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وزارة المالية
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Mr. Jim Yong Kim
President of the World Bank Group
World Bank
1818 H Street, N.W.
Washington D.C. 20433
U.S.A.

Ref: Letter of Development Policy

**Iraq: Emergency Fiscal Stabilization, Energy Sustainability and State-Owned Enterprise
Transparency Development Policy Financing**

Dear Mr. Kim,

1. While Iraq's recent history has been painfully marred by security, economic and human development challenges, today Iraq finds itself at a particularly critical juncture and facing two exogenous shocks. We are battling an existential fight against the so-called Islamic State group (Daesh) and grappling with a potential economic and social crisis as a result of the sharp downturn in the price of oil affecting our main export and source of revenues. Yet, for the sake of our country and its unity, we are determined to overcome these formidable challenges through strategic vision, security-focus, and the implementation of necessary reforms with the support of bilateral and multilateral partners.

Background

2. The incursion of Daesh into Iraq has been brutal including on the humanitarian and economic fronts. We have launched a concerted and ongoing military campaign against Daesh. This campaign has already produced important victories, as shown by regaining the control of large cities such as Tikrit, Dyala, and Baiji, and we are currently working on reinstating the presence of the State in these areas (we are doing so in partnership with the World Bank through the US\$350 million Emergency Operation for Development). Despite these gains, large parts of Iraq's territory still remain under Daesh control. In addition to the lives lost as a result of terrorist activity, we are witnessing the unfolding of a humanitarian crisis: over 3 million Iraqi citizens are internally displaced and 245,000 Syrian refugees that have fled the conflict in their country are placing a large burden on our already stressed public services. The conflict is also leading to large destruction in physical assets.
3. The oil economy, the main driver of our economy, has also been severely hit by the sharp reduction in oil prices since 2014. While we have been able to mitigate this shock by increasing the supply of exported oil (with oil production in 2015 forecast to increase to 3.4 million barrels per day (mbpd) from 3.1 mbpd in 2014), the economy, public finances, external balance and oil wealth have been negatively impacted by this second shock.

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4. As a result, advances we had made in some development indicators have reversed and poverty has been increasing. As estimated by the World Bank, employment has been drastically cut, by 800,000 jobs. The shocks have also pushed an additional 2.8 million Iraqis into poverty. Beyond the human suffering and tragedy, IDPs are under particularly difficult economic circumstances: about 500,000 of them are poor and the poverty rate among IDPs is a staggering 40 percent, almost twice Iraq's national average. For the population as a whole, the twin shocks have, in a very short period of time, resulted in a sharp reduction in our GDP per capita, from about \$7,000 in 2013 to about \$5,000 in 2015.

Macroeconomic, external and fiscal sectors, current and outlook

5. The economy, public finances and the external sector have been severely affected by the two exogenous shocks facing Iraq. The economy rebounded sharply after the global recession, and was able to grow in real terms by double digit rates over 2012 and 2013. By contrast, in 2014 the economy contracted by 2.2 percent. The persistence of the shocks continue to weigh heavily on 2015, with growth projected to reach 1.5 percent. These numbers mask an even more dire economic and social situation. Given the non-diversified nature of our economy, oil-sector growth—which has a relatively low labor intensity—provided the impetus for the tepid economic activity we are observing. The non-oil economy is, however, facing a brutal recession with a collapse in growth from an expansion of 10.2 percent in 2013 to a contraction of 7 percent in 2014 and a further contraction of 6.7 percent projected for 2015. This dire non-oil economic situation has led to the loss of 800,000 jobs mentioned above. Inflation remains restrained reaching 1.6 percent on an end-of-period basis at the end of 2014 and is expected to reach 3.0 percent end-2015, although we are concerned about potentially higher inflation rates in areas within Daesh control.
6. On the external front, the current account balance is forecast to reach a deficit of 7 percent of GDP by end 2015 compared to a deficit of 1.3 percent in 2014, when it first turned negative. This deterioration is led by the plunging of oil prices since 2014 which negatively affects revenues from oil exports. The latter are expected to fall by 25 percent in 2015 compared to 2014 when they had already contracted by 7 percent compared to the previous year. With these balance of payment pressures, our gross reserves have been on a downward path since 2013, estimated to reach US\$51.1 billion by end-2015. This level of reserves is comfortable to maintain our peg, as recently assessed in the 2015 IMF Article IV consultations published on August 2015.
7. On the fiscal front, the fall in oil prices has abruptly reduced our revenue while the Daesh shock has necessitated an increase in spending thereby pushing our fiscal balance into a large deficit. Our initial budget envisaged a high fiscal deficit which, given our limited sources of financing and instruments available would have been very challenging to finance. Cognizant of this, we revised the 2015 budget law by introducing new revenue and expenditure measures worth ID 13 trillion. Unfortunately, passage of our revenue measures was not approved by Parliament. As a result, most of the brunt of the adjustment is falling on the expenditure side, and in particular on investment spending which is one of the few large discretionary items in the budget. We are also taking measures to ensure that the country can boost its oil exports, so as to limit the impact of the subdued international oil prices on our budgetary revenues. Thanks to these steps, our fiscal deficit for 2015 is projected to be contained to 14.5 percent of GDP according to the IMF and the World Bank. As a result, our public debt-to-GDP ratio is forecast to reach 61.7 percent by end-2015 up from 38.9 percent at end-2014. We are mindful of this sharp increase and we are committed to sound and improved debt management to manage the debt and to fiscal consolidation to narrow the deficit.



8. The large widening of the deficit coupled with our limited sources of financing have made it difficult to finance the deficit in 2015. We have sought to diversify the sources of funding to close our remaining financing needs. Yet, given our underdeveloped domestic debt market and no previous tapping of international bond markets, we are resorting to Treasury Bill issuances and borrowing from state-owned banks, the Central Bank of Iraq (CBI), and multilateral partners. As these sources were not sufficient to meet our financing needs, we have been forced to delay the payment of some of our domestic expenditure. We do not, however, have payment arrears with the international oil companies operating in Iraq so as to avoid jeopardizing any crucial investments and operations on their part.
9. In 2015, our external arrears were primarily towards international oil companies, and these arrears have been substantially paid. In 2016, we will not resort to the accumulation of new arrears. We have committed to pay US\$12 billion in 2016 to international oil companies. With regards to domestic arrears, at end-April 2015, the government identified ID7.3 trillion in domestic arrears, out of which ID 5 trillion accumulated in 2015. We envisage the payment of ID 2.4 trillion of domestic arrears in 2016. As an IMF SMP structural benchmark, we have agreed to undertake a survey to assess the extent of the arrears accumulated. As a first step, the Ministry of Planning will complete, by end-February 2016, a survey of domestic arrears on investment spending accumulated by all ministries, and the Ministry of Finance will complete a survey on current spending accumulated by the same units. On the basis of these surveys, we will prepare a plan for the orderly payment of these arrears, which will include an independent audit of these arrears and a repayment schedule in line with our financing capacity.
10. Despite challenges and a continued low oil price which we conservatively set at US\$45/barrel for our 2016 draft budget, we expect some improvement over the next year although the situation remains challenging. With increased oil production projected at 4.2mbpd in 2016, we expect overall growth to pick up with a return to positive/flat growth in the non-oil economy on the back of a projected improvement in the security situation. With higher oil exports, we envisage an improved trade and current account balances in 2016. Given fiscal consolidation efforts, we expect the fiscal deficit to narrow by 3.6 percent of GDP in 2016 to reach 10.9 percent of GDP. We also expect that the fiscal deficit will be fully financed through multiple funding sources both domestically and externally from international financial institutions, donors and capital markets.

The Government's reform focus

11. The Government of Iraq is steadfast in pursuing reforms despite challenges and we are committed to implement our 2014-18 Action Plan (*Action Plan* thereafter). The priority of this program is security and stability for all of Iraq, liberating Daesh-controlled areas and reinstating rule and order, a prerequisite for an improved economy and for development. The second priority is to step up the level of public services including provisioning of electricity, water, health, education and ameliorating the social protection system. The August 2015 protests from citizens were a call to speed up our reform efforts. The Government listened to the people's demands and launched a series of reforms in governance in addition to other social and economic reforms towards inclusive growth, improved fiscal management, augmented electricity provision and enhanced investment environment and movement towards a market economy.



12. On the fiscal management front, we are eager to improve the efficiency of our current and investment expenditures. We recognize that this will require difficult and socially-sensitive measures. In line with our commitment to fiscal sustainability and sound macroeconomic policies, we commit to implementing such measures as we did in 2007 when eliminating direct budgetary fuel subsidies.

- a. At an estimated 17.1 percent of GDP, our wage bill, the largest expenditure item, is high compared to international standards and still growing. With a comparatively high salaries for top public sector employees (when compared to similarly educated private sector workers), large bonuses and allowances, non-transparent recruiting into the public sector, and weak payrolls and disbursement process, there is much scope to improve auditing, efficiency, and fairness. As such, the Government has prepared and endorsed a new salary scale for state and public sector employees. This new scale reduces the nominal salary of top public sector employees while also, for fairness and social cohesion in the public sector, increases the nominal wage of lower grade public sector employees.
- b. The rationalization and prioritization of investment projects is urgently needed. Our investment projects currently suffer from a number of structural inefficiencies, low execution and low utilization rates. Improvement is needed not only to prioritize and effectively and efficiently implement the limited investment spending that is feasible for 2016, but also to be able, over the medium term to afford to undertake the large investment projects required for rebuilding the country. To address this, the Prime Minister has issued a decree to adopt a Public Investment Management (PIM) Framework. This framework covers the public investment cycle from project feasibility to post evaluation phases of a project, including preparation of a Cost-Benefit analysis for capital projects. To further support the implementation of the framework, the Ministry of Planning will set up and host the Central PIM Unit which is expected to be operational by end-2016 to oversee project appraisal and monitoring. Additionally, by the end of the following year, we aim to make a specialized monitoring and ex-post evaluation team within this unit.
- c. With a debt-to-GDP ratio that has almost doubled in the last two years and is forecast to reach 69 percent by end-2016, embarking on improvements in our debt management is key. As such, I have established a Debt Management Section within the Ministry of Finance to improve our capacity to record and report on the debt in line with international best practice, improve management of the debt, prepare medium-term debt strategies, coordinate with the Central Bank of Iraq on issues of debt management and develop the legal framework to introduce new instruments in line with diversifying our funding sources. Building capacity in this unit will also be crucial to explore new financing instruments, develop our nascent domestic debt market and improve our access to international capital markets having learned from our recent unfruitful Eurobond issue attempt. We have already secured the assistance of JICA for the purpose of building capacity in this unit. By end-2016, we aim to adopt a medium-term debt strategy which will support increasing the average debt maturity of domestic public debt from the current short average duration of 0.6 years—which exposes public finances to large debt rollover risks—to an average duration of 1 year by end-2016. We shall also undertake and publish the results of a DEMPA by this time. This will provide us with a comprehensive and candid assessment of our public debt management, assessed against international best practices.



- d. At about 4 percent of GDP, our pension spending is high compared to international standards. It is fragmented, suffers from coverage gaps and is unsustainable. In line with efforts to reform pensions, the National Board of Pension is removing at least 30,000 non-eligible retirees from the data registry -these represent about 10 percent of the Fund's current beneficiaries- leading to a reduced budget of the National Pension Board in 2016. Additionally, we aim to continue medium-term reforms on this front with planned amendments to the pension law by end-2016, through unification of the State and private sector pension systems into the same national scheme the following year and through more comprehensive coverage of active workers.
13. On the energy supply front, we are striving to improve the sustainability of supply particularly given that this is a priority concern for our citizens and in line with the fourth strategic priority of our *Action Plan*. To reduce our chronic 6-7 GW electricity shortage which generates a significant cost to our economy, we need to make better use of domestic gas, which is our least cost option, and reduce our dependency on more expensive crude and heavy fuel oil and imported diesel. Despite being one of the world's most gas-rich countries in terms of proven reserves, inefficiencies mean that almost 60 percent of our associated gas is flared in-field rendering Iraq the fourth largest gas flaring country in the world. This generates large economic and fiscal costs which can be reversed, through capturing flared gas, ensuring it is transmitted to markets, and promoting the efficient use of domestic gas, for instance by introducing combined-cycle power plants (CCGT) and supporting industries that depend on gas feedstock and gas fuel.
- a. In line with our 2013 Integrated National Strategy of Energy, the Ministry of Oil has committed to reducing gas flaring to zero by 2030. The projected reduction is expected to result in the capture of US\$2.1 billion worth of associated gas by end-2016. Absent this measure, our otherwise planned increase in oil production would result in even larger quantities of flared gas. With this commitment, the expected increase in supply from capturing, processing and the transportation of the natural gas produced, would provide a long term fuel supply for the additional generation capacity required to meet the growing electricity demand in Iraq, resulting in economic and social benefits and the reduction of air pollution and CO₂ emissions. As an important first step, we have committed to increase the processing of flared gas, and we are committed to pay \$236 million in arrears to the Basra Gas Company by end-January 2016, which will enable us to significantly increase gas available to the power grid within one year. By end-2016, we are also planning to adopt and begin implementation of a Gas Pricing Policy, which will increase the value of flared gas. The following year we also aim to implement a fuel pricing plan for the reduction in fuel subsidies to domestic, industrial, commercial and retail consumers.
- b. Today, about 80 percent of the fuel used in power generation consists of fuels that are heavy and costlier than natural gas, and that degrade power generation equipment faster. In order to shift power generation to natural gas, and reduce the fiscal burden of the power sector, the Council of Ministers set up an inter-ministerial committee to develop a five-year "Gas to Power Action Plan." This will address such issues as the sequencing of conversion of power plants to Combined Cycle Gas Turbines (CCGT) and the sequencing of construction of gas and electricity transmission. We expect to launch the plan's implementation by end-2016 and evaluate and update it in line with achieving its targets by end-2017. These measures, coupled with our plan to reduce the share of



gas flared, are intended to enhance the share of natural gas in the power sector ultimately resulting in large fiscal and balance of payment savings.

- c. One of the impediments in attracting much needed investments in the power sector has been low electricity tariffs that have been frozen at below cost recovery levels since the 1990s. This has put pressure on Government funding when coupled with technical losses in transmission and distribution and weak billing and collection. To reduce this fiscal burden and improve service delivery, we realize the need to rationalize the tariff structure. As such, we have approved the implementation of a new (unsubsidized) commercial tariff for large commercial consumers (except for hospitals) who would like a continuous supply of electricity via contracts with the Ministry of Electricity. This scheme targets commercial users, and does not impact households. We are aware that Iraqis rely on private diesel generators to complement power supply available from the grid, and they pay significantly higher prices for this. We are planning a phased approach towards cost recovery in power generation and fiscal savings through progressive electricity tariff adjustments, which will be implemented while we are improving the quantity of power available in the grid. However, we are mindful of the impact this could have on vulnerable parts of our population and we are working to ensure that the planned tariff increases are mitigated for these citizens. By the end of 2016 we aim to approve such tariff adjustments and by the end of the following year, we aim to implement the plan in line with a progressive electricity tariff recovery plan that will carefully consider affordability for consumers.
14. In line with efforts to improve governance, we are committed to improving the transparency of State-Owned Enterprises (SOEs). At the moment, SOEs are largely weakly accountable, overstaffed, generating fiscal costs and posing a liability for the Government. Given poor reporting from the 176 non-financial SOEs, it is challenging to quantify these potential liabilities. Addressing enhanced transparency of these SOEs would also contribute towards transitioning our economy to a market-based economy that supports private sector development and is able to generate the jobs needed for our population, both in quantity and in quality. This is consistent with the third and fifth strategic priorities of our *Action Plan* calling for a shift towards the private sector and implementing administrative and financial reform of Government institutions.
- a. In order to better inform decisions in monitoring and managing the large number of SOEs, support enhanced accountability, and mitigate the fiscal risks they pose, we are undertaking measures to improve the information collected on SOEs in a central repository. To this end, the Prime Minister has issued a decree stipulating the establishment of a committee to establish, operate and supervise a database to monitor the fiscal risks of non-financial SOEs. The committee has also been tasked with updating and publishing the financial and employment data of these SOEs, in a first stage, on an annual basis on the Council of Ministers website. We aim for this information to be available for 75 percent of SOEs (outside of Daesh-controlled areas and the KRG) by end-2016. By the end of 2017, we expect that SOE coverage will be complete for all SOEs (outside of Daesh-controlled areas).
 - b. Also in line with enhanced transparency and stimulating the private sector towards financial intermediation, we are implementing actions that support the development of private banks which currently account for only 11 percent of the banking system's deposits. Given the dominance of our seven state-owned banks, and the Financial Action Task Force's (FATF) assessment of Iraq as



being noncompliant or partially compliant with core recommendations, we have adopted two measures to level the playing field between state-owned and private banks by allowing for a wider range of financial services that private banks may provide to Government ministries and SOEs as stipulated by a Council of Ministers decision. We are also removing the risk of Iraq being blacklisted by FATF, which would be detrimental to the Iraqi economy. This was done through the passage of the Combatting of Money Laundering and the Financing of Terrorism Law, No 39 in 2015. These reforms are part of a medium-term plan to strengthen the banking sector's resiliency. Under this plan the CBI is planning to issue further regulations in line with FATF recommendations by end-2016. We are committed to prepare terms of reference for an audit of the Rasheed and Al-Rafidain's balance sheets by a reputable audit firm, contract the audit, and complete and publish the audit by the end of 2016. We plan to prepare these terms of reference along international standards and to reach agreement with the IMF and the World Bank on the terms of reference by end-February 2016. Based on the results of the audit, we are committed to formulate and start implementation of a restructuring plan for these two state banks in 2017. Also on the AML/CFT front, we expect a Financial Intelligence Unit at the CBI to be fully operational by end-2017.

Partnership with international partners including the World Bank

- 15 The Government of Iraq is working hand in hand with international partners to garner financial support and technical assistance to implement the reforms to which we have committed. Following the Rapid Financing Instrument (RFI) and subsequently approved Staff-Monitored Program (SMP) with the IMF on November 10, 2015, we expect negotiations on a Stand-By Arrangement (SBA) to start around July to September 2016. In spite of the challenging times the country is facing, the agreed fully-financed SMP requires a firm and resolute implementation of policies but the proposed adjustment is realistic and we are committed to diligently implementing it and successfully demonstrating a good performance track record on the SMP. We are looking at the Fund SBA, the proposed World Bank Development Policy Financing (the DPF) and JICA budget support to be catalytic in sending a strong signal to international financial markets that Iraq is undertaking strong short-term and structural reforms with international partners. We expect this signal to enable us to access such markets on financial terms and conditions that are acceptable for the Republic of Iraq. We have also engaged into a comprehensive medium-term technical assistance program with partner countries and institutions. In particular, we have a program with JICA on public debt management (as mentioned), another one with the Energy Sector Management Assistance Program (ESMAP) on the reduction of electricity subsidies, a third one on improving the transparency of financial SOEs and banking sector reforms which is supported by the World Bank and financed by Japan. We also have other envisaged technical assistance support by other international partners such as DFID and USAID that are in the process of being finalized in the areas of public financial management, pension reform, reduction of gas flaring, expanding gas use to power generation and improving the transparency of non-financial SOEs.
- 16 The World Bank is a trusted partner in this quest. We value the partnership and support from the Bank when Iraq was hit by a similar oil price crash-induced fiscal shock in 2009 but at that time without the security shock that Daesh is currently presenting. At that time we embarked on a Development Policy Loan to mitigate the impact of this shock and support Iraq's medium-term reform program. Most recently, the Bank's Board approved the US\$350 million Emergency Operation for Development in July 2015 for rapid assistance to



resume basic services in areas reclaimed from Daesh, including in improving damaged electricity transmission and distribution networks. In addition to these lending operations, we continue to appreciate advisory support from the Bank on a range of development areas including PIM, pension reform, tariff reforms, pricing of natural gas flared, and short-term actions to reduce power cuts.

17. The Government of Iraq expresses its full commitment to the implementation of the reform plan outlined above. To this end, we seize the opportunity to request continuing support from the World Bank for its implementation through the proposed DPI. The proposed DPI is aligned with the Government's priorities and is a welcome and important element of our strategy towards the successful achievement of specific reform actions and financing support. Particularly, the DPI will support us to improve our budgetary spending through reforms in the wage bill, PIM, public debt management and pensions. It will also support another objective to develop the sustainability of energy supply through reduced gas flaring, the expanded gas use to power generation and reduced electricity subsidies. And finally, the operation will sustain enhanced transparency of state-owned enterprises in line with our goal to improve governance, through reforms in SOEs, both financial and non-financial, and banking sector reforms.
18. In closing, we appreciate the World Bank's support of Iraq's reform agenda over the past critical years across lending and advisory roles. The Government of Iraq requests the approval of the World Bank support of our most recent program as outlined above during these utmost challenging times.

Yours sincerely,

Hoshyar Zebari

Minister of Finance