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December 17, 2008

Iraq: Letter of Intent and Second Supplementary Memorandum of Economic and Financial Policies

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IRAQ—LETTER OF INTENT

Baghdad, November 29, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Strauss-Kahn:

The Executive Board of the IMF approved a request for a Stand-By Arrangement (SBA) for Iraq on December 19, 2007, in support of our economic program for 2008. The first review was completed on September 3, 2008. The security situation has improved in recent months but remains precarious. Nevertheless, we continue to make progress in the implementation of our program. In particular, growth prospects have improved as crude oil production and exports have increased compared to previous years while inflation has remained subdued, despite a large increase in government spending provided for in the 2008 supplementary budget and higher food prices. We have also advanced with the implementation of structural reforms.

Iraq has met all quantitative performance criteria set for end-June 2008, except for the quantitative performance criterion on the government wage and pension bill because payment of the civil service salary increase included in the 2008 supplementary budget started earlier than anticipated. In completing the first review under the SBA, the Fund has granted a waiver for the nonobservance of this performance criterion. All structural performance criteria have been met. We request completion of the second and final review under the SBA.

In the period ahead, we will strive to maintain macroeconomic stability and take measures that will enable Iraq to move toward a path of high and sustainable growth as proposed in the attached second Supplementary Memorandum of Economic and Financial Policies (SMEFP). The sharp drop in world oil prices triggered by the current international financial and economic crisis is having a serious adverse impact on Iraq's fiscal and external positions. We have based the draft budget for 2009 on a crude oil export price of \$62.5 per barrel, which is much lower than the average crude oil export price of \$101.3 per barrel realized during January-September 2008. In order to maintain a sustainable fiscal stance, we have significantly scaled down our initial spending plans for 2009. At the same time, we have maintained a sizable allocation for government investment, including in the oil sector, to further step up our reconstruction efforts. In the event that the average export price of Iraqi

oil in 2009 would fall below \$62.5 per barrel and fiscal sustainability is at risk, we will prepare a supplementary budget to further cut current spending and adjust investment. We will also continue the appropriate management of the exchange rate of the dinar and maintain a tight monetary policy stance, in order to keep inflation under control.

The attached memorandum updates our economic program for 2008 and outlines the main elements of our program for 2009. We believe that the policies and measures set forth in the second SMEFP are adequate to achieve the objectives of the program that is supported by the SBA through March 2009. However, we will take any additional measures that may be needed to ensure that the program remains on track. We will consult with the Fund on the adoption of such measures, and in advance of revisions to the policies contained in the second SMEFP, in accordance with the Fund's policies on such consultation. We will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives.

We intend to continue to treat the SBA as precautionary and consent to the publication of this letter and the second SMEFP. Finally, we would like to thank the Fund for its support to Iraq's economic programs over the last four years under very difficult circumstances, and hope that we can count on the continued support of the Fund for the implementation of Iraq's economic policy agenda.

Sincerely yours,

/s/

Dr. Sinan Al-Shabibi
Governor of the Central Bank of Iraq

/s/

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

**IRAQ—SECOND SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL
POLICIES FOR 2008–09**

November 29, 2008

I. INTRODUCTION

1. This memorandum supplements the Memorandum of Economic and Financial Policies for 2008 (MEFP) and the first supplement thereto, annexed to our letters dated December 4, 2007 and August 10, 2008, respectively. It describes additional economic objectives and policies agreed in the context of the second review under the Stand-By Arrangement (SBA). Policies and unfulfilled commitments specified in the MEFP and the first supplement thereto continue to be part of the program.

II. RECENT DEVELOPMENTS UNDER THE STAND-BY ARRANGEMENT

2. Economic developments have been encouraging so far in 2008. Oil production in January–August 2008 rose on average to 2.3 million barrels per day (mbpd), compared to 1.9 mbpd in the same period of 2007, and is expected to remain at that level for the year as a whole. Oil exports in January–September 2008 were running slightly ahead of the target average for the year of 1.8 mbpd. Indications are that the improved security situation is also starting to benefit the non-oil sector. Preliminary estimates by the Central Organization for Statistics and Information Technology (COSIT) show that real non-oil GDP increased by about 8 percent, year-on-year, in the first half of 2008. Total real GDP growth is projected to increase to close to 10 percent in 2008, from 1½ percent in 2007. Headline inflation has remained subdued thus far in 2008, mainly because of a further decline in (black-) market fuel prices and the limited initial price effect of the civil service salary increase that came into effect in June. On this basis, it seems likely that inflation in 2008 will be kept below the target of 14 percent. Annual core inflation (excluding fuel and transportation costs), however, remained at 13½ percent in October, in part because of increasing food prices.

3. The fiscal outturn through July 2008 showed a surplus, mainly on account of higher-than-expected oil revenues resulting from both higher export prices and volumes of crude oil. Underspending on investment also contributed to the surplus, although our efforts to improve investment execution have resulted in a doubling of recorded capital expenditures in January–July 2008 compared to the same period last year. The balance in the Development Fund for Iraq (DFI) increased by almost \$11 billion to \$23.5 billion at end-September 2008. The salary increase for civil servants granted this year is being phased in gradually, in line with the program ceilings for the government wage and pension bill. Taking account of the increased spending included in the 2008 supplementary budget and the sharp drop in oil export prices since the summer, an overall budget surplus of almost 8 percent of GDP is expected for 2008 (compared to a surplus of 2.8 percent in the revised program).

4. The Central bank of Iraq (CBI) has stepped up the rate of appreciation of the dinar vis-à-vis the U.S. dollar to about ½ percent per month since mid-2008 to keep inflation under control and counter dollarization. Since November 2006, the dinar has appreciated by 20 percent to ID 1,176 per dollar at end-October 2008. Net international reserves increased to a level of \$44.3 billion at end-September. In light of the subdued inflation thus far in 2008, the CBI has reduced its policy interest rate from 16 percent to 15 percent as of November 3, 2008, while keeping the real interest rate in positive territory (as measured against core inflation).

5. All quantitative performance criteria for end-June 2008 were met, except for the performance criterion on the government wage and pension bill, which was missed because the implementation of the civil service salary increase granted in 2008 started earlier than anticipated (Table 1). All structural performance criteria were met (Table 2).

6. We have also continued to make progress toward resolving external claims. Bilateral agreements with eleven non-Paris Club official creditors have already been signed. The United Arab Emirates has announced the full cancellation of Iraq's debt and we have finalized the debt negotiations with Greece, Morocco and Tunisia; we hope to sign the relevant debt agreements in the near future. Also, debt negotiations are underway with several other non-Paris Club official creditors, notably some Gulf countries and China. Regarding private creditors, we have completed a cash settlement of about \$470 million of commercial debt in August. The process to resolve most of the remaining private claims as part of the liquidation of the London branch of Rafidain Bank has also begun.

III. ECONOMIC AND FINANCIAL POLICIES IN THE REMAINDER OF 2008 AND IN 2009

7. The serious international financial and economic crisis, notably the recent precipitous fall in world oil prices, has significantly worsened Iraq's external outlook for the period ahead. The projected drop in oil export revenues in 2009, in particular, presents a challenge in view of strong spending pressures fueled by the high oil revenues and fiscal surpluses of recent years. We are determined to strengthen spending discipline to better ensure that the reduced public resources are put to productive use and preserve fiscal sustainability. Therefore, we have revised our spending plans for 2009 downwards by reducing non-priority current outlays and by better aligning the investment budget with our implementation capacity. Appropriate management of the exchange rate and a positive real policy interest rate remain instrumental to keep inflation under control. We will also continue with structural reforms to achieve high growth over the medium term and to strengthen governance and administrative capacity in the public sector.

8. Provided violence continues to decline, real GDP growth is expected to remain strong at about 7½ percent in 2009. Growth would be driven by the ongoing expansion of oil output and a further recovery of non-oil activity. We will strive to further increase average crude oil production and exports to 2.5 mpbd and 2.0 mbpd, respectively, in 2009. We aim to contain

inflation at 10 percent in 2009. With average oil export prices projected to fall from \$93 per barrel in 2008 to \$62.5 per barrel in 2009, oil export earnings would drop by about one-quarter. As a result, the surplus in the external current account of 15 percent of GDP in 2008 is projected to disappear in 2009. The net international reserves of the CBI are expected to further increase to about \$64 billion by end-2009.

A. Fiscal Policy and Reforms

9. The 2009 draft budget adopted by Cabinet is designed to preserve fiscal sustainability over the medium term in light of sharply lower expected oil revenues, while continuing to support a sizable investment program. The draft budget provides for sizable security outlays while strictly limiting other current spending. The 2008 civil service salary increase will be fully funded, including the carry-over of the part that was postponed in 2008. We will not grant any additional wage increases and there will be no net hiring of non-security personnel in 2009. In order to limit its costs, we have initiated a reform of the in-kind Public Distribution System aimed at restricting eligibility of well-off beneficiaries as of mid-2009. Other transfers, including to state-owned enterprises, will be strictly limited. In view of the improved investment execution, we have somewhat increased next year's investment budget for the oil, electricity, water and sanitation, education, health, and agricultural sectors. The practice of carrying over unspent investment allocations from the previous year will be stopped, and we will step up our efforts to safeguard the quality of investment spending.

10. Despite this significant fiscal adjustment, a sizable fiscal deficit is foreseen for 2009, which we intend to eliminate over the next two years. The draft budget aims to limit the overall deficit to ID 17 trillion or 17.3 percent of GDP in 2009. The deficit will be financed by drawing down part of the balance in the DFI and by using some of the bank deposits accumulated during 2006-08. In order to maintain a benchmark for market interest rates and help develop a secondary market for treasury bills, we will continue our regular bi-weekly issuance in the order of ID 150-200 billion.

11. We are considering to increase official fuel prices for regular and blended gasoline, diesel, and kerosene in the first part of 2009. The adjustment will depend on developments in international oil and fuel prices, and aim to reduce the still sizable indirect subsidies and to counter smuggling. At the same time, we will continue to work on the development of a periodic adjustment mechanism for fuel prices, based on the recommendations of a recent Fund technical assistance mission.

12. We have made some progress in developing a medium-term tax reform strategy with the objective to streamline the tax system while broadening the tax base and increasing revenue collection. A draft law on import tariffs has been prepared and will be discussed with the Fund before submission to the Council of Ministers. The objective of the draft law is to establish a transparent and efficient tariff system with fewer exemptions. We are working on the development of a sales tax as a precursor for a value-added tax. As a first step, we intend

to introduce a mobile phone tax in 2008. We are also considering to reduce the number of income tax brackets. We will seek technical assistance from the Fund and other international partners to support our tax reform efforts.

13. We are making progress in modernizing public financial management (PFM). The Board of Supreme Audit (BSA) has completed the audit of the final accounts of the federal budget for 2005 and the audit of the final accounts for 2006 is underway. We have submitted the final accounts of the federal budget for 2007 to the BSA in October. The audit reports will be submitted to the Council of Representatives and published. We have also adopted, in consultation with the Fund and the World Bank, a three-year action plan that identifies priority measures to modernize PFM, notably as regards budget preparation, execution and reporting; cash management; public procurement; cash management; and the accounting framework. We will step up our efforts to put in place, in cooperation with USAID, the renewed Iraq Financial Management Information System (IFMIS), in order to make this system fully operational in 2009.

14. We have completed about 25 percent of the data collection for the census of public service employees at end-October, but finalization of the project is being delayed due to technical problems. We will make all efforts to have the census completed by end-January 2009. After completion of the census we will move swiftly to eliminate ghost workers and adopt an action plan to computerize the payroll, as a first step for a comprehensive civil service reform. In parallel, the BSA has begun a project to verify the personnel records in line ministries, in order to clean up the existing payroll.

B. Monetary and Exchange Rate Policies

15. The policy stance of the CBI will continue to be geared to keeping inflation under control. The subdued inflationary pressures thus far in 2008 and the fiscal adjustment envisaged for 2009 would help in this regard. The current policy to appreciate the exchange rate of the dinar will be continued at least until end-2008. Once annual core inflation is brought down to single digits, we intend to maintain a stable exchange rate as the nominal anchor for the economy. The CBI will keep its policy interest rate positive in real terms (measured against core inflation) to signal our firm commitment to continue fighting inflation. Any downward adjustments of the policy interest rate that would be made possible by lower inflation, will be implemented gradually.

16. We continue 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 independent audit committee has also been set up, which will be made operational shortly. The audit committee includes one external expert and is tasked with making recommendations regarding external and internal audit oversight, financial reporting, and controls. Efforts will be stepped up to reconcile suspense accounts

and CBI intra-branch accounts, and to establish a register of outstanding off-balance sheet commitments (letters of credit and guarantees). We will also appoint shortly an external auditor to undertake the audit of the CBI 2008 financial statements in accordance with International Standards on Auditing. The CBI will work with the Ministry of Finance to adopt an audit selection and rotation policy for future audits. To facilitate implementation of International Financial Reporting Standards (IFRS) by end-2009, we will engage an external expert to assist the CBI in the conversion process. We are also moving ahead in implementing our new reserves management guidelines that were adopted in early August.

17. We have made progress in moving towards accepting the obligations of Article VIII, Sections 2(a), 3, and 4, of the Fund's Articles of Agreement. The review of exchange laws and regulations is nearing completion. We will work with Fund staff to complete the review as soon as possible and are ready to implement the Fund staff's recommendations once we receive them. In the meantime, we are committed to not impose any restrictions on the making of payments and transfers for current international transactions nor to introduce any multiple currency practices.

C. Other Structural Policies

18. Transparency and good governance in the oil sector remain a top priority. The metering system for the Al-Basra oil export terminal has been installed. 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 October 2009. Also, a comprehensive custody-transfer metering system is largely installed and will be completed by September 2009, while a computerized tracking system for oil transports by road and rail is up and running. Since joining the Extractive Industries Transparency Initiative (EITI), implementation procedures are underway, especially with regards to informing the public about oil production, exports and domestic consumption. The Iraqi Committee of Financial Experts (COFE) is set to take over the responsibilities of the International Advisory and Monitoring Board (IAMB) as the audit and oversight body for the DFI by the end of this year. The COFE has published the audit report, which covers DFI operations in the first half of 2008, on its website. The COFE has also presented its first semi-annual report to the Council of Ministers.

19. We will accelerate the further implementation of our reform strategy for the banking sector. Before the end of the year, we will start, with assistance from the World Bank and other international partners, to develop restructuring plans for Rafidain and Rasheed banks, based on their completed financial and operational audits. The BSA will begin the reconciliation of the foreign debt held by Rasheed and Rafidain and the cleaning up of their large suspense accounts before year-end. The Restructuring Oversight Committee (ROC) will complete its preparation of individual strategies for the three specialized state-owned banks by March 2009. In the meantime, the BSA will start its diagnostic review of these banks. Based on these strategies and the results of the diagnostic reviews, we will develop restructuring plans for these three banks.

20. We have partially completed the set of prudential regulations for commercial banks. Nine key regulations have already been finalized. Work on the relevant reporting tables for the banks will be completed soon. We will make every effort to draw up the remaining regulations as soon as possible, including those related to minimum capital requirements, liquidity risk, and anti-money laundering. This work will be carried out in consultation with the Fund and other providers of technical assistance. At the same time, we are pursuing our efforts to further develop banking supervision practices in line with international standards and best practices. In addition, we will continue to work toward changing the commercial banks' accounting norms in line with IFRS, and prepare a set of financial soundness indicators for commercial banks.

III. OTHER ISSUES AND PROGRAM MONITORING

21. We will continue our efforts to resolve outstanding external claims under terms that are consistent with the 2004 Paris Club agreement. We are working to finalize the negotiations on a number of debt agreements with non-Paris Club creditors, including China, in the near future. We will continue our best efforts to reach bilateral debt agreements with other remaining non-Paris Club creditor countries with a view to an early conclusion of debt agreements. We will also make every effort to complete the settlement phase of commercial claims as part of the liquidation of the London branch of Rafidain Bank as soon as possible.

22. We will continue our efforts to improve Iraq's statistical database. Monetary and balance of payments data are now being published in the IMF's *International Financial Statistics* regularly. Annual national accounts data has been compiled up to 2007. We will now focus on improving the quality of these annual data before turning our attention to further developing quarterly national accounts data. While the Socio-Economic Household Survey has been completed, the updating of the CPI weights has been delayed because of difficulties with the start-up of the software for processing the new CPI. We will step up our efforts to resolve these problems and update the CPI weights as soon as possible. We have appointed a new national coordinator for the General Data Dissemination System (GDDS). Once we have finalized the remaining meta data, we intend to start participating in the GDDS in the course of next year.

23. Macroeconomic policy performance will continue to be monitored through quarterly quantitative performance criteria and an indicative target (Table 1). Progress in structural reform will be monitored through benchmarks (Table 2).

Table 1. Iraq: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement, 2007–08 1/
(In billions of Iraqi dinars, unless otherwise indicated)

	Amount at 6/30/07	Performance Criteria				
		12/31/07	3/31/08	6/30/08	9/30/08	12/31/08
<i>Cumulative change from June 2007</i>						
Net international reserves of the CBI (floor; in millions of U.S. dollars) 2/ (Actual)	20,635	0	0	0	0	0
		10,820	13,487	22,400	23,625	...
Lending to the government and the private sector by the CBI (ceiling) 3/ (Actual)	5,230	0	0	0	0	0
		0	0	0	0	...
<i>Cumulative flow from beginning of calendar year</i>						
Central government total financing (ceiling) 4/ (Actual)	...	7,600	2,200	3,750	-2,400	-3,200
		-7,894	-9,024	-6,879	...	...
Government wage and pension bill (ceiling) 4/ 5/ (Actual)	...	10,100	2,750	5,500	11,650	14,400
		8,324	2,385	6,579	...	...
Government imports of petroleum products (ceiling) 4/ (Actual)	...	400	100	200	300	400
		195	108	172	...	...
Direct government subsidies to the fuel sector (Actual)	...	0	0	0	0	0
		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) 4/ 6/ (Actual)	...	500	500	500	500	500
		0	0	0	0	...
External arrears on existing/rescheduled debt and new borrowing (in millions of U.S. dollars; ceiling) 7/ (Actual)	...	0	0	0	0	0
		0	0	0	...	...
<i>Indicative target</i>						
Revolving government credit to the State Oil Marketing Organization (ceiling) (Actual)	...	400	400	400	400	400
		400	400	400	...	...

1/ The Technical Memorandum of Understanding will provide for precise definitions of all performance variables.

2/ Amount at 6/30/07 has been revised from 21,045 at the time of the Board meeting in light of updated data.

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

4/ Flows for 2007 and 2008 are cumulative starting 1/1/2007 and 1/1/2008, respectively.

5/ Excluding salaries paid by ministries of defense and interior.

6/ Concessionality is defined as loans with a grant element of 35 percent or higher.

7/ To be monitored on a continuous basis.

Table 2. Structural Performance Criteria, and Structural Benchmarks Under the Stand-By Arrangement

I. Structural Performance Criteria		
Avoid administrative measures limiting participation or bids in the CBI's regular auction of foreign exchange other than screening related to anti-money laundering or counter-terrorism.	Continuous	Met
Enact the amendments to the pension law to make it fiscally sustainable.	December 31, 2007	Met
Completion by an external auditor of an audit of the CBI net international reserves data reported to the IMF as at December 31, 2007, including a full count of gold and foreign exchange holdings at the CBI.	March 31, 2008	Met
Completion by an external auditor of the audit of the CBI 2007 financial statements in accordance with International Standards on Auditing.	June 30, 2008	Met
II. Structural Benchmarks		
Implementation of regular reconciliation in the CBI accounts of (i) local banks' current accounts; (ii) intra-branch accounts; and (iii) suspense accounts.	March 31, 2008	Partially met 1/
Adoption of reserves management guidelines by the CBI.	March 31, 2008	Met on August 4
Completion of the operational and financial audits of Rasheed and Rafidain banks based on their 2006 financial accounts.	May 31, 2008	Met on July 10
Incorporate new weights in the CPI based on the 2007 household expenditure survey.	May 31, 2008	Underway
Submission to the Board of Supreme Audit of the final accounts of the Federal Budget for the year ending December 31, 2007.	June 30, 2008	Met on October 19
Completion of census of all public service employees (central government and military)	June 30, 2008	Delayed 2/
Adoption of an action plan for modernizing the government's financial management system.	July 31, 2008	Met on November 10
Completion of the set of prudential regulations for commercial banks.	July 31, 2008	Partially met 3/
Publication of audit reports mandated by the Committee of Financial Experts (COFE) and presentation of the first semi-annual COFE report, covering the period January–June 2008 and including recommendations, to the Council of Ministers.	September 15, 2008	Met on December 2
Development of a periodic adjustment mechanism for fuel prices based on changes in domestic production costs and import costs to prevent re-emergence of direct budget subsidies on fuel products.	September 30, 2008	Underway
Adoption of an operational restructuring program for Rafidain bank based on the findings of the audits.	September 30, 2008	Delayed 4/
Adoption of operational and financial restructuring programs for Rasheed bank based on the findings of the audits.	September 30, 2008	Delayed 4/
Submission to the Council of Representatives and publication of the audited accounts of the Federal Budget for the year ending December 2007, in accordance with the Financial Management Law of 2004.	November 15, 2008	Underway

1/ Reconciliation of local banks' current account has improved after the CBI tightened its reporting requirements from the banks. No progress has been made with respect to the reconciliation of suspense accounts (mainly with the Ministry of Finance), and of CBI intra-branch accounts.

2/ Expected in January 2009.

3/ Nine key regulations have been finalized.

4/ Preparation of the restructuring programs will start before end-2008.