growth. Projections of the revenue side is needed in this step. Current macroeconomic projections over the medium term (see accompanying staff report) are used. Beyond 2024, oil revenue (r^{oil}) is projected to grow by 3 percent (1 percent increase in oil exports and 2 percent increase in oil prices). Non-oil revenue (r^{non}) grows in line with nominal non-oil GDP growth, which is 8 percent. Using the overall balance level identified in Step 1 and these revenue projections, the expenditure level (e^*) consistent with the rule can be calculated as a residual:

$$E^* = (r^{oil} + r^{non}) - ob^* \quad (5)$$

- Creating space for capital expenditure.** From the overall expenditure envelope, a ceiling on current expenditure (ce^*) can be set to ensure adequate space for capital expenditure ($capex^*$), which would be a target in the rule, $ce = e^* - capex^*$. Determining how much and how fast public investment can be scaled up would be challenging given data limitations. One approach is to use benchmarks: for instance, the level of investment and capital stock shows that Iraq's capital stock is well below those in comparators (125 percent of GDP versus 175 in the GCC region). These estimates (available in the IMF expenditure assessment tool database) follow a uniform approach of accumulating public investments and do not reflect the destruction to infrastructure caused by wars and violence in Iraq over the past decades. More sophisticated general equilibrium models are proposed as an alternative option (IMF, 2012), but they are also very sensitive to parameter calibration.
- Taking into account capacity limitation.** Gradually scaling up investment would give the authorities time to improve absorptive capacity and public investment efficiency and build fiscal buffers to prevent a disruption to investment if there is a negative oil shock (IMF, 2012). Iraq can safely increase the level of non-oil capital expenditure from about 1.4 percent of GDP in 2018 to about 5 percent over the medium term (so total capital expenditure including oil, which is linked to oil production targets, would increase from about 5.3 percent in 2018 to 9 percent of GDP in 2024). This would help Iraq cover about half of damage caused by latest war with ISIS (estimated by the Work Bank at \$88 billion). The nonoil capital expenditure should be a target under the rule but can be adjusted upward once the buffer target is reached, taking into account capacity of implementation. At the same time, the rule should specify that unexecuted capital spending should be saved in the buffer.
- Choosing the time horizon.** The authorities should determine the timetable to achieve the rule's objectives and, based on that, set a fixed annual ceiling on current spending. As an illustration, to achieve the buffer target of 12 percent of GDP over the medium term and increase capital spending to 4.8 percent by 2024 and remains constant afterwards, the annual growth in current expenditure should not exceed 1.8 percent. A more gradual approach which staff suggests at current oil price projections is to achieve the buffer target over a 10-year horizon, which would allow a higher annual growth in current spending of 2.5 percent (Figure 3).¹⁴

42. Adjusting the ceiling upward in case of structural increase in non-oil revenue.

Adjustment should take place on an ex-post basis to avoid using overly optimistic revenue projections to relax the rule. One option is to adjust the ceiling by one year lagged change in the moving average of the ratio of non-oil revenue to non-oil GDP (R^{non}).

¹⁴ This ceiling—on the growth of overall current spending—is equivalent to the ceiling of 2 percent growth proposed in the accompanying staff report, which is set on primary current spending excluding one-off compensation payments to Kuwait.

$$ce = (e^* - capex^*) + \Delta_{t-1}R^{non} \tag{6}$$

This would give more flexibility in the rule without risking long-term sustainability and would not affect the buffer target and its coverage to oil price risks.



Box 2. Fiscal Buffers

Saving a share of oil resources for precautionary reasons would help Iraq manage oil revenue volatility.

Building fiscal buffers during good times that can be tapped when oil revenues fall short is a self-insurance mechanism that would help smooth expenditures and promote countercyclical policy. Most resource-rich countries have established some sort of fund for this purpose,¹ ranging from separate institutions with discretion and autonomy, to funds that amount to a little more than a government account. Empirical evidence has shown that such funds can help achieve policy objectives if they are well designed, supported by strong institutions, closely linked to broader policy objectives, and backed by a strong political commitment (IMF, 2015).

Many resource-rich countries have set pre-announced thresholds, above (below) which funds are built up (drawn down).

For example, in Mexico, oil revenues in excess of 4.6 percent of GDP are saved in the reserve fund, which can be drawn upon when oil revenues fall below this benchmark. In Russia, when current oil prices are above the benchmark long-term oil price, the resulting savings are deposited in the reserve fund until it reaches 7 percent of GDP; when current oil prices are below the benchmark price, the reserve fund can be tapped. Other resource-rich countries, however, have accumulated buffers without establishing specific rules, relying on discretionary transfers, and net flows into the stabilization fund are a residual of the overall fiscal balance and financing mix decided by the government.

The appropriate size of the fiscal buffer depends on country circumstances. In general, at a certain degree of risk tolerance, precautionary buffers should be larger the more dependent the country is on resource revenues (i.e., the less diversified is the revenue base), and the larger and more persistent is the volatility of resource revenue. Credit-constrained countries need larger buffers to provide more self-insurance against shocks. The optimal size also depends on the strength of the government's balance sheet, the structure of expenditure, and the costs and speed of adjustment in the event of shocks. For Iraq, these considerations point to the need for sizable buffers, although this should be weighed against the country's pressing development needs, which would make maintaining very large buffers difficult to justify and achieve.

Iraq does not have formal arrangements to save from oil revenues, but in the past has built buffers during windfalls.

These buffers were insufficient to withstand large oil price shocks (Iraq saved only 8 percent of oil revenue on average annually during 2004–18) and they were quickly exhausted. During 2011–14, when oil prices exceeded \$100 on average, a very small share—less than 4 percent of oil revenues—was saved. The government has often used conservative oil prices in annual budgets to guard against oil price declines, but intra-year spending increases through supplementary budgets and off-budget spending has also prevented the buildup of buffers.

Iraq could move gradually towards maintaining a stabilization buffer on a risk-based approach. A pragmatic approach is for the government to target a certain level for the fiscal buffer over the medium term. Including in the budget documents alternative macro-fiscal scenarios showing the implications of changes in key macroeconomic assumptions such as different oil price and production scenarios, could be a basis for determining the size of the precautionary buffers and the space that needs to be created in the budget to achieve the targeted buffer. The existing balances of the government at the central bank would act as a "virtual" stabilization fund. As assets build up to significant levels, the government would then need to establish rules for transparency and management of these assets. At this stage, a formal stabilization fund with fixed rules may prove difficult to design and operate in Iraq.

Several methods have been advanced in the literature to calculate the level of net financial wealth on a risk basis.

For instance, IMF (2012) proposes a few options including use of a value-at-risk (VaR) approach or a model-based approach to estimate the minimum buffer that can absorb tail risks in resource revenue volatility, and proposes that the buffer should be large enough that—with a high probability—it is not fully depleted over the forecast horizon and, therefore, expenditure cuts can be avoided. Another approach developed in IMF (2015) calibrates the level of financial savings to ensure that investment returns on financial assets are sufficient to avoid a large fiscal adjustment in the event that commodity prices fall. To illustrate, IMF (2015) computes, for three major oil exporters, the level of financial assets that would generate sufficient investment returns to cover half the lost revenue over five years with 75–90 percent probability.

¹/ Countries that have or have had resource fund are Algeria, Azerbaijan, Bahrain, Brunei, Chad, Ecuador, Gabon, Equatorial Guinea, Iran, Kazakhstan, Kuwait, Libya, Mexico, Norway, Oman, Qatar, Russia, Sudan, Timor-Leste, Trinidad and Tobago, and Venezuela. The State of Alaska and the Province of Alberta also have funds, and Alberta also has a fiscal rule.

E. Conclusions

43. A strong policy framework can help Iraq manage the challenges arising from its heavy dependence on volatile oil revenues. The procyclicality of fiscal policy has led to short-term economic volatility and hindered long term development. Important fiscal institutions such as fiscal rules, stabilization funds, and fiscal responsibility laws that exist in many resource-rich countries are lacking in Iraq. The authorities need to move away from formulating fiscal policy in the context of the annual budget to multi-year fiscal planning, underpinned by robust budget processes and PFM systems. This will help Iraq delink expenditure from oil revenue, scale up and protect capital expenditure to support reconstruction, and safeguard long-term fiscal sustainability.

44. Moving to a risk- and rules-based approach can be part of the new policy framework and would be timely. The two main building blocks of this approach involve anchoring fiscal policy on maintaining adequate fiscal buffers, and introducing operational fiscal rules designed to achieve this target for buffers and protect capital expenditure. A well-designed and communicated fiscal rule can help manage public expectations and resist spending pressures as oil price recover from the sharp decline in 2014–16. Fiscal rules would also help lock-in the consolidation achieved during that period.

45. The choice and design of a fiscal rule is guided by a set of desirable features which should be assessed against Iraq’s specific circumstances including policy priorities and capacity limitations. A rule on current expenditure of the central government is proposed for Iraq on the basis of its simplicity, operational guidance, ease of monitoring and control, and the support it would provide to protecting public investment. Allowing adjustment of the rule ceiling to durable increases in non-oil revenue would help encourage revenue diversification.

46. Calibration of the rule shows that Iraq should set a ceiling consistent with current expenditure growth of between 1.8–2.5 percent annually over the medium term (the upper limit is consistent with the 2 percent growth in primary current spending—excluding one-off factors—recommended in the attached staff report). This would strike a reasonable balance between mitigating risks and creating space to scale up capital expenditure in the coming years. Controlling current expenditure in this range would allow Iraq to cover about half of post-ISIS reconstruction spending over the medium term and would enable the authorities to gradually build fiscal buffers equivalent to 12 percent of GDP, sufficient to withstand one year revenue loss from a permanent oil price shock.

Annex I. Fiscal Rules in Selected Resource-Rich Countries

	Description of the Rules
Country Name	Key Elements of Fiscal Rules
Botswana	Botswana has one binding debt limit and two fiscal targets that were embedded in past National Development Plans: (i) a debt limit introduced by the Stock, Bonds, and Treasury Bills Act of 2005 that caps total domestic and foreign debt each to 20 percent of GDP; (ii) spending limits on total government spending; and (iii) a balanced budget rule (in cash terms) over the NDP planning period. The expenditure limits include a 40 percent of GDP government spending cap introduced in 2006 (NDP9), and a target reduction of government spending to 30 percent of GDP by the end of FY2015/16 (NDP10). The 40 percent limit has not been breached except during the 2008 financial crisis. Excluding the debt ceilings, these rules are budget targets rather than institutionalized binding constraints.
Cameroon	<u>Supranational rules:</u> Central African Economic and Monetary Community (CEMAC). <u>BBR (since 2002):</u> The basic fiscal balance, defined as total revenue net of grants minus total expenditure net of foreign-financed capital spending, should be in balance or surplus. <u>BBR (since 2008):</u> In 2008 the CEMAC Commission introduced two supplementary criteria: (i) the basic structural fiscal balance in percent of nominal GDP should be in balance or surplus—this concept is derived from the main criterion by replacing actual oil revenue with its three-year moving average; and (ii) the non-oil basic fiscal balance in percent of non-oil GDP should be in balance or in surplus. <u>DR:</u> The stock of external plus domestic public debt should be kept below 70 percent of GDP.
Canada	From 1991–96, the Federal Spending Control Act limited all program spending except self-financing programs. Overspending in one year was permitted if offset in following two years. Compliance with the Act was assessed by Auditor General. <u>BBR, DR, ER (1998–2005):</u> In 1998, the debt repayment plan set out a “balanced budget or better” policy which, however, was not a legislated rule at the federal level. A Contingency Reserve and an economic prudence factor are built into the federal budget and may be devoted to debt reduction if not needed. In 2006, the government abandoned the “balanced budget or better” rule with targets of CAD 3 billion debt reduction, coupled with eliminating net general government debt by 2021 and federal debt by 2013/14 (later changed to 2011/12).

	Description of the Rules
Country Name	Key Elements of Fiscal Rules
Chile	<p><u>BBR (since 2001)</u>: Structural balance with an independent body providing key inputs. Under the structural balance rule, government expenditures are budgeted ex ante in line with structural revenues, i.e., revenues that would be achieved if: (i) the economy were operating at full potential; and (ii) the prices of copper and molybdenum were at their long-term levels. The implementation of the rule has changed somewhat since 2009. From 2001–07 a constant target for the structural balance (surplus of 1 percent of GDP) was defined; in 2008 a new constant target was specified (surplus of 0.5 percent of GDP). In 2009, while the target was a structural balance, a de facto escape clause was used to accommodate countercyclical measures. The 2010–14 administration has specified a target path (to converge to a 1 percent of GDP structural deficit by 2014). An independent committee of experts was called on (May 2010) to propose recommendations to improve the fiscal rule; based on this, the government published in October 2011 a second generation structural balance rule. Starting from the 2015 budget, the government no longer adjusts revenues based on long-term prices of molybdenum. A fiscal council started operating in June 2013. The council will oversee two existing independent committees—on potential GDP and long-run copper price—and ensures such parameters are correctly used in the computation of the structural balance. The council will also advise the Minister of Finance on issues regarding the structural balance rule including regarding methodological changes. The council, whose views will be made public but not binding, will help enhance the rigor and transparency of the rule.</p>
Colombia	<p><u>BBR (since 2011)</u>: structural balance rule for CG (approved by Congress in 2011), sets a path for fiscal consolidation that lowers the structural deficit for the CG to 2.3 percent of GDP in 2014 and sets a ceiling for the deficit of 1 percent effective in 2022. The rule also allows for fiscal expansion when the expected output growth rate is at least 2 p.p. lower than the long-term growth rate (allowing for countercyclical fiscal policy in cases of emergencies and/or large macro shocks); and creates a sovereign wealth fund (SWF) to save windfall revenue from natural resources. Annual targets are framed by a medium-term fiscal framework. An independent advisory commission was also established to help operationalize the structural balance rule and assess its implementation. There is an escape clause specified in art. 11: “In case of extraordinary events threatening the macroeconomic stability of the country, enforcement of the fiscal rule may be temporarily suspended, subject to the favorable opinion of CONFIS” (an internal fiscal council headed by the Finance Minister). <u>ER (since 2000)</u>: on current expenditure growth on CG.</p>

	Description of the Rules
Country Name	Key Elements of Fiscal Rules
Ecuador	<u>ER (from 2010)</u> : The rule states that permanent expenditure cannot be higher than permanent revenue, though neither is clearly defined. Exceptionally, non-permanent revenue may be used to pay for permanent spending if the government deems it necessary. This rule is on a statutory basis and not enforced and not monitored outside the government. It was adopted in 2010 and applied to the 2011 and 2012 budgets. <u>DR (from 2010)</u> : The rule limits non-financial public sector debt to 40 percent of GDP, and Article 125 limits decentralized entities debt to 200 percent of their annual revenue and their debt service to 25 percent of their annual revenue. <u>BBR (2003–09)</u> : Annual reduction in the non-oil deficit until a balanced budget is achieved. <u>DR (2003–09)</u> : Reduction to 40 percent of GDP. The rule applies only ex ante. It does not bind outcomes and does not apply for supplements during the course of the year. The reforms introduced by the 2002 Fiscal Responsibility, Stabilization and Transparency Law set fiscal deficit limits, i.e., annual growth of primary central government expenditure must not exceed 3.5 percent in real terms (excluding capital spending), the fiscal deficit as a percentage of GDP (excluding oil export revenue) must decrease by 0.2 percent each year, and non-financial public debt must not exceed 40 percent of GDP. The FRL and above rules were superseded by a new 2010 FRL.
Equatorial Guinea	<u>Supranational rules</u> : Central African Economic and Monetary Community (CEMAC). <u>BBR (since 2002)</u> : The basic fiscal balance, defined as total revenue net of grants minus total expenditure net of foreign-financed capital spending, should be in balance or surplus. <u>BBR (since 2008)</u> : In 2008 the CEMAC Commission introduced two supplementary criteria: (i) the basic structural fiscal balance in percent of nominal GDP should be in balance or surplus—this concept is derived from the main criterion by replacing actual oil revenue with its three-year moving average; and (ii) the non-oil basic fiscal balance in percent of non-oil GDP should be in balance or in surplus. <u>DR</u> : The stock of external plus domestic public debt should be kept below 70 percent of GDP.
Gabon	<u>Supranational rules</u> : Central African Economic and Monetary Community (CEMAC). <u>BBR (since 2002)</u> : The basic fiscal balance, defined as total revenue net of grants minus total expenditure net of foreign-financed capital spending, should be in balance or surplus. <u>BBR (since 2008)</u> : In 2008 the CEMAC Commission introduced two supplementary criteria: (i) the basic structural fiscal balance in percent of nominal GDP should be in balance or surplus—this concept is derived from the main criterion by replacing actual oil revenue with its three-year moving average; and (ii) the non-oil basic fiscal balance in percent of non-oil GDP should be in balance or in surplus. <u>DR</u> : The stock of external plus domestic public debt should be kept below 70 percent of GDP.
Indonesia	<u>DR (since 2004)</u> : Total central and local government debt should not exceed 60 percent of GDP. <u>BBR (since 1967)</u> : The consolidated national and local government budget deficit is limited to 3 percent of GDP in any given year. These rules are set out in the State Finance Law and Government Regulation 23/2003.
Liberia	<u>DR since 2009</u> : Ceiling of 60 percent of GDP on nominal public debt.

	Description of the Rules
Country Name	Key Elements of Fiscal Rules
Mongolia	<u>ER (2013)</u> : Under the Fiscal Stability Law (FSL), which was enacted in 2010, expenditure growth cannot exceed the growth of non-mineral GDP from 2013. <u>BBR (2013)</u> : Under the FSL, the structural deficit cannot exceed 2 percent of GDP from 2013. The structural balance is defined as the difference between structural revenues and overall expenditures, and structural revenues are defined as revenues that would be received if the prices of major minerals were at a particular level, defined as a 16-year moving average of mineral prices. <u>DR (2014)</u> : Public debt in NPV terms cannot exceed 40 percent of GDP from 2014. The government in February 2015 amended the FSL and enacted a new Debt Management Law: (i) structural fiscal deficit limits are temporarily raised (5 percent of GDP in 2015, 4 percent of GDP in 2016, and 3 percent of GDP in 2017) but kept at 2 percent of GDP for 2018 and beyond; (ii) non-commercial DBM (Development Bank of Mongolia) spending is brought onto the budget and thus included in the calculation of the structural fiscal deficit; (iii) debt limits are temporarily raised (58.3 percent in 2015, 55 percent in 2016 and 50 percent in 2017) but remain at 40 percent for 2018 and beyond; and (iv) the definition of debt is narrowed from public to general government debt (with the new definition, SOE debt and government guarantees that are fully secured by government securities are excluded).
Namibia	<u>ER (since 2010)</u> : Public expenditure levels below 30 percent of GDP. <u>DR (since 2001)</u> : Public debt-to-GDP ratio of 25 to 30 percent annually.
Niger	<u>Supranational rules (from 2000)</u> : The rules refer to the fiscal convergence criteria of the West African Economic and Monetary Union (WAEMU). Initial first-order convergence criteria included a balanced budget rule (excluding budget grants and foreign-financed capital expenditures, including HIPC/MDRI financed expenditures) and a 70 percent of GDP ceiling on public debt. These were complemented with less binding convergence targets, called 2nd tier, which included a 20 percent floor on revenues. In January 2015 changes to the WAEMU convergence criteria were enacted. The first order convergence criteria on balanced budgets now specifies that the overall fiscal deficit (including grants) should remain below 3 percent of GDP. The nominal debt-to-GDP ratio was kept at 70 percent of GDP.
Nigeria	<u>BBR (since 2007)</u> : Annual overall deficit ceiling of 3 percent of GDP.
Norway	<u>BBR (since 2001)</u> : Non-oil structural deficit of the central government should reflect the expected return of the Government Pension Fund Global (GPF), which is estimated to be 4 percent, in the long run. The fiscal guidelines allow deviations from the rule over the business cycle to both directions.

	Description of the Rules
Country Name	Key Elements of Fiscal Rules
Peru	<p><u>BBR (2000, 2013)</u>: Deficit ceiling for the non-financial public sector. The ceiling was set at 2.0 percent of GDP for 2000 and 2003, 1.5 percent of GDP for 2001, 2002 and from 2004–08. The application of rule was suspended in 2001 and 2002. In 2009 and 2010, the application of the deficit rule was suspended owing to the implementation of the fiscal stimulus plan and a new limit of 2 percent was set. In 2013, it was specified that the NFPS balance could not show a deficit. Law 30099, adopted in October 2013, eliminates the budget balance rule replacing it by ex-ante guidelines for the structural balance of the non-financial public sector. Under the new law, every government must enact a macro-fiscal policy statement within 90 days of assuming office which details the guidelines for the structural balance of the NFPS for the whole presidential period. The structural deficit cannot exceed 1 percent of GDP. <u>ER (2000, 2012, 2013)</u>: Ceiling on the real growth in current expenditure set at 2 percent (2000–02), 3 percent (2003–08) and 4 percent since 2009. The application of any of the fiscal rules may be suspended for up to three years when (a) real GDP is declining, with the ceiling on the deficit being raised up to 2.5 percent of GDP, with a minimum annual reduction of 0.5 percent of GDP until the 1 percent deficit ceiling is reached; and (b) in other emergencies declared by the Congress at the request of the Executive. The Executive must specify in its request the ceilings to be applied during the period of exception for the deficit and expenditure rules, with the minimum annual reduction of 0.5 percent of GDP on the deficit applying also in this case. In 2012, expenditure on maintenance of infrastructure, expenditure on goods and services of social programs covered by the Performance-Based Budgeting scheme and equipment intended for Public Order and Security were excluded from current expenditure. Also, the rise in the average annual CPI for Metropolitan Lima rather than the BCRP target was used to calculate real growth of current expenditure. Subsequently, in 2013, the application of the expenditure rule was waived. Law 30099 established that the non-financial expenditures of national government cannot exceed the limit consistent with the guidelines of the structural balance set by the macro-fiscal policy statement. <u>DR (2013)</u>: Debt ceiling of NFPS is 30 percent of GDP. For subnational governments (SNGs), debt/ (average of last four years revenue) <100 percent.</p>
Russia	<p><u>National rules: ER (effective from 2013)</u>: Parliament adopted in mid-December 2012 a new oil-price based fiscal rule. The rule sets a ceiling on expenditures (oil revenue at the “base” oil price, plus all nonoil revenues, plus a net borrowing limit of 1 percent of GDP). Oil revenues above the “base” oil price need to be saved in the Reserve Fund until it reaches 7 percent of GDP (though there are some allowable exceptions to this under the law). Once the Reserve Fund reaches this threshold, at least half of excess oil revenues should go to the National Wealth Fund, while the remaining resources would be channeled to the budget to finance infrastructure and other priority projects. Starting in 2013, the rule will use a five-year backward-looking average of oil prices as the base, which will gradually increase to a ten-year average by 2018, to avoid abruptly moving to a very low base oil price. <u>BBR (2007–09)</u>: The BBR was approved in 2007 and became effective in 2008. Under the BBR, Russia's legal fiscal framework relied on the non-oil balance as a key fiscal indicator. The budget included a long-term non-oil deficit target of 4.7 percent of GDP. This was suspended in April 2009 as a result of the global financial crisis, and formally abolished in 2012.</p>
Sources: IMF, Fiscal Rules Dataset (2016) and Budina and others (2012), "Fiscal Rules at a Glance: Country Details from a New Dataset" (http://www.imf.org/external/pubs/cat/longres.aspx?sk=40101.0)	

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FINANCIAL DEVELOPMENT AND FINANCIAL INCLUSION¹

Financial development coupled with financial inclusion of households and small- and medium-sized enterprises (SMEs) can play an important role in Iraq by channeling funds to profitable projects, helping diversify the economy, promoting a vibrant private sector and creating jobs. A number of mainly structural factors have held back financial development and inclusion so far, and Iraq lags regional benchmarks. Drawing on the economic literature and experience of other developing countries, this paper provides recommendations that would help the Iraqi authorities reap the benefits of financial inclusion.

A. Context

1. As in many other developing countries, financial development and inclusion can offer Iraq considerable benefits.² It can relax the credit constraints facing SMEs and households, enabling them to flourish and create jobs, and helping them to smooth consumption and investment when shocks occur. It can also support financial stability by helping banks diversify funding sources and the composition of their portfolios, subject to adequate supervision.

2. The authorities have therefore identified these issues as policy priorities. The Central Bank of Iraq has taken a number of initiatives to promote financial inclusion,³ while also seeking to upgrade prudential regulations and strengthen supervision (including AML-CFT measures). Efforts are also underway to improve financial sector architecture, including the development of a deposit insurance scheme and technological solutions to encourage direct salary payments.

3. However, the country is starting from a low base, and further reforms would help the authorities derive the full benefits while maintaining financial stability. Firms in Iraq have identified access to finance as a major impediment to their growth,⁴ a reflection of the underdevelopment of the financial sector, which is dominated by public banks with private commercial banks currently playing an insignificant intermediation role.

4. This paper highlights a wide range of reforms that can help the financial system to fulfill its full potential. Plans are underway to restructure the two largest public banks, develop a deposit insurance scheme, strengthen payment systems and encourage salary payments directly into bank accounts and these efforts should be accelerated. Bank regulation and supervision should

¹ Prepared by Salim Dehmej and Amgad Hegazy, with research analysis by Alexander de Keyserling.

² Financial development refers to the development of financial intermediation, institutions, markets and instruments. Financial inclusion covers access to and use of formal financial services by households and firms (Sahay and others, 2015), and can be assessed through indicators covering (i) access to financial services such as payment, savings, credit and insurance; (ii) usage by clients; and (iii) their quality (i.e., the extent to which they match client needs).

³ Central Bank of Iraq "Financial Stability Report 2017."

⁴ The World Bank Enterprise Survey found that less than 3 percent of firms rely on banks to finance investment projects.

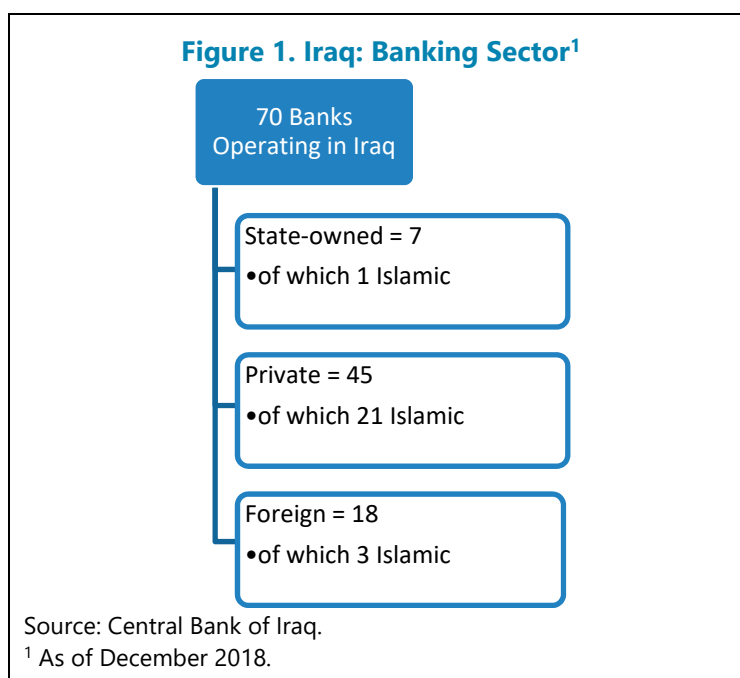
be strengthened and refocused on the two largest public banks. Also, improving credit information and strengthening legal procedures should encourage banks to relax collateral requirements and facilitate access to credit. Fintech can help banks improve their risk management and help channel additional financial resources. Building on the relatively large coverage of wireless mobile in Iraq, financial inclusion could be improved substantially by developing mobile banking.

5. The remainder of this paper is organized as follows: Section B presents stylized facts on financial development in Iraq as well as the financial inclusion of households and SMEs. Section C highlights the main impediments to financial inclusion and development, while Section D presents the benefits and macroeconomic gains in terms of growth and employment from removing these impediments. Finally, Section E concludes with policy recommendations to promote financial inclusion while maintaining stability.

B. Financial Development and Inclusion: Stylized Facts

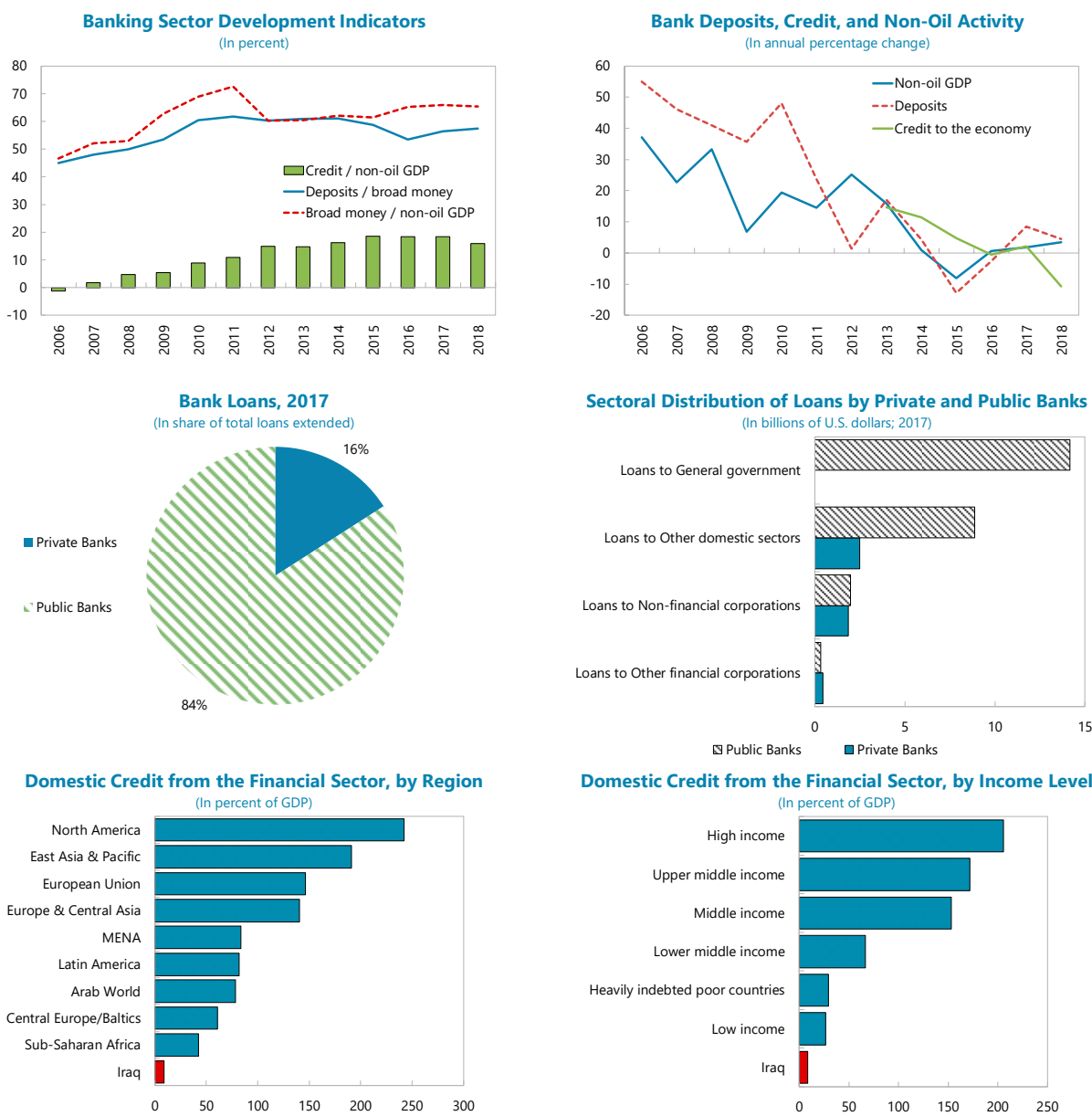
Financial Development

6. Iraq's financial sector is small, underdeveloped, and dominated by public banks. The private banking sector comprises 63 generally small banks that together account for a modest share of assets, and play a minor role in financial intermediation (Figure 1).⁵ This reflects the dominant role of the larger public banks, which continue to account for the lion's share of banking system assets, lending and deposits (Figure 2).



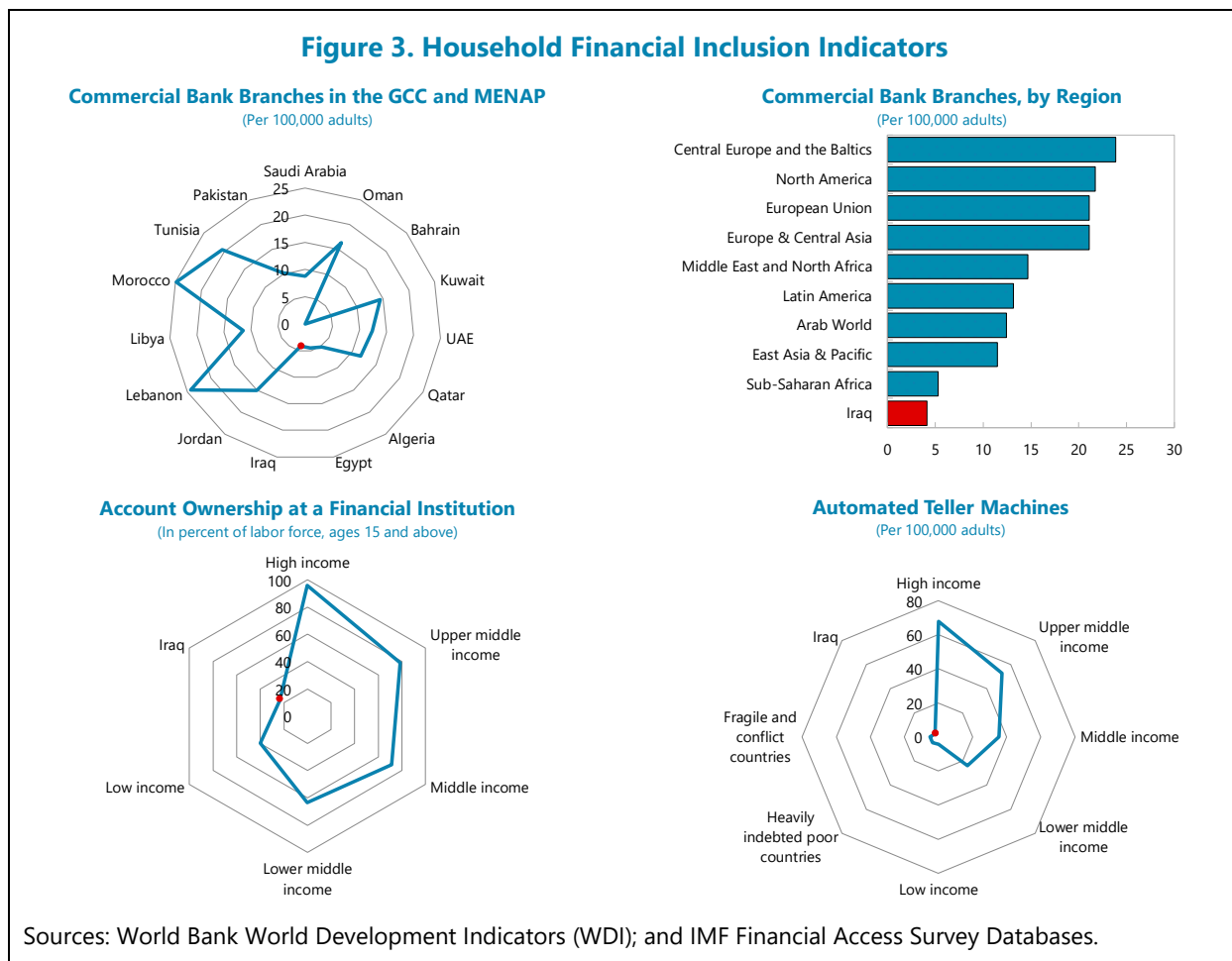
⁵ Until recently, private banks derived considerable profits by purchasing FX from the Central Bank, and reselling to the private sector at a sizable spread, and they largely abstained from traditional lending operations. As FX spreads have narrowed over the past year, the profitability of such transactions has fallen sharply.

Figure 2. Iraq: Selected Banking Sector Indicators, 2006–18



Sources: Iraqi authorities; and Global Financial Inclusion (Global FINDEX) Database.

7. Public banks are fragile after years of on-lending to the government. The two largest public banks—Rafidain and Rasheed—have lent directly to the government and undertaken numerous quasi-fiscal operations, while also still carrying legacy assets from the Saddam Hussein era. This has undermined their liquidity, solvency and profitability, and increased risks to financial stability (Figure 3). Repeated efforts to cleanse the balance sheets of Rafidain and Rasheed have yet to be successfully concluded, and restructuring efforts have been delayed, partly due to the lack of accurate data about their financial position.



8. Financial depth is shallow in Iraq. Private sector credit is only 9 percent of GDP, by far the lowest in the MENAP region (Figure 2), and Iraq scores “zero” on the depth of credit information index.⁶ In 2011, almost half of firms identified access to finance as a major constraint on their operations.⁷ The loan-to-deposit ratio in Iraq—measured as banks’ credit to deposits—is the second lowest among MENAP countries (at 40 percent), and around half the level in the GCC.

Financial Inclusion of Households

9. Access to financial services in Iraq is underdeveloped (Figure 3):

- **Account ownership.** Only a quarter of adults have opened accounts at a financial institution, the lowest ratio in the region.⁸ According to surveys, this is largely because branches are too far away and financial services are seen as too expensive, but respondents also said they had

⁶ According to the World Bank World Development Indicators.

⁷ Global Financial Development Database, World Bank.

⁸ The aggregate figures also mask gender disparity since the ratio is only 20 percent for females against 26 percent for males (World Bank FINDEX Database).

insufficient funds to open an account or did not trust financial institutions. A further factor is the underdevelopment of mobile/e-banking that would allow access to all services, including online payment and transfers from phones.

- **Branch network.** There are only four branches in Iraq per 100,000 adults, which is well below the MENAP average (around 12 branches).⁹
- There are also only three **automated teller machines (ATM)** per 100,000 adults, much lower than the MENAP average (32 machines per 100,000) and especially the GCC (50 machines per 100,000).

10. A range of indicators highlight the low utilization of financial services:

- Only 6 percent of **adults with an account** at a financial institution said they had made an ATM withdrawal within a 12-month period, far below the regional average.
- Likewise, fewer than 30 percent of Iraqis received any **deposits** into their account in the previous 12 months, half the MENAP average.¹⁰
- On the credit side, very few Iraqis (less than 3 percent) have **borrowed** from a financial institution in the previous 12 months.¹¹
- **The usage of credit and debit cards** as a means of payment is much lower than in other countries in the region; only 2 percent of adults possess a credit card,¹² a reflection of the dominant role of cash in Iraq.
- Moreover, the share of adults using **digital technology to make payments** (e.g., through mobile money, mobile phones or the internet to pay bills, make purchases or transfers) remains lower in Iraq than peer countries, despite some increase over time.
- Another indicator of the usage of financial services—the share of employees whose wages were paid into **an account at a financial institution**—remains low at 15 percent.

Financial Inclusion of Small- and Medium-Sized Enterprises (SMEs)

11. **SMEs are underdeveloped in Iraq.** Even though they contribute almost 90 percent to private sector employment in Iraq, the micro, small and medium size enterprise (MSMEs) density—

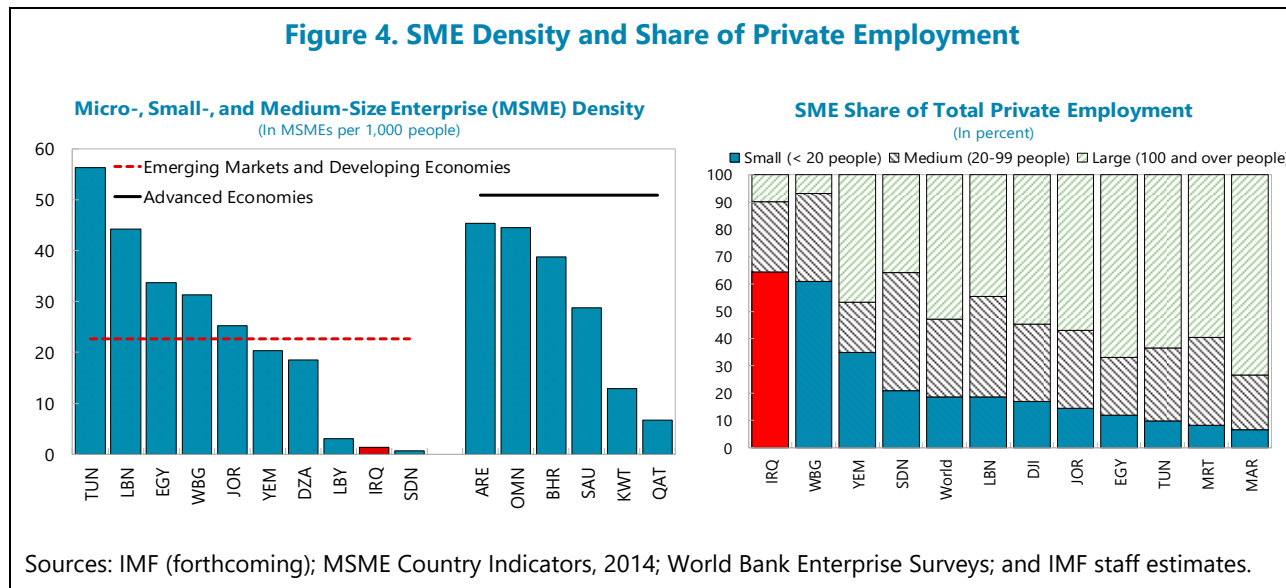
⁹ Branch network and ATM figures are obtained through the IMF Financial Access Survey Database.

¹⁰ Deposits measured under this indicator include cash, electronic deposits or other money transfers.

¹¹ The highest ratio in the region was in Iran, where 24 percent of adults had borrowed from a bank or other financial institution.

¹² Credit card ownership is much higher in the most advanced financial markets in the region, such as 45 percent in UAE.

measured by the number of MSMEs per 1,000 people—is substantially lower than both the MENA region and emerging and developing countries (Figure 4).



12. Iraqi firms, especially SMEs, suffer from lack of access to finance. This is a regional phenomenon: lending to SMEs accounts for only 9 percent of bank loans in 2017, both in Iraq and on average in MENAP countries, one of the lowest ratios in the world (IMF, 2019), and a third of firms in MENAP identify access to credit as a major constraint.¹³ In Iraq, only 2.7 percent of firms have financed investment projects through banks loans compared with an average of 23.7 percent in MENA (excluding high income countries).¹⁴ Lending standards are stringent, with banks generally demanding collateral of more than 150 percent of the loan value.¹⁵ This explains why Iraq’s weakest score in the World Bank Doing Business report (2019) relates to “getting credit,”¹⁶ and also helps explain why Iraq lags behind the MENA average in business environment rankings.

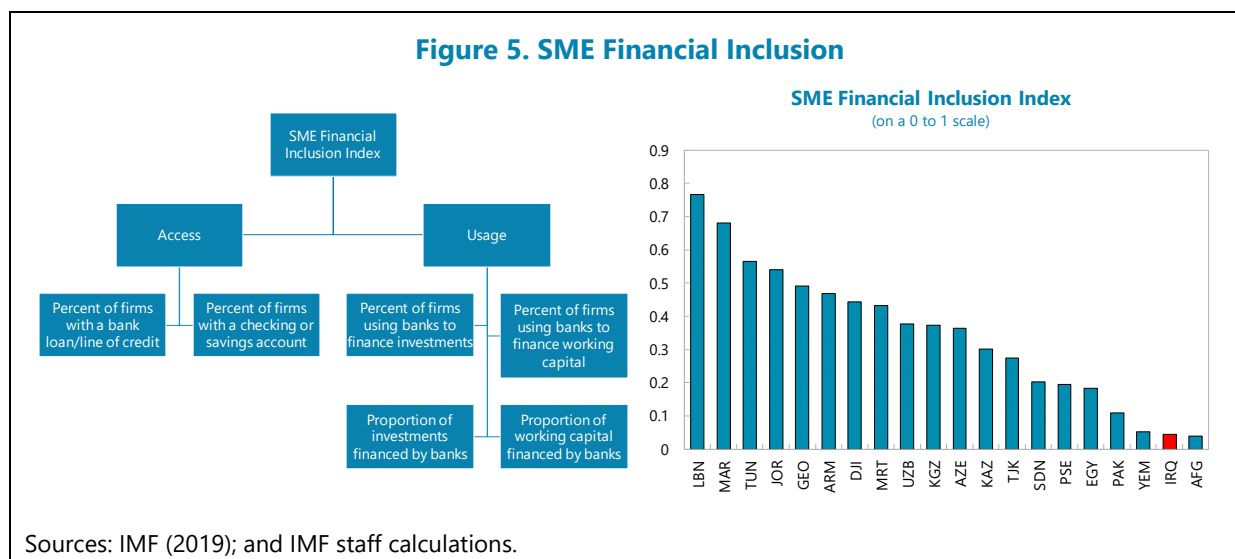
13. A composite index of SME financial inclusion illustrates the key trends. It captures both SMEs’ access to financial services (loans, saving or checking accounts) as well as their usage (IMF, 2019). It is calculated using principal component analysis and firm-level data from the World Bank Enterprise Surveys. In line with the indicators discussed above, Iraq has the second lowest score for SME financial inclusion in the MENAP and CCA region after Afghanistan (Figure 5).

¹³ This compares with a global average of 26 percent, according to the World Bank Enterprise Survey.

¹⁴ According to the World Bank’s Enterprise Survey, the ratio was 2.7 percent in 2011, which is the latest available data. The ratio for other countries is much higher: 14.6 percent in Egypt (2016), 34.8 percent in Morocco (2013), 46.8 percent in Jordan (2013), and 53.1 percent in Lebanon (2013). The average for this ratio is 23.7 percent for MENA (excluding high income countries). Even for low income countries the ratio is higher (16.9 percent). This is also consistent with the low level of households borrowing from financial institutions, estimated at 3 percent in 2017 (FINDEX Database).

¹⁵ Latest data available (2011), according to the World Bank’s Global Financial Development Database.

¹⁶ Iraq’s score for getting credit is zero, while the regional average is 36 (on a scale from 0 to 100).



C. Obstacles to Financial Development and Inclusion in Iraq

14. The scale and frequency of conflicts, most recently with ISIS in 2014–17, is a major factor behind the lack of financial development. Conflicts have undermined the business environment and confidence in the economy, weakened the infrastructure, and negatively affected bank asset quality either directly—e.g., through misappropriated assets—or indirectly because clients’ financial difficulties led to a worsening of bank soundness.

15. A wide range of interrelated factors further explain the underdevelopment of the financial sector, which can be divided into structural and financial sector factors. While demand factors play a role, it is hard to disentangle them from supply factors. Moreover, while some of these factors highlight the lack of resources available for lending to the private sector, others suggest that banks are reluctant to lend, especially for riskier projects.

Structural Factors

- **The structure of the economy.** The government accounts for a large share of economic activity, and mainly re-distributes oil wealth rather than providing an enabling environment for private enterprise. The size of the government (including SOEs) has impaired private sector development, especially SMEs, through crowding out as well as preferential financial terms exacerbated by the dominant role of public banks.
- **Oil price shocks.** A decline in oil prices may weaken the financial system and depress government revenues, forcing cuts in public investment which depress growth. This normally leads to the government withdrawing deposits at commercial banks and accumulating arrears, impacting suppliers that have borrowed from banks (IMF, 2016).

- **Weak legal and institutional frameworks** related to property rights, the protection of shareholder rights, contract enforcement, insolvency regimes, governance and corruption undermine the business climate. These factors make it difficult for banks to undertake proper risk management, and complicate asset recovery proceedings in the event of insolvency/default.
- **Informational asymmetries** discourage banks from lending to SMEs and households given the perceived risks arising from the private sector's informality, poor financial reporting standards and lack of credit history (credit registries/bureau). Lending to SMEs tends to be at higher risk premia and high collateral requirements, which would crowd out safer projects/investors. Banks complain that there is a lack of viable projects.
- **High collateral requirements** represent a serious hurdle to SMEs financing, especially when compounded by the lack of acceptable collateral. Whereas banks typically seek fixed assets as collateral, such as land and real estate, private firms mainly possess movable assets such as equipment and inventories (Love, Martinez Peria, and Singh, 2016); banks use also checks as collateral since they are easier and faster to enforce.

Financial Sector Factors

- **Weak financial architecture.** A number of factors may undermine confidence in the financial system, including undercapitalization of several banks, poor corporate governance of the banks, the lack of independence of the public banks, deviations of certain prudential practices from international standards (e.g., classification of NPLs and provisioning), the lack of comprehensive published audits, and lack of an operational deposit insurance scheme may undermine confidence in the financial system depressing deposit collection and lending capacity.
- **Imperfect risk management systems,** which are not completely digitized, inhibit effective screening and monitoring of borrowers and increase operational costs.
- **Bank competition is subpar.** This is explained by the dominance of public banks, despite the large number of private banks. Indeed, Rafidain and Rasheed together hold about 71 percent of banks' deposits (86 percent held in total by public banks) and extend 54 percent of credit (80 percent extended in total by public banks).
- **Large public banks suffer from erosion of the deposit base.** Iraq has the lowest deposits-to-GDP ratio in the region (at 23 percent for 2016).¹⁷ The same applies to the size of financial system deposits-to-GDP in Iraq.¹⁸ This reflects a lack of confidence in the banking system, as well as the dominant role of cash in Iraq.

¹⁷ The ratio exceeds 100 percent in Jordan, Lebanon, and even in a number of oil exporters in the GCC.

¹⁸ 24 percent for Iraq, compared to a range of 90–100 percent for Jordan, Kuwait, Morocco, Qatar, and UAE.

Figure 6. Bank Performance in a Competitive Setting



Sources: Global Financial Development Database (World Bank); Bankscope; Financial Soundness Indicators (IMF); and International Financial Statistics (IMF).

- High non-performing loan (NPLs) ratio.** The official ratio—around 37 percent for private commercial banks—is three times above the MENAP average. Public banks show lower NPLs, around 13 percent, although this may understate the true picture, because a material share of loans are not being fully serviced, yet not shown as non-performing because of (uncalled) government guarantees.

- **High interest rate spread.**¹⁹ Iraq has the highest interest rate spread in the MENAP region, at about 7 percentage points, implying high funding costs for the private sector. This may reflect the inefficiency in banks (higher operating costs translating into higher lending rates to customers), lack of competition among banks (higher mark-ups), or simply elevated risk perceptions. In turn, higher interest spreads may exclude households and SMEs, and also be a factor behind elevated NPLs since only the riskiest projects seek bank funding.

D. Benefits for Iraq of Financial Development and Inclusion

16. Financial inclusion can promote growth and macroeconomic stability through several channels that are relevant in Iraq. This reflects the greater scope for financing new projects (boosting growth), smoothing consumption and investment (dampening growth volatility), reducing inequality between rich and poor households—by financing opportunities for poor households—on one hand, and large and small firms on the other, by releasing financing constraints. Access to formal lending improves monetary transmission and helps the monetary authorities ensure price stability (IMF, 2019).

17. Financial inclusion supports financial stability when accompanied by appropriate financial regulation, supervision and education/literacy. It can help economic agents manage financial risks and boosts banking intermediation while diversifying funding sources and portfolio allocation through additional financial resources (deposits and savings) and new projects to be financed.

18. The use of electronic/mobile payments and transfers rather than cash can provide sizable benefits for senders and recipients (e.g., receiving salaries and government transfers or paying utilities or transferring money). The benefits include lower uncertainty about financial transfers, broader reach (distance), lower transfer costs of social programs and/or cross-border remittances, lower corruption and crime, and higher transparency (Demirguc-Kunt, Klapper, and Singer, 2017). Moreover, it helps build payment and credit histories that can be leveraged to improve access to credit for borrowers, and enhances risk management for lenders (financial stability).

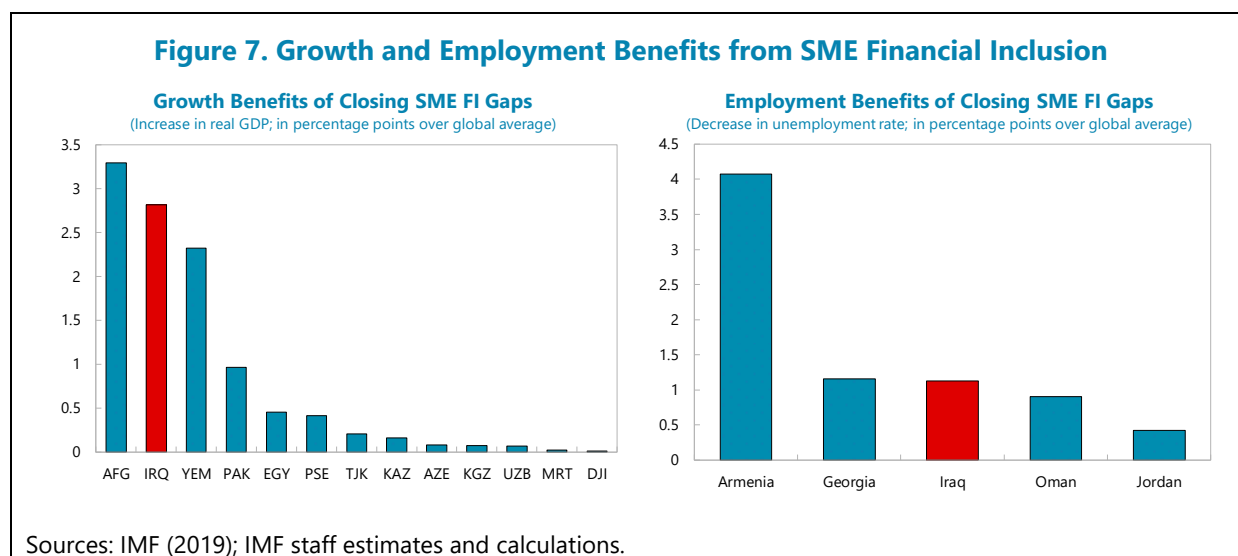
19. Access to saving products provides safety against theft and could facilitate cash management while providing remuneration (interest income). Households with bank accounts can use this as proof of their saving capacity and prudent financial management if at some later stage they want to take out a loan.

20. Nevertheless, the benefits of access to formal financial services (payments, savings, credit, and insurance) are product-specific. Whereas empirical studies show robust results for the benefits of improved payment solutions and saving vehicles, the results are generally less conclusive for credit, perhaps reflecting tradeoffs with financial stability.

¹⁹ Lending over deposit rates. The deposit rate for Iraq was higher than those in the GCC countries for which data was available during 2016–17.

21. Cross-country evidence demonstrates a strong positive relationship between SMEs' access to finance and employment growth. On average, firms which secure a loan see their employment growth rise by 1 to 3 percentage points relative to those that are financially constrained, and this link seems to be even stronger among SMEs than larger firms (Ayyagari and others, 2016). This is important given that SMEs represent almost half of the workforce in emerging and developing countries and that small firms are the largest contributors to employment growth (45 percent of new jobs) (Ayyagari and others, 2014).

22. Closing the SME financial inclusion gap would therefore enhance prospects for inclusive growth in Iraq. A recent study (IMF, 2019) finds significant gains in employment, labor productivity and economic growth if MENA countries close the SME financial inclusion gap with respect to EMDEs. In Iraq's case, it would translate into a 2.7 percent increase in GDP (above the MENAP and CCA levels, estimated at 1 percent), and a reduction in unemployment of more than 1 percentage point (Figure 7).



E. Policies to Strengthen Financial Development and Inclusion in Iraq

23. The Central Bank of Iraq (CBI) has launched a number of schemes to promote financial inclusion:

- To address the low level of bank lending, in 2015 the CBI launched an initiative to finance SME projects through banks specialized in agricultural, industrial and commercial activities.²⁰ Some 1,095 projects were financed during 2015–17 totaling ID 1 trillion (\$840 million), with individual loans ranging from ID 5 million to ID 50 million.²¹

²⁰ The initiative includes also financing large projects, with an amount of ID 5 trillion (around USD 4.2 billion).

²¹ CBI Financial Stability Report (2017). The total amounts given to banks until December 31, 2018 exceeded ID 73 billion dinars. CBI Statement, January 14, 2019 "initiative of one trillion dinars to finance small- and medium-sized enterprises."

- The CBI is also trying to modernize payment systems, promote electronic payments and encourage banks to open more branches across the country.
- A large share of public employees already receives their salaries via public banks through electronic cards (Qi cards), and an initiative to grant employees the choice of receiving salaries electronically via private banks is underway.

24. A package of further reforms would help advance this agenda. A financial inclusion strategy involving the main stakeholders (ministries, CBI, banking sector, private sector) and backed by international institutions would help the authorities accelerate progress. While most of the policy recommendations are general, some would have particular benefits for SMEs:

- At the macroeconomic level, **sound economic policies** reduce uncertainties, encourage investment (more demand for funding) and enable the government to limit its financing needs, thereby avoiding the crowding out of the private sector. There is also a critical need to diversify the economy, stimulate the private sector and encourage firms to join the formal sector.
- Promote **legal, judiciary and governance reforms** that reinforce property rights, shareholders' protection, contract enforcement, effective insolvency regimes, governance and combat corruption. This would help promote a business-friendly environment and lower uncertainty and the costs faced by banks.
- Strengthening the **financial and institutional architecture** is a high priority, with potential benefits beyond financial inclusion. This would involve establishing efficient credit information systems (credit registries and bureaus) that allow banks to reduce informational asymmetries and accurately assess borrowers' creditworthiness. Likewise, additional reforms can include improving auditing and accounting standards as well as corporate governance, and expanding the range of accepted collaterals (both fixed and movable).²² International experience shows that credit guarantee schemes, when well designed to avoid market distortions and contingent fiscal risks, can help alleviate financing constraints. These reforms should allow banks to better assess borrowers' credit risk, which would in turn reduce collateral requirements and borrowing costs.
- **Strengthening financial regulation and supervision—with an operational deposit insurance corporation**—are essential for Iraq to derive the benefits of financial inclusion without jeopardizing financial stability. The literature has established a tradeoff between financial development and macroeconomic stability beyond a certain threshold of financial deepening (Arcand, Berkes, and Panizza, 2015). Low financial development in Iraq suggests significant untapped potential for economic growth. The remit of supervision should be progressively extended beyond the banking sector to include microfinance and mobile payments, and the authorities should take steps to promote financial education/literacy and

²² Love, Martinez Peria, and Singh (2016) find that the introduction of collateral registries for movable assets can increase the likelihood of firms accessing bank financing by 10 percentage points, while reducing lending rates and increasing loan maturities.

develop institutions to protect consumers. Finally, ongoing efforts to establish a deposit insurance corporation would help level the playing field, increase the trust in the banks and offer private banks more space. However, this step should be accompanied by restructuring weak banks and strengthening banking regulation and supervision to avoid exposing the government to undue contingent liabilities.

- **Fintech** can help banks improve their risk management systems, enhance competition between banks and new operators and help channel additional financial resources to the financial system. Digital technologies could boost efficiency and offer customized services (including payments and transfers) that can be delivered instantly and are available 24/7. Fintech also has the potential to reduce operational costs by automating tasks such as accounts consolidation, compilation of key indicators and detection of irregularities.²³ In addition, fewer branches and human resources are needed when mobile/e-banking offers alternative access to financial services. Financial inclusion could be improved substantially in Iraq by developing mobile banking, building on the relatively large coverage of wireless mobile in Iraq (both geographically and from a user perspective).^{24,25} The experience of several developing countries in Sub-Saharan Africa (such as Kenya) and East Asia shows how mobile banking can pave the way for greater access to traditional banking. To harness mobile banking, additional reforms such as investments in infrastructure (electricity, telecom and internet availability nationwide) in human capital (IT skilled employees), attempts to lower the cost for users, and strengthened regulation and cybersecurity are needed (Lukonga, 2018).
- **A clear and comprehensive plan is needed to accelerate the long process of restructuring public banks.** As discussed in the staff report, the priority is to establish core banking systems, which are a pre-requisite for an international audit, accurate assessment of capital needs and eventual recapitalization.
- There is some **scope for consolidation in the private banking sector** to build healthier, stronger institutions that compete with public banks at the national level and exploit economies of scale.
- **Promoting banking competition, while insuring a level playing field between public and private banks** should foster innovation and diversification of financial products, including those customized to SMEs' needs. The process of localization of salaries—paying employees through banks' accounts instead of cash—should be accelerated to enlarge the deposit base and attract and familiarize new customers with banking services.

²³ See The Economist Intelligence Unit (2018).

²⁴ Mobile subscriber penetration in Iraq is between 50 and 60 percent (GSMA–Middle East & North Africa–The Mobile Economy 2018).

²⁵ Zain Cash was launched in Iraq in 2015 by Zain and Iraq Wallet, and licensed by the Central Bank of Iraq. Zain Cash allows customers to have a mobile money account linked to their SIM card or mobile application, through which they can make a range of financial transactions (money transfer, electronic bill payment, funds disbursement service).

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