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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/66-1

10:00 a.m., July 19, 2019

1. Iraq—2019 Article IV Consultation and Proposal for Post-Program Monitoring

Documents: EBS/19/70 and Correction 1; and Correction 2; and Supplement 1; SM/19/185

Staff: Gray, MCD; Kostial, SPR

Length: 53 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
	K. Carvalho da Silveira (AF), Temporary
	J. Di Tata (AG)
N. Ray (AP)	
	P. Fachada (BR)
	Y. Zhao (CC), Temporary
	J. Montero (CE), Temporary
L. Levonian (CO)	
R. Kaya (EC)	
	A. Sode (FF), Temporary
	K. Merk (GR)
	M. Siriwardana (IN)
	P. Di Lorenzo (IT), Temporary
	Y. Saito (JA)
	C. Sassanpour (MD), Temporary
H. Beblawi (MI)	
	H. Etkes (NE), Temporary
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
M. Mouminah (SA)	
	K.Tan (ST)
P. Inderbinen (SZ)	
	R. Masood (UK), Temporary
	P. Pollard (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
D. Alcantara, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Fiscal Affairs Department: S. Yousefi. Finance Department: L. Chidawaya, H. Chociay. Legal Department: C. Blair, A. El Murr. Middle East and Central Asia Department: J. Azour, A. de Keyserling, S. Dehmej, W. Gray, A. Holland, T. Koranchelian, G. Shbaikat. Strategy, Policy, and Review Department: K. Kostial. World Bank Group: K. Carey, A. Maseeh.

Executive Director: G. Lopetegui (AG), M. Raghani (AF). Alternate Executive Director: R. Alkhareif (SA), S. Geadah (MI), A. Guerra (CE), M. Psalidopoulos (IT). Senior Advisors to Executive Directors: M. Choueiri (MI), G. Heim (SZ), Z.Mahyuddin (ST), Z.Mohammed (BR), G. Vasishtha (CO). Advisors to Executive Directors: F. Al-Kohlany (MI), P. Al-Riffai (MI), O. Bayar (EC), J. Corvalan (AG), J. Essuvi (AE), D. Fadhel (MI), I. Fragin (GR), R. Lopes Varela (AF), M. Merhi (MI), A. Park (AP), M. Shimada (JA).

1. IRAQ—2019 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING

Mr. Beblawi and Ms. Choueiri submitted the following statement:

On behalf of the Iraqi authorities, we would like to thank staff for their constructive engagement, as well as the valuable capacity development provided to Iraq in support of its policy and reform efforts.

Recent Developments

Since the last Article IV discussion for Iraq, several elements contributed to improved political and economic conditions in the country: The formation of a new government, the recapture of territories previously held by ISIS, and a gradual recovery in oil prices. Millions of people displaced by the war against ISIS returned home, and negotiations around trade agreements with neighboring countries have progressed. Nonetheless, hundreds of thousands remain internally displaced and reconstruction efforts are delayed by many factors, including implementation capacity.

The economy is gradually recovering following the deep economic strains of the last four years. Growth is expected to be robust in 2019, reversing the contraction seen in the past two years, thanks to a notable improvement in security conditions and higher oil prices. The non-oil economy is projected to grow at more than 5 percent, due to better rainfall, a rebound in electricity production, and the fiscal stimulus. Inflation remained low in 2018 and the fiscal balance turned to a large surplus of about 8 percent. Higher oil prices have also supported a steady increase in international reserves to US$65 billion, helping to rebuild solid buffers to external shocks and retire domestic debt, including unwinding about US$1 billion of indirect monetary financing. Growth and the positive fiscal balance contributed to reducing public debt-to-GDP by about ten percentage points in 2018 and the government has adopted a framework to control the issuance of guarantees, in cooperation with the Fund. Higher oil prices and the improvement in the underlying fiscal position also contributed to a marked improvement in the external position, as reflected in the large current account surplus (about 7 percent of GDP). At the same time, the spread between official and market foreign exchange rates has narrowed to below 2 percent in recent months.

The authorities are fully aware that Iraq is facing the challenge of maintaining economic stability, while ensuring durable peace and inclusive growth. This entails rebuilding much needed infrastructure, addressing the legacy of conflict, ensuring the provision of services and job opportunities for all Iraqis, particularly the youth, and modernizing the economy. To address these challenges, the newly formed Government of Iraq has launched an ambitious reform and reconstruction agenda, outlined in the Recovery, Reconstruction, and Development Program and National Development Plan. In February 2018, in Kuwait, the international community committed to supporting Iraq's reconstruction and development and pledged US$30 billion in the form of loans and guarantees at the International Conference for the Reconstruction of Iraq. A small portion of the needed reconstruction effort has, however, taken place to date, mainly due to limited absorptive and implementation capacity, as well as slow disbursement of pledged donor financing due to the heavy documentation requirements and project procedures.

Fiscal Policies and Reforms

The authorities are faced with pressures to increase employment in the public sector to address unemployment, achieve justice for some groups that were affected by past fiscal consolidation efforts including militia forces that helped defeat ISIS, and meet legal requirements to absorb graduates of certain specializations. Accordingly, tightening the fiscal stance in the short run is politically and socially difficult. Nonetheless, the authorities fully agree on the need for reforms over the medium term, particularly in the areas of non-oil revenues, subsidies, and civil service. Parliament recently adopted a new civil service law as part of their effort to conduct a comprehensive review of the public sector functions and size. The reform of the electricity sector ranks high on the authorities' agenda and priority has been given to increasing generation capacity to address power outages. Work in this area has resulted in increased electricity generation by about 25 percent in mid-May relative to the year before. Work to settle electricity-related cross-liabilities is ongoing. The authorities acknowledge that important challenges in the electricity sector remain, as outlined in paragraph 30 of the staff report.

The authorities also concur with staff on the need to adopt a risk- and rules-based approach to fiscal policy as part of broader fiscal reforms to manage oil revenue more effectively, and they appreciate staff's analytical work on the subject. In this connection, Parliament adopted a new General Financial Management Law in May 2019 that strengthens the legal framework for public financial management. The law defines general government for the first time, establishes the need for a medium-term fiscal framework and enshrines fiscal transparency requirements. It also limits parliament's capacity to amend the budget, as well as the scope for spending to be authorized outside budget processes.

Public financial management (PFM) reforms continue to rank high on the authorities' agenda. They have adopted tight procedures for the approval of government guarantees, kept arrears under control, and enacted a new PFM law in May 2019. They are also designing and implementing a commitment control system for budget execution to avoid the emergence of new arrears. Moreover, budget transfers to the Kurdistan Regional Government were progressively restored during 2018 and have been included in the 2019 budget. The Ministry of Finance is planning to implement an Integrated Financial Management Information System with the support of the World Bank, for which the adoption of an updated budget classification and a chart of accounts is a prerequisite. Work in these areas is progressing, with the support of Fund technical assistance.

Monetary, Exchange Rate, and Financial Sector Policies and Reforms

The authorities remain committed to the peg to the U.S. dollar as it continues to provide a key nominal anchor to the economy.

The authorities are taking measures to enhance the stability of the banking sector. The two largest state-owned banks, Rasheed and Rafidain, are being restructured. The authorities have made progress in procuring suppliers for core banking systems and have segregated legacy assets and liabilities into "bridge branches." The Bureau of Supreme Audit is working on finalizing their accounts for 2014 and subsequent years. Once the core banking systems are fully operational, the authorities intend to have the two banks audited to international standards, which would allow their capital needs to be assessed accurately.

At the same time, the Central Bank of Iraq (CBI) is pursuing its efforts to strengthen the regulatory framework and improve prudential regulations in banking supervision to align them with Basel II Committee on Banking Supervision standards and guidelines. In this connection, supervisory guidelines on bank internal audit and compliance functions were prepared in the fall, with Fund technical assistance. Work is progressing on early identification of bank risks and the way to deal with weak banks, including early intervention of supervisors, corrective actions and their enforcement, banking crisis management and the supervisor's role, as well as techniques for liquidating unviable banks. The CBI also intends to develop a deposit insurance scheme, which would help level the playing field across the banking sector. To promote financial development and inclusion, the CBI is working on strengthening payment systems and encouraging deposits, including public salary payments directly into bank accounts.

In June 2018, the Financial Action Task Force (FATF) welcomed Iraq's significant progress in improving its AML/CFT regime and noted that "Iraq has established the legal and regulatory framework to meet the commitments in its action plan regarding the strategic deficiencies that the FATF identified in October 2013." FATF thus considered that Iraq was no longer subject to the FATF's monitoring process under its ongoing global AML/CFT compliance process. The authorities will continue to work to strengthen the AML/CFT framework. They consider that continued progress on AML/CFT will also help them address the transfer of illicit gains.

Good progress has been made in implementing the recommendations of the 2016 safeguards assessment of the CBI. Amendments to the Law on the Central Bank of Iraq to strengthen CBI governance have been enacted, and the revised audit committee charter now prohibits CBI executive representation on the committee. Work is ongoing on strengthening the capacity of internal audit and financial reporting.

Anti-Corruption Reforms

The government is prioritizing anti-corruption efforts, with a focus on strengthening public institutions. A new High Council on Combatting Corruption, chaired by the Prime Minister, was established in February 2019. A Commission on Integrity was established in 2011 with the tasks of corruption prevention and enforcement, and it has investigated several high-profile corruption cases. Legislation to criminalize illicit enrichment, trading in influence, embezzlement, and all forms of bribery has been drafted. Iraq has also developed a system of asset declarations, and a large number of public officials are currently required to disclose their assets. The authorities agree with staff that streamlining the anti-corruption framework would make it more effective and less onerous for economic activity.

Conclusion

Notwithstanding an improvement in security conditions and oil prices, Iraq faces the serious challenge of maintaining economic stability, while ensuring durable peace and inclusive growth. The Iraqi authorities very much value the Fund's policy advice in addressing its economic challenges, and they would welcome a Post-Program Monitoring engagement. Continued

Fund capacity development would be essential in the period ahead. The authorities have been calling on the Fund to resume visits to Baghdad, similar to the practice of other international institutions. They welcome the recent lowering of the Fund's security rating for Baghdad to a medium level of residual risk and look forward to welcoming Fund staff again.

Mr. Fachada and Ms. Mohammed submitted the following statement:

We thank staff for the comprehensive reports and Mr. Beblawi and Ms. Choueiri for their helpful statement. We welcome this first opportunity to discuss economic developments in Iraq since the 2016 Stand-by Arrangement went off-track in the second half of 2017. Against the background of the weakening of the ISIS insurgency and the recovery in oil prices, millions of displaced people were able to return to their homes and the authorities started rebuilding the country and addressing urgent social issues. However, economic recovery has been relatively slow and substantial risks to the outlook persist, including volatility in oil prices, geopolitical tensions and social unrest.

Adopting a rules-based approach to fiscal policy, including a ceiling on primary expenditure, would be sensible. Against the backdrop of oil price volatility, we have concerns about the continuation of the current procyclical fiscal expansion without appropriate fiscal consolidation. We see merit in Iraq adopting broader fiscal reforms to manage oil revenue more effectively together with bolstering non-oil revenue as it would create space for public investment, while keeping public debt on a declining path and allowing the rebuild of fiscal buffers. We note that expenditures—in particular public wages—have expanded unsustainably in recent years. Therefore, we urge the authorities to contain current spending and strengthen the public financial management framework, including the establishment of a Treasury single account. We welcome the new General Financial Management Law, which is expected to strengthen the legal framework for public financial management.

Further reforms are essential to bolster fiscal sustainability. Improved public investment management is encouraged to ensure efficient resource spending, while strengthening capacity for compliance to terms of donor financing. Noting that access to electricity was the main obstacle to business according to the 2011 World Bank Enterprise Survey—a paradox in a major oil producing country—we concur with staff that ambitious reforms in the energy sector can reduce the drag on the budget, while providing more stable electricity supply.

Restructuring of the public banks and strengthening supervision are essential to ensure financial stability. We welcome the initiation of the restructuring of the two largest public banks and encourage authorities to move quickly to have both banks audited in accordance with international best practices to ensure that their capital needs are assessed accurately. We also welcome the development of a deposit insurance scheme, but concur with staff that it should be complemented with a robust supervisory framework to limit associated risks. The authorities are encouraged to continue to implement a strong AML/CFT framework, including the supervision of banks and exchange houses to improve compliance and enhance the integrity of the financial system, as well as to support anticorruption efforts. Finally, we commend the authorities for their efforts in ensuring that Iraq was removed from the Financial Action Task Force (FATF) list.

Combatting corruption should be a priority. The establishment of the new High Council for Combatting Corruption is welcome, but we agree that enforcement policies need to be strengthened. The authorities are encouraged to address the gaps in the legal and institutional frameworks, as well as streamline institutional structures to promote effective anticorruption policies. As in other countries, we believe that E-governance can be beneficial in simplifying procedures and limiting opportunities for corruption. While we take positive note that Iraq has an asset declaration system for public officials, it should be strengthened in accordance with staff's recommendations to be effective.

Finally, we support the initiation of Post-Program Monitoring (PPM), but in line with Mr. Beblawi and Ms. Choueiri statement, we encourage staff to consider holding the missions in Iraq, rather than offsite in Jordan. Can staff elaborate about the prospects of holding future PPM and Article IV consultations in Baghdad? Also, given that credit outstanding to Iraq is expected to decline below the SDR 1.5 billion threshold in early April next year, can staff inform what are the plans in terms of future PPMs?

Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the informative set of papers and Mr. Beblawi and Ms. Choueiri for their insightful buff statement.

Iraq's economic performance continues to be adversely affected by significant institutional weaknesses and inadequate policy frameworks. Iraq faces major development needs, including repairing infrastructure and improving the provision of electricity, water, and other public services.

However, post-war reconstruction and economic recovery have been slow. Notwithstanding a modest increase in non-oil GDP, overall real GDP contracted by around 0.6 percent in 2018 owing to cuts in oil production. Inflation remained close to zero while the fiscal and external positions improved markedly due to the rebound in oil prices and under execution of capital spending. Gross international reserves exceed standard reserve adequacy metrics, but gross financing needs are expected to remain above the high-risk threshold over the medium term. Staff expects economic growth to pick up in 2019-20 before declining significantly starting in 2021. Downside risks include a possible fall in oil prices, an escalation of geopolitical tensions, failure to address low absorptive capacity, and a further deterioration in the quality of public institutions. Could staff comment on the medium-term projections for oil production and on the authorities' more optimistic outlook, including their higher projections for oil prices?

We agree with the focus of the Article IV discussions on changes in policy settings and structural reforms to restore medium-term sustainability and lay the foundations for inclusive growth. In this regard, we concur with staff that Iraq's immediate priority is to use its energy resources to rebuild physical and human capital while increasing investment efficiency and improving limited absorptive capacity. At the same time, we would have liked the report to give more emphasis to strengthening non-oil revenues and eliminating central bank financing of the government.

Staff notes that the fiscal position would deteriorate further over the medium term, reaching a deficit of about 6 percent of GDP by 2024, as oil prices would subside and current expenditure would remain elevated. In this connection, the 2019 budget already implies a shift to a projected deficit of 4 percent of GDP, from a surplus close to 8 percent in 2018, due to lower oil prices and a significant increase in the wage bill, transfers, goods and services, and allocations to the Kurdistan Regional Government (KRG). Under these circumstances, could staff explain the reasons behind the authorities' decision to abolish non-oil taxes in the 2019 budget?

Against this backdrop, we share the staff's view that there is a need to develop a robust fiscal framework to provide space for investment while reducing procyclicality and vulnerabilities to oil price fluctuations. Accordingly, we support the staff's recommendation to adopt a risk- and rules-based approach to manage oil revenue more effectively by establishing a ceiling on current primary spending, supported by measures to improve capital spending efficiency. We broadly agree with the gradual adjustment in the non-oil fiscal deficit envisaged in the staff's macroeconomic framework but, given the authorities' political and social constraints to reduce current spending, we would have given more emphasis to further strengthening non-oil revenues not only by improving tax administration but also by considering tax policy measures. We would appreciate staff's comments on this issue as well as on the extent to which staff's projections incorporate the authorities' current spending priorities discussed in paragraph 33. In addition, could staff elaborate further on the financing mix, especially on the policy actions (higher interest rates?) to rely more on domestic bank financing while eliminating central bank financing of the government? We support structural measures to achieve durable savings over the medium term based on a functional workforce review and deeper civil service reform.

Regarding the energy sector, we would emphasize the importance of adjusting tariff rates and addressing non-payment of electricity bills, poor maintenance, and generation and distribution losses while protecting vulnerable groups from the impact of these reforms. Inter-ministerial debt should also be addressed. We welcome the recent adoption of the new General Financial Management Law. Going forward, we encourage the authorities to address remaining gaps, including regarding the establishment of a treasury single account; reinforce commitment controls and monitoring of arrears; and strengthen cash management.

Banks' balance sheets remain weak, with the two largest public banks (Rafidain and Rasheed) burdened by legacy assets and loans to SOEs. We take note of the progress made in procuring suppliers for core banking systems for these two public banks. Going forward, we encourage the authorities to accelerate the long-delayed restructuring of these banks while strengthening governance and oversight to prevent a further deterioration in their financial condition. We concur with staff on the importance of conducting a targeted review of the quality of these banks' main assets, with focus on loans to SOEs that are government guaranteed. At the same time, we notice that the profitability of the private banks has been adversely affected by a compression of spreads in the FX market and that several entities exhibit high NPLs. Could staff comment on the likelihood of a consolidation of private banks?

Addressing banks' weaknesses would help promote financial development. The work underway to strengthen the payments systems and Fintech have the potential to improve financial inclusion. At the same time, better credit information and legal procedures could facilitate access to credit. We support the authorities' intention to establish a deposit insurance scheme and agree with staff on the need for an effective supervision to limit risks. We also take positive note of the significant improvements in the AML/CFT framework and encourage the authorities to focus on strengthening implementation, including through risk-based oversight of financial institutions. We welcome the amendments to the Central Bank of Iraq law to strengthen CBI governance.

We notice progress in addressing corruption and governance issues but concur with staff that there is significant scope for further efforts in this area. In particular, there is a need to put in place a sound legal framework criminalizing all corruption offences and establishing effective sanctions and to improve coordination between public agencies. We appreciate Box 1 of the report, which provides a quantification of the macroeconomic benefits of improved governance.

Lastly, we support the initiation of post-program monitoring as well as the proposal to revert the Article IV Consultation to the 12-month cycle. As noted in the buff statement, continued Fund capacity development will be crucial in the period ahead.

With these comments, we wish the Iraqi authorities every success in their future endeavors.

Mr. Merk and Mr. Fragin submitted the following statement:

We thank staff for the informative set of reports, and Mr. Beblawi and Ms. Choueiri for their helpful buff statement.

We concur with the thrust of staff's appraisal. While an improved security situation and higher oil prices represent a window of opportunity to press ahead with reforms, obstacles to progress persist. Iraq continues to suffer from a challenging economic and political situation. Social indicators are weak, post-war reconstruction and economic recovery have been slow and the country faces major development needs as well as institutional weaknesses. Domestically, poor policy implementation, deficiencies in governance, low investments and popular protests could undermine improved long-term growth prospects. On the external side, geopolitical tensions, large swings in oil prices and resurgence of terrorism constitute downside risks to the growth outlook.

With high current expenditures and the budget deficit expected to increase further, a sustainable reorientation of fiscal policy appears warranted. Marked by low government savings, cuts in investment and large increases in current spending during a period of high oil prices, Iraq's fiscal policy is procyclical. Against this background, it is worrisome that the 2019 budget implies a large fiscal loosening. Given that Iraq's wage bill relative to GDP is one of the highest in the world, a further increase of public wages would be unwarranted. As staff warns, the government would rely heavily on quasi monetary financing in case of a deterioration of the fiscal position over the medium term. While we take note that Iraq does not face major solvency risks, it does face high liquidity risks with large financing needs, making public debt particularly vulnerable to growth and interest rate shocks. In this context, we note that so far little donor financing has been used. Given the changed economic and political conditions, does staff have an update on the expected financing mix, particularly with regard to donor financing? In addition, given rigidities in public expenditures and small fiscal buffers, the economy is especially vulnerable to oil price shocks. We therefore echo staff's call for a more risk- and rules-based fiscal approach and encourage the authorities to commit to medium-term ceilings on current spending in order to facilitate a sustainable shift towards a more growth-friendly composition of government expenditures. Regarding staff's baseline outlook, we find the adjustment scenario of 11 percent of non-oil GDP over the medium term being rather ambitious, especially in light of the forecast track record for Iraq's primary balance and the risks surrounding fiscal adjustment. Additional staff comments on this issue would be welcome. On a more technical note, we wonder what is behind the large increase in 'other current spending' in 2018 (fig. 4)?

Regarding the external position, we take note that it has significantly improved in 2018 due to a rise in oil prices. At the same time, we would like to caution that this development can quickly reverse, considering the volatility of oil prices. In this context, we take note of staff's analysis on Iraq's prospective international reserve coverage and its rising financing needs. We would like to point out that a shock to oil prices could result in an even sharper decline in reserves or elevated public debt, which again highlights the importance of adjusting current spending and raising fiscal buffers.

Legacy assets and poor financial inclusion continue to impede progress towards financial stability and hamper the improvement of the business environment. The two troubled state-owned banks mentioned by staff have yet to be restructured: with loans to SOEs that are in parts not being serviced and low capitalization, their capacity to lend is very limited. At the same time, as staff outlines, private banks struggle with high NPLs, with the compression of spreads and with sharply reduced FX trading incomes. Together with the shortcomings in the financial architecture, these challenges hamper the access to credit for businesses, weighing on inclusive growth. We therefore echo staff's recommendation regarding the need for an overhaul of the banking sector and reforms to promote financial inclusion. We find it particularly important to strengthen governance and oversight in order to prevent the risk of monetization of the government deficit.

Corruption as well as risks related to money laundering and terrorism financing from the informal economy continue to weigh on Iraq's macroeconomic performance. We note with concern that the legislation to criminalize activities such as bribery has been drafted but not yet enacted; that corrupt public officials are as yet not barred from holding office; and that asset declarations are not shared with the relevant public authorities. With regard to the financial sector, the system is not sufficiently effective to safeguard the sector against illicit flows and criminal activity. We therefore strongly encourage the authorities to strengthen legal frameworks as well as the rule of law, develop anti-corruption policies and effectively implement the AML/CFT regime.

Reforming weak governance and strengthening public financial management would also benefit improving Iraq's poor social indicators. Strengthening governance and combatting corruption remains important to ensure the adequate use of resources for investment, inter alia to ensure a more stable electricity supply. In this context, we strongly support the Fund's capacity development activities in structural reform areas.

Finally, given that Iraq meets the criteria for Post-Program Monitoring, we consent to its initiation. At the same time, we also take note that authorities' and staff's views differ quite substantially in some major aspects related to the outlook and reform path ahead. Staff comments would be welcome.

Last but not least, we strongly encourage the authorities to consent to the publication of the report. A timely release of the report can help the effectiveness of Fund surveillance.

Ms. Mannathoko and Ms. Nainda submitted the following statement:

We thank staff for the well written reports and Mr. Beblawi and Ms. Choueiri for their helpful buff statement. It is encouraging that after two years of recession, the economic outlook has now improved with almost 5 percent growth expected in 2019 with higher oil prices and improved security conditions. Nevertheless, long-standing challenges remain, including the need to improve welfare assistance to internally displaced peoples and reconstruction delays due in part to inadequate implementation capacity. We are in broad agreement with staff's assessment and support the Managing Director's recommendation for post-program monitoring.

Priority should be given to strengthening the fiscal framework. We support staff's case for a risk and rules-based fiscal policy and note that the authorities concur. Notwithstanding substantial reconstruction needs, public investment's share in GDP declined sharply between 2015 and 2018. Meanwhile recurrent spending dominated expenditure, with the public sector wage bill being one of the highest in the world, and the 2019 budget providing a further large increase in recurrent spending. A rules-based framework will help to address this. We also agree with staff that in the short run, the authorities could consider capping allowances, bonuses and other non-base wage payments; while a more effective wage-bill management plan is crafted for the medium term. We welcome parliament's adoption of a new General Financial Management Law in May 2019 and encourage the authorities to ensure its speedy implementation and enforcement, even while secondary legislation is crafted to address remaining gaps. With respect to revenues and the oil price, could staff elaborate on the reasons for their difference with authorities on the oil price trajectory going forward?

We encourage a well-structured public investment plan. We would urge a reconstruction investment program that takes into account project management capacity needs and maps out a workable public investment path. With public investment having declined significantly over the past three years, we were pleased to note the ramped-up allocation for capital spending in the 2019 budget. However, we also note staff's caution regarding absorptive constraints, that public investment practices require significant reform, and that in staff's view investment should be scaled up gradually and projects prioritized, given investment inefficiencies and weak institutions. We appreciate staff's perspective as informed by the investment needs model, and wonder if staff can use the model to estimate optimal public investment rates for Iraq over the medium term? Given the magnitude of public investment reconstruction needs, we also wondered whether the investment rate of about 7 percent of GDP used in projections from 2021 onwards will be adequate? Staff views are welcome.

We encourage exploring alternatives to using public sector jobs to address unemployment. Like staff, we note that an excessive government wage bill limits authorities' current and future resources for development spending. We also note that the 8 percent unemployment rate clouds the fact that the country has one of the lowest labor force participation rates in the world, and that many displaced people are underemployed. While noting pressures on government to hire, the growing wage bill is unsustainable and inefficient, and we encourage the authorities to consider lessons from elsewhere in crafting a solution. Could staff comment on the authorities' strategy to grow the non-oil sector and generate meaningful employment in the private sector, especially for youth?

Reforming state-owned enterprises will support non-oil private sector growth. We support the envisaged package of reforms in the electricity sector, given its drag on public resources. We would support similar reforms for other state-owned enterprises drawing on public resources. We also welcome steps taken by the authorities to allocate contracts for the rehabilitation of plants and improved generation and highlight the importance of protecting the poor and vulnerable from the impacts of these reforms.

Financial sector and structural reforms: We welcome the Central Bank of Iraq (CBI) enactment of amendments to the CBI law. However, while we are encouraged by the commencement of the restructuring process for the two largest, troubled state-owned banks as reported in the buff statement, we urge the supervisory authorities to ensure their full rehabilitation before recapitalization. We also welcome the significant progress made by Iraq in improving the legal and regulatory framework for its AML/CFT regime. Nevertheless, as weak governance has eroded public institutions and discouraged private-sector investment and job creation, in line with staff, we encourage the development of national anti-corruption policies, accelerated adoption of laws strengthening the asset declaration regime and criminalizing illicit gains, and strengthened enforcement of the AML/CFT regime in order to support both the integrity of the financial system and improved governance. Regarding the state banks, could staff clarify if the banks' audits are complete? Could staff also comment on whether authorities have requested additional TA in the remaining areas of the AML/CFT framework including the restructuring of the two banks?

With these comments we wish the authorities peace and success with their reforms.

Mr. Inderbinen and Mr. Heim submitted the following statement:

We thank staff for the insightful set of reports and Mr. Beblawi and Ms. Choueiri for their informative buff statement. Iraq's macroeconomic performance has strengthened on the back of improved security conditions and higher oil prices. Real GDP has reversed from its previous contraction and is set to further accelerate. Furthermore, inflation remains moderate and the external position has been strengthened. That said, the authorities continue to face significant challenges to achieve economic sustainability, inclusive growth and long-term development. We encourage the authorities to seize the opportunity of the improved environment to implement the policy changes and structural reforms that are called for to address these challenges.

We support the proposal to initiate post-program monitoring. Given the significant credit outstanding and the elevated vulnerabilities, we strongly support the conduct of post-program monitoring. We encourage authorities to implement the Fund's policy advice and to make timely repayments of outstanding Fund credit. We deem the post-program monitoring also important against the backdrop of the mixed performance under the SBA program, which went of track after the second review. Furthermore, staff mentions an incidence of misreporting at the time of the second review. Could staff shed more light on this incidence and provide an update on the investigations?

The deteriorating fiscal position calls for a reversal of policy. The 2019 budget implies a sizable fiscal loosening, primarily due to the significant increase of the public wage bill. We are concerned about the projected shift from a surplus of nearly 8 percent of GDP in 2018 to a deficit of 4 percent in 2019. This has the potential of jeopardizing the sustainability of the fiscal position. Against this background, we share staff's call to build fiscal buffers and to reduce pro-cyclicality. Particularly, the non-oil revenue base should be broadened to reduce the exposure to oil price developments. Iraq's non-oil revenues have amounted to less than 5 percent of non-oil GDP, which is very low compared to other oil exporting countries in the region.

A stronger fiscal policy framework is needed. We strongly agree with staff that developing a multi-year fiscal framework and implementing a fiscal rule would be highly beneficial. We welcome the adoption of the General Financial Management Law. Nonetheless, major gaps remain and should be addressed vigorously. A fiscal rule would be particularly important to manage oil revenues more effectively. This should go in hand with increased PFM capacity and fiscal transparency. Staff provides very valuable analytical work on fiscal frameworks and rules in the SIP, and we encourage the authorities to take this work into due consideration.

There is a strong need to improve both core public services and the overall business environment. As recent protests in the southern part of the country have demonstrated, there is a continuous risk of wide social unrest due to the severe lack of basic utilities and limited job opportunities, especially for the youth. The overall improved security situation provides an opportunity to restore public services and infrastructure and to foster the business climate. The latter is of particular importance, given the young and fast-growing population. In this context, we note the limited job opportunities for the estimated 800,000 annual entrants to the labor market. Could staff elaborate on the prospects of the private sector labor market?

Strengthening the rule of law and improving governance and transparency must remain priorities. Iraq continues to score among the lowest on corruption and governance indicators. Corruption is widespread and endemic, not least because of the legacies from the past. While there has recently been some progress in implementing the Fund's policy advice, e.g. by creating a new High Council on Combatting Corruption, broader efforts to address governance weaknesses have yet to bear fruit.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for a well-written set of reports and Mr. Beblawi and Ms. Choueiri for their informative buff statement. We welcome this opportunity to review recent developments in Iraq and, since we broadly agree with the thrust of staff conclusions and policy recommendations, we would like to emphasize the following points.

Developments in Iraq are encouraging but important challenges remain. Since the last Article IV consultation, completed by the Board two years ago, Iraq has defeated ISIS and started the difficult process of reconstruction and resettlement of refugees. On the back of improved security situation, the economy is recovering and the rebound in oil prices is helping the authorities to rebuild fiscal and external reserves buffers. However, addressing the legacy of the war and ensuring durable political and financial stability are important challenges confronting the authorities. Against this background, we welcome, the new Recovery, Reconstruction, and Development Program and National Development Plan recently launched by the new government. Could staff offer some elaborations on this strategy and indicate to what extent it could help address some of the challenges facing the country?

We welcome the improved fiscal situation but encourage the authorities to avoid under execution of the capital budget. Iraq would clearly benefit from a sustainable fiscal position, anchored on containing current spending and keeping public debt on a declining trend and staff is making sensible recommendations to this end. However, we can sympathize with the authorities' view regarding the urgent and short-term need to provide job opportunities and support economic growth. We are also comforted by their agreement with staff on the importance of reforms over the medium-term to strengthen non-oil revenues, reform subsidies, the civil service, the electricity sector, and adopt fiscal rules, as part of their medium-term fiscal strategy. In this regard, we welcome the approval by Parliament of a new General Financial Management Law, which introduces a medium-term fiscal framework and will help in promoting sound fiscal management, good governance, and transparency. As the reconstruction needs remain elevated, we encourage the authorities to protect capital spending, enhance investment efficiency, and strengthen the administrative capacity and we encourage the Fund and other development partners to support these efforts through capacity development and financial support.

We agree with the authorities on the importance of maintaining the peg to the U.S. dollar. We welcome the indication that all previously identified exchange restrictions have been eliminated and that Iraq no longer maintain multiple currency practices (MCP) subject to Article XIV. Could staff clarify why the requirement to have a bank account for a minimum of six months, referred to in footnote 1 of the Informational Annex, is an MCP subject to Fund approval under Article VIII, Section 3 and why no decision for its temporary approval has been proposed since staff is monitoring its application?

Finally, we agree on the importance of reforming the banking sector. Iraq will benefit from a restructuring of its public banks to enhance financial stability and ensure an adequate intermediation and financing of the private sector. Here, we welcome the indication that the authorities agree on the need to address weak banks and strengthen financial sector supervision and resolution with the TA support from the Fund. Staff report indicates that the financial system is currently overbanked. In this context, we wonder which indicators have been used to reach such conclusion. We also welcome the progress being made in improving the AML/CFT framework, including the removal of Iraq from the FATF list of jurisdictions with strategic deficiencies and encourage the authorities to continue with their reform efforts.

With these remarks, we agree that Iraq meets the criteria for initiating post-program monitoring (PPM) and wish the authorities further success.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the well written reports and Mr. Beblawi and Ms. Choueiri for their helpful buff statement.

Iraq's economic recovery is gradually picking up following the considerable strains emanating from the conflict years. With the war ending, the challenges of addressing the legacies issues, rebuilding the infrastructure and addressing the development needs of the population, remain difficult. The economic outlook has improved with higher oil prices and the better security situation, but vulnerabilities remain from spillovers of geopolitical developments and domestic risks from governance and investment slags. The authorities are cognizant of the challenges and encourage the authorities to maintain a resolute effort to pursue economic stability, while ensuring durable peace and inclusive growth. We broadly concur with the thrust of the staff report, support the initiation of post-program monitoring and the reversion of the Article IV to the 12-month cycle.

Reorientation in the fiscal framework should aim to incorporate the post war recovery agenda and to deliver on social objectives. In this context, we align ourselves with the staff recommendation on adopting a risk- and rules-based fiscal framework. We welcome the measures taken by the authorities for adopting a new General Financial Management Law in May 2019 for strengthening the legal framework for public financial management. Hereon, a policy mix focusing on enhanced tax administration, boosting non-oil revenue, prioritized capital spending alongside building of buffers and fiscal space, appears appropriate. The buff articulates that tightening the fiscal stance in the short run is politically and socially difficult. In the present conjecture, where the primary focus would be on ensuring stability, we remain ambivalent on sequencing of the wage rationalization. We invite staff comments.

Enhancing the stability and supervision of the banking sector is essential to preserve financial health. We welcome the progress made on this account for the two largest state-owned banks, Rasheed and Rafidain, being restructured and the efforts of the central Bank of Iraq in strengthening the regulatory framework. We appreciate the Staff analyses in selected issues paper on financial development and inclusion for promoting the private sector, jobs and increasing access to credit. An overhaul of the banking sector is vital from a structural and supervision standpoint, and we encourage the authorities to commission a targeted quality review of the public banks main assets, especially loans to SOEs that are government guaranteed. All this, along with use of Fintech should be pursued as a collective strategy for wider financial stability and inclusive growth.

Steady strengthening of governance, accelerating implementation of AML/CFT and anti-corruption measures can be instrumental for growth. We join staff in calling for bolstering AML/CFT implementation to enhance the integrity of the financial system and support anti-corruption efforts. Combatting corruption on the legislative and institutional levels should continue to be positively reinforced with impactful implementable. We appreciate the Annex on Capacity Development Strategy and would encourage continued engagement of the Staff to meet the challenges facing the Iraqi authorities.

With these comments, we wish the authorities success in their endeavors.

Mr. Tan and Mr. Mahyuddin submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Beblawi and Ms. Choueiri for their informative buff statement.

An improved security situation and the rebound in oil prices offer an opportunity for the Iraqi authorities to rebuild the country and address structural problems. We recognize the formidable challenges to make progress on policy priorities and the significant downside risks to the outlook, given the volatile oil prices and geopolitical risks. To this end, we welcome the ambitious reform and reconstruction agenda, outlined in the Recovery, Reconstruction, and Development Program and National Development Plan, by the newly formed government. We are also encouraged by the strong commitment from the international community to support Iraq's reconstruction and development. As the criteria for initiating post-program monitoring are met, we support the proposed recommendation. We also broadly agree with staff's appraisal and offer the following comments for emphasis.

Steadfast implementation of fiscal reforms is important to build adequate buffers and create space for capital spending. We note that the fiscal position improved significantly in 2018 due partly to the rebound in oil prices. However, budgetary revenue remains highly sensitive to oil prices, as highlighted by staff's oil prices scenario analysis. We urge the authorities to remain cautious on transitory and procyclical factors, as downward adjustment to oil prices could have a material impact to the fiscal position, especially when current expenditure persists at an elevated level and non-oil revenue remains low. Therefore, we encourage the authorities to undertake a careful but necessary fiscal policy consolidation to reduce vulnerabilities and further improve non-oil revenue to create space for investment needs. In this regard, we commend staff for the comprehensive assessment and recommendation on the risk- and rules-based approach to fiscal policy for Iraq. This reform would help minimize pro-cyclicality and lower the country's vulnerability to oil price shocks. To this end, we take positive note that the authorities agreed on the need for reforms over the medium-term and expressed interest in integrating the fiscal rules into their medium-term fiscal strategy.

We take note of staff's recommendation to focus on the wage bill, given its existing size and the strong pressure to increase employment in the public sector. However, as highlighted in Annex VII, ad hoc wage adjustments such as capping allowances and bonuses tend to unravel if not accompanied by appropriate structural reforms. We note that these adjustments were ineffective when the Iraqi authorities implemented them under the SBA. We invite staff to comment on this vis-à-vis other alternative near-term measures. In addition, reforms in the electricity sector are equally important to reduce large public expenditure, and at the same time provide a more stable electricity supply that could support greater economic activities. We note positively that the reform ranks high on the authorities' agenda and reiterate that the poorest and most vulnerable must be protected throughout the reform process.

Financial sector restructuring should be accelerated to preserve financial stability and promote financial inclusion, including access to credit. We look forward to the successful restructuring of the two state-owned banks. Enhanced bank supervision and regulation that are in line with international standards will be critical to strengthen banks' balance sheets and business models. In this regard, we welcome the efforts by the Central Bank of Iraq to strengthen the regulatory framework and improve prudential regulations as well as the ongoing technical assistance provided by the Fund. Given that the financial system is currently overbanked, we seek staff's comments on the measures that the authority may take to help facilitate banking consolidation? We take positive note that the Financial Action Task Force has removed Iraq from its list of jurisdictions with strategic deficiencies. However, strengthening AML/CFT implementation remains critical as the country continues to face significant money laundering and terrorist financing risks from the informal economy and cross-border movement of cash.

Structural reforms to support stronger economic recovery and address social needs must be supported by strong governance, particularly in public financial management, regulatory and legal institutions. We take positive note of the new General Financial Management Law that strengthens the legal framework for public financial management. We encourage the authorities to further develop an implementation plan for the new law, including measures to address the remaining gaps highlighted by staff in the report. We also encourage the authorities to enhance governance and anti-corruption efforts, particularly in addressing overlapping functions that create inefficiencies, improving capacity on enforcement activities and aligning the legal framework to international best practices.

With these comments, we wish the authorities every success in their future endeavors.

Mr. Sigurgeirsson and Ms. Skrivere submitted the following statement:

We thank staff for an insightful set of reports and Mr. Beblawi and Ms. Choueiri for their helpful buff statement. While we recognize the challenges faced by Iraq, it is somewhat discouraging to read how the SBA program has gone off track and several important structural fiscal measures have been reversed or not enacted. We generally share staff's appraisal and offer the following points on fiscal policy and governance issues for emphasis.

We share staff's recommendations on the fiscal policy mix, and strongly encourage the authorities to consider staff's advice and ensure fiscal sustainability over the medium-term and aim towards constructing a fiscal framework that can manage oil wealth. Given the rebound in oil prices, the large fiscal surplus in 2018 masks the less positive underlying developments, including a decline in non-oil revenue collection and an expansion of current spending. The significant fiscal loosening envisaged in the 2019 budget is worrisome, and we urge the authorities to contain the rapid increase in the already-sizeable public sector wage bill. We strongly recommend reversing the generally procyclical fiscal policy and saving windfall gains during oil price booms, which could serve to enhance the economy's resilience to oil price shocks. Staff's analysis of Iraq's vulnerability to even modest swings in oil prices clearly illustrates the need for adjusting the fiscal policy mix. Further efforts are also needed to channel additional resources to boost human and physical capital. This could help lift Iraq's economic growth potential and contribute particularly to the development of the non-oil sector, where growth still remains meagre.

More forceful and coordinated actions are needed to effectively combat corruption and strengthen the enforcement of the AML/CFT framework. We note with concern that there are notable gaps in the legal and institutional framework for tackling corruption. Legislation to criminalize illicit enrichment, trading in influence, embezzlement, and bribery has been drafted but not enacted; public officials convicted of corruption are not barred from holding office; public officials often fail to submit asset disclosures, and even those declarations that are submitted are not shared with the relevant authorities, while capacity constraints are limiting the adequate verification process of these declarations. We strongly encourage the authorities to address these notable deficiencies. We thank staff for a very good analysis of the quantification of the macroeconomic benefits of improving governance, which further illustrates the need to address these issues. While the FATF has removed Iraq from its list of jurisdictions with strategic deficiencies, the ML/TF risk remains high and there is a need to further enhance the effectiveness of the supervisory framework. There is an important link between anti-corruption and AML/CFT policies, and we encourage the authorities to further strengthen cross-institutional cooperation and information sharing.

The last formal Board meeting on Iraq was almost two years ago. Given the complex and challenging situation, this case demonstrates the importance of keeping the Board closely engaged and informed on programs that have gone off track.

We encourage the authorities to consent to publication of the report.

Mr. Doornbosch, Mr. Psalidopoulos, Mr. Etkes and Mr. Di Lorenzo submitted the following joint statement:

We thank staff for the candid report and Mr. Beblawi and Ms. Choeuri for their helpful buff statement. We broadly agree with the thrust of the staff's appraisal, so we will limit our comments to the following points.

In a very fragile context marked by several factors of vulnerability there is no shortage of formidable challenges ahead. The end of the conflict with ISIS has left a very difficult social situation, creating strong pressures for some immediate spending measures. However, the deep-rooted institutional and economic weaknesses, aggravated by the severe shocks that have hit the country, call for an immediate credible commitment to a reform agenda oriented to restoring economic stability and fiscal sustainability, while modernizing the economy. We welcome the reassurances reported in the buff in this respect and we support the proposal for a post-program monitoring, that is essential to maintain an intense policy dialogue between the Fund and the authorities. We also welcome the large capacity building efforts provided by staff in several critical areas, as for instance in tax administration given the ultra-low level of tax revenue. Staff's analysis rightly emphasizes the macroeconomic benefits that can potentially be obtained through an improvement in this as well as in other critical governance areas, such as corruption and investment efficiency. We note that staff is investigating on the possible misreporting of information in the context of the expired SBA and we would like to have more details on the range of the possible remedy measures that can be implemented in these circumstances.

We see strong merit in implementing the fiscal reform advocated by staff, starting by a gradual reduction in current expenditure as a share of GDP. The approval of the new law reforming the public financial management is an encouraging signal that needs to be completed by short-term measures to slowdown the increase in the wage bill, while continuing to work on a multipronged reform strategy for the public sector. Staff's views on the recent enacted civil service law are welcome. As oil revenues are likely to represent the only substantial revenue stream in the medium-term, it is essential to put in place an effective framework built around a credible fiscal rule that would ensure lower spending procyclicality, while reviewing the adequacy and efficiency of social spending, and safeguarding capital spending. Given that spending procyclicality is compounded by the high elasticity of the budget to volatile oil prices, we encourage the authorities to use energy revenues primary to rebuild the country through large investments in physical and human capital; to facilitate disbursement from donors, improvements in the efficiency of investment spending are warranted. We welcome that the authorities concur with staff's views on the need to fully reform the electricity sector to decrease the drag on the budget and to create conditions for expanding medium-term growth.

Staff asserts that the peg to the USD serves Iraq well. We note that this peg imposes fiscal fluctuations as the price of oil fluctuates relative to the USD and the pegged dinar. Pegging to a currency that co-moves with the price of oil, such as the Euro as recently noted by the New York Federal Reserve Bank[1], could help Iraq to reduce fiscal fluctuations. Can staff assess the share of fiscal expenditures in Iraqi Dinar (e.g. wages), USD (e.g. public imports from non-Euro countries), and Euro (e.g. public imports from Euro countries)

[1] Klitgaard, Pesenti, and Wang, "The Perplexing Co-Movement of the Dollar and Oil Prices," Federal Reserve Bank of New York Liberty Street Economics (blog), January 9, 2019.

and the resulted basket of USD and Euro that will minimize Iraq's fiscal fluctuations due to the fluctuations in oil prices?

Public banks represent an important source of vulnerability, and the current process of restructuring should be completed and accompanied by stronger governance and heightened supervisory efforts. While these reforms can help fostering credit access by cleaning the banks' balance sheets, a series of complementing actions is likely to be needed to overcome the number of factors limiting financial inclusion and credit to real economy. Moreover, despite the progress being made in strengthening the AML/CFT framework, more still needs to be done to significantly curb the risks stemming from these activities. By the same token, the draft law on the fight against corruption should be approved and enforced without delays, while continued efforts aimed at strengthening governance remain key.

We welcome Annex I on the Technical Assistance (TA) priorities, as a good step forward in the much-desired integration of Capacity Development (CD) and surveillance. The annex briefly describes past TA missions and lays out the objectives and priorities for the next few years. It notes that much of the TA has had a training component, yet the authorities make limited use of the online and frontal training options offered by the Fund. Can staff identify the reasons for this limited use of training options? What steps are taken to enhance the take up? We encourage staff to complement the annex with more data on past TA and training of officials by topic, asses if past CD activities were effective, and whether the authorities' absorption capacity is an effective constraint.

Finally, we encourage the authorities to consent to the publication of the Article IV report.

Mr. Ray and Ms. Park submitted the following statement:

We thank staff for the report and Mr. Beblawi and Ms. Choueiri for their buff statement. Iraq faces considerable challenges. Higher oil prices and the improved security situation are positive for the near term, but risks to the outlook are elevated in the context of oil price volatility and geopolitical tensions. Reconstruction and development needs are high and while substantial donor support has been pledged, absorptive capacity is weak. We agree that policy priorities include strengthening fiscal frameworks and reorienting public spending, as well as financial sector reforms and a multi-pronged strategy to combat corruption. We note that the authorities' and staff's views differ on the outlook and near-term policy priorities. In this context, we see value in careful consideration of how the Fund can assist in building the case for needed reforms and strengthening implementation capacity, and call for continued constructive engagement, including through well-targeted capacity development efforts. We support the initiation of post-program monitoring and the proposal to return to a 12-month Article IV consultation cycle.

We share the staff's view that the development of a more risk- and rules- based fiscal framework and a reorientation of public expenditure is needed to maintain medium-term sustainability while meeting social objectives. We agree that ceilings on current spending, achieved by containing growth in the public wage bill and progressing electricity sector reforms, would create space for needed investment. This should be supported by enhanced processes for public investment management to ensure resources are well used. Staff's oil price scenario analysis is a valuable illustration of the potential impact of movements in the oil price and reinforces the need to tackle the low level of non-oil tax revenue to create fiscal space and improve resilience to oil price fluctuations.

We welcome the prioritization of anti-corruption efforts by the authorities and urge them to further strengthen the legal framework and foster co-ordination between public agencies. As Box 1 shows, progressing governance reforms could provide a substantial boost to growth in the medium term. Better enforcement of the AML/CFT regime would also support governance and the integrity of the financial system.

Given weak institutional capacity, structural reforms should be carefully sequenced and prioritized, and granular staff advice linked to relevant technical assistance will be particularly helpful. Could staff expand on Annex 1's brief description of the planned capacity development activities in support of the main Article IV policy recommendations in the coming year?

We continue to see a need to ensure Board visibility of off-track programs. Iraq was last considered by the Board almost two years ago, at the time of the second review under the 2016 Standby Agreement. From this perspective, we support the initiation of post-program monitoring and the proposal to revert the Article IV Consultation to the 12-month cycle. Could staff expand on the planned engagement with the Iraqi authorities under post-program monitoring?

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for a set of well-written papers and Mr. Beblawi and Ms. Choueri for their helpful buff statement. In addition to earlier destruction, Iraq has been hit hard in 2014-2016 by a double shock from the war with ISIS and oil price fall. Large areas of the country were destroyed. The violent conflict and oil revenue losses caused enormous suffering of the Iraqi people, led to disruption of economic activity and deterioration of government services. However, over the past two years the situation has substantially improved, as security conditions have broadly normalized, while recovery in oil prices has provided resources for growth recovery and economic stabilization. Higher oil revenue boosted international reserves. Fiscal balance turned positive in 2018, which helped to reduce public debt-to-GDP ratio by about ten percentage points. These positive developments, if sustained, provide an opportunity to rebuild the country, improve the living conditions of Iraqis, and mitigate social problems.

At the same time, prudent economic policies should not be based on the optimistic expectations, as favorable external conditions may not persist. The risk of the fall in oil prices is always present. Geopolitical tensions in the region are very high, and in case of a conflict in the Gulf the Iraqi economy will inevitably be affected. Domestic political situation also remains fragile.

Taking these risks into account, we share staff's view that fiscal policy should avoid pro-cyclicality and focus on building resilience. Major relaxation of the fiscal policy stance envisaged for 2019-20, especially substantial increase in wages and other current spending, would be a risky strategy. It would reduce fiscal buffers and increase Iraq's vulnerability to shocks. The authorities should resist the pressures to increase public employment and payroll. In this regard, we support staff's recommendation to commit to a rules-based approach to fiscal policy, including a ceiling on current primary spending. Following the 2019 fiscal easing, gradual fiscal consolidation is needed to reduce public debt while prioritizing capital spending.

On the revenue side, more needs to be done to increase revenue performance. We note that non-oil revenue collection declined significantly in 2018 due to weak compliance. We also note that the report refers to "the abolition of non-oil taxes" (page 7). Could staff provide more details about the extent of the non-oil taxes reduction and whether this is the authorities' strategy?

Strengthening the public financial management is essential for improving efficiency of public spending. The approval of the General Financial Management Law is a welcome step, but its implementation requires the adoption of secondary legislation. The authorities should accelerate transition from the paper-based budget management to the Integrated Financial Management Information System and continue their work on establishing a Treasury Single Account.

The electricity sector remains a major structural bottleneck for growth of the Iraqi economy and a significant drag on public resources. Large-scale capital investments are needed to improve its efficiency and reduce operational losses. At the same time, the authorities should address the non-payment of electricity bills and low electricity tariffs, while protecting the most vulnerable population groups. We note that around a third of electricity supply comes either directly from Iran or from the Iraqi plants reliant on Iranian gas. In this regard, could staff provide more information about the impact of the U.S. sanctions on Iraq's electricity/gas imports, electricity supply, and economic costs of a needed import substitution?

The Iraqi financial system remains weak and can provide only limited credit to the economy. Regrettably, there were only limited improvements in the Iraqi financial system. Progress in the restructuring of the Rafidain and Rasheed banks (R&R) has been slow, with continued delays in implementation of the necessary steps, including an audit based on international standards. We urge the authorities to step up their efforts on the restructuring of the R&R. We note that, according to staff, the use of fintech technologies can help improve financial development and inclusion. However, it should be supported by stronger supervision and improvements in the AML/CFT framework. With respect to the latter, we welcome the recent decision by the FATF to remove Iraq from the list of jurisdictions with strategic deficiencies.

We note that weakness in the authorities' administrative capacity remains a major impediment for effective implementation of economic policies. In this regard, we welcome extensive technical assistance provided by the Fund. The proposed Post-Program Monitoring will provide an opportunity for close engagement with the authorities on policy issues. We, therefore, support the proposed decisions.

With these remarks, we wish the authorities success.

Ms. Levonian and Ms. Vasishtha submitted the following statement:

We thank staff for their informative set of reports and Mr. Beblawi and Ms. Choueiri for their helpful buff statement. Iraq faces daunting development needs and institutional weaknesses reflecting decades of political instability and armed conflict. Although the recent rebound in oil prices has helped support a large budget surplus and significant reserve accumulation, the post-war recovery remains sluggish and highly vulnerable to fluctuations in oil prices. Addressing Iraq’s socio-economic needs, including widespread poverty, while maintaining medium-term sustainability and reducing over-reliance on oil, will require significant changes in the policy setting and structural reforms. We broadly concur with the staff appraisal and offer the following comments for emphasis.

Post-war recovery has been slow. Reconstruction efforts expected in the liberated areas have yet to materialize, with capital spending amounting to less than 0.5 percent of the estimated damage. Over the medium term, the government will likely be unable to fulfill more than a quarter of reconstruction needs, according to staff estimates. This, together with the heavy reliance on Iran for electricity and gas, has the potential to create further challenges that will need to be carefully managed. Hence, we support staff’s call for the pledged donor financing (from the donors’ conference in Kuwait in February 2018) to be expedited to support capital expenditures.

Building a robust fiscal framework is essential for managing oil wealth. We support staff’s recommendation for a more rules- and risk-based approach to fiscal policy, including a ceiling on primary expenditures. Reducing current spending and boosting non-oil revenues are essential for building fiscal buffers and ensuring debt sustainability. We also encourage the authorities to address other pressing economic issues including privatization, support to other sectors such as agriculture, and reducing energy theft and wastage as part of a more balanced package of income generation for the state.

Efforts to strengthen public financial management (PFM) frameworks are essential to appropriately monitor public spending. While we welcome the adoption of a new General Financial Management Law, we urge the authorities to take further steps to adopt decrees or secondary legislation to decentralize financial responsibilities, in line with staff’s recommendations. We also support replacing the current paper-based systems with more robust systems that are essential to establish a modern PFM system.

Addressing governance and corruption issues should be a priority. We support the authorities' efforts to develop an anti-corruption framework and strongly encourage them to streamline and strengthen it further. We urge them to develop coherent national anti-corruption policies and ensure close coordination among the relevant agencies. Furthermore, AML/CFT implementation should also be strengthened to enhance financial system integrity and support anti-corruption efforts.

Comprehensive banking sector reforms are essential to ensure financial stability and support financial development and inclusion. We welcome the initiation of the restructuring of public sector banks as well as the development of a deposit insurance scheme. As noted by staff, strengthening banking supervision will also be essential to contain risks.

We support the recommendation for post-program monitoring. Given the significant downside risks to the outlook and that the authorities have largely abandoned the reforms they committed to under the SBA, it is essential for staff to maintain close engagement with the authorities. Relatedly, we are concerned that issues around the misreporting of off-budget spending have not yet been resolved, and urge the authorities to work actively with staff in addressing these issues. Also, could staff elaborate on whether Iraq's actual level of debt owed to Arab states has been determined? Will there be a degree of debt forgiveness, and if so, to what extent?

Finally, all off-track programs should be subject to greater scrutiny. We would welcome further discussion on lessons learned from off-track programs and how to deal with them, including through greater Board oversight and use of staff monitored programs. A more effective mechanism to closely track program performance – beyond reliance on the MONA database – should be considered. Staff's views are welcome.

Mr. Kaya, Mr. Just and Mr. Bayar submitted the following statement:

We thank staff for the comprehensive set of reports, and Mr. Beblawi and Ms. Choueiri for their candid buff statement. Against very severe economic and political challenges, the improved security situation and higher oil prices provide Iraq with a crucial window of opportunity to entrench economic stability, rebuild economic institutions, expedite reconstruction efforts, and promote a more inclusive growth model. Nonetheless, risks to the outlook are significant and could quickly undermine the nascent improvements in the headline macroeconomic aggregates. The authorities should, therefore, reformulate their policy settings, inter alia, to avoid fiscal procyclicality, address financial sector vulnerabilities, improve governance, and enhance the business environment. We agree with the thrust of the staff appraisal and would like to provide the following comments for emphasis.

A robust fiscal framework including a fiscal policy anchor that could contain the unsustainable growth of current expenditures would serve the Iraqi economy well. Lacking strong institutions that would effectively oversee the conduct of fiscal policies and inculcate a consistent sense of priority vis-à-vis competing spending claims, the Iraqi authorities are exposed to significant political pressures to spend the windfall oil revenues in areas that would not necessarily increase the productive capacity of the economy. As staff's analysis indicates, a continuation of the current fiscal policies – which, among other things, induced a steep increase of the public wage bill to more than 17 percent of GDP, as well as a significant decline in non-oil revenues – could lead to a sharp deterioration in fiscal and external balances and thus, limit the authorities' ability to address pressing infrastructure and social needs. Further, the quasi-fiscal costs of the restructuring and recapitalization of the two largest state-owned banks (i.e. Rafidain and Rasheed [R&R]) pose a non-negligible risk to the medium-term outlook. We appreciate the in-depth analysis presented in the first Selected Issues Paper and concur that a well-designed rules-based fiscal policy could provide an effective anchor to cap current spending, as well as create space for post-war reconstruction efforts and close infrastructure gaps. We take positive note of the authorities' intention to move in this direction and welcome their initial steps, including the adoption of the General Financial Management Law, as well as the tighter procedures for the approval of government guarantees. We underscore the importance of the continued provision of technical assistance by the Fund and other development partners in this regard.

Overhauling the banking sector and addressing legacy problems are essential to buttress financial stability. Balance sheet strains in the banking sector hinder effective financial intermediation and consequently, inclusive growth. We positively note the commencement of the R&R's long-delayed restructuring process with the procurement of core banking systems, as well as the segregation of legacy assets and liabilities into "bridge branches." We encourage the authorities to swiftly operationalize R&R's core banking systems and conduct independent audits in line with international standards in order to provide an adequate assessment of the recapitalization needs. Does staff have a preliminary estimate about the size of the banking sector-related contingent liabilities? We agree that a successful conclusion of this process hinges critically on following a comprehensive and well-structured plan, which should delineate and coordinate the actions by related government agencies. In the interim, we caution the authorities against piecemeal capital injections. We support the authorities' intention to enhance financial inclusion, including through the development of a deposit insurance scheme, which would help level the playing field in the banking sector.

We welcome Iraq's removal in 2018 from the Financial Action Task Force's list of jurisdictions with strategic deficiencies on account of the improvements to its legal framework. Nevertheless, the country continues to face significant money laundering and terrorist financing risks, which call for sustained efforts to strengthen the AML/CFT framework and ensure its effective implementation. On a similar note, we are encouraged by the authorities' steps to develop an anti-corruption framework and build the necessary institutional setup. However, gaps remain both in the legislative and institutional frameworks, as well as on the implementation front. We therefore call on the authorities to tackle these gaps, coordinate the related agencies' enforcement efforts, and set a strong track record of implementation.

Finally, we support the initiation of the Post-Program Monitoring, as well as the proposal to hold Article IV Consultations on a standard 12-month cycle.

Mr. Rosen, Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for the Article IV and interesting set of Selected Issues (SI) papers. On the back of rising commodity prices, Iraq's economy strengthened in 2018 and its fiscal and external position improved. Still, Iraq faces large downside economic risks and internal and external imbalances could quickly materialize. In this context, we support staff's call to avoid pro-cyclical fiscal policy, improve the fiscal framework and build space for capital spending, and enhance governance. We agree with the staff appraisal in the Article IV and support post-program monitoring engagement.

While the headline fiscal position improved in 2018, staff note that the underlying fiscal position, measured by non-oil revenue and spending as a percentage of non-oil GDP, suggest limited improvement. Staff also expect a large fiscal loosening in 2019 driven by increases in current spending. Against this background, we strongly urge the authorities to recalibrate fiscal adjustment in 2019 by containing current spending and boosting non-oil revenue.

Many of recommendations are longstanding: improving the efficiency and quality of expenditures, including identifying and canceling payments to ghost workers and ghost pensioners, reducing staff through attrition, and improving the targeting of social transfers and service delivery. We found it unfortunate that some of the current spending benchmarks under the SBA were reversed.

We strongly support stronger public financial management (PFM) and more transparent fiscal reporting. Staff also recommend a relatively simple fiscal rule to provide an anchor and provide a comprehensive SI paper on the topic. Even with the research and rationale for a fiscal rule, we question whether the implementation of a fiscal rule is practical and realistic at the current juncture. The potential for recent misreporting of government guarantees and extra-budgetary spending also raises questions on whether spending control is sufficient to implement a fiscal rule. Staff elaboration would be welcome.

Finally, we underscore staff's message that the authorities should enhance the anti-corruption framework. The authorities have begun to set up a framework and a system for asset declarations for public officials, but implementation as been slow and coordination weak among government agencies. More progress on this front would permeate across the economy and policy-making process, helping boost potential growth and service delivery for the most vulnerable.

Ms. Riach and Mr. Masood submitted the following statement:

We thank staff for a very clear and comprehensive report, as well as Mr. Beblawi and Ms. Choueiri for their insightful buff statement. We agree with the thrust of the staff report and welcome the proposal for post-program monitoring.

We agree with staff's assessment that a widening budget deficit hinders the authority's ability to make essential investment to rebuild the country and improve public services, while eroding reserves and posing risks to medium-term sustainability. The importance of oil revenues coupled with oil price volatility means pro-cyclical spending leaves public finances exposed during downtowns. Government expenditure should be managed in a way that restrains spending in peaks and leaves sufficient buffers to sustain spending during troughs through a risk- and rules-based approach to fiscal policy. This should enhance the authority's capacity to support sustainable growth over the medium- to long-run. Similarly, we agree with the need to reduce the public wage bill. The suggested focus on using natural attrition is a good starting point. However we would welcome more detail from staff on medium and longer-term solutions, especially given the current use of public sector employment to maintain patronage networks.

Effective public institutions are essential to provide the framework within which long-term growth can be delivered. Cooperation between public agencies and anti-corruption measures play an important role in this. It is important to take a nuanced, evidence-based strategic approach to tackling this to avoid the risk of creating distortions that benefit certain actors over others. We would welcome the High Council for Combatting Corruption further strengthening its role.

Given lack of Fund presence in country, working closely with the World Bank and other donors is of particular importance to assist the identification and facilitation of reforms on the ground. We encourage staff to consider how it can use new tools for coordinating donor efforts, especially the World Bank's new I3RF Trust Fund, to help realize some of the reforms identified. We also welcome proposed capacity development for PMF. Have staff considered further areas for capacity development? Many of the recommendations, especially around the business environment and anti-corruption, could be facilitated by donors who have pledged export credits to Iraq coming together to demonstrate the need for a better business environment in order to unlock this funding.

We note that we haven't had any Board engagement on the program since August 2017. This emphasises the importance of regular engagement for programs where reviews aren't completed in a timely manner.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for their comprehensive set of reports, as well as Mr. Beblawi and Ms. Choueiri for their insightful buff Statement.

Despite the good macro-economic and fiscal performance in 2018 underpinned by high oil prices, Iraq macroeconomic policies remain excessively procyclical and the picture of the overall progress made over the recent years is sobering. After a very significant rebound in 2018 (+30,1 percent), growth is projected to decelerate sharply in 2019 already (+7,8 percent). It will remain dynamic nonetheless and while being cognizant of the complex social and political environment, we encourage the authorities to seize the current opportunity created by the ongoing recovery to adopt policies that support medium-term economic stability, diversification and inclusiveness. Reconstruction being one of the greatest issues faced by the country, we also encourage the authorities to prioritize capital spending when using windfall gains from favourable oil prices.

Though fiscal procedures have improved in certain areas, some significant challenges remain. Given the room for improvement of fiscal management capacity, we welcome the General Financial Management Law passed in May 2019, which is a first step toward a sound fiscal policy framework. Looking ahead, we encourage the authorities to remain committed to a continued fiscal framework improvement, especially through the implementation of a Treasury Single Account, better spending commitment controls and improvements in public investment management.

We see the dynamics of expenditures and revenues as a cause for concerns. Concerning the expenditure side, we note that strong instability in the country for the past decades lead to depreciation of both human and physical capital, but also of absorption capacity. Though we agree that the political risks are high and that the authorities should mitigate internal instability, we think that the sharp increase in current primary expenditure, especially in the wage bill, relying on unexpected surplus is highly pro-cyclical and increases vulnerability in case of shocks. We call for a longer-term perspective in line with the staff recommendations, by building buffers and investing surpluses in physical reconstruction, public services delivery and education. This orientation would insure at the same time inclusive growth prospect and broad support by the public. We particularly encourage better screening in public investment project to insure effective reconstruction in Iraq. In that regard, we would like to know how the staff assesses the efficiency and absorption of TA provided by the Fund in public investment management. Concerning the revenue side, we note with concern the higher reliance on oil revenues due to lower efforts towards domestic resources mobilization, thus leading to an increased exposure to oil price fluctuations. Without a better fiscal management strategy, higher volatility leads to increased probability of sharp pro-cyclical tightening in the future and therefore increased political and social vulnerability.

We strongly encourage the authorities to undertake longstanding structural reforms identified by the Fund. We notably encourage the authorities to implement the restructuration of the two major state-owned banks.

We welcome the authorities’ commitment to curb corruption and we fully support staff’s advice for further reforms. Corruption is historically a major issue in Iraq, and the 2011 Commission on Integrity, though a good starting point, exhibited a lack of results, due to low coordination among public entities and low enforcement. We fully support staff's recommendation to rationalize anti-corruption public entities, to reinforce their independence and to penalize corruption acts, especially by tightening the conditions for amnesty. We encourage the authorities to further enhance their AML/CFT framework, especially by improving their financial supervision and fully implementing the AML/CFT law passed in 2015.

Finally, we strongly encourage the authorities to promptly take the necessary measures to resolve the misreporting issues reported by staff.

We support the initiation of post-program monitoring.

Mr. Saito and Mr. Shimada submitted the following statement:

We thank staff for their comprehensive report and Mr. Beblawi and Ms. Choueiri for their insightful statement. The end of the war against ISIS and higher oil prices have given the authorities an opportunity to rebuild the country and tackle social issues, but the challenges Iraq is facing are formidable. While we welcome that under the SBA, Iraq achieved the preservation of the pegged exchange rate, a reduction in external arrears, and progress on AML/CFT, we take note with concern that a number of structural fiscal measures were reversed or not enacted, and there has been limited progress on strengthening the banking sector and public institutions. Considering many challenges the authorities face to rebuild the country, the IMF support including capacity development (CD) is essential. In this regard, while we appreciate the capacity development strategy shown in Annex I, we would like staff to elaborate more on the sequence and timeframe of CD in Iraq. As we broadly concur with staffs' appraisal and support proposal for post-program monitoring, we will limit our comments on the following points.

Fiscal policy

We concur with staff that fiscal policy should be anchored on scaling up capital spending and building fiscal buffers within a risk- and rules-based fiscal framework. In 2018, thanks to higher oil prices, the fiscal conditions improved significantly, but in the absence of policy changes, the fiscal position will deteriorate over the medium term. We concur with staff that a risk- and rules-based fiscal framework would limit the expenditure and create the fiscal buffer, which reduces pro-cyclicality and protects investment in case of low oil prices. Based on the framework, the expenditure reforms are also necessary. The authorities need to curve the sharp increase of wage bill and invest more into physical and human capitals. In light to this, there are some difference of views between the authorities and staff, especially regarding the necessity and feasibility of reform implementation in short term due to political situation. While we understand the political challenge the authorities face, we strongly encourage the authority to implement fiscal reform expeditely, while continuing effort to garner social support.

Financial Sector

The authorities need to address the weak banking sector, including restructuring of the public banks. The capacity to lend of the two largest public banks is restricted by mounting NPLs toward public sectors. It is necessary to push forward the delayed restructuring of the public banks. During the transition period, we concur with staff that the authorities should closely monitor the asset quality of banks, through a quality review of loans to SOEs that are guaranteed by the government but not fully serviced. We also underscore that financial inclusion should be promoted. Regarding AML/CFT, we positively take note that the legal and institutional framework improved and the FATF removed Iraq from its list of jurisdictions with strategic deficiencies in the AML/CFT framework. However, Iraq still faces significant risks of money laundering and terrorist financing, hence we encourage the authorities to implement the AML/CFT strategy effectively through improving supervision of financial institutions.

Anti-Corruption

We concur with staff that modification to the legal framework and closer coordination between public agencies is needed to address corruption. We positively take note that Iraq has begun developing an anti-corruption framework, but further efforts are needed to strengthen it. All corruption should be criminalized, and public officials convicted of corruption should not hold office. It is also necessary to develop national anti-corruption policy based on the cooperation across the agencies.

Mr. Jin and Ms. Zhao submitted the following statement:

We thank staff for the informative set of reports, and Mr. Beblawi and Ms. Choueiri for their helpful buff statement. In light of the slow post-war reconstruction and sluggish economic recovery, it is crucial for the authorities to grasp the opportunity of improved fiscal and external positions, and press ahead with steadfast reforms to guarantee medium-term fiscal sustainability.

We broadly support staff's appraisal and would limit our comments to the following.

Building a robust fiscal framework is essential to maintain sustainable fiscal and external positions. We support staff's recommendation to adopt a risk- and rules-based approach to manage oil revenue more effectively by establishing a ceiling on current primary spending. Given the country's vast investment and post-war reconstruction needs, capital spending should be protected, and capital spending efficiency should be improved. To minimize the social impact of fiscal consolidation, we encourage the authorities to review the adequacy and efficiency of social spending and ensure that poor and vulnerable groups are protected throughout the current expenditure reforms.

Reallocating public expenditure plays a key role in promoting inclusive growth. The wage bill should be the focus, with short-term measures to avert further large increase and more durable measures to achieve large and sustainable reduction over time. We concur with staff that ambitious reforms in the energy sector can reduce the drag on the budget, while achieving the government's goal of providing a more stable electricity supply. We welcome the newly adopted General Financial Management Law, which is expected to strengthen the legal framework for public financial management.

Enhancing financial stability and financial intermediation is essential to transform the financial sector. We agree with staff on the importance of conducting a targeted review of the quality of these banks' main assets, with a focus on loans to SOEs that are government guaranteed. We notice that several private banks are losing money with sharply reduced FX trading incomes and wonder whether it could provide an opportunity to incentivize private banks to channel more credit to the real economy rather than speculating the spreads in the FX markets. Staff's comments are welcome. We support the authorities' intention to establish a deposit insurance scheme and agree with staff on the need for an effective supervision to limit risks. We encourage the authorities to strengthen legal frameworks as well as the rule of law, develop anti-corruption policies, and effectively implement the AML/CFT regime.

Finally, we support the initiation of post-program monitoring. We encourage staff to provide continued capacity development which will be crucial in the period ahead.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Mr. Beblawi and Ms. Choueiri for their helpful buff statement.

Iraq faces formidable challenges to rebuild the country in the aftermath of the armed conflict with ISIS. Following two years of recession, growth is projected to resume in 2019, reflecting higher oil prices, better rainfall, a rebound in electricity production, and the fiscal stimulus. Inflation remains low and the spread between the official and parallel exchange rates has narrowed to below 2 percent. While the improved security situation and the recovery in oil prices will help contain near-term vulnerabilities, downside risks to the outlook warrant further efforts to consolidate public finances, enhance financial stability, and accelerate structural reforms. We concur with the thrust of staff appraisal and support the proposed decisions to initiate the post-program monitoring and place the Article IV consultation on the standard 12-month cycle.

Gradual and growth-friendly fiscal consolidation is essential to build fiscal buffers, reduce large financing needs, and place public debt on a declining trajectory, while creating room for the much-needed priority social and infrastructure outlays. A risk-and rules-based fiscal framework will help dampen procyclicality and lower vulnerability to oil price shocks. We see merit in setting a ceiling on current primary spending of the central government while allowing capital expenditure to increase gradually commensurate with enhancements in absorptive capacity and investment efficiency. Fiscal adjustment requires broadening the tax base and strengthening tax and customs administration coupled with containing the wage bill and lowering subsidies to the electricity sector while putting in place well-targeted social safety nets to protect the poorest and most vulnerable. Could staff indicate if and when the authorities are ready to develop a standalone tax bill that reintroduces the abolished sales tax and ensures strengthened compliance? Staff may also wish to elaborate on the newly-introduced elements of fiscal federalism that could erode nonoil revenue. We welcome efforts to strengthen public financial management, including by the recently-enacted general financial management law, and encourage closing the law’s identified gaps through secondary legislation or decrees and implementing it at an early date.

The pegged exchange rate remains an appropriate nominal anchor for macroeconomic policies. Like several other oil exporters, the dominant share of hydrocarbons in exports and the high import content of domestic production leave little role for exchange rate flexibility to adjust the external imbalance. Fiscal adjustment in the near- to medium-term and structural reforms in the longer run are necessary to manage external pressures, bring the current account into line with fundamentals, and support the peg. We are pleased to note that all previously-identified exchange restrictions have been eliminated.

The underdeveloped, overbanked, and state-dominated financial sector is undercapitalized, with high NPLs. The two-largest public banks—Rafidain and Rasheed (R&R)—are burdened by legacy assets as well as loans to SOEs, while private banks are losing money due to the compression of spreads in the FX market. Work should continue to install core banking systems in R&R before they are audited, restructured, and recapitalized, while non-profitable private banks merge with others or exit the system. Strengthened regulation and supervision calls for a targeted quality review of the public banks' loans to SOEs, which are government guaranteed but not fully serviced, and caution in licensing new private banks as well as enhanced framework for liquidating unviable ones. Plans to establish a deposit insurance company, ensure greater use of mobile banking, and increase SME access to credit bode well for financial development and inclusion. We are pleased to note that FATF has removed Iraq from its list of jurisdictions with strategic AML/CFT deficiencies, as reiterated by Mr. Beblawi and Ms. Choueiri, and appreciate staff indication of the extent to which this has eased pressure on correspondent banking relationships.

Achieving sustainable high and inclusive growth requires reinvigorating structural reforms aimed at a more diversified economy by upgrading human and physical capital, restructuring SOEs, and improving the business environment. More needs to be done to close large infrastructure gaps, improve subpar health and education outcomes, and alleviate the widespread poverty. Reforming SOEs and the electricity sector will help increase efficiency and deliver budgetary savings. We welcome priority accorded to enhancing governance and combating corruption to strengthen public institutions, encourage private sector investment, and create alternative employment opportunities for the young and fast-growing population.

We wish the authorities success in their future endeavors.

Mr. Raghani, Mr. Carvalho da Silveira and Mr. Lopes Varela submitted the following statement:

We thank staff for the set of comprehensive papers and Mr. Beblawi and Ms. Choueiri for their helpful buff statement.

Some macroeconomic indicators in Iraq are recovering amid severe economic, social, and political challenges in the aftermath of long conflicts. Although overall GDP declined slightly in 2018, improvements in security conditions and higher oil prices have contributed to strengthening the external and fiscal positions, which reached surpluses of 6.9 percent and 8 percent of GDP, respectively. This also helped reduce the public debt, by 9.6 percentage points, to about 49 percent of GDP, and boost international reserves.

Going forward, significant policy actions are needed to maintain and accelerate the momentum in light of the persistent socio-political challenges and the uncertain global environment. We note that the reconstruction has been slow and, while growth is projected to move to positive territories this year and over the medium-term, the enhancements of macroeconomic indicators may be short-lived, notably on the fiscal and external fronts. In addition, the balance of risks to the outlook are tilted to the downside. These include volatility in oil prices, geopolitical tensions as well as political instability and social unrest. We share the view that the current favorable environment provides a significant impetus to implement critical fiscal and structural reforms to achieve medium-term macroeconomic stability and inclusive growth.

We broadly agree with the staff's assessment and policy advice and support the proposal for post-program monitoring (PPM) for Iraq with the Fund.

We wish to add the following remarks for emphasis.

We concur that a strong rules-based fiscal framework is paramount to entrench macroeconomic stability while building buffers against shocks and creating space for much-needed investments, including in the electricity sector. Given the economy's sensitivity to oil price developments and fiscal deficits are expected to widen anew in the medium-term, efforts should be geared toward boosting non-oil revenue, notably by increasing tax compliance. In this respect, we support staff's call for the development of a tax bill reintroducing the canceled tax measures while ensuring that the large taxpayers' office is properly equipped to efficiently carry out its functions. On the expenditure side, we see merit in establishing a ceiling on current spending to better control expenditures, build stronger buffers and contain procyclicality. These steps should be complemented by additional measures to close gaps in the public financial management (PFM) framework associated with guarantees and promote the treasury single account. We urge the authorities to better target social spending to ensure improvement in social indicators.

Maintaining financial stability requires resolving the ailing state-owned banks and reinforcing the regulatory and supervisory framework. Installing the core banking systems of the two troubled state-owned banks is a first step towards strengthening Iraq's financial system and limit fiscal costs. We encourage the authorities to continue on this path that should lead to the audit, restructuring, and recapitalization of these banks. Further efforts by the authorities to bolster the regulatory and supervisory frameworks would help bolster investors' confidence. We welcome the fact that the Iraqi's legal and supervisory framework for AML/CFT is now in line with the Financial Action Task Force (FATF)'s requirements and international standards. The amendments to the Central Bank Law and the revisions to the audit commission charter are also worth noting but we encourage the authorities to make progress in scaling up the capacity of internal audit and financial reporting. We urge the authorities to seek support from partners to tackle illicit flows and other financial related criminal activities. We appreciate the measures taken to buttress financial inclusion, including efforts for salaries to be paid directly to employees' bank accounts and to develop a deposit insurance scheme.

The focus of structural reforms should be geared towards reforming the electricity sector, increasing social safety nets and strengthening governance. Steps need to be taken to address the main issues related to electricity shortages which cause large budget costs. Viable avenues should include a review of tariff rates and the distribution network. Close attention should also be paid to broadening the social safety net in order to protect the most vulnerable during the reform process. With respect to governance, we take positive note of measures undertaken, including the establishment of a High Council for Combatting Corruption. Looking ahead, we urge the authorities to remain steadfast in fighting corruption and to consider recommendations contained in Annex VI of the staff report given the challenges facing Iraq in these areas and the substantial returns illustrated in Box 1.

Continued IMF involvement is essential given difficult circumstances faced by the country. To this end, post-program monitoring (PPM) with the Fund can help the Iraqi authorities address macroeconomic challenges and advance with their structural reform agenda. Given that Iraq meets the criteria for PPM, we support the proposed decision.

With these remarks, we wish the Iraqi authorities every success in their future endeavors.

The Acting Chair (Mr. Furusawa) made the following statement:

Iraq's recent strengthening of political and economic conditions is encouraging. Nevertheless, the country faces enormous challenges, and the authorities have a daunting task ahead. As Directors have noted in their gray statements, it is important to use the improved security conditions and higher oil prices to implement the policies and structural reforms aimed at ensuring macroeconomic and financial stability, tackling longstanding social problems, and promoting sustainable and inclusive growth. A robust fiscal framework, focused on containing current spending and boosting non-oil revenues, will be important going forward.

Mr. Beblawi made the following statement:

I thank Directors for their helpful advice. I also thank Directors for recognizing the many challenges facing the Iraqi authorities—notably, addressing the legacy of the war and ensuring durable social, political, and physical stability. I would like to make two points.

First, on the need for fiscal consolidation, many Directors noted the importance of fiscal consolidation by containing current spending and boosting non-oil revenue. The authorities fully agree on the need for reform over the medium term, particularly in the areas of non-oil revenues and civil service. Their immediate focus has been on ensuring social and political stability. Reforms in the electricity sector are equally important to reduce large public expenditures, and they rank high on the authorities' agenda and are ongoing.

Second, on the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) efforts, I thank Directors for acknowledging the progress made in improving the AML/CFT framework, including the removal of Iraq from the Financial Action Task Force (FATF) list of jurisdictions with strategic deficiencies. The Central Bank of Iraq (CBI) is aware that continued vigilance is needed in view of the persistent risk. It will continue to work with the Fund and World Bank's assistance to strengthen the AML/CFT framework.

To conclude, I thank Directors for their support and Mr. Gray and his team for their highly appreciated work.

The staff representative from the Middle East and Central Asia Department (Mr. Gray), in response to questions and comments from Executive Directors, made the following statement:[2]

We are very grateful for the questions and points which Directors raised in their gray statements, most of which we have answered in writing. I will cover in my oral remarks the feasibility of adjustment, our capacity development strategy, misreporting, the long time that has elapsed since the last Board meeting, and the implications of the revised security rating.

First, the context, as we tried to lay out in the report, Iraq has deep-rooted fragilities, following decades of upheaval, and public institutions are weak. The economic analysis we presented in the report has been grounded in that context, and our policy advice has been adapted to what we see as being feasible. This thinking led us to recommend that the authorities establish expenditure ceilings as part of the fiscal adjustment. I should mention that expenditure ceilings were already a part of the budget director's forecasting framework, and they were envisaged in the recently adopted General Financial Management Law, which was adopted in May. We regard the simplicity of such rules as a benefit. They are easier to operationalize in a context of weak institutions, and they can be explained to non-economists, which is essential for political buy-in. Moreover, it would be hard to protect capital spending in Iraq unless current spending is controlled over the medium term. At the same time, introducing a fiscal rule would not be sufficient on its own to restore sound fiscal policy. We have emphasized in our discussions and in the paper the importance of strengthening public financial management, as well as the need for political resolve.

A related question concerned the size of the proposed adjustment and whether this was overly ambitious. I want to emphasize that the scenario we presented in the staff report is for a phased adjustment, with most of the savings materializing over the medium term. It reflects the considerable scope

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

for savings in wages and electricity. For example, over five years, it would imply bringing the wage bill back to roughly the same order of magnitude in which it was in 2017 and 2018. In the adjustment scenario, we have assumed what we see as modest gains from non-oil taxation. While we see that scenario as technically feasible, I would not downplay the political challenges of implementing it in the current context.

On wages, Iraq's mixed experience with ad hoc measures in recent years is very much in line with the literature. At the same time, with heavy pressure on the wage bill, we believe that measures such as capping allowances and bonuses may be essential in the near term, if the authorities are to dampen those pressures. What we attempted to do in the staff report was to lay out the menu of strategies of structural measures over the medium term. Further work will be required on this to identify those measures which will be technically feasible and also which could command political buy-in.

Moving on to capacity development, the context of fragility which I referred to also underscores the importance of the Fund's capacity development in Iraq. On this, we have a continuous dialogue with the authorities, with the aim of understanding their needs and also how the Fund can help the Iraqi authorities alongside and relative to other capacity development providers.

Our capacity development in Iraq can take the form of multi-stage projects, in which there are multiple missions over a number of years, sequenced depending on progress on implementation. This has been the model of much of our work to strengthen statistics. But we also, when there is demand, have tackled specific discrete requests when there are more immediate needs. That has been the case recently when it has come to work on guarantees and extra-budgetary funds. Overall, traction will continue to be the key determinant of our technical assistance (TA). We are open to covering new areas, if there is well-grounded demand from the authorities.

Turning now to misreporting, staff became aware of a possible misreporting in April 2018, when we learnt for the first time of expenditure by an extra-budgetary fund that had been financed by government-guaranteed loans and which should have been included in calculations for the end-2016 performance criterion relating both to the budget balance and the level of debt. This information had been used to assess performance when the Board completed the second review under the Stand-By Arrangement (SBA).

During a mission in September 2018, we received more specific information on the scale of these transactions for end-2016, which implied that this would not be a de minimis misreporting case. Last December, the Managing Director wrote to the authorities, laying out our understanding of the situation. We received a response from the authorities in March, confirming the numbers and identifying a number of measures that the authorities had taken to reduce the risk of a recurrence of such transactions.

In April, during the Article IV mission, the authorities disclosed to staff additional guarantees, dating back to 2009-2012, which implies a higher level of public debt for end-2016, relative to the figures we had received in March. We also became aware of at least one transaction, one guarantee that had been approved outside the authorities' framework for guarantees, which has called into question corrective actions.

That is the situation now. The staff and the authorities are continuing to work closely to resolve this issue, including through TA. Once that technical work is complete, the Acting Managing Director will write to the authorities, and a paper will be presented to the Board once we have received the authorities' response, in line with the policy.

Turning now to the issue which was raised in a number of gray statements about the long time that has elapsed since the last Board discussion of Iraq, which was in August of 2017. I wanted to highlight that, for much of late 2017 and early 2018, staff was closely engaged in discussions with the authorities on policies that will be sufficient to complete the third review under the SBA. Then there was a period of a political vacuum in Iraq in the run-up to the May 2018 parliamentary elections. It took nearly five months after those elections for a government to be formed. Understandably, policy discussions were limited during this period. Once we engaged with the new government, which was toward the end of 2018, it made sense to proceed with the Article IV consultation, which we are discussing today.

In retrospect, we can see that it would have been better if we had found an opportunity to brief the Board at some stage, at least to present macroeconomic developments in Iraq, although there might have been less that we could say about policies.

Finally, on security, the lowering of the rating earlier this month will, in principle, allow short visits to Baghdad by a small number of staff to meet high-level Iraqi representatives but only when such visits are deemed a high priority. We will continue to hold missions for technical and policy discussions, such as Article IV consultations and TA visits, in Amman and other non-high-risk locations.

Mr. Beblawi made the following statement:

On the issue of misreporting, I would like to inform the Board that this is taken very seriously by the Government of Iraq. The authorities are working with the staff to quantify the misreporting of information about guarantees and extra-budgetary spending at the time of the second review of the program.

The authorities have taken measures to strengthen the vetting process for government guarantees and to limit the authorization of off-budget expenditures. They have also requested the Fund's TA with regard to off-budget operations. They are ready to take additional remedial measures to address this situation.

The misreporting resulted partly from an accounting practice of the government that has since been changed, as well as the difficult coordination among agencies, particularly during a period of conflict and tremendous stress. This highlights the importance of continued capacity development by the Fund and other partners in the period ahead. This issue is high on the agenda of the government.

Mr. Montero made the following statement:

We did not issue a gray statement, but we would like to make some remarks. First, let me thank staff for the value-added reports. We support the proposed decisions on post-program monitoring (PPM) and the Article IV cycle. Staff provides an insightful set of reports, and we have particularly appreciated the selected issues paper n a risk- and rules-based approach to fiscal policy and financial inclusion. We also would like to thank Mr. Beblawi for his remarks, and along with Ms. Choueiri, for their candid buff statement and its clear description of the political economy constraints in Iraq. We broadly share the staff's appraisal, and we would like to focus on a few issues.

First, on the pace of reform, the new government faces a difficult balancing act in fostering economic stability and rebuilding the economy, while ensuring durable peace and inclusive growth. The more favorable outlook, supported by the rebound in commodity prices, provides room for maneuver, but it is anchored on thin ground, with significant downside risks, particularly linked to the volatility of oil prices. We note the political difficulties, as stressed by Mr. Beblawi and Ms. Choueiri, which reduced the margin for tightening the fiscal stance and rebuilding buffers. This said, the authorities have a larger margin for more efficient and better targeted expenditures and to decisively undertake and accelerate institutional reform, including improving the fiscal policy framework.

Second, on the fiscal framework, building a robust fiscal framework is probably the central challenge for Iraq. We welcome the staff's emphasis on a risk- and rules-based approach to fiscal policy, and we would like to highlight the need for greater revenue mobilization. As stressed in the selected issues paper, Iraq has one of the most undiversified revenue bases among oil exporters, and the legal weaknesses of the budget framework introduced budget volatility, including expenditures being approved outside the budget procedures. We welcome the new General Financial Management Law, which is a first step in setting up a clearer fiscal framework, but it will have to be further developed. The selected issues paper provides a good standard to work with, anchored on a clear and transparent budget process, expenditure rule, and medium-term budget. We would welcome staff's comments on the political viability of the new government carrying out these reforms.

On spending, we subscribe to staff's and most Directors' comments on the need to re-orient public expenditures to enhance capital investment and social spending. We also share that there is scope to review the rapidly growing public wage bill and to reduce the high weight of the electricity sector bill on the budget through an ambitious reform of this sector. The central problem here is reviewing the public spending and investment procedures. We would also welcome the staff's recommendation to review the adequacy and efficiency of spending. Given the weak institutional capacity, this is an effort that warrants a strong capacity building effort. Annex I underscores that this is a TA priority, and we would welcome staff's comments on the next projects in the pipeline in this area.

Finally, on anti-corruption. We would also highlight the staff's emphasis on the scope of strengthening the anti-corruption strategy, including a more coherent national framework, streamlined institutional structures, and bolstering AML/CFT implementation.

With these comments, we wish the authorities the best.

Ms. Levonian made the following statement:

We thank Mr. Beblawi and Ms. Choueiri for their helpful buff statement and the remarks today. We thank staff for their comprehensive report and responses to questions this morning.

We have issued a comprehensive gray statement, supporting the proposal for PPM. We also support the proposal to revert to a 12-month cycle for the Article IV consultation. I just want to make one point today, which you have addressed a bit already.

The point today is on the issue of engaging with the Board on off-track programs, which is something this chair has raised before. The last Board meeting on Iraq was almost two years ago at the time of the second review of the SBA, and you explained what has happened since then. But while we acknowledge the challenging circumstances in Iraq, we were disappointed to learn that the authorities have abandoned several of the reforms that they committed to under the SBA. Again, the staff explained the rationale for what was feasible in that instance. But like some other Directors, we want to underscore the importance of keeping the Board engaged on programs that go off track to allow us to closely monitor the program performance. This is a broader point that I am making, not specific to this one.

With that, I wish the authorities well.

Mr. Mouminah made the following statement:

I thank staff for the comprehensive answers and for their remarks this morning and also Mr. Beblawi and Ms. Choueiri for their buff statement and introductory remarks.

The developments in Iraq are encouraging, with the economy recovering and rebounding oil prices helping the authorities to rebuild fiscal and external reserves and buffers. However, addressing the legacy of the war and ensuring durable political and financial stability are important challenges confronting the authorities.

I would like to take this opportunity to emphasize a few points that we have made in our gray statement and additional points based on the discussion this morning.

First, I welcome the improved fiscal situation but encourage the authorities to avoid an under-execution of the capital budget.

Second, I agree with the authorities on the importance of maintaining the peg to the U.S. dollar.

Third, reforming the banking sector and restructuring public banks are critical to safeguard financial stability. I welcome Mr. Beblawi's remarks on this.

I would also like to add that, in their reform efforts, the authorities should be guided by the need to provide the right incentives and an appropriate business environment to allow the private sector to grow and flourish in Iraq. To this end, increasing investment in infrastructure, reforming the banking sector, and strengthening the rule of law are some of the reforms that will go a long way in nurturing the private sector initiative and investment, which will hopefully contribute to increasing employment opportunities, which is highly needed.

On misreporting TA is extremely important to ensure that the authorities are aware of what they are doing and to make sure that they are compliant going forward. Again, I was reassured by Mr. Beblawi's comments on this. I would like to just underscore the continuous discussion between staff and the authorities to ensure that they support them and help them on their journey.

With these remarks, I wish the authorities all the success.

Mr. Sigurgeirsson made the following statement:

I thank staff for the excellent report and for the added information this morning and Mr. Beblawi for his helpful comments at the start of the meeting.

We have issued a comprehensive gray statement, highlighting our views on fiscal policy and governance issues, and we agree to the proposal for the PPM.

The issue I wanted to raise is more general in nature, on programs that have gone off-track and keeping the Board updated. Like Ms. Levonian mentioned, we and other chairs have previously raised this issue on several occasions, and this was also discussed at the Agenda and Procedures Committee (APC) meeting in March. We appreciate that the Secretary's

Department (SEC) has responded to these concerns. There is a new table on the status of Fund programs that has been added to the regular note on the Board Work Program, and Board program issues now feature more prominently in the regional briefings that we have before the Spring and the Annual Meetings. This is all good and well.

But I appreciate staff's acknowledgement that more could have been done to inform the Board on the status in Iraq over the past two years. This is something that we put a lot of resources into, including through capacity development. But it raises a question, whether more should be done to strengthen the reporting and monitoring processes to improve the Board's oversight of programs that have gone off track. If staff cares to comment on that, that would be welcome.

Mr. Ray made the following statement:

Like other Directors, I thank staff for a very good report and also Mr. Beblawi and Ms. Choueiri for their buff statement and Mr. Beblawi for his helpful remarks. Like others, I have issued a gray statement. I just wanted to talk about three points, two of which are more general than this specific circumstance, and I wanted to say something about misreporting.

First, the staff report provides very clear policy advice to the Iraqi authorities, and it is supported by a detailed analysis. But the main challenge is in getting traction. In many areas, the authorities face political constraints and weaknesses in institutional capacity and governance. We all know that. The Fund's advice would be most effective where it is integrated with the capacity building efforts of the Fund and other TA providers. As Ms. Riach and Mr. Masood highlighted in their gray statement, where the Fund is not on the ground, it is important that they work very closely with the World Bank and other donors to assist the identification and facilitation of reforms. We look forward to hearing more about the capacity development strategy at the first PPM discussion later in the year. I have listened carefully to what Mr. Gray had to say about the implications of the lowering of the security rating. The Independent Evaluation Office (IEO), in its evaluation on fragile states, made some fundamental observations in this area, in that, these are exactly the sorts of cases in which we should be on the ground. That raises quite a challenge for us, as Directors. It does seem to me that at some point, we should revisit how we think about security and staff visits. Perhaps it is a matter for Strategy, Policy, and Review Department (SPR), rather than the area department. But this is a general issue. I do worry that we are not getting traction because we are not on the ground. It does seem that it is particularly difficult to deliver capacity development remotely in these circumstances.

Second, I just want to emphasize a point that Ms. Levonian and Mr. Sigurgeirsson have stressed and that this chair has stressed often, and this is around off-track programs. I continue to worry about the tendency for these programs that are in difficult circumstances to become invisible to the Board. It is precisely in such complicated and challenging situations where the Fund faces the highest reputational risk. I appreciate what Mr. Gray had to say this morning. It seemed that a series of very well-meaning decisions made at different points in time, and in retrospect, we realize we would not have done this if we had known where we were going to end up. And it does strike me that the types of things that we have been pressing for around this table, just to have more regular reporting. Regardless of whether nothing can be happening because the authorities are in abeyance, the staff should continue to report and tell us that, rather than let a program just disappear from sight. The regular reporting that SEC has initiated is very welcome.

Lastly, I particularly welcome Mr. Beblawi's report on his authorities' intent to address misreporting. I noticed the request for TA in this area, and I would just encourage staff to give that a high priority.

Ms. Pollard made the following statement:

Let me begin by thanking staff for their comments this morning and Mr. Beblawi for his as well. They were very helpful. I also thank the staff for the answers to the technical questions.

We welcome the increase in growth in Iraq over the last few years and the improvement in their fiscal and external positions. However, there are still clear issues with the fiscal stance, both in terms of capacity and just general weaknesses that need to be addressed. I welcome staff's comments on the fiscal rule and how such a rule could simplify things, but also the recognition that it is not going to solve all the problems facing the fiscal authorities and that there are other issues that need to be addressed jointly with that. It is an interesting proposal to consider.

In terms of the spending, I echo the comments of Mr. Mouminah, that the underspending on capital projects is a large problem, and the composition of expenditures needs to be addressed.

On misreporting, I appreciate staff's comments and welcome the comments by Mr. Beblawi that the authorities are committed to addressing these issues and are asking for TA. We look forward to an update on this from staff in the coming months.

On PPM, I was interested in the answer to the question and am looking forward to staff's input on whether they believe it is useful to have an extension beyond April 2020. I look forward to that.

Finally, on the off-track programs, I very much agree with the comments of Ms. Levonian, Mr. Sigurgeirsson, and Mr. Ray. This has been a persistent problem that the Board has raised over the last year, if not longer, and it is an issue that, although improving, still has some way to go to provide the Board with adequate information on programs that are either temporarily or permanently off track.

Mr. Inderbinen made the following statement:

As stated in our gray statement, we support the initiation of PPM for Iraq. In our gray statement, we had asked about the context in which the misreporting had occurred, and we thank Mr. Gray for the elaborations that he has offered this morning. I also thank Mr. Beblawi for his helpful remarks. We are encouraged that the authorities are taking this seriously and have initiated corrective measures.

It does serve as a good example of the point that has been made by Ms. Levonian, Mr. Sigurgeirsson, and others this morning, that we can continue to improve on the information that is provided to the Board in cases where programs have gone off track and remain off track for some time. We fully appreciate that incidents like these come to light slowly and that staff needs additional engagement to get the whole view of what has happened. We also understand that information on macroeconomic data and on the authorities' policies may not be sufficient to give a wholesome briefing to the Board. But in situations like this, it is also important just to know the relationship of the Fund with the country, even if we do not have a full picture of what the macroeconomic situation is like. The Board would be very appreciative of just having that and would understand that the macroeconomic picture is not a whole one. We would encourage staff and management to give additional thought to how to brief the Board in those situations.

Mr. Tan made the following statement:

We thank Mr. Beblawi and Ms. Choueiri for the helpful buff statement and the opening remarks. We also express our appreciation to staff for the informative staff report.

We want to come back to one issue regarding the wage bill. We have raised some questions on that in our gray statement, regarding how effective and helpful the short-term ad hoc measures would be, given past experience, as well as the likelihood of the longer-term structural measures in addressing the root cause of the wages increasing. We are mindful of the context of the capacity constraints in Iraq, given the institutional weaknesses and the sociopolitical conditions. In this regard, we welcome staff's clarifications at the start of the meeting on the many options that you are considering, as well as the follow-up to be done on what will be feasible in order to get the political buy-in. It is important to learn from past experience and that of the other countries, as noted in Annex VII. We also support comments from other Directors, like Mr. Ray, on traction and the TA strategy.

With that, we would encourage the authorities to work closely with staff going forward, and we wish them well.

Mr. Sode made the following statement:

We thank staff for the helpful set of reports and for the insightful meeting we had with them prior to the Board. We also thank Mr. Beblawi and Ms. Choueiri for their insightful buff statement and the additional comments he made this morning.

While Iraq experienced a cyclical recovery in 2018, significant challenges lie ahead, and longstanding reforms still need to be undertaken. We issued a gray statement, so I will be brief and just add a few points.

First, we see the reform of the fiscal framework as a key priority, as noted by staff. While we positively note the General Financial Management Law passed in May 2019, two main issues remain—the procyclicality of revenue and expenditure—which remain strongly dependent on oil price fluctuations, and the excessive growth of current spending and the lack of capital spending. A sound fiscal framework should streamline revenue for reconstruction needs, rather than privatizing the public wage bill, while building fiscal buffers when oil prices are high. Given the challenge to achieve these reforms, we agree with Mr. Ray's comments that TA is key and that cooperation with other TA providers is essential. We also support the call for exploring the possibility to provide TA on the ground as the security situation improves.

Second, we also see the continuous efforts in the AML/CFT framework as a priority. We take positive note of the efforts by the authorities, which led to the removal of Iraq from the FATF monitoring in 2018. Looking ahead, we encourage the authorities to remain committed to the implementation of the 2015 AML/CFT law and to ensure greater cooperation with the anti-corruption authorities.

Third, we still think that the restructuring of the two main state-owned banks is also a key reform that needs to be undertaken. It is necessary to improve the financing conditions in the country but also to develop a sound sovereign bond market. The monetization of public debt by the central bank in a fixed exchange rate regime puts high pressure on foreign exchange reserves and puts the economy on an unsustainable path. We encourage the authorities to tackle this issue.

Fourth, we encourage the authorities to tackle the issue of misreporting concerning public debt, and we welcome Mr. Beblawi's comments on this issue.

Finally, I support the call by Ms. Levonian and other colleagues about monitoring off-track programs.

With this, we wish the best for the authorities.

Ms. Mannathoko made the following statement:

We appreciate Mr. Beblawi's comments and staff's responses to our questions. I just have a few points.

First, we commend the authorities on Iraq's removal from the FATF monitoring list. But in this regard, we also want to encourage effective implementation. In addition to that, we just noted the adverse effects of corruption. Like other chairs, we encourage the authorities to give more attention anti-corruption enforcement, especially before it becomes even more deeply entrenched.

Second, we support Ms. Levonian's and others' request for regular reporting on program countries.

Third, in the next reporting cycle, like Mr. Ray, we would also appreciate a bit more reporting on the capacity development program, especially on plans, along with other international financial institutions, to help in the rebuilding of fiscal, monetary, economic, governance systems, and institutions in Iraq, since these processes are central to the Fund's mandate.

Fourth, like Mr. Mouminah, Ms. Pollard, and others, we also noted in our gray statement the significant importance of improving public investment.

Beyond that, we wish the Iraqi authorities success going forward.

Mr. Etkes made the following statement:

I thank staff for the very good report and selected issues paper and Mr. Beblawi for his opening remarks.

We issued a gray statement, and we want to add only one comment.

We appreciate the efforts of staff to write a good report, with challenges. We support the authorities' request to consider resuming visits to Baghdad to meet high-level officials, but not only at a high level. We feel that perhaps the capacity development efforts on the technical level could be more important than the high-level meetings because then you can go and see the units themselves and appreciate the shortcomings in their operations, and see how they can enhance the effectiveness of their operations.

It could be an important signal to push the quality of the capacity development. Obviously, staff's safety should be our first priority, but we understand that some agencies do go on the ground and provide capacity development on the ground, and perhaps staff could consider doing likewise.

The staff representative from the Middle East and Central Asia Department (Mr. Gray), in response to further questions and comments from Executive Directors, made the following additional statement:

> I wanted to come back on three points. First, there was a question about the political viability of fiscal adjustment. Clearly, the Fund's comparative advantage is on technical work. At the same time, in our engagement with a country like Iraq, you discover quickly what could be politically viable and what cannot be. That is very much integrated into our thinking. I sense that the way forward is to deepen technical work, working with other partners on reforms to the expenditure side. At the same time, as we emphasized in the oral comments, it will be politically challenging to undertake those reforms, and we are under no illusions in that regard.
>
> One further point on misreporting, I wanted to clarify that the Fund has already provided TA to the authorities on guarantees. The first mission took place last month, and we will continue that work in the coming months to resolve this case.
>
> Finally, we can certainly, at the time of the next Article IV, come back to the Board on capacity development issues. PPM is governed by a different framework, and I would not expect the PPM staff report to go into the same depth on this issue.

The Deputy Director of the Strategy, Policy, and Review Department (Ms. Kostial), in response to questions and comments from Executive Directors, made the following statement:

> There are two issues that the Board raised which have brought up policy implications, and I wanted to respond to those.
>
> First, on the question of off-track programs, you have heard Mr. Gray state that, in retrospect, probably it would have been better to brief the Board earlier on Iraq. The view from SPR is that the ball there is in the court of the area department because it is not about whether a program is off track or on track, but it is the reasons behind being off track and on track that are important.
>
> I am glad that you welcome that SEC is already providing better tables, but I would also like to let you know that there are some other initiatives that will help in that regard.

First of all, the MONA database, which reports on programs, has been upgraded, and it is available for Directors. We are happy to resend the link. In there, you can see whether a program is off or on track.

Second, we are planning to do a quarterly bulletin that reports on programs. That will be shared with the Board as well. It will report on several indicators and will also draw on the MONA database, including showing whether a program is off or on track.

Lastly, we are drafting a guidance note in response to the discussion of the Review of Conditionality. For the guidance note, we are thinking of providing guidance to staff on best practices for how to report to the Board if a program is off track.

The second point that was raised was on security issues. Indeed, there is the IEO report of mid-last year on fragile and conflict-affected states. We provided a management implementation plan (MIP) that was endorsed by the Board in October. Security is one of the issues. The Managing Director stressed very strongly that of utmost priority to us is that our staff are safe and that nothing is going to happen to them.

When you look at this MIP, security is one of the many aspects in order to improve our traction on fragile states. In October, right before the Annual Meetings, the Managing Director issued a statement on how we are going to enhance our engagement with fragile states, whether that is program-related, whether that is through capacity building, or whether also through our own HR strategy. In a sense, when I reviewed the staff report, I thought this was already a very nice step, going in the right direction. Because one of the issues that the IEO observed was that staff reports for fragile states read like normal staff reports. I think that the team very nicely addressed fragility and also thought very much about the issue of capacity building to help institution building.

Lastly, let me point out that, at the end of this year, the Board will be updated on the progress staff has made overall on fragile states as planned in the MIP of October 2018.

Mr. Beblawi, in a brief concluding statement thanked Directors for their remarks, and encouraged the staff and management to consider resuming missions in Iraq.

Mr. Ray agreed that security was incredibly important for staff, but noted that other organizations, such as the World Bank, had staff on the ground in Iraq. He supported Mr. Beblawi's remarks.

The Acting Chair (Mr. Furusawa) noted that Iraq is an Article XIV member, but no longer maintained transitional measures under that article. Iraq maintains one multiple currency practice subject to Fund approval under Article VIII. It was not recommended to approve this measure and, hence, no decision was being proposed.

The following summing up was issued:

> Executive Directors agreed with the thrust of the staff appraisal. They were encouraged by the recent strengthening of Iraq's economy but recognized that the country continues to face daunting challenges. Social conditions remain harsh, post-war reconstruction progress is slow, development needs are large, and institutional weaknesses are significant. Volatile oil prices and a difficult regional and geopolitical environment pose additional difficulties. Directors encouraged the authorities to seize the opportunity presented by the improved security situation and higher oil prices to implement policies and structural reforms aimed at ensuring macroeconomic and financial stability, tackling long-standing social problems, and promoting sustainable and inclusive growth.
>
> Directors emphasized that building a robust fiscal framework is essential to maintain fiscal and macroeconomic stability and strengthen buffers. They encouraged the authorities to adopt a risk- and rules-based approach to fiscal policy as part of broader reforms to manage oil revenue more effectively, reduce tendencies for procyclicality, and shift to a more growth-friendly composition of expenditure. Directors supported scaling up reconstruction and development expenditure gradually in line with improving absorptive capacity. They underscored the need to strengthen public financial management to ensure public spending is appropriately monitored and to reduce vulnerabilities to corruption. In this context, Directors welcomed the newly adopted General Financial Management Law and encouraged its full implementation.
>
> Directors emphasized that gradual fiscal adjustment, including containing current primary spending and boosting non-oil revenues is essential for maintaining fiscal and debt sustainability. They recommended that spending measures should give priority to containing the growth in wage bill and lowering subsidies to the electricity sector. Directors emphasized that the poorest and the most vulnerable must be protected from the adjustment

process.

Directors underscored that an overhaul of the banking sector is necessary to maintain financial stability. They encouraged the authorities to restructure the large state-owned banks, enhance their supervision, and implement other reforms to increase financial intermediation. Directors highlighted the benefits of increasing financial inclusion, especially for the SME sector, which has a large potential to absorb entrants to the labor market.

Directors agreed that building public institutions and enhancing governance is key for success, and highlighted the scope for Fund capacity development to support these efforts. They welcomed progress in developing an anti-corruption framework and called for further modifications to the legal regime for combatting corruption coupled with stronger coordination between the relevant government agencies, while continuing to strengthen the framework for Anti-money laundering and combatting the financing of terrorism (AML/CFT). Directors also recommended strengthening Public Investment Management framework to ensure that spending is well directed and that donor funds targeting reconstruction are put to the most efficient use.

Directors looked forward to continued close engagement between the authorities and the Fund in the context of post-program monitoring.

It is expected that the next Article IV consultation with Iraq will be held on the standard 12-month cycle.

The Executive Board took the following decisions:

Iraq—Proposal for Post-Program Monitoring

Iraq is expected to engage in post-program monitoring with the Fund, in accordance with Decision No. 13454-(05/26), as amended. (EBS/19/70, 7/8/19)

Decision No. 16565-(19/66), adopted
July 19, 2019

Iraq—Article IV Consultation Cycle

It is expected that the next Article IV consultation with Iraq will take place on the standard 12-month cycle. (EBS/19/70, 7/8/19)

Decision No. 16566-(19/66), adopted
July 19, 2019

APPROVAL: October 1, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

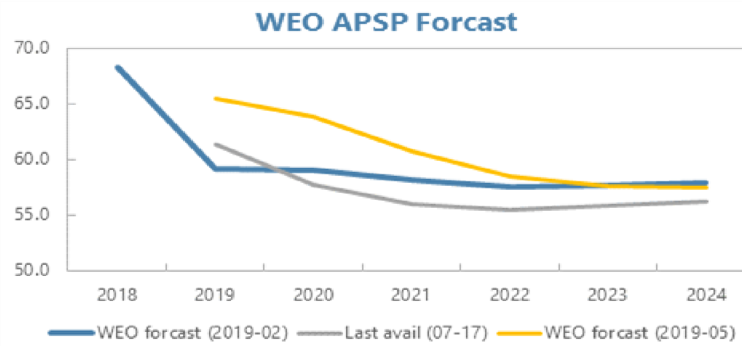
Real and oil sectors outlook

1. ***Could staff elaborate on the reasons for their difference with authorities on the oil price trajectory going forward?***

2. ***We also take note that authorities' and staff's views differ quite substantially in some major aspects related to the outlook and reform path ahead. Staff comments would be welcome.***

3. ***Could staff comment on the medium-term projections for oil production and on the authorities' more optimistic outlook, including their higher projections for oil prices?***

- Oil prices have been very volatile in recent months. The assumptions for oil prices in the Staff Report are based on the WEO assumptions prevailing during our policy discussions, with the level adjusted to reflect that Iraqi crude trades at a discount to international benchmarks. Prices have gone up and down since then and are now somewhat lower than the assumptions in the Staff Report from 2020 and over the medium term. The authorities' views on the oil market have tended to be guided by short-term developments, especially reflecting geopolitical tensions and their role in keeping oil prices elevated.
- The medium-term projections for oil production draw on our discussions with the authorities and industry experts. Staff takes also into account the major constraints on production, such as the availability of water and export capacity, as well as progress in structural projects that might alleviate these constraints. After a strong recovery of production in the short term, linked to the end of OPEC+ agreement, staff assumes that production will increase by 1.7 percent annually over the medium term to reach 5.2 mbpd by 2024. The authorities consider the capacity could, in an optimistic scenario, reach 5.5 mbpd—but that would require faster progress on structural projects.



4. ***Could staff comment on the authorities' strategy to grow the non-oil sector and generate meaningful employment in the private sector, especially for youth?***

5. ***We welcome, the new Recovery, Reconstruction, and Development Program and National Development Plan recently launched by the new government. Could staff offer some elaborations on this strategy and indicate to what extent it could help address some of the challenges facing the country?***

6. ***Could staff elaborate on the prospects of the private sector labor market?***

- The authorities have articulated a high-level objective of diversifying the economy, largely through a revival of industry and agriculture, and promoting a vibrant private sector. However, specific policies and detailed measures to achieve these objectives have not yet been formulated.
- Labor market prospects will depend on the authorities' success in creating an enabling environment for the private sector to lead growth and job creation. Building infrastructure and improving basic service delivery including electricity, strengthening governance, and increasing financial inclusion and access to finance (especially by the SME sector) will be important. Policies to control public employment and reduce generous compensations coupled with education reforms to adapt labor skills would help increase private employment.

7. ***We appreciate staff's perspective as informed by the investment needs model, and wonder if staff can use the model to estimate optimal public investment rates for Iraq over the medium term? Given the magnitude of public investment reconstruction needs, we also wondered whether the investment rate of about 7 percent of GDP used in projections from 2021 onwards will be adequate? Staff views are welcome.***

- The Investment Needs Model is designed to estimate current account norms for resource-rich developing countries with scarce capital stocks and high investment needs. However, it is not designed to determine a point estimate for the optimal level of public investment. The projected increase in non-oil investment, which will more than double over the medium term, is based on staff assessment of capacity to scale up capital spending but also available fiscal space in light of widespread spending pressures. Staff encouraged the authorities to increase capital expenditure further as absorptive capacity improves, which will take time and should be supported by measures to improve Public Investment Management Systems.

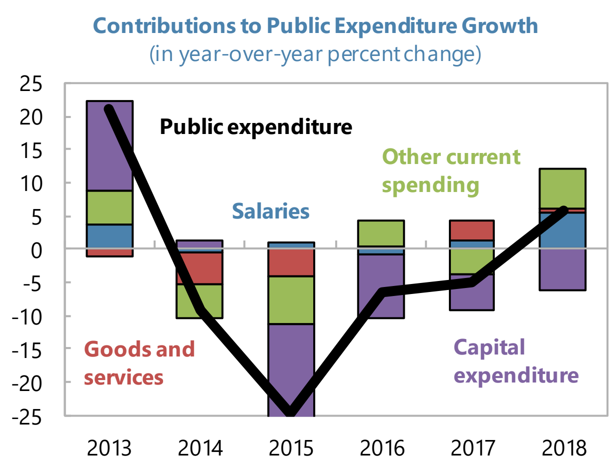
8. ***Could staff provide more information about the impact of the U.S. sanctions on Iraq's electricity/gas imports, electricity supply, and economic costs of a needed import substitution?***

- Around a third of electricity supply comes either directly from Iran, or from Iraqi plants reliant on Iranian gas. Substitution of the Iranian gas from other countries or domestically will take time and sizable investment—although it would ultimately lower the costs of production and have positive environmental benefits given the plentiful domestic supply of gas that is currently being flared. Iraq has been given temporary waivers from sanctions. If waivers on U.S. sanctions were not renewed, Iraq could face difficulties in sourcing and paying for electricity and gas imports, potentially with a sharp adverse impact on domestic electricity supply.

Fiscal adjustment and reform

9. ***We wonder what is behind the large increase in 'other current spending' in 2018 (fig. 4)?***

- There was an error in the chart pertaining to 2018, and the increase due to other current spending was only 6 percent (see revised chart). This increase reflects higher transfers (including to special programs and SOEs), domestic interest payments, and war reparations to Kuwait.



10. ***Could staff explain the reasons behind the authorities' decision to abolish non-oil taxes in the 2019 budget?***

11. ***Could staff provide more details about the extent of the non-oil taxes reduction and whether this is the authorities' strategy?***

12. ***Could staff indicate if and when the authorities are ready to develop a standalone tax bill that reintroduces the abolished sales tax and ensures strengthened compliance? Staff may also wish to elaborate on the newly-introduced elements of fiscal federalism that could erode nonoil revenue.***

- The sales tax measures were introduced in the 2018 budget but collection was very limited due to weak compliance and a lack of enforcement mechanisms. These taxes were removed by parliamentarians during discussions of the 2019 draft budget law. The authorities have thus far not shown interest in reintroducing these taxes or implementing further tax policy measures.
- With regards to fiscal federalism, the recently adopted GFML specifies that governorates would receive 50 percent of federal fees and taxes collected by centrally-funded departments in the governorates, a share of revenues arising from border crossings, and some share of oil exports from the region in question (so called "petrodollars").

13. ***We would appreciate staff's comments on this issue as well as on the extent to which staff's projections incorporate the authorities' current spending priorities discussed in paragraph 33.***

- Staff's projections assume continued growth in wages in nominal terms over the medium term. Although the authorities agreed with the necessity of implementing tax policy and revenue administration measures, and with the thrust of the recommendations to contain the wage bill (para 33), they showed no firm intention in their implementation in the near to medium term. Therefore, the baseline projections do not incorporate any gains from the proposed measures.

14. ***Given the changed economic and political conditions, does staff have an update on the expected financing mix, particularly with regard to donor financing?***

- Donor financing has been slow so far but is assumed to increase under an adjustment scenario. Implementing reforms and improving capacity to identify and prepare projects and meet documentation requirements by donors would help expedite disbursements.

15. ***Could staff elaborate further on the financing mix, especially on the policy actions (higher interest rates?) to rely more on domestic bank financing while eliminating central bank financing of the government?***

- The overall financing requirement would be lower in staff's adjustment scenario. In such a scenario, donors would likely be willing to lend greater volumes to Iraq, and staff advice would be to rely to the extent possible on such external project financing which is directed to capital spending. In such a scenario, the overall need for domestic financing would be lower than in the baseline. Moreover, with reforms, banks would have some capacity to lend from their own resources. This would also enable the authorities to limit recourse to the central bank, thereby reducing pressures on central bank reserves. In view of the fixed exchange rate, interest rates in Iraq are largely determined by external developments.

16. ***Staff's views on the recent enacted civil service law are welcome.***

- The staff has not yet received a copy of the law for review. Our technical counterparts have not articulated firm views on its implications.

17. ***Could staff elaborate on whether Iraq's actual level of debt owed to Arab states has been determined? Will there be a degree of debt forgiveness, and if so, to what extent?***

- The stock of legacy arrears owed to non-Paris Club creditors from Gulf countries is USD 27.6 billion, compared with the total legacy arrears owed to non-Paris Club creditors of USD 40.1 billion. The authorities have already reached agreements with Brazil and Morocco for forgiveness on Paris-Club terms. There is no available information on possible forgiveness by other non-Paris Club creditors.

Monetary and financial sector

18. ***Could staff comment on the likelihood of a consolidation of private banks?***

19. ***Given that the financial system is currently overbanked, we seek staff's comments on the measures that the authority may take to help facilitate banking consolidation?***

20. ***Staff report indicates that the financial system is currently overbanked. In this context, we wonder which indicators have been used to reach such conclusion.***

- Staff encouraged caution in licensing new banks, and urged the authorities to strengthen the frameworks for handling troubled banks. Staff thinks there is some scope for consolidation in the private banking sector to build healthier, stronger institutions that compete with public banks at the national level and exploit economies of scale.
- The assessment that the system is overbanked is widely shared (including by the Central Bank of Iraq (CBI), in light of the large number of banks (70 in total) but low level of intermediation. The CBI is currently working to encourage mergers and acquisition in the private sector. In July, it approved rules for the mergers of Banks in its resolution No. 90 of 2019, which emphasizes the benefits from merging banks (improved access to CBI loans and to FX; upgrade of the rating by CBI using the CAMELS Rating System). https://cbi.iq/news/view/1173.

21. ***Regarding the state banks, could staff clarify if the banks' audits are complete?***

22. ***Does staff have a preliminary estimate about the size of the banking sector-related contingent liabilities?***

- The Iraqi Bureau of Supreme Audit is still in the process of auditing the public banks' accounts, and an international audit has yet to be completed.
- Once public banks accomplish the installation of the core banking system, and supervisor/auditors complete the audit of financial accounts, we should be able to obtain a clearer picture of banks contingent liabilities.

23. ***We notice that several private banks are losing money with sharply reduced FX trading incomes and wonder whether it could provide an opportunity to incentivize private banks to channel more credit to the real economy rather than speculating the spreads in the FX markets. Staff's comments are welcome.***

- The reduced profitability from FX trading should incentivize the private banks to engage more in private sector lending. Staff also encourages the authorities to insure a level playing field for the private banks (for example creation of a deposit insurance corporation) and restructuring public banks.

24. ***Could staff clarify why the requirement to have a bank account for a minimum of six months, referred to in footnote 1 of the Informational Annex, is an MCP subject to Fund approval under Article VIII, Section 3 and why no decision for its temporary approval has been proposed since staff is monitoring its application?***

- The MCP arises from the lack of a mechanism to ensure that the exchange rate at the CBI foreign exchange window does not deviate from the market rate by more than two percent.

25. ***We are pleased to note that FATF has removed Iraq from its list of jurisdictions with strategic AML/CFT deficiencies, as reiterated by Mr. Beblawi and Ms. Choueiri, and appreciate staff indication of the extent to which this has eased pressure on correspondent banking relationships.***

- Staff believes that the progress to strengthen the implementation of the AML/CFT framework as well as broader financial reforms should help Iraq improve correspondent banking relations. At present we do not high-frequency data on CBRs that would allow us to assess if this has taken place.

26. ***Staff asserts that the peg to the USD serves Iraq well. We note that this peg imposes fiscal fluctuations as the price of oil fluctuates relative to the USD and the pegged dinar. Pegging to a currency that co-moves with the price of oil, such as the Euro as recently noted by the New York Federal Reserve Bank, could help Iraq to reduce fiscal fluctuations. Can staff assess the share of fiscal expenditures in Iraqi Dinar***

(e.g. wages), USD (e.g. public imports from non-Euro countries), and Euro (e.g. public imports from Euro countries) and the resulted basket of USD and Euro that will minimize Iraq's fiscal fluctuations due to the fluctuations in oil prices?

- Staff does not have any information on the currency composition of public expenditure. At the same time, the majority of its revenues (from oil exports) are in US dollars. Available data suggests that a significant share of external public debt is denominated in U.S. dollars, while much of the population saves in dollars. Thus, changing the exchange rate peg could lead to adverse balance sheet effects.

Technical assistance

27. ***Can staff identify the reasons for this limited use of training options? What steps are taken to enhance the take up?***

- We will take this up in future discussions with the authorities.

28. ***We also welcome proposed capacity development for PFM. Have staff considered further areas for capacity development? Could staff also comment on whether authorities have requested additional TA in the remaining areas of the AML/CFT framework including the restructuring of the two banks?***

- Our strategy for Capacity Development reflects an ongoing dialogue with the authorities, and we will continue to explore the scope to expand our Capacity Development, including on issues related to governance. We have not received a request for TA relating to the restructuring of the two large public banks.

29. ***In that regard, we would like to know how the staff assesses the efficiency and absorption of TA provided by the Fund in public investment management.***

- The Fund has not provided any TA to the Iraqi authorities on public investment management in recent years, as the World Bank has taken the lead on this area. However, our advice on PFM complements the World Bank's work.

Post Program Monitoring

30. ***Could staff expand on the planned engagement with the Iraqi authorities under post-program monitoring?***

31. ***Given that credit outstanding to Iraq is expected to decline below the SDR 1.5 billion threshold in early April next year, can staff inform what are the plans in terms of future PPMs?***

- We envisage a PPM mission in the fall, with a Board discussion towards the end of this year. In line with the policy, PPM will complement Article IV surveillance, exploring in greater depth the full range of risks to capacity to repay the Fund, in particular from oil price and production shocks. PPM will expire automatically next

April, when credit outstanding falls below the SDR1.5 billion threshold, unless there is a Board decision recommending that PPM be extended. Staff will assess the case for an extension in the context of preparations for the 2020 Article IV.