

## International Monetary Fund

[Iraq](#) and the IMF

**Iraq:** Letter of Intent, and Technical Memorandum of Understanding

**Press Release:**

[IMF Executive Board  
Completes First  
Review Under Stand-  
By Arrangement with  
Iraq, Grants Waivers  
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## LETTER OF INTENT

September 18, 2010

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

Dear Mr. Strauss-Kahn:

In February 2010, the International Monetary Fund (IMF) approved a Stand-By Arrangement (SBA) for Iraq, to help us address the challenges created by the deterioration of the external environment, including the sharp drop in international oil prices from their peak in 2008 and the slowdown in the global economy. In addition, the program also aims to accelerate the pace of structural reforms, in particular to improve the management of public resources and to develop the financial sector. This arrangement is providing us with needed financial support and a valuable anchor during a period of political transition and considerable uncertainty with regard to the global economic outlook.

We remain, of course, committed to implementing the policies described in our Letter of Intent dated February 8, 2010 and the Memorandum of Economic and Financial Policies attached to that letter. This supplementary Letter of Intent provides information on our recent efforts and achievements, as well as on additional policy measures we plan to undertake during the remainder of 2010 to help ensure that the objectives of the SBA will be met.

Overall economic performance so far in 2010 has been favorable, aided by oil prices that were higher than we had conservatively assumed in our 2010 government budget. Export prices of Iraqi crude oil averaged \$75 per barrel in the first half of the year, compared to a budgeted price of \$62.50 per barrel. Oil export volumes averaged 1.88 million barrels per day (mbpd), however, in the first half of the year, falling short of our target of 2.10 mbpd for 2010. This was due mainly to adverse weather conditions that delayed tanker loadings at our main export terminals in the Gulf, but also reflecting difficulties in securing an increase in oil exports from the northern oil fields. Nevertheless, with the higher-than-budgeted oil prices, government oil revenues were slightly higher in the first half of the year than projected. As a result, fiscal performance has been strong and while the pace of budget execution has been relatively strong also, the budget deficit in the first half of the year is estimated to have remained below its ceiling. Similarly, the balance in the Development Fund for Iraq (DFI) has exceeded the program floors through end-June 2010.

Inflation continues to be in the low single digits so far in 2010 and the exchange rate has remained stable. With core inflation hovering around 3 percent, the Central Bank of Iraq (CBI)

lowered its policy interest rate further to 6 percent (from 7 percent) and reserve requirements to 20 percent (from 25 percent) effective April 1, 2010. With continued strong demand for foreign exchange in the foreign exchange auctions and somewhat lower than expected transfers from the DFI to the Ministry of Finance's accounts with the CBI, the CBI's international reserves declined to \$41 billion by end-June, falling below program targets. Our combined international reserves (the sum of the CBI reserves and the balance in the DFI), however, remained broadly stable during the first half of 2010, an outcome that was significantly better than projected.

In the remainder of 2010 and in 2011, we plan to continue with our fiscal and monetary policies as set forth in our letter of February 8, 2010. We hope to be able to fully execute the 2010 government budget, in particular the investment budget, and we are working hard to improve administrative capacity. The 2011 government budget will again be based on conservative assumptions with regard to oil prices and export volumes, and will aim for a substantial reduction in the budget deficit with a view to returning to a sustainable fiscal position, while addressing the large rehabilitation needs of the country. Monetary policy will continue to aim at keeping inflation low, predominantly through a continuation of our exchange rate policy.

We have also made steady progress in advancing our structural reform agenda and most of the structural benchmarks through end-June were fully or largely observed. In the area of program safeguards, the external audits of the CBI's 2008 and 2009 financial statements were completed, as well as a special audit of the CBI's net international reserves as of end-December 2009. The CBI has also started to report on its international reserves in line with IMF recommendations. In the area of fiscal reporting and transparency, the final fiscal accounts for 2008 were submitted to the Board of Supreme Audit (BSA), while the BSA completed the audit of the 2005–07 fiscal accounts and submitted these to the parliament. Publication of these audited accounts requires a decision from parliament. Government spending units have improved their monthly financial reporting, although some difficulties remain, while the processing of this information is hampered by capacity constraints at the Ministry of Finance resulting from the repeated attacks on the ministry. The budget circular issued to line ministries in June for the preparation of the 2011 government budget included ceilings for each ministry for current and capital spending that aim to substantially reduce the size of the budget deficit in 2011. In the area of oil sector transparency, Iraq became a candidate member of the Extractive Industries Transparency Initiative in February 2010. Furthermore, we have submitted an action plan to the UN Security Council to prepare for a post-DFI mechanism. In this regard, we remain committed to maintaining a single oil export revenue account that is subject to the same principles of transparency and accountability as the DFI currently.

The review of all accounts in the banking system that are classified as central government accounts proved to be more difficult than expected, given the vast number of accounts. We have, however, been able to identify which of the accounts reported by banks as central government deposits truly belong to the government, and also clarified the ownership of the bulk of the remaining accounts. As we had expected, the accounts which do not belong to the central

government include mainly the pension fund, state-owned enterprises, and various agencies and funds that operate at arm's length of the central government. The CBI is working with the banks to ensure proper differentiation between central government (budget) accounts and other public sector accounts.

Similarly, little progress was made in the restructuring of the balance sheets of the two largest state-owned banks, Rafidain and Rasheed. With the assistance of the IMF, however, we have now developed a way forward to remove the legacy items of the Saddam-era regime from the balance sheets of these banks. More specifically, we will establish a Bank Reconciliation Unit (BRU), with participation at a technical level of staff from these two banks, the CBI, the Ministry of Finance, the BSA, and experts of Ernst & Young (who were the agents of the Ministry of Finance in the external debt restructuring process) to: (i) deal with all legacy external liabilities taking into account the government's actions in the context of Iraq's external debt restructuring (ii) identify and propose to write-off nonperforming loans to defunct state-owned enterprises; (iii) propose a course of action for other remaining unreconciled accounts; and (iv) after the balance sheets have been cleaned up, revalue the remaining foreign currency denominated balance sheet items. The BRU will work under the supervision of the Restructuring Oversight Committee (ROC), consisting of the Minister of Finance, the Governor of the CBI, and the Chairman of the BSA. The BRU will send its recommendations for final approval to the ROC to ensure that the restructuring of these banks' balance sheet has the necessary support and authorization. Through this process, we aim to complete the restructuring of the balance sheets of Rafidain and Rasheed by end-June 2011 (a new date for the completion of this structural benchmark).

Meanwhile, the Ministry of Finance will continue to modernize these banks by moving ahead with the plans for their operational restructuring, and these banks will operate on a fully commercial basis, on market terms. Decisions on the recapitalization of Rafidain and Rasheed will not be made until the restructuring of their balance sheets has been completed and adequate progress has been made in their operational restructuring, especially by establishing an appropriate governance structure and strengthening risk management and control functions. More generally, given the vulnerabilities these (and other) banks face due to operational risks, the CBI will continue to improve its oversight systems and monitor closely the activities of the banks, particularly during the transition process.

We are working to address the remaining safeguard risks at the CBI identified by the IMF's safeguards assessment that was completed in June 2010. The CBI will contract a multi-year co-sourcing agreement with a reputable accounting firm by end-December 2010 (a new structural benchmark under the program), with the external consultant to work alongside its internal audit staff to review and improve the internal audit function. In addition, the CBI Board has adopted a decision to transform the Internal Control Committee into an Audit Committee that will be headed by one of the CBI's deputy governors, but otherwise will consist of a majority of

non-executive members and will have a comprehensive mandate to exercise effective oversight. This committee will be effective in this new format no later than end-October 2010 (also a new structural benchmark under the program). Furthermore, the CBI will continue to have an external auditor conduct reviews of its net international reserves and also of its net domestic assets for each test date under the SBA (with the exception of end-March), with the review for end-June 2010 to be completed by end-October 2010 (another new structural benchmark under the program), and with the scope of the NDA review expanded to include a review of the operations of the Memorandum of Understanding between the CBI and the Ministry of Finance with regard to IMF disbursements and debt service obligations and the operational controls over government accounts.

We are also making additional efforts to strengthen public financial management. We will shortly finalize and distribute to all spending units a new accounting manual that will help to improve the implementation of the new Chart of Accounts (a new structural benchmark for end-December 2010). In addition, to further improve the fiscal reporting by spending units, we have issued a circular instructing them to provide additional information on advances and letters of credit. The collection of information for the census of civil service employees is proceeding slowly, but we still hope to be able to gather all the necessary information by end-December 2010. Meanwhile, we will also review, with the assistance of the World Bank and the United Nations, the new Civil Service Law that is currently with the Shura Council in view with international best practices and to ensure effective implementation.

We have met all the performance criteria for end-March 2010, with the exception of the floor under the CBI's net international reserves. We have also met all of the performance criteria for end-June 2010 that can already be assessed, again with the exception of the floor under the CBI's net international reserves. We request a waiver of nonobservance for the missed performance criterion for end-June and also request a waiver of applicability for the end-June 2010 performance criterion related to the central government current spending bill for which data is not yet available and for which there is no evidence that it was not observed. Furthermore, due to the delay in completing the first review, we request rephrasing of the disbursements under the SBA. The second review is expected to take place on or after October 30, 2010 and the third review on or after May 31, 2011.

Overall, our economic program is off to a good start and we believe that our policies set forth in our letter of February 8, 2010 and supplemented by the policies described in this letter are adequate to achieve our objectives. In support of our policies, we request the Executive Board of the IMF to complete the first review and approve the second disbursement under the SBA of SDR 475.36 million. We are fully aware of the many challenges ahead and we 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 and will maintain a close policy dialogue with IMF staff. We authorize the IMF to publish this 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/

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

/s/

Dr. Sinan Al-Shabibi  
Governor  
Central Bank of Iraq

Table 1. Iraq: Quantitative Performance Criteria  
Under the Stand-By Arrangement, 2009–11 1/  
(In billions of Iraqi dinars, unless otherwise indicated)

	Amount at 12/31/09	Performance Criteria						Indicative targets 6/30/11	
		3/31/10			6/30/10				12/31/10
		Program	Adjusted	Est.	Program	Adjusted	Est.		Program
Stock of net international reserves of the CBI (floor; eop stock, in millions of U.S. dollars)	44,337	44,257	44,257	43,895	44,178	44,178	41,388	44,019	45,816
Net domestic assets of the CBI 2/ (ceiling; eop stock)	-1,243	-398	-398	-4,117	38	38	-1,085	1,320	717
Development Fund for Iraq balances (DFI) (floor; eop stock; in billions of U.S. dollars, excl. FMS)	9.9	8.0	8.6	11.9	4.5	6.0	9.8	2.6	4.6
<i>Cumulative flow from beginning of calendar year</i>									
Central government fiscal deficit (CGFD, ceiling) 3/ 4/ 5/	...	5,382	4,698	-3,584	9,149	7,378	-2,575	17,939	4,450
Central government current spending bill (ceiling) 3/ 5/	...	8,141	8,141	4,854	14,926	14,926	...	27,138	15,327
Direct government subsidies to the fuel sector 6/	...	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) 6/ 7/	...	2,000	2,000	0	2,000	2,000	0	2,000	2,000
External arrears on existing/rescheduled debt and new borrowing (in millions of U.S. dollars; ceiling) 6/	...	0	0	0	0	0	0	0	0

1/ The Technical Memorandum of Understanding (TMU; EBS/10/28) 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: Structural Benchmarks Under the Stand-By Arrangement 1/

	Date	Status
<b>Program Safeguards and Central Banking</b>		
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	Met
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	Met
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	Largely met
4. <i>Completion by an external auditor of special audits of the CBI's net international reserves and net domestic assets as of June 30, 2010</i>	<i>October 30, 2010</i>	
5. <i>Put into effect the changes to the CBI Internal Audit Committee, including majority non-executive membership and a terms of reference establishing mandate and independence</i>	<i>October 30, 2010</i>	
6. <i>Contract an external audit firm to assist the CBI with strengthening its internal audit function</i>	<i>December 31, 2010</i>	
<b>Bank Restructuring</b>		
7. Completion of the restructuring of the balance sheets of Rasheed and Rafidain banks.	June 30, 2010 (Extended to June 30, 2011)	Not met
<b>Public Financial Management</b>		
8. 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	Partially met
9. Submit	March 31, 2010	Met
<ul style="list-style-type: none"> <li>• 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;</li> <li>• 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</li> <li>• 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.</li> </ul>	March 31, 2010	Largely met
10. 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	Partially met
11. 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	Largely met
12. 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	
13. 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	
14. Completion of census of all central government employees (excluding those employed in the security area).	September 30, 2010	



	<i>(Extended to December 31, 2010)</i>	
<i>15. Complete and distribute to all spending units a new, comprehensive accounting manual</i>	<i>December 31, 2010</i>	
<b>Oil Sector</b>		
16. Complete the process of becoming a candidate for membership in the EITI.	March 31, 2010	Met
17. Complete the installation of all domestic metering systems to allow accurate measurement of domestic oil flows.	December 31, 2010	
18. 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	
19. 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	Met

1/ Benchmarks in italics are new.

## ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING

September 18, 2010

1. The Technical Memorandum of Understanding of February 8, 2010 will remain in effect except for the changes described below.
2. The definition of net international reserves is modified as follows: 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 nonresidents with original maturity of one year or less, and all liabilities to the Fund, but excluding the liabilities represented by SDR allocations.* 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. As of December 31, 2009, (net) international reserves amounted to US\$44.34 billion, all comprising of reserve assets.