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Iraq and the IMF

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IMF Executive Board Approves US$3.6 Billion Stand-By Arrangement for Iraq
February 24, 2010

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Iraq: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

February 8, 2010

LETTER OF INTENT

February 8, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

In the past few years, despite a very difficult security situation, Iraq's economic performance strengthened considerably owing to improved macroeconomic management and a favorable external environment that lasted until mid-2008. These improvements also reflected the assistance we received from the international community, including from external creditors and the International Monetary Fund (IMF). Growth accelerated, inflation was reduced to single digits, and fiscal and external sustainability improved substantially. Since 2004, we have successfully completed three economic programs supported by the IMF, with our last Stand-By Arrangement (SBA) ending in March 2009.

Already at the time of the last SBA review it became evident that the external environment was deteriorating rapidly due to the sharp drop in international oil prices and the onset of a slowdown in the global economy. As the proceeds from oil exports account for the bulk of Iraq's export receipts and government revenue, the decline in oil prices has posed considerable challenges to our internal and external stability. During 2009, we have been able to absorb much of the adverse impact of these external shocks by using the financial buffers we built up in recent years. However, unless oil prices increase markedly, we would be forced to constrain government spending in 2010 and 2011, at a time when our developmental and security-related needs remain high. A fiscal contraction would hurt the economy and undermine our hard-won macroeconomic stability, and could also contribute to a deterioration of the security situation.

To address these challenges, we have developed the attached economic program for 2010–2011. Our program aims to manage the effects on the Iraqi economy of the lower oil prices and the slowdown in global economic activity. The program focuses on keeping inflation low, increasing growth by boosting oil production, and ensuring fiscal sustainability. While our main focus is on macroeconomic policies, we are also accelerating the pace of structural reforms, especially to improve public financial management and develop the financial sector. To support our efforts, and based on the economic program and the specific targets set out in Tables 1 and 2 attached to this letter, we request a 2-year Stand-By Arrangement from the IMF in the amount of SDR 2,376.8 million (approximately $3.8 billion), equivalent to 200 percent of Iraq's quota, to help cover our balance of payments needs.

Given the large uncertainties and the high volatility of international oil prices, our projections and the government's budget for 2010 are conservatively based on an average price of $62.5 per barrel for Iraqi oil. In the event that our oil export revenues turn out to be higher than projected, we plan to save half of the additional revenues to rebuild our financial buffers, while using the other half to finance additional investment to improve the delivery of basic public services. Moreover, if by the time of the first or second program review futures markets indicate that we will be able to obtain, on average, an oil price equal to or higher than $73 per barrel for our exports in 2010, we intend to treat the SBA as precautionary, given that we would no longer expect to have a financing need, provided that our oil export volume (projected at 2.1 million barrels per day) is sustained (this issue will be examined in detail at the time of each program review discussion). Vice versa, should oil export receipts fall below our assumptions, we will reduce spending by half of the revenue shortfall and cover the remaining gap by further using our financial buffers and seeking additional external support, including from the IMF. If the revenue shortfall turns out to be sizable, or if the reserve position of the CBI weakens below program targets in between test dates, we will consult on the policy response with IMF staff.

In the same vein, we intend to treat the SBA as precautionary if it is expected that the 2010 investment budget will not be fully executed. Disbursements of capital spending in 2009 fell short of budgeted amounts, due in part to severe disruptions of administrative capacity as a result of the bombings of the Ministry of Finance in August and December. Investment remains a key priority, however, as underscored also by the Council of Representatives' provision of additional investment spending at the time of approval of the 2010 budget. The 2010 capital budget would imply a large increase over last year's estimated investment outturn. In order to ensure that the disruptions of administrative capacity do not lead to poor quality implementation, we are working hard to rebuild and expand capacity, including by restoring information systems and strengthening project approval processes. With these efforts, we will aim to execute the full envelope for the year. If capacity issues cannot be fully addressed, however, investment could again fall short of budgeted amounts. Therefore, at the time of the second review we will reach understandings with IMF staff on the expected rate of execution of the 2010 investment budget. If the rate of execution is expected to be less than 93 percent, we intend to treat the SBA also as precautionary.

We understand that the requested SBA will be subject to semi-annual reviews, semi-annual performance criteria, and structural benchmarks, as set out in the attached Tables 1 and 2, and described in more detail in the attached Technical Memorandum of Understanding (TMU). In this regard, we understand that the completion of the first review under the SBA—expected to take place on or after May 31, 2010—will require observance of the quantitative performance criteria for end-March 2010 specified in Table 1, and that completion of the second review—expected to take place on or after August 31, 2010—will require observance of the quantitative performance criteria for end-June 2010.

We believe that the policies set forth in our economic program are adequate to achieve our objectives but are prepared to take additional measures if necessary. We will consult with the IMF on the adoption of these measures and in advance of any revision to the policies contained in our economic program, in accordance with IMF policies on such consultation. The Iraqi government and the Central Bank of Iraq will continue to provide the IMF with the necessary information for assessing progress in implementing our program, as specified in the attached TMU, and will maintain a close policy dialogue with IMF staff. We authorize the IMF to publish the Letter of Intent and its attachments, as well as the related staff report, on the IMF's website following consideration of our request by the IMF's Executive Board.

Sincerely yours,

//s//	//s//
Mr. Baqir S. Jabr Al-Zubaydi Minister of Finance of Iraq	Dr. Sinan Al-Shabibi Governor Central Bank of Iraq

IRAQ: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2010–11

February 8, 2010

I. INTRODUCTION

1. Since 2004, Iraq has successfully completed three economic reform programs supported by the International Monetary Fund (IMF): one under the Emergency Post Conflict Assistance (EPCA) facility and two (precautionary) Stand-By Arrangements (SBA). During this period, we have made considerable progress under very difficult circumstances, including a very challenging security situation. We have successfully reduced inflation, showed fiscal discipline, and started rebuilding our economic institutions. These achievements have helped us to obtain generous debt relief from Paris Club and other creditors that has substantially improved our external position.

2. These hard-won gains of recent years could be undermined, however, by the large drop in oil prices from their peak levels of mid-2008. After reaching a high in July 2008, when Iraqi crude oil sold for $124 per barrel, prices fell to a low of $35 per barrel in January 2009, before slowly recovering to a level of around $68 per barrel in the second half of 2009. The average export price in 2009 was $57 per barrel, well below the average export price of $92 per barrel in 2008. In addition, due to dire infrastructural problems, the volume of oil exports in the early months of the year fell below 2008 levels (to 1.75 million barrels per day (mbpd) in the first five months). We have been working to address these problems and oil exports reached 2 mbpd towards the end of 2009, bringing the average for the year to 1.88 mbpd.

3. As the proceeds from oil exports account for the bulk of our total export receipts, and for the majority of government revenues, the lower oil prices are posing considerable challenges to our internal and external economic stability. To maintain macroeconomic stability, and foster growth and employment, we have adopted an economic adjustment program for 2010–11 for which we seek support from the IMF under a new 2-year SBA, as well as financial assistance from other international institutions and countries. This Memorandum of Economic and Financial Policies (MEFP) describes our economic objectives and policies, including the structural reforms, for this period.

II. RECENT ECONOMIC DEVELOPMENTS

4. Due to the temporary drop in oil production, real GDP growth is estimated to have slowed to 4 percent in 2009, from almost 10 percent in 2008. There are indications, however, that the improved security situation has supported economic activity in the non-oil sector. The Central Organization for Statistics and Information Technology (COSIT) estimates that

real non-oil GDP grew by about 5½ percent in 2008 and that the pace of non-oil growth remained broadly unchanged in 2009.

5. The Central Bank of Iraq (CBI) has been successful in keeping inflation under control, by managing the exchange rate and by keeping the policy interest rate positive in real terms. When inflationary pressures emerged in 2008, the CBI stepped up the rate of appreciation of the dinar vis-à-vis the U.S. dollar (to about ½ percent per month until late 2008), which also helped counter dollarization. As a result, headline inflation fell to 6.8 percent by end-2008. Inflation remained well below the target of 6 percent in 2009, with prices falling by 4½ percent, mainly because of a further decline in fuel prices. Food price inflation has picked up more recently, however, and core inflation (excluding fuel and transportation) ended 2009 a 6 percent, down from 12 percent at end-2008.

6. With headline and core inflation low, the exchange rate has been stable since the beginning of 2009. The policy interest rate has been reduced gradually to 7 percent. Net international reserves increased to $50.2 billion at end-2008, but have fallen to $44 billion at end-2009, reflecting the drawdown of the government's deposits with the CBI.

7. The government budget recorded a modest surplus in 2008 (almost 2 percent of GDP). Higher-than-expected oil revenues enabled us to increase spending. Particularly, and due also to our efforts to improve the execution of the investment budget, we were able to substantially increase capital expenditures in 2008, compared to the previous year.

8. With the drop in oil prices, the external current account is estimated to have moved into a large deficit in 2009, of over 20 percent of GDP. And as oil revenues account for the bulk of government revenues, the government budget is also estimated to have shifted into a large deficit, of over 20 percent of GDP in 2009. The 2009 budget, which was adopted at a time when sharply lower oil revenues were expected, was designed to support as much as possible our investment program and the required security outlays, while containing current spending. The bombings of the Ministry of Finance in August and December of 2009, however, affected our capacity to fully execute our investment plans. Despite this, the 2009 budget deficit, based on preliminary financing data, is estimated to have recorded a deficit of over ID 17 trillion. This deficit was covered mainly by drawing down the balances the government had built up in the CBI and by mobilizing domestic resources through the issuance of Treasury bills.

III. Economic and Financial Policies in 2010-2011

9. The global financial and economic crisis has worsened Iraq's external outlook significantly. The drop in oil export revenues, in particular, presents a major challenge in view of the country's vast reconstruction and rehabilitation spending needs. Under these circumstances, we are determined to strengthen fiscal discipline to better ensure that the reduced public resources are used more efficiently and that fiscal sustainability is preserved.

We have adopted a budget for 2010 that aims to further reduce non-priority current outlays and align the investment budget with our national priorities and implementation capacity. We seek to reduce the government's budget deficits during 2010 and 2011, with a view to returning to a budget surplus in 2012. In addition, we aim to maintain a financial buffer in our accounts equivalent to three months of government wages. Appropriate management of the exchange rate and an interest rate policy aimed at keeping the policy interest rate positive in real terms will continue to be the main instruments to keeping inflation under control. We will also continue to advance our structural reform agenda, with a particular emphasis on public financial management and financial sector reforms.

10. By continuing to pursue sound economic policies and intensifying our efforts to boost oil production, we aim to accelerate the pace of economic growth. We seek to increase average crude oil production and exports to 3.1 mbpd and 2.5 mbpd, respectively, by 2012. As a result, we expect real GDP growth to increase to almost 7 percent in 2010 and to 7½-8 percent in 2011 and 2012. We will also strive to keep inflation at around 5–6 percent in the coming years.

11. As oil prices and production are expected to rise in the medium term, the current account deficit would narrow markedly in the coming years. Since the decline in oil revenues is expected to be temporary until oil production reaches higher levels, we intend to secure adequate financing to avoid a major economic contraction. The international reserves held in the CBI and the DFI (excluding the FMS subaccount) are expected to fall from $55 billion at end-2009 to $46 billion by end-2010 and to broadly remain at that level in 2011 and 2012, before increasing in the following years.

A. Fiscal Policy and Reform

The 2010 Budget

12. The 2010 budget aims to contain current spending to limit the deficit and create room for higher investment outlays. In this regard, we will contain the government's wage bill by refraining from granting new wage increases following the large catch-up in salaries in 2008, which carried over into 2009. In addition, net hiring of non-security personnel in 2010 will be limited to new teachers and doctors, until the civil service census is completed. To limit spending related to the in-kind Public Distribution System (PDS), we have initiated reforms that seek to target the benefits of the program to the poorest Iraqis. In addition, we have decided to reduce the number and volume of goods distributed under the PDS system. At the same time, we plan to expand the new targeted cash transfer system. Generalized transfers, in particular to state-owned enterprises, will be sharply reduced, reflecting the improved financial position of many of these enterprises. As a result of these measures, current spending will be curtailed at ID 62.9 trillion (in the IMF's presentation). By doing so, we have been able to increase the capital budget to ID 25.8 trillion, with an increased focus on

electricity, water and sanitation, health, and agriculture. The overall deficit will be limited to ID 17.9 trillion (19 percent of GDP) in 2010 (in the IMF's presentation).

13. As our financing needs in 2010 will still be substantial, we will step up our efforts to mobilize domestic financing through the Treasury bill market. To that end, we will conduct regular auctions, and refrain from cancellations, while allowing interest rates to be determined by the market. This will have additional benefits by determining a benchmark interest rate, while the development of a secondary market for treasury bills will allow banks to improve their liquidity management. Also, to ensure integrity in our payment and budget systems, we will refrain from accumulating domestic expenditure arrears.

Public Financial Management Reforms

14. Over the next two years, we intend to transform and modernize our public financial management (PFM) system. Late last year, in consultation with the IMF and the World Bank, we adopted a three-year action plan that identified priority measures in the areas of budget preparation, execution and reporting; cash management; public procurement; and the accounting framework. Specifically:

- To improve budget preparation, we will clearly define priorities, set ceilings in the budget circular for current and investment spending in line with a sustainable medium-term budget strategy, and develop overall sector strategies;

- To strengthen reporting and cash management, we will require spending units to submit reports on all spending including investment, advances, and letters of credit no later than two months after the end of each month, and to reconcile these amounts with the cash balances at the beginning and end of the reporting period. Cash releases will be approved only after the Ministry of Finance has reviewed the report from three months before. This will reduce the idle balances in spending units' accounts to the minimum required to ensure the continuity of government operations. Moreover, by end-March 2010 we will review all accounts in the banking system that are classified as central government accounts and reconcile them with Treasury records, and will return any idle balances received from the budget to the central Treasury.

- With regard to advances, we will review the outstanding stock of advances to identify those that are recoverable and set a time schedule for their recovery and for writing off irrecoverable advances based on appropriate authorization at a high level. We will prepare a detailed report to document the results of the review. The basis on which debts have been classified as recoverable or irrecoverable, and actions taken to recover doubtful amounts before recommending that they be written-off will be clearly specified.

- To strengthen internal audit and control systems, we will reexamine our internal policies and procedures at the Ministry of Finance, as well as the accounting systems, processes and internal controls used by the accounting department; and review the internal controls of the largest spending units' operating systems. To strengthen the quality of our investment agenda and accelerate the reconstruction of Iraq's infrastructure, we will ask the Board Supreme Audit (BSA) to review the largest investment projects financed with 2008 budget allocations. This audit report will evaluate (i) the criteria for approving capital investment projects: whether a cost-benefit analysis was carried out; (ii) the procurement process: whether it conformed to international standards of transparency and competitiveness; and (iii) the project management process: whether the projects were delivered on time and within budget. The report will provide recommendations that could be used in the following budgeting process to enhance the agenda on public investment.

- We will also undertake an assessment of the functionality of the Iraq Financial Management Information System (IFMIS) developed with the assistance of USAID, and make the changes required to ensure that this system is fully operational (with the inclusion of a commitment control system and the ability to produce regular comprehensive reports in line with best practices) in 2011.

- We will continue to submit to the BSA and to the Council of Representatives the final accounts for each fiscal year no later than September 30 of the following year. The BSA has already completed the audit of the final accounts of the federal budget for 2005-06, and it is reviewing the 2007 and 2008 accounts.

15. To avoid the obstacles we encountered last year in data collection for the census of public service employees, we have narrowed the coverage to include all central government employees that work outside of security related areas. We will make all efforts to have the census completed by September 30, 2010. After completion of the census, we will move swiftly to eliminate ghost workers and adopt an action plan aimed at developing a computerized human resource database and a computerized payroll system, as a first step toward comprehensive civil service reform. In parallel, the BSA has begun a project to verify the personnel records in the line ministries in order to clean up the existing payroll.

Tax Reforms

16. We have made some progress in developing a medium-term tax reform strategy with the objective of streamlining the tax system, broadening and diversifying the tax base, and increasing revenue collection. As a first step, in 2008 we introduced a mobile phone tax. Looking ahead, we plan to introduce a sales tax in the coming years as a precursor for a value-added tax, and are also considering to reduce the number of income tax brackets. We will seek technical assistance from the IMF and other international partners to support our tax

reform efforts. We will urge the Council of Representatives to adopt the new customs law that will establish a transparent and efficient tariff system with fewer exemptions.

Oil Sector Reforms

17. We will ensure that no direct subsidy is placed on any fuel products in Iraq. Moreover, to continue reducing the size of indirect subsidies to fuel products and counter smuggling, we intend to increase official fuel prices as needed especially if the world prices of fuel products continue to rise. To eliminate hidden subsidies, we will ensure that all ministries, governmental agencies, and public enterprises will pay domestic market prices for fuel purchases starting in 2011. We will also work on developing a periodic adjustment mechanism for fuel prices, with technical assistance from the IMF.

18. We want to ensure that the oil sector is fully transparent, to strengthen accountability of how this important natural resource is used. To that end, we intend to maintain a single account for oil export proceeds and will continue to adhere to the strict transparency and accountability rules that currently govern the DFI. The accounts will continue to be subject to an independent external audit, and to the oversight of the Committee of Financial Experts (COFE). If it were no longer possible to maintain the DFI, we will establish another single account for oil export proceeds governed by similar principles.

19. We will complete the process of becoming a candidate for membership in the Extractive Industries Transparency Initiative (EITI) by March 31, 2010. In addition to regular publication of our production, refining, and export data, we have appointed a senior government official, the Inspector General of the Ministry of Oil, to take the lead on EITI implementation. The next steps will be to convene a stakeholders' meeting (government, private sector and civil society) and put together a fully costed plan including measurable targets, a timetable for implementation, and an assessment of capacity constraints.

20. To promote transparency and good governance in the oil sector, we plan to complete the metering project in the next years. The metering system for the Al-Basra oil export terminal has already been installed. Moreover, the second phase of the installation of metering systems for the northern pipeline and the Khor Al-Amyah export terminal has started, and will be completed by early 2010. Also, in addition to a computerized tracking system for oil transports by road and rail that is already up and running, a comprehensive domestic custody-transfer metering system is being installed and will be completed by December 31, 2010. These mechanisms would enable a full review of the domestic oil sector allowing the flows of oil and oil products to be fully reconciled with the financial flows between the state-owned oil companies and the budget by mid-2011. In this connection, we also plan to conduct a streamlined Public Expenditure Review of the oil ministry, together with the ministries of health, education, and public works, with the assistance of the World Bank.

B. Monetary and Exchange Rate Policies and Financial Sector Reform

21. The CBI will continue to be independent in the pursuit of its policy objectives. The CBI's monetary and exchange rate policies will continue to be aimed at keeping inflation under control and safeguarding international reserves. The subdued inflationary pressures thus far in 2009 have helped to maintain the nominal exchange rate stable since the beginning of the year and to reduce the policy interest rate to 7 percent. The policy interest rate will be kept positive in real terms (measured against core inflation) to signal the CBI's firm commitment to maintain a low rate of inflation. We are accelerating plans to roll out a new CPI based on more recent household expenditure data, which will help us better monitor underlying inflationary dynamics.

22. The banking sector is in urgent need of reform to foster financial intermediation and enable banks to contribute to the development of a strong private sector. With the help of the World Bank and other international agencies, we have developed a banking sector reform strategy. The first important step will be to finalize the restructuring of Rafidain and Rasheed banks, based on their completed financial and operational audits. In this regard, the foreign liabilities incurred by Rafidain and Rasheed on behalf of the previous regime and the large suspense accounts will need be removed from these banks' balance sheets. We aim to complete the restructuring of the balance sheets of Rafidain and Rasheed by June 30, 2010. Once their balance sheets are cleaned up and restructured, based on the decision already made by the Economic Committee, the capital of Rafidain and Rasheed will be raised to ID500 billion and ID400 billion, respectively. We are also strengthening their internal audit capacity, developing legal arrangements within the banks, and working towards providing missing data identified in the audit reports. The BSA has also completed the financial and operational audits for the three specialized state-owned banks and has proposed an individual strategy for each bank that was discussed by the Restructuring Oversight Committee (ROC). The three banks have set up a restructuring committee which includes BSA members to implement the recommendations from the proposed strategy.

23. We have already completed the set of prudential regulations for commercial banks, including those related to minimum capital requirements, liquidity risk, and anti-money laundering, and will begin the implementation phase. Work on the relevant reporting tables for the banks will be completed soon in consultation with the IMF and other technical assistance providers. At the same time, we are stepping up our efforts to further develop banking supervision practices in line with best international practices. In addition, we have asked the commercial banks to conform their accounting norms to the International Financial Reporting Standards (IFRS) as per end-2009, and to prepare a set of financial soundness indicators that could be used to monitor sectoral developments. Finally, to assess the progress made so far, we are in the process of conducting a full assessment of the banking supervision department.

24. We have continued to strengthen the accounting and reporting framework of the CBI. The CBI has appointed a control committee, which is responsible for developing control procedures and manuals, and for establishing a modern internal audit function with the assistance of external consultants. An internal audit committee including two external experts has also been set up to make recommendations regarding external and internal audit oversight, financial reporting, and controls. We have also reconciled almost all the outstanding suspense accounts and CBI intra-branch accounts, and established a register of outstanding off-balance sheet commitments (letters of credit and guarantees). As of July, the CBI has completed the process of becoming IFRS compliant.

25. We are committed to strengthening the management of international reserves by moving ahead with the implementation of new reserves management guidelines that were adopted in early August 2008. We will follow the guidelines to diversify currency composition and establish appropriate duration and credit risk, build capacity for risk analysis, and work towards establishing a dealing room. We will also provide by end-March 2010 more frequent reports to the CBI board based on the investment criteria established in the guidelines.

26. To improve the functioning of foreign exchange auctions, we plan to develop organized exchange markets outside the central bank, including an interbank foreign exchange market. Our aim is to establish a forward market in Iraqi dinars in the near future.

IV. Program Safeguards and Monitoring, Debt and Data Issues

27. As we intend to use the domestic counterpart of IMF resources for budget support, the CBI—which is the fiscal agent—will request the IMF to disburse the resources directly into a government account at the CBI. To provide adequate safeguards to the Fund, the following steps have been taken or will be implemented in the near future:

- A Memorandum of Understanding has been agreed between the CBI and the government clarifying responsibilities with regard to servicing the debt to the Fund;

- An external auditor has been appointed to undertake the audit of the CBI 2008 financial statements in accordance with International Standards on Auditing, and the audit is expected to be completed by March 31, 2010. The external auditor has already completed a verification of the CBI's international reserves as of June 30, 2009. The completion of the external audit will allow the IMF to prepare a safeguards assessment update by the time of the first review of the program. In the future, the CBI will work with the Ministry of Finance to adopt a timely selection and rotation policy for future audits; an auditor for the 2009 CBI financial statements will be appointed before end-February 2010.

- The external auditor will also undertake special audits of (i) CBI Net International Reserves, and a full count of gold and foreign reserves held at the Central Bank, as of June 30, 2009, (ii) CBI data reported to the Fund, including, but not limited to, Net International Reserves, Net Domestic Assets, credit to government and a full count of gold and foreign reserves held at the Central Bank, as of December 31, 2009, December 31, 2010, December 31, 2011 and the other test dates during the SBA, and (iii) procedures surrounding government accounts at the CBI.

28. Progress has been made in moving toward accepting the obligations of Article VIII, Sections 2(a), 3, and 4, of the IMF's Articles of Agreement. We have worked with IMF staff to complete the review of exchange laws and regulations and are considering measures to remove the identified exchange restrictions on current international transactions. We remain committed to avoid imposing any restrictions on the making of payments and transfers for current international transactions or introducing any multiple currency practices.

29. We will continue our efforts to resolve outstanding external claims under terms that are consistent with the 2004 Paris Club agreement. Bilateral agreements with twelve non-Paris Club official creditors have already been signed and are being implemented. We will continue our best efforts to reach bilateral debt agreements with the remaining non-Paris Club creditors. The United Arab Emirates has announced the full cancellation of Iraq's debt, and implementation of a bilateral agreement with Greece is awaiting the Greek parliament's approval. Debt reconciliation was completed with Morocco, Egypt, and China, and we hope to sign the relevant debt agreements, particularly with China with which an agreement has been initialed recently, in the near future. Regarding private creditors, most of the commercial debt has been restructured, and is serviced as agreed. We also expect that the proceeds of the liquidation of the London branch of Rafidain Bank will be distributed to private claim holders by the end of the year.

30. Efforts will continue to improve Iraq's statistical database. Monetary and balance of payments data are now being published in the IMF's *International Financial Statistics* regularly, and annual national accounts data have been compiled up to 2007. We will focus on improving the quality of these annual data developing quarterly national accounts data. While the Socio-Economic Household Survey has been completed, the updating of the CPI weights has been delayed for a number of reasons. A new national coordinator for the General Data Dissemination System (GDDS) has been appointed. As of December 15, we are participating in the GDDS and comprehensive information on Iraq's statistical production and dissemination practices now appears on the IMF's Dissemination Standards Bulletin Board.

31. Performance under the program will be monitored through twice-yearly reviews, with macroeconomic policy performance monitored through semi-annual quantitative performance criteria (Table 1). Progress in structural reforms will be monitored through benchmarks (Table 2).

Table 1. Iraq: Quantitative Performance Criteria
Under the Stand-By Arrangement, 2009–10 1/
(In billions of Iraqi dinars, unless otherwise indicated)

	Amount at	Performance Criteria		
	12/31/09	3/31/10	6/30/10	12/31/10
Stock of net international reserves of the CBI (floor; eop stock, in millions of U.S. dollars)	44,337	44,257	44,178	44,019
Net domestic assets of the CBI 2/ (ceiling; eop stock)	-1,243	-398	38	1,320
Development Fund for Iraq balances (floor; eop stock; in billions of U.S. dollars, excl. FMS)	9.9	8.0	4.5	2.6
Cumulative flow from beginning of calendar year				
Central government fiscal deficit (ceiling) 3/ 4/ 5/	...	5,382	9,149	17,939
Central government current spending bill (ceiling) 3/ 5/	...	8,141	14,926	27,138
Direct government subsidies to the fuel sector 6/	...	0	0	0
New medium-and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (in millions of U.S. dollars; ceiling) 6/ 7/	...	2,000	2,000	2,000
External arrears on existing/rescheduled debt and new borrowing (in millions of U.S. dollars; ceiling) 6/	...	0	0	0

1/ The Technical Memorandum of Understanding (TMU) provides for precise definitions of all performance variables.
2/ Excluding other items net.
3/ End-March, end-June, and end-December performance criteria are cumulative from January 1, 2010.
4/ The fiscal balance will be measured via the sources of financing. See TMU for details.
5/ The current spending bill includes wages (excluding ministries of defense and interior), public distribution system, and transfers to state owned-enterprises. See TMU for details.
6/ To be monitored on a continuous basis.
7/ Concessionality is defined as loans with a grant element of 35 percent or higher. See TMU for details.

Table 2. Iraq: Prior Actions and Structural Benchmarks Under the Stand-By Arrangement

I. Prior Action for Board discussion of the new Program	Date	Status
Program safeguards		
1. A Memorandum of Understanding must be signed between the CBI and the government, clarifying responsibilities with regard to servicing the debt to the Fund.		Met
2. Completion by an external auditor of a verification of the CBI net international reserves data reported to the IMF as at June 30, 2009, including a full count of gold and foreign exchange holdings at the CBI.		Met
3. Appoint an external auditor to conduct the audit of the CBI 2009 financial statements, including a verification of the CBI net international reserves and net domestic assets data as at December 31, 2009, in accordance with International Standards on Auditing.		Pending

Table 2. Iraq: Prior Actions and Structural Benchmarks Under the Stand-By Arrangement

II. Structural Benchmarks	Date	Status
Program Safeguards and Central Banking		
1. Completion by an external auditor of the audit of the CBI 2008 financial statements in accordance with International Standards on Auditing.	March 31, 2010	
2. Prepare and submit to the Governor of the CBI monthly reports on the status of the CBI's investment portfolio, in light of the investment criteria established in the reserve management guidelines.	March 31, 2010	
3. Provide to IMF staff: (i) the completed special audit data as of December 31, 2009, including on the CBI's net international reserves and net domestic assets, and (ii) the draft 2009 audited financial statements and draft management letter.	March 31, 2010	
Bank Restructuring		
4. Completion of the restructuring of the balance sheets of Rasheed and Rafidain banks.	June 30, 2010	
Public Financial Management		
5. Complete review of all accounts in the banking system that are classified as central government accounts and reconcile them with Treasury records, returning any idle balances received from the budget to the central Treasury.	March 31, 2010	
6. Submit • to the Board of Supreme Audit and to the Council of Representatives the final accounts of the Federal Budget for the year ending December 31, 2008; • to the Council of Representatives and publish the audited accounts of the Federal Budget for the years ending December 31, 2005 and December 31, 2006; and • to the Board of Supreme Audit and to the Council of Representatives the final accounts of the Federal Budget for the year ending December 31, 2009.	March 31, 2010 March 31, 2010 September 30, 2010	
7. To strengthen reporting and cash management: (i) start receiving monthly reports from spending units on spending, including investment, advances, and letters of credit, no later than two months after the end of each month and reconcile these amounts with the cash balances at the beginning and end of the reporting period; and (ii) approve cash releases only after the Ministry of Finance has reviewed the report from three months before.	Continuous from April 30, 2010	
8. To improve budget preparation for 2011, set ceilings in the budget circular for current and investment spending, in line with a sustainable medium term budget strategy.	June 30, 2010	
9. Prepare a detailed report documenting a review of the outstanding stock of advances to identify those that are recoverable; on the basis of the review, classify the debts as recoverable or irrecoverable; set a time schedule for their recovery, and for writing off irrecoverable advances based on appropriate authorization at a high level. Once actions have been taken to recover doubtful amounts, recommend that they be written-off.	September 30, 2010	
10. Complete an audited review of the largest investment projects initiated in 2008. The review, conducted by the BSA, should discuss the criteria used for approving the projects; the procurement process and the project management process.	September 30, 2010	
11. Completion of census of all central government employees (excluding those employed in the security area).	September 30, 2010	
Oil Sector		
12. Complete the process of becoming a candidate for membership in the EITI.	March 31, 2010	
13. Complete the installation of all domestic metering systems to allow accurate measurement of domestic oil flows.	December 31, 2010	
14. Conduct an audited review of the domestic oil sector to reconcile the flows of oil and oil products at key points in the national system with the financial flows between the various state-owned companies and the budget.	June 30, 2011	
15. Maintain a single account for oil export proceeds, subject to the strict transparency and accountability rules that govern the DFI, including an independent external audit, and the oversight of the Committee of Financial Experts (COFE).	Continuous	

IRAQ: TECHNICAL MEMORANDUM OF UNDERSTANDING

February 8, 2010

1. This memorandum describes the quantitative and structural performance criteria, benchmarks, and indicators for the third Stand-By Arrangement (SBA) with the International Monetary Fund (IMF). It also specifies the periodicity and deadlines for transmission of data to the staff of the IMF for program monitoring purposes.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATORS

2. The quantitative performance criteria are the following:

(i) a floor on net international reserves of the Central Bank of Iraq (CBI);

(ii) a ceiling on net domestic assets of the CBI;

(iii) a ceiling on the central government fiscal deficit;

(iv) a ceiling on the central government current spending bill;

(v) a floor under the balance in the Development Fund for Iraq (DFI);

(vi) a ceiling on direct government subsidies to the fuel sector;

(vii) a ceiling on contracting and guaranteeing of new medium- and long-term non-concessional external debt contracted or guaranteed by the central government and/or the CBI; and

(viii) a ceiling on external payments arrears on any rescheduled and new debt of the central government and/or the CBI.

II. DEFINITIONS

3. For purposes of monitoring under the program, a **program exchange rate** will be used. This program exchange rate will be set at ID 1,170 per U.S. dollar. The program exchange rate will be used to convert into Iraqi dinars the U.S. dollar value of all CBI foreign assets and liabilities denominated in U.S. dollars, as required. For CBI assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted in U.S. dollars at their respective SDR-exchange rates prevailing as of December 31, 2009, as published on the IMF's website.

4. For the purpose of this program, the **international or world oil price** is understood to be the Average Petroleum Sport Price (APSP) used in the IMF's World Economic Outlook (WEO), which is the simple average of UK Brent, Dubai Fateh, and West Texas Intermediate

spot prices reflecting world exports of light, medium, and heavy crude oil. The **projected international or world price** for a particular year is the latest WEO price projection for that year as released by the IMF's Research Department to IMF staff. IMF staff will provide these oil price projections to the Iraqi authorities. For purposes of assessing whether the SBA will be treated as precautionary, the **relevant projected international or world price** will be the average of APSP futures prices for the current year during the 30-day period prior to the circulation to the IMF's Executive Board of the documents for the respective review. In turn, the **projected Iraqi oil price** for purposes of assessing whether the SBA will be treated as precautionary will be calculated as the difference between the relevant projected international or world price (as defined above) and the average differential between the international price and the actual price at which Iraqi crude has been sold in the preceding 18-month period. IMF staff will make the APSP futures prices available to the Iraqi authorities on a regular basis.

5. For program purposes, **central government** is defined to include the central administration, the Kurdish government, as well as agencies included under Section 6 (the local boards, Iraqi media network, Iraqi national Olympic committee, Bait-Al-Hikma, Ammant Baghdad, Municipality institutions, as well as the General directorates of sewerage and water).

6. **Net international reserves (NIR)** are defined as gross usable reserves minus reserve-related liabilities of the CBI. Gross usable reserves of the CBI are claims of the CBI on nonresidents that are controlled by the CBI, denominated in foreign convertible currencies, and are immediately and unconditionally available to the CBI for meeting balance of payments needs or for intervention in foreign exchange markets, and are not earmarked by the CBI for meeting specific payments. They include CBI holdings of monetary gold, SDRs, Iraq's reserve position in the IMF, foreign currency cash, and deposits abroad, except for the resources of the DFI but including the CBI DFI sub-account. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options). Reserve-related liabilities shall be defined as foreign currency denominated liabilities of the CBI to residents and nonresidents with original maturity of one year or less, and all liabilities to the Fund. They include: foreign currency reserves of commercial banks held at the CBI; commitments to sell foreign currency arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies. Excluded from reserve liabilities are the government's foreign currency deposits at the CBI. As of December 31, 2009, (net) international reserves amounted to US$44.34 billion, all comprising of in reserve assets. The program floors on the net international reserves of the CBI are reported in Table 1.

7. **Net domestic assets of the CBI** include (i) net claims on the general government, comprising of gross claims on the general government minus general government domestic and foreign currency deposits at the CBI; (ii) gross claims on commercial banks; (iii) monetary policy instruments, including dinar and foreign currency denominated term deposits and CBI bills; and (iv) gross claims on non-bank, non-government entities. For the purpose of this arrangement, net domestic assets of the CBI excludes other items net, comprising of net fixed and other assets, minus revaluation accounts and capital and reserve accounts. As of end-December 2009, net claims on the general government amounted to ID 2,740 billion; gross claims on commercial banks stood at ID 4 billion; monetary policy instruments amounted to ID -3,988 billion; and gross claims on non-bank, non-government entities were nil, resulting in a stock of the CBI's net domestic assets of ID -1,243 billion. As of end-December 2009, OIN amounted to ID -1,040 billion. The program ceilings of the net domestic assets of the CBI are reported in Table 1.

8. The **central government fiscal deficit** will be calculated as the sum of domestic and external financing of the central government balance, adjusted for any deviations in the amounts of (i) donor financing for projects and (ii) "other financing" in excess of program projections. Domestic financing includes any form of resident financing of the consolidated budget from (i) the central bank; (ii) commercial banks; (iii) non-bank financial institutions; (iv) nonfinancial enterprises; (v) privatization proceeds; (vi) changes in arrears; (vii) households; and (viii) all other domestic financing not elsewhere classified. External financing includes financing from (i) the Development Fund for Iraq, (ii) donor financing for projects, (iii) other financing not elsewhere classified, net of (iv) the amortization of external debt. The ceilings for end-March 2010, end-June 2010, and end-December 2010 will be measured on a cumulative basis from January 1, 2010. The program ceilings of the central government fiscal deficit are reported in Table 1.

9. The **central government current spending bill** includes the wage and pension bill, the in-kind transfers under the Public Distribution System (PDS), and transfers to state-owned enterprises (SOEs). The **wage and pension bill** includes all wage and pension payments made by the central government, excluding wage payments made by the ministries of defense and interior. Specifically, with reference to the 2009 budget classification, it includes expenditures under Section 1 (except those for the ministries of defense and interior) and Section 6, sub-section 1, items 2(1), 3(1, 3, 5, and 7), 4(1), 5(1), 7(1), 8(1), 9(1), 10(1), 11(1), 12(1), and 13(1). The **Public Distribution System** bill includes the spending reported under Section 7, sub-section 2, item 1(1). The **transfers to the SOEs bill** covers expenditures covered in Section 5, net items covered under subsection 2, items 1(1 to 6). The ceilings on the government current spending bill for end-March 2010, end-June 2010, and end-December 2010 will be measured on a cumulative basis from January 1, 2010. The program ceilings of the central government current spending bill are reported in Table 1.

10. The **balance in the DFI** consists of: (i) the main account held at the Federal Reserve Bank of New York that consolidates all receipts from export sales of petroleum and petroleum products; proceeds from frozen assets in foreign countries; balances related to the United Nations Oil for Food Program; interest or other revenue accrued from income investments (i.e., overnight deposits and repos, interests derived from the PCO, FMS and TBI balances) and T-bills; returned Letters of Credit; and other deposits and revenue covered under the UNCR 1483 (2003) resolution; and (ii) the balance in the PCO account. For program purposes, the balance in the FMS account is excluded from the balance in the DFI. The program floors on the balance in the DFI are reported in Table 1.

11. **Direct government subsidies to the fuel sector** shall comprise of any financial assistance rendered by the Ministry of Finance to fuel-related enterprises. The ceilings for end-March 2010, end-June 2010, and end-December 2010 will be measured on a cumulative basis from January 1, 2010. The program ceilings of the direct government subsidies to the fuel sector are reported in Table 1.

12. A continuous ceiling applies to the non-accumulation of **external payments arrears** on rescheduled debt and new external debt contracted or guaranteed by the central government and/or the CBI. External payment arrears consist of external debt service obligations (principal and interest) falling due after December 31, 2009 and that have not been paid at the time they are due, as specified in the contractual agreements. The program ceilings of the external payments arrears are reported in Table 1.

13. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000), the term "**debt**" will be understood to mean a current liability (i.e., not contingent), created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits), and temporary exchanges of assets that are equivalent to fully collateralized loans, under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception

of the lease) of all lease payments expected to be made during the period of the agreement, excluding those payments that cover the operation, repair or maintenance of the property. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

14. For purposes of the program, the **guarantee of a debt** arises from any explicit legal obligation of the government or CBI or any other agency acting on behalf of the government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or CBI to cover a shortfall incurred by the loan recipient.

15. The limits on **medium- and long-term external debt** apply to the contracting or guaranteeing by the government and/or the CBI of new, nonconcessional external debt with an original maturity of more than one year. This limit applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. External debt will be considered to have been contracted at the point the loan agreement or guarantee is ratified by the Iraqi parliament. Excluded from this limit are leases of real property by Iraqi embassies or other foreign representations. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on December 31, 2009, as published on the IMF's website. The program ceilings of the contracting or guaranteeing of medium- and long-term external debt are reported in Table 1. These limits are applied on a continuous basis to the contracting and guaranteeing of external debt on or after January 1, 2010 and the limit during the period preceding each test date will be the ceiling set for that particular test date.

16. **Concessionality** will be based on currency-specific discount rates based on the Organization for Economic Co-operation Development (OECD) commercial interest reference rates (CIRRs). For loans of an original maturity of at least 15 years, the average of CIRRs over the last 10 years will be used as the discount rate for assessing the concessionality of these loans, while the average of CIRRs of the preceding six-month period will be used to assess the concessionality of loans with original maturities of less than 15 years. To the ten-year and six-month averages of CIRRs, the following margins will be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–30 years; and 1.25 percent for over 29 years. Under this definition of concessionality, only loans with grant element equivalent to 35 percent or more will be excluded from the debt limits. The debt limits also will not apply to loans contracted for debt

rescheduling or refinancing (including the deferral of interest in commercial debt), and credits extended by the IMF and the World Bank.

V. Program Adjustors

17. If oil revenues exceed/fall short of the amounts projected under the program ($22.6 billion in the first half of 2010 (of which $11.8 billion in the first quarter); and $48 billion for the entire year 2010), the **ceilings on the central government fiscal deficit** for end-March 2010, end-June 2010, and end-December 2010 will be adjusted *downwards/upwards* by half of the excess/shortfall as compared to the respective projected amounts, multiplied by the program exchange rate. In case oil revenues exceed the amounts projected under the program, half of the additional revenues can be used only to finance capital spending. In 2010, this additional capital spending will be limited to the equivalent of $4 billion ($2 billion in the first half of 2010), subject to a reassessment in the context of the first and second reviews under the program.

18. The **ceilings on the central government fiscal deficit** will be adjusted (i) *upwards/ downwards* by the cumulative amount (prorated for the relevant period) of any excess/shortfall in external project loans, and/or external debt interest payments, relative to the program amounts (included in the table below); and (ii) *downwards* by the cumulative amount (prorated for the relevant period) of any excess in external budget support grants relative to the program amounts (included in the table below).

Program amounts on External Grants and Loans and
External Debt Service Payments , 2010
(In billions of Iraqi dinars)

	2010
Grants	1,691
Project	1,691
Budget support	0
Loans 1/	2,627
Project financing	1,223
Oil-related soft loans	1,404
Interest on External Debt	715

1/ Excludes the IMF SDR allocation.

19. The **floors under the balance in the DFI** for end-March 2010, end-June 2010, and end-December 2010 will be adjusted upwards/downwards by half of the excess/shortfall in oil revenues as compared to the projected amounts as described in paragraph 17.

VI. Provision of Information to the Fund Staff

A. Data

20. To monitor developments under the SBA, the authorities agree to provide the Fund, the information specified below after SBA approval. The program is designed with semester quantitative performance criteria and the actual outcome should be provided within eight weeks following the end of the semester. However, in order to facilitate regular monitoring, many of the indicators should be provided with higher frequencies, as indicated below.

- CBI gross foreign exchange reserves (weekly) and balances of the DFI held at the FRBNY. This should be reported no longer than 2 weeks after the end of the reference week.

- The monthly balance sheet of the CBI, with a month lag.

- The monthly consolidated balance sheet of the other depository corporations (commercial banks), with an eight week lag.

- The depository corporations (monetary) survey of all commercial banks and the CBI (quarterly), with an eight weeks lag.

- Weekly preliminary monetary and financial aggregates as in "Key Financial Indicators", including exchange rate data (daily), currency in circulation, transferable and other deposits held at commercial banks, balances on government accounts at the CBI, interest rates on loans and on deposits at commercial banks, holdings of government securities, and credit outstanding to the public and private sectors. The data, excluding exchange rates, should be reported no longer than three weeks after the end of the reference period.

- Consumer price index (CPI), including indices for main cities (monthly). These should be reported no longer than a month after the end of the relevant month.

- Detailed revenues, operating and capital expenditure, and financing items of consolidated fiscal and oil operations, and overall fiscal balance. These data should include the execution of the Iraqi budget, operations and deposits of the oil-related state-owned enterprises, disbursements of external assistance and loans, execution of letters of credit financed under the UN oil-for-food program, all operations of the DFI and its sub-accounts, balances of all government accounts held at the CBI and the commercial banks, and outstanding stock of government securities (including treasury bills). These data should be reported on a monthly basis and no later than eight weeks after the end of the reference month.

- Amount of total imports of petroleum products financed from the budget on a quarterly basis starting with the first quarter of 2009. These data should be reported no later than eight weeks after the end of the reference quarter.

- Indicators of oil activity on crude oil and gas production and use, production and sales (export and domestic) of refined petroleum products, including heavy residuals (monthly). These data should be reported no longer than eight weeks after the end of the reference quarter.

- Indicators of non-oil real economic activity (quarterly), including production of cement, fertilizers, and electricity, reported no longer than eight weeks after the end of the reference quarter.

- Detailed data on disbursement of external assistance (both project and budget financing) from the U.S. and other donors, including by recipient sector; foreign debt amortization and interest payments made; and total outstanding domestic and external debt. These data should be reported on a monthly basis no more than eight weeks after the end of the reference month.

- List of short, medium, and long-term government or government-guaranteed external loans contracted during each quarter, identifying for each loan: the creditor, the borrower (ultimate obligor), the amount and currency, the maturity and grace period, repayment terms, and interest rate arrangements (monthly).

- Details on new debt rescheduling and debt relief agreements with bilateral, multilateral, and commercial creditors, including new outstanding amount and currency, schedule of payments (principal and interest), terms of agreement, repayment terms, and interest rate arrangements.

- Foreign trade statistics (imports, exports, re-exports) (quarterly). This should be reported no longer than eight weeks after the end of the reference quarter.

- The balance sheet of the Trade Bank of Iraq (TBI) as well as data on issued, implemented and outstanding Letters of Credit, with no more than an eight weeks lag.

- The amount and terms of concessional loans contracted and their grant element, on a quarterly basis, with no more than eight weeks lag.

B. Structural Reforms

21. The authorities will prepare and send to the IMF reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial planning, and specifying expected revised completion dates.

C. Other Information

22. Other details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff, for consultation or information.