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PREFACE

The *Iraq Economic Monitor* provides an update on key economic developments and policies over the past six months. It also presents findings from recent World Bank work on Iraq. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy on the outlook for Iraq. Its coverage ranges from the macro-economy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Iraq.

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LIST OF KEY ABBREVIATIONS USED

bpd	barrel per day
CBI	Central Bank of Iraq
CSO	Central Statistical Organization of Iraq
DPF	Development Policy Financing
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IDPs	Internally Displaced Persons
IFIs	International Financial Institutions
IMF	International Monetary Fund
ISF	Iraqi Security Forces
ISIS	Islamic State of Iraq and Syria
KRG	Kurdistan Regional Government
MENA	Middle East and North Africa
NIC	National Investment Commission
PPP	Public Private Partnership
RFI	Rapid Financing Instrument
SMEs	Small and Medium Enterprises
SOEs	State-Owned Enterprises
SOMO	State Oil Marketing Organization
TFER	Task Force for Economic Reforms and Private Sector Capacity

EXECUTIVE SUMMARY

i. Iraq is facing daunting challenges of ISIS insurgency, political upheaval, and profound economic and humanitarian crises. In mid-2014, the ISIS group managed to capture and control nearly one-third of Iraq's territory plunging the country into a deep political and security crisis. Despite progress made by the Iraqi Security Forces to recapture some ISIS-controlled cities, the insurgency group still holds large swaths of the country, including Fallujah, about 40 miles from Baghdad. As a result of the ongoing conflict, 20,035 Iraqis died in 2014, the most since 2007, and a further 17,080 died in 2015; and 4 million persons are internally displaced. This situation poses a major humanitarian, social and development crisis. The population remains extremely vulnerable to the ongoing security and economic issues. Extreme poverty is widespread, exacerbated by constant and recently worsening violence. Poverty reached 22.5 percent in 2014 nationwide; and in the ISIS-affected governorates, the direct impact of economic, social and security disruptions is estimated to have caused a doubling of the poverty rates to 41.2 percent. Internally displaced persons (IDPs) make up half of Iraq's poor in 2014.

ii. Compounding the ISIS-related crisis, the sharp decline in global oil prices has resulted in significant decline in oil export revenues (Figure 1). Lower oil revenues, by US\$40 billion, in addition to higher humanitarian and security-related expenditure, led to a fiscal deficit of 14.5 percent of GDP in 2015. In fact, the deficit could have reached 18.4 percent if the government had not implemented a number of fiscal consolidation measures. The current account deficit worsened from 0.7 percent of GDP in 2014 to 6.6 percent estimated for 2015, reflecting significant decline in oil export revenues. At the same time, imports remained unchanged in 2015 in part reflecting capital goods needed to

expand oil-production, but also because of the surge in government spending including security-related imports to combat ISIS. Total international reserves have declined from US\$66.7 billion at end-2014 to US\$54.3 billion at end-2015. In light of pressing fiscal and balance of payment needs, the IMF supported Iraq through a one-off disbursement of US\$1.2 billion in July 2015 under its Rapid Financing Instrument (RFI). In addition, to safeguard economic stability and basic service delivery, the World Bank disbursed another US\$1.2 billion through a Development Policy Financing (DPF) in December 2015.

iii. Implementation of political reforms, announced in August 2015, has been slow due to constitutional constraints and systemic resistance to changes. Sparked by demonstrations against weak public service delivery in August 2015, Prime Minister Haider al-Abadi launched a major restructuring of the administration with the elimination of the three vice-president and three deputy prime minister positions, a reduction in the number of ministries from 33 to 22, and the elimination of 128 Secretary General positions. Implementation of these political reforms, however, has been challenged on constitutional grounds and by antagonized political figures. Faced with large shocks of a sudden nature and of unknown duration, the Government has, nonetheless, been undertaking some fiscal consolidation measures.

iv. Iraq's economic prospects are subject to significant risks. Large fiscal and external financing gaps have arisen for 2016 as oil prices to date in 2016 have been significantly below the budgeted US\$45 per barrel (Iraq's average selling price in January was US\$22 per barrel). Under the assumption of a ramp up in oil production, an increase in oil-related FDIs, structural reforms, implementation of the IMF

program, and a lessening of the incremental impact of the ISIS insurgency going forward, the economy is projected to recover in 2016 from a low base with a growth rate of 7.2 percent and to hover around 5 percent in the next few years. However, a weaker-than-projected global growth or continued excess global oil supply could put downward pressure on global oil prices and renew pressures on Iraq's twin deficits. Any worsening of the ISIS insurgency would materially and negatively impact Iraq's economy. Domestic political tensions could rise anew, which could undermine the reform effort. The large fiscal consolidation effort, especially highly sensitive streamlining of the wage bill, could also give rise to social tensions, impact the implementation of reforms and exacerbate further existing fragilities and conflict. Given the rapid worsening of the fiscal stance in line with the further drop in oil prices in 2016, the Iraqi authorities have requested from the IMF to have a Stand-By Arrangement as soon as possible.

v. Iraq has recently achieved some important steps towards strengthening its investment climate, but much remains to be done. The World Bank's Doing Business 2016 Report ranks Iraq 161st out of 189 economies, significantly behind other countries in the region such as United Arab Emirates (31), Bahrain (64), Qatar (68), and Oman (70). Iraq ranks 142nd for starting a business and 189 for resolving insolvency—the worst score in the world—because it is not possible to legally close a business. In Iraq, there are at least 5 procedures and it takes around 51 days to register a property. Rampant corruption and soaring costs due to electricity shortages and deteriorating security also complicate running a business in Iraq. The KRG's investment and trade regime is considered significantly more favorable to the conduct of business.

vi. An attractive investment climate is integral to economic growth and poverty reduction. Firms operating in the private sector are at the heart of the development process: as part of their search for profit they innovate, invest, and employ, collectively driving economic growth and underpinning the growth in incomes that enables poverty reduction. An attractive investment climate benefits society as a

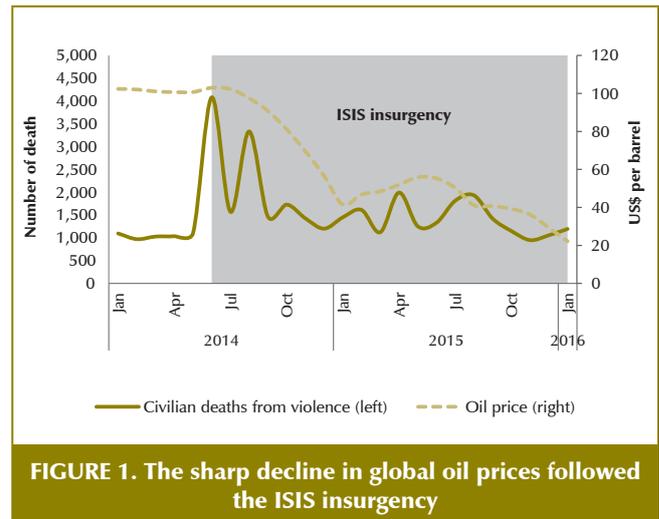


FIGURE 1. The sharp decline in global oil prices followed the ISIS insurgency

Source: Iraq Body Count, and World Bank.

whole, not just firms. A key task of the Government is to balance the interests of society and individual firms. A stronger investment climate does not equate with a more comfortable life for individual firms. The Government must manage these trade-offs: global analysis of the World Bank's investment climate surveys shows that firms facing strong competition are on average 50 percent more likely to innovate than firms reporting no such pressure. Innovation, in turn, is a key ingredient for productivity improvement. The special focus section explores the different aspects of the investment climate in order to better understand their importance. With this background, we then look at Iraq's investment climate and recent efforts to strengthen it. Finally, we look at priorities for improving Iraq's investment climate going forward.

العامة، ولاسيما تبسيط قانون الأجور الذي يتسم بحساسية كبيرة، أن يتسبب هو الآخر في تأجيج التوترات الاجتماعية، ويؤثر في تنفيذ الإصلاحات ويفاقم أكثر من حدة نقاط الضعف ومن الصراع. وبالنظر إلى التدهور السريع في الوضع المالي بما يعكس استمرار الهبوط في أسعار النفط في ٢٠١٦، فقد طلبت الحكومة العراقية من صندوق النقد الدولي وضع ترتيبات استعداد ائتماني في أقرب وقت ممكن.

v. وقد خطا العراق في الآونة الأخيرة بعض الخطوات المهمة على طريق تدعيم مناخه الاستثماري، ولكن لا يزال أمامه الكثير مما ينبغي عمله. ويضع تقرير ممارسة أنشطة الأعمال لعام ٢٠١٦ الصادر عن البنك الدولي العراق في المرتبة رقم ١٦١ من بين ١٨٩ اقتصاداً عالمياً، وهي مرتبة تقل كثيراً عن غيره من بلدان المنطقة كالإمارات العربية المتحدة (٣١)، والبحرين (٦٤)، وقطر (٦٨)، وسلطنة عُمان (٧٠). ويأتي العراق في المرتبة رقم ١٤٢ فيما يتعلق بتأسيس الشركات ورقم ١٨٩ فيما يتعلق بتسوية حالات الإعسار - وهي أدنى مرتبة في العالم - لأنه لا يمكن قانوناً تصفية الشركات. وفي العراق يتطلب الأمر اتخاذ ٥ إجراءات على الأقل ويستغرق نحو ٥١ يوماً لتسجيل عقار أو مبنى. كما أن الفساد المتفشي والتكاليف الباهظة بسبب انقطاعات الكهرباء وتدهور الأمن تزيد هي الأخرى من تعقد إدارة الشركات في العراق. ويُعد نظام الاستثمار والتجارة لدى حكومة إقليم كردستان موالياً بدرجة أكبر بكثير للقيام بنشاط تجاري.

vi. ويمثل وجود مناخ استثماري جذاب أمراً لا بد منه لتحقيق النمو الاقتصادي والحد من الفقر. ويحتل تسيير الشركات بالقطاع الخاص موقع القلب من عملية التنمية: فهذه الشركات، في إطار سعيها للربح، تبتكر وتستثمر وتوظف الناس، وهو ما يدفع في النهاية بالنمو الاقتصادي ويؤدي لنمو الدخل مما يتيح الحد من الفقر. ومن شأن وجود مناخ استثماري جذاب أن يعود بالنفع على المجتمع كله، لا على الشركات وحدها. ومن المهام الرئيسية للحكومة أن توازن بين مصالح المجتمع والشركات المنفردة. كما أن وجود مناخ استثماري أقوى ليس مرادفاً لإتاحة حياة أكثر راحةً ومواءمةً للشركات الفردية. ولا بد للحكومة من أن تأخذ في حساباتها هذه المفاضلات: فالتحليل العالمي لاستقصاءات البنك الدولي الخاصة بمناخ الاستثمار يظهر أن احتمالات الابتكار في الشركات التي تواجه منافسة قوية تزداد بنسبة ٥٠ في المائة في المتوسط مقارنةً بالشركات التي لا تواجه مثل هذه الضغوط. والابتكار، بدوره، يمثل مكوناً رئيسياً لتحسين الإنتاجية. ويستكشف قسم محور التركيز الخاص الجوانب المختلفة لمناخ الاستثمار بغية التوصل لفهم أفضل لمدى أهميتها. وفي ضوء تلك الخلفية ننظر بعدها في مناخ الاستثمار بالعراق وما بُدّل في الآونة الأخيرة من جهود لتدعيمه. وفي النهاية ننظر في الأولويات اللازمة لتحسين مناخ الاستثمار في العراق مستقبلاً.

الملخص التنفيذي

منها المالية أو ذات الصلة بميزان المدفوعات، قام صندوق النقد الدولي بمساندة العراق من خلال صرف مبلغ مقطوع قدره ١,٢ مليار دولار في يوليو/تموز ٢٠١٥ من خلال أداة التمويل السريع لدى الصندوق. وفضلاً عن ذلك، ومن أجل صون الاستقرار الاقتصادي وتقديم الخدمات الأساسية، قام البنك الدولي في ديسمبر/كانون الأول ٢٠١٥ بصرف مبلغ آخر قدره ١,٢ مليار دولار من خلال أداة تمويل السياسات الإنمائية.

iii. واتسم تنفيذ الإصلاحات السياسية، التي أُعلن عنها في أغسطس/آب ٢٠١٥، بالبطء بسبب قيود دستورية ومقاومة أنظمة وأجهزة الدولة للتغيير. وبتأثير مظاهرات اندلعت ضد سوء تقديم الخدمات العامة في أغسطس/آب ٢٠١٥، شرع رئيس الوزراء حيدر العبادي في عملية إصلاح هيكلية كبرى للجهاز الإداري شملت إلغاء مناصب نواب رئيس الجمهورية الثلاثة وثلاثة من نواب رئيس الوزراء، وخفض عدد الوزارات من ٣٣ إلى ٢٢، وإلغاء مناصب ١٢٨ من الأمانة العمومية. غير أن هذه الإصلاحات السياسية واجهت تحديات على أسس دستورية ومن جانب شخصيات سياسية من المتضررين. وفي مواجهة مثل هذه الصدمات القوية ذات الطبيعة المفاجئة والأمد غير المحدد، فإن الحكومة تقوم رغم ذلك كله بتنفيذ بعض إجراءات ضبط الأوضاع المالية العامة.

iv. وتظل آفاق المستقبل الاقتصادي للعراق عرضة لمخاطر جمّة. فقد طرأت فجوات في التمويل المالي والخارجي لعام ٢٠١٦ في ظل انخفاض أسعار النفط فيما مضى من عام ٢٠١٦ إلى ما يقل كثيراً عن الرقم المقدر في الموازنة وهو ٤٥ دولاراً للبرميل (ففي يناير/كانون الثاني كان متوسط سعر بيع النفط العراقي ٢٢ دولاراً للبرميل). وفي ضوء افتراض حدوث ارتفاع في إنتاج النفط، وزيادة في الاستثمار الأجنبي المباشر ذي الصلة بالنفط، والإصلاحات الهيكلية، وتنفيذ برنامج صندوق النقد الدولي، وتقليل الآثار الإضافية لتمرد داعش مستقبلاً، فمن المتوقع للاقتصاد العراقي أن يتعافى في عام ٢٠١٦ من خط الأساس المنخفض ليحقق معدل نمو يبلغ ٧,٢ في المائة، على أن يراوح حول ٥ في المائة تقريباً خلال السنوات القليلة المقبلة. غير أن من الممكن لحدوث ضعف أكثر مما هو متوقع في النمو العالمي أو استمرار الفائض في إمدادات النفط العالمية أن يلقي بضغط نزولية على أسعار النفط العالمية ويجدد الضغوط الواقعة على نسبي العجز المزدوج اللتين يعاني منهما العراق. ومن شأن حدوث أي تصاعد في تمرد داعش أن يحدث أثراً سلبياً ملموساً على اقتصاد العراق. فالتوترات السياسية الداخلية قد تزداد من جديد، وهو ما قد يقوض من جهود الإصلاح. ويمكن للمجهود الكبير المبذول في سبيل إجراءات ضبط الأوضاع المالية

i. يواجه العراق تحديات جسماً من تمرد حركة داعش، والاضطراب السياسي، والأزمات الاقتصادية والإنسانية المتجددة. ففي منتصف عام ٢٠١٤، تمكنت حركة داعش من الاستيلاء والسيطرة على قرابة ثلث مساحة العراق لتلقي بالبلد في هوة أزمة سياسية وأمنية عميقة. وعلى الرغم مما أحرزته قوات الأمن العراقية من تقدم نحو استعادة بعض المدن التي استولت عليها داعش، لم تزل الحركة المتمردة تستحوذ على مساحات كبيرة من الأرض العراقية، ومن بينها الفالوجة الواقعة على مسافة نحو ٤٠ ميلاً من بغداد. ونتيجة للصراع المستمر، لقي ٢٠٣٥ عراقياً حتفهم في عام ٢٠١٤، وهو العدد الأعلى منذ عام ٢٠٠٧، كما لقي ١٧٠٨٠ شخصاً آخر حتفهم في عام ٢٠١٥، وأصبح ٤ ملايين شخص في عداد النازحين والمشردين داخلياً. ويشكل هذا الوضع أزمة كبرى، إنسانياً، واجتماعياً، وإنمائياً. ولا يزال السكان معرضين بشدة لخطر المشكلات الأمنية والاقتصادية الجارية. فالفقر المدقع متفش بينهم، يفاقمه العنف المستمر الذي ازداد سوءاً في الآونة الأخيرة. وبلغت نسبة الفقر ٢٢,٥ في المائة عام ٢٠١٤ على مستوى العراق ككل؛ أما في المحافظات التي تأثرت بعمليات داعش فيقدر أن الآثار المباشرة للاضطراب الاقتصادي والاجتماعي والأمني قد تسببت في تضاعف معدلات الفقر لتصل إلى ٤١,٢ في المائة. وفي عام ٢٠١٤ كان عدد النازحين والمشردين داخلياً يمثل أكثر من نصف فقراء العراق.

ii. وفضلاً عن الأزمات ذات الصلة بتمرد داعش، جاء الانخفاض الحاد في أسعار النفط العالمية لتسبب في حدوث هبوط ملموس في عائدات تصدير النفط (انظر الشكل ١). وأدى هبوط عائدات النفط، بمقدار ٤٠ مليار دولار أمريكي، علاوة على زيادة النفقات ذات الصلة بالمشكلات الإنسانية والأمنية، إلى حدوث عجز في الموازنة بلغت نسبته ١٤,٥ في المائة من إجمالي الناتج المحلي في عام ٢٠١٥. وفي حقيقة الأمر، فقد كان من الممكن أن يصل العجز إلى ١٨,٤ في المائة لو لم تنفذ الحكومة عدداً من إجراءات ضبط الأوضاع المالية العامة. وساء عجز الحساب الجاري من ٠,٧ في المائة من إجمالي الناتج المحلي في عام ٢٠١٤، ليصل إلى قرابة ٦,٦ في المائة، وهي النسبة التقديرية لعام ٢٠١٥، مما يعكس الانخفاض الملموس في عائدات تصدير النفط. وفي الوقت نفسه، ظلت الواردات بلا تغيير في عام ٢٠١٥، وهو ما يعكس في جزء منه تكلفة السلع الرأسمالية اللازمة للتوسع في إنتاج النفط، ولكنه يرجع أيضاً إلى ارتفاع الإنفاق الحكومي بما في ذلك الواردات ذات الصلة بالأمن لمحاربة داعش. وتراجع إجمالي الاحتياطيات من النقد الأجنبي من ٦٦,٧ مليار دولار في نهاية عام ٢٠١٤ إلى ٥٤,٣ مليار دولار في نهاية ٢٠١٥. وفي ضوء الاحتياجات الملحة، سواء

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

GLOBAL AND REGIONAL CONTEXT: THE SLOWING GLOBAL ECONOMY AND FALLING OIL PRICES

Global economy grew slower than previously projected in 2015. The slower growth is largely attributable to economic slump in key emerging countries which heavily rely on commodity exports. China's economic rebalancing not only slowed its economy but commodity-exporting countries through decline in its demand. Anticipated monetary tightening in the United States imposed another downward pressure on commodity exporters through currency depreciation, reduced capital inflows and enhanced financial market volatility. Oil-exporters in the Middle East and North Africa suffered from significant decline in oil prices and revenues.

Global Economy

1. Slower growth prospects in key emerging countries, the decline in commodity prices, and the elevated security situations have contributed to slower global growth in 2015. The World Bank revised its estimates downwards by 0.4 percentage points to 2.4 percent in December 2015, from its previous estimates in June 2015 (Figure 2). Developing countries are estimated to grow slower from 4.9 percent in 2014 to 4.3 percent in 2015, largely attributable to slower growth in commodity-

exporting countries. Brazil and Russia have been suffering from recessions, due partly to the sharp decline in commodity prices, and partly to external and domestic challenges. Chinese economy decelerated due to its economic rebalancing, and its weak demand for commodities imposed downward pressures on global commodity prices. In light of anticipated tightening of U.S. monetary policy, developing countries, especially commodity exporters, faced significant currency depreciation, reduced capital inflows and enhanced financial market volatility. Unlike developing countries, high-income countries maintained growth momentum. Stronger domestic demand, particularly in the United States where employment conditions are robust, and higher credit growth and lower unemployment in the euro area led the growth. The recovery remains fragile in Japan despite substantial policy stimulus.

Regional Economy

2. Among developing countries in the Middle East and North Africa (MENA), oil-importing and exporting countries contrasted growth performance. In most oil-importing countries, lower oil prices, as well as lower food prices, supported higher consumption and helped reduction in fuel subsidies. This in turn resulted in higher growth at 3.5 percent in 2015, up from 2.8 percent in 2014, with inflation kept subdued and government debt remained stable (Figure 3). On the contrary, developing oil-exporting countries have been suffering from below fiscal break-even levels of oil prices, with average growth rate decelerating from 2.3 percent in 2014 to 1.7 percent in 2015. Current account balances in region's oil exporters, which were all surplus in 2013, swung into deficit

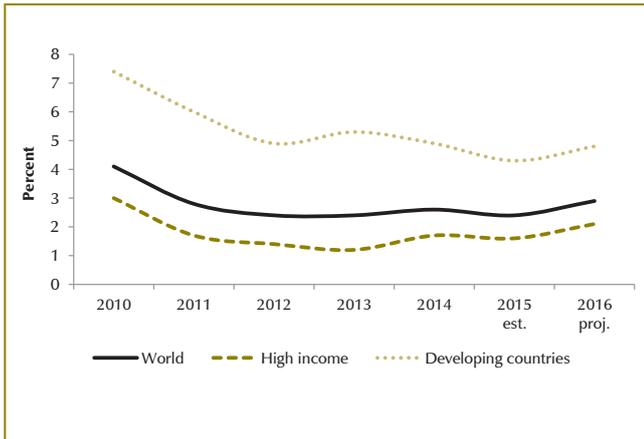


FIGURE 2. Global economy slowed in 2015 due to slower growth in developing countries (Year-on-year growth)

Source: World Bank (2016).

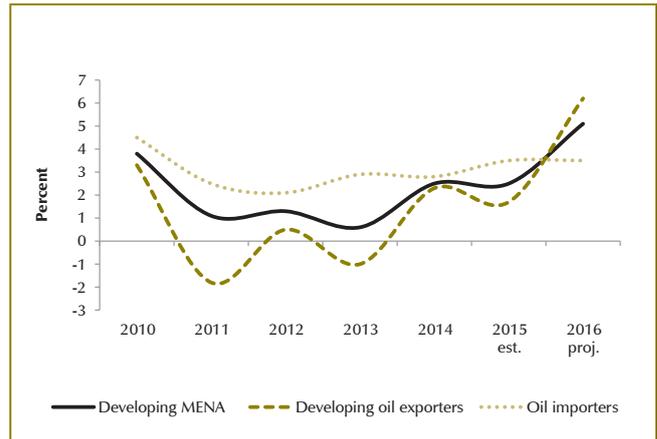


FIGURE 3. Oil price decline led to contrasting growth performance in the region (Year-on-year growth)

Source: World Bank (2016).

Note: Developing oil exporters include Algeria, Iran, Iraq and Libya. Oil importers are Egypt, Tunisia, Djibouti, Jordan, Lebanon, Morocco and West Bank & Gaza.

BOX 1. Global oil prices continued to fall sharply

Global crude oil prices fell by 47 percent from US\$96.2 per barrel in 2014 to US\$50.8 per barrel in 2015, the lowest annual level since 2004. From November 2015, oil prices declined steadily, slipping below US\$30 per barrel in mid-January in a slide that may not reflect fundamentals. Weak oil prices mirrored continued ample supply from non-OPEC producers, expectations of an expansion of Iranian exports in light of earlier-than-expected lifting of sanctions, OPEC’s continued resolve to defend market share, high stocks due to mild weather conditions in the northern hemisphere, and weakening growth prospects in major oil-importing economies.

Oil production in non-OPEC countries recorded gains, averaging nearly 2 million bpd over 10 consecutive quarters until the third quarter of 2015. More than two-thirds of production gains came from the United States. Despite sharp cuts in investment, U.S. production has remained more resilient than projected, thanks to efficiency gains and cost cuts. OPEC (excluding new member Indonesia) crude oil production averaged 31.6 million bpd, up from 30.5 million bpd a year earlier. Most of the gains came from Iraq and Saudi Arabia. Iraq’s output reached a record 4.3 million bpd in September, but the country is not expected to exceed this level in 2016 under the strain of low oil prices and a costly conflict against ISIS. At the OPEC meeting on December 2015, the Organization decided to keep producing at current levels, with key exporter, Saudi Arabia, intent on maintaining market share. The group abandoned its 30 million bpd production target, which had been in place since the beginning of 2012. Adding to the uncertainty were expectations that Iran would increase exports earlier-than-expected.

Global oil consumption has faced two offsetting pressures: weakening real income growth and sharply lower prices. While weakening growth, especially in emerging countries, has weighed on consumption, the sheer magnitude of the oil price decline, two-thirds of which was attributable to production increase, has spurred consumption. On balance, consumption growth reached a five-year high at 1.8 percent in 2015, despite some weakening in the fourth quarter to 1.1 percent as a result of lower heating oil consumption amidst mild winter weather in the northern hemisphere. While gasoline demand remained robust, weak diesel demand reflected economic rebalancing in China and tepid global industrial activity.

by 2015 except Iran. Similarly, fiscal balances were severely hurt, particularly in the Gulf Cooperation Council countries. For instance, Saudi Arabia has lost about a half of its 2015 fiscal revenues due to the significant decline in oil prices, equivalent to US\$110 billion or about 15 percent of GDP. In addition to lower oil prices, civil unrest and violent insurgencies

have compounded problems in affected countries, including Iraq, through marked deterioration in fiscal balances due to increased security-related expenditure.

POLITICAL AND SOCIAL CONTEXT: THE ISIS INSURGENCY REMAINING AS A MAJOR THREAT

The ISIS insurgency since mid-2014 has not only seriously affected Iraq's security situation but also imposed humanitarian and social crises to Iraq. ISIS controls nearly one third of Iraq's territory, while more than 30,000 civilians were killed and 4 million Iraqis have been internally displaced and about 250,000 Syrian refugees have flooded into the country. Implementation of political reforms has been delayed, and the dispute between the central government and the Kurdish regional government continues.

3. Since mid-2014, the ISIS insurgency has seriously affected Iraq's security situation. ISIS has rapidly extended its control to nearly one third of Iraq's territory, plunging Iraq into a deep political and security crisis. In 2015, some notable progress has been made by Iraqi Security Forces (ISF) to recapture some of ISIS-controlled cities, such as Tikrit in March and Ramadi in December. In late March 2016, the Iraqi army launched an offensive to retake Mosul. The insurgency group, however, still holds large swaths of the country, including Fallujah, about 40 miles from Baghdad. The ISIS insurgency is hurting the country's economic and social development prospects. Violence and sabotage also hinder the revival of the non-oil economy in much of Iraq due to destruction of infrastructure and assets, and disruption of trade routes.

4. The ISIS insurgency has brought not only severe security challenges, but humanitarian and social crises to Iraq. The number of civilian deaths from violence more than doubled from 9,851 in 2013 to 20,035 in 2014 and additional 17,080 killed in 2015. The total documented civilian deaths from violence since 2003 are estimated at 171,479

people at end-2015. In addition, 4 million Iraqis have been internally displaced and about 250,000 Syrian refugees have flooded into the country. This situation poses a major humanitarian crisis and places an enormous strain on the local economy and public service delivery. The standard of living has deteriorated and a noticeable share of the population has fallen into poverty or is vulnerable to falling into poverty. Food and rent prices are increasing, especially in the Kurdistan Regional Government (KRG) which is hosting over 1.8 million internally displaced persons (IDPs) and Syrian refugees.

5. Implementation of political reforms, announced in August 2015, has suffered a setback due to constitutional constraints and systemic resistance to changes. Responding to weeks of countrywide demonstrations over the lack of basic services across the country, including power shortages, and to a call for drastic change and to fight corruption, Iraq's cabinet approved in August 2015 a series of significant administrative reforms. These include the reduction of number of cabinet positions from 33 to 22, abolition of the country's three vice-presidents, spending cuts, and restart of corruption investigation programs. Implementation of these reforms, especially the political ones, however, has been delayed due to legal challenges and oppositions by affected groups. By end-2015, the Government closed six ministries, consolidated others and cut more than 300 senior officials. Social tensions are growing among both those negatively affected by the reforms and those frustrated against delayed implementation of the reforms. To accelerate fight against corruption, Prime Minister al-Abadi reshuffled his cabinet.

6. The dispute between the central government and the KRG continued in 2015. The KRG and the central government reached an agreement in November 2014 under which the KRG would deliver export revenues of 550,000 bpd to the State Oil Marketing Organization (SOMO) and the central government would transfer 17 percent

of its net state expenditures,¹ which corresponds to about US\$12 billion a year to the Erbil government. However, implementation of this agreement stopped by mid-2015, with the KRG ramping up independent oil sales while transfers from Baghdad to the KRG have also been significantly below the agreed level. Baghdad government transferred only US\$1.9 billion in 2014 and US\$2 billion in 2015, respectively. Recently, the KRG and the Iraqi federal government held discussions on the resumption of the oil revenue sharing agreement.

THE REAL SECTOR: LOSING THE NON-OIL ECONOMIC OUTPUT BY THE ISIS INSURGENCY

The ISIS insurgency and the oil price shock since mid-2014 have severely impacted the economy. The non-oil sector is projected to contract by 9.0 percent in 2015 following an 8.8 percent fall in 2014. In contrast, growth in the oil sector has remained resilient, with output rising 12.9 percent in 2015 to a new high of 3.50 million barrels per day, supported by the southern oil fields which are beyond ISIS' reach and which account for 90 percent of total production. After contracting 2.1 percent in 2014, real GDP is estimated to have rebounded to 2.4 percent in 2015, dragged by conflict-led contraction in the non-oil sector.

Economic Growth

7. The ISIS insurgency since mid-2014 has sharply decelerated Iraq's non-diversified, oil-dependent economy. Since the ISIS insurgency

¹ Net state expenditures are defined as gross expenditures minus KRG's contribution to the cost of the Iraqi government's sovereign expenses such as the military and federal oil-contractor payments.

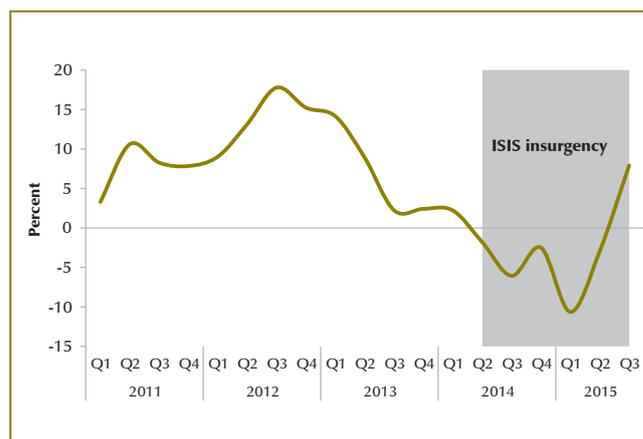


FIGURE 4. The ISIS insurgency pushed quarterly GDP growth into negative for five quarters (Year-on-year growth)

Source: Central Statistical Organization of Iraq (CSO).

in June 2014, Iraq's economy contracted in five consecutive quarters (Figure 4). As a result, Iraq's economy contracted 2.2 percent on an annual basis in 2014, which is the lowest since 2003 (Figure 5). After contracting over five consecutive quarters, the oil sector strongly led the economy in the third quarter of 2015, reflected to a bounce of the economy estimated at 2.4 percent on an annual basis in 2015. On the expenditure side, the economic crisis, coupled with political instability in 2014, decelerated private-sector consumption and investment, and limited government spending, particularly on investment projects.

8. The poor performance is attributable to conflict-led contraction in the non-oil sector. The non-oil sector contracted 8.8 percent in 2014 and projected to a contract additional 9.0 percent in 2015, due to the loss of economic output in the ISIS-occupied territories that have seen the destruction of infrastructure assets, disruption of trade routes and deterioration in investor confidence (Figure 6). Ongoing fiscal consolidations since mid-2015 impose further downward pressures on the non-oil economy as government expenditure is a major contributor to the non-oil economy. In 2014 and the first three quarters of 2015, all of the non-oil sectors negatively contributed to GDP growth (Figure 7). The contraction in non-oil economy can be observed in various subsectors. The building and construction subsector was the main drag, contracting 23.3 percent and 66.4 percent, and contributing to the

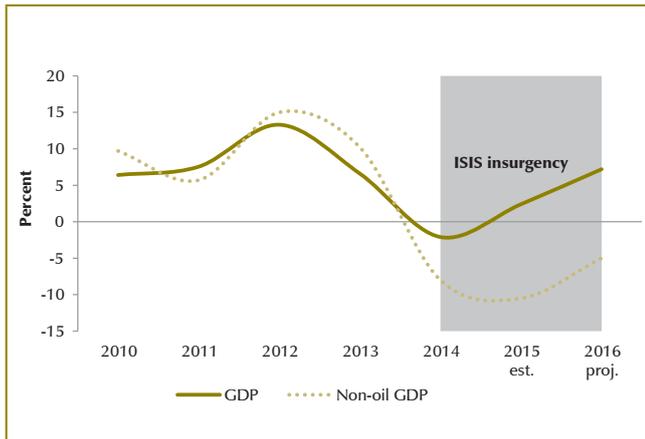


FIGURE 5. The ISIS insurgency severely hurt the non-oil economy... (Year-on-year growth)

Source: Central Statistical Organization of Iraq (CSO).

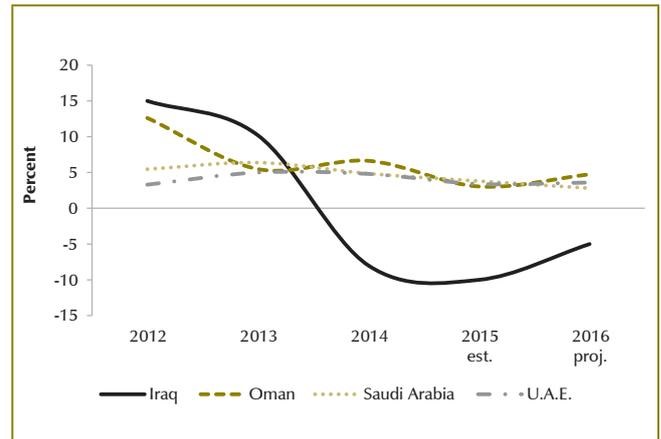


FIGURE 6. ... which is evident by international comparison... (Year-on-year growth)

Source: World Bank projections.

overall growth by -2.3 percentage points and -5.0 percentage points in 2014 and the first three quarters of 2015, respectively. The manufacturing subsector sharply contracted 48.9 percent in 2015, dragging the overall growth by 0.9 percentage points. Reflecting disruption of trade routes, wholesale and retail trade subsector grew negatively at 15.0 percent in 2014. In light of the contraction in the non-oil economy, banking and insurance subsector contracted 19.1 percent in the first three quarters of 2015. The agriculture sector grew at -8.3 percent and -17.0 percent, contributing -0.3 percentage points and -0.6 percentage points to the overall growth in 2014 and in the first three quarters of 2015.

Oil Sector

9. The hydrocarbon sector is the major contributor to the Iraqi economy and its key growth driver through these challenging times. With 144 billion barrels in 2015, Iraq is the second biggest oil producer in OPEC after Saudi Arabia, and has the fifth largest proven oil reserves in the world. The hydrocarbon sector accounts for 50 percent of the country's GDP, 98 percent of the country's exports, and more than 90 percent of central government revenue. Although Iraq's oil production has grown slower than expected due to infrastructure constraints and the ongoing conflict, crude oil production grew by 950,000 barrels per

day (bpd) over the past five years (Figure 8). The oil sector continues to expand in the southern oil fields, which accounts for over 90 percent of production and beyond the reach of the insurgency group.² Oil production level in 2015 stood at an average of 3.5 million bpd, up from 3.11 million bpd in 2014, and already reached the end-2016 production target at 4.1 million bpd in January 2016. The largest importers of Iraq's crude oil in 2014 were China, followed by India and the United States. The major obstacles to expansion plans include inadequate storage, pumping, and pipeline capacity in the south to facilitate larger export volumes.

10. Higher reliance on oil inevitably makes the Iraqi economy vulnerable to oil price shocks.

The recent collapse in global oil prices has had a major impact on Iraq's fiscal and external positions. After surging to an average of US\$104 per barrel in the 2012-2013 period, Iraq's oil export price fell to US\$48 per barrel in 2015 and is expected to drop to US\$30 per barrel in 2016, according to the latest World Bank projections (Figure 9). Iraq's monthly oil export revenues declined from US\$5,161 million in December 2014 to US\$2,920 million in December 2015 (Figure 10). The increased oil export volumes have been more than offset by the decline in oil prices. In addition to the fiscal crisis and related service delivery issues, the revenue sharing agreement with the KRG collapsed as Baghdad broke its fiscal transfers' commitments under the deal while the

² Libya's crude production has been significantly affected by civil unrest since 2011.

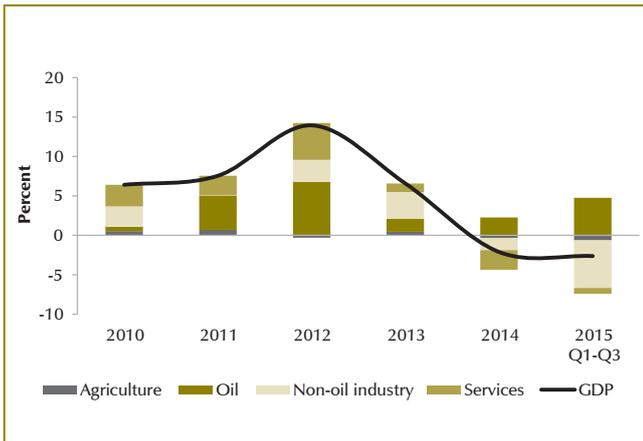


FIGURE 7. ... and GDP growth decomposition (Year-on-year growth)

Sources: CSO, and World Bank calculation.



FIGURE 9. Iraq's oil price sharply fell since mid-2014

Source: Iraq Ministry of Oil.

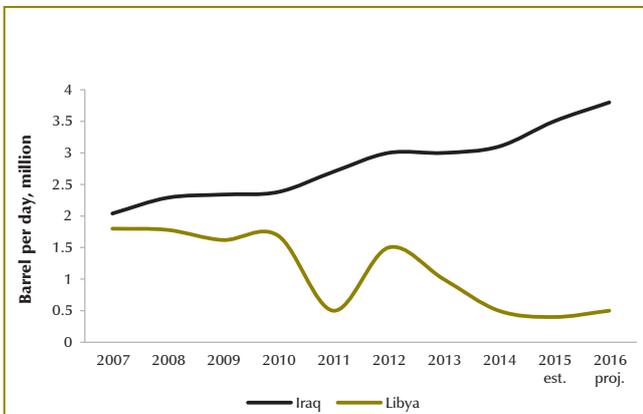


FIGURE 8. Iraq's crude production robustly grew despite the ISIS insurgency

Source: IMF (2015).

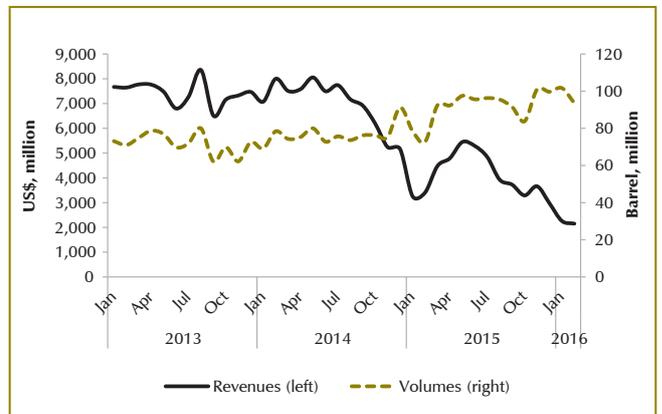


FIGURE 10. Despite increased oil export volumes, oil export revenues continued to decline

Source: Iraq Ministry of Oil.

KRG stopped supplying its oil to the SOMO, instead independently exporting its oil.

The internal displacement of 4 million Iraqis and the influx of Syrian refugees has exacerbated local economic situations.

LABOR MARKET AND EMPLOYMENT: 800,000 JOBS LOST BY THE ISIS INSURGENCY

The ISIS insurgency has not only reduced employment by 800,000 since mid-2014, but also shifted employment from more productive/higher earning jobs to less productive/low earning jobs.

11. Labor force participation remains exceedingly low in Iraq, especially for women and the youth. Unemployment is officially estimated at 11 percent in 2011, although actual levels, particularly among the youth, are significantly higher. Only 15 percent of adult Iraqi women of working age participate in the labor force while 70 percent of adult men are employed, well below the already low rates of female labor force participation in the Middle East and North Africa Region. Youth constitute nearly half the population in Iraq, yet their labor force participation is low and stagnant. In 2012, 42 percent of young Iraqi men and 93 percent of young women were out of the labor force. Among

the youth aged 15-29, 72 percent of women and 18 percent of men were neither in school nor employed.

12. The ISIS insurgency has led to an estimated reduction in employment by 800,000. Also, employment appears to be shifting away from more productive/higher earnings jobs in manufacturing and construction to less productive/lower earnings and possibly more informal jobs in agriculture and services. The displacement of 4 million Iraqis, in addition to the influx of 250,000 Syrian refugees, has further disrupted local economic conditions. The Public Distribution System provides the only safety net for the vast majority of the poor, and is currently being stretched to its limits. However, the 2.8 million new poor are left largely uncovered by any public safety net. The Government is considering important reforms to the Social Security Network to improve its targeting coverage and efficiency.

PUBLIC FINANCE: DETERIORATING FISCAL POSITION

The twin crisis has resulted in a sharp deterioration of the fiscal deficit, widening from 5.6 percent of GDP in 2014 to an estimated 14.5 percent in 2015, due to significantly lower oil revenues and higher humanitarian and security-related expenditure. Government implemented fiscal consolidation measures in mid-2015, aimed at improving revenue collections, in particular from oil, and at containing non-oil primary spending. The large fiscal deficit, meanwhile, has been financed through external borrowing, including loans from the IMF under the Rapid Financing Instrument and the World Bank under the Development Policy Financing.

BOX 2. Regional conflict and economic and social disruptions exacerbated the structural vulnerabilities

The structural vulnerabilities that were evident prior to the crisis have been exacerbated by the ongoing violence and economic and social disruptions. Microsimulation estimates suggest a reversal of the hard-won welfare gains of the past, with poverty rising from 19.8 percent in 2012 to 22.5 percent in 2014. Poverty was accompanied by a massive human capital deficit—in health, education and access to basic services. Many Iraqis live close to the poverty line, vulnerable to increases in the price and availability of necessities, and/or the loss of assets and livelihoods. According to the World Bank projections, the recent shocks have increased the number of people living below the poverty line by an estimated 2.8 million by end-2014. IDPs make up half a million of Iraq's poor in 2014, with an estimated poverty rate of 40 percent, almost twice the average. The Kurdistan Region experienced a quadrupling of poverty rates to 12.5 percent, due to the large influx of IDPs and Syrian refugees and the increased competition for jobs, goods and services. In the ISIS-affected governorates, the direct impact of economic, social and security disruptions is estimated to have doubled poverty rates to 41.2 percent.

The increasing trend in poverty is expected to continue during the regional crisis. The ensuing population displacement, and the postponement of spending on socio-economic infrastructure, will further hinder the government's ability to deliver services. The population remains extremely vulnerable to the ongoing security problems, the continued lack of basic services, scarcity in access to food and basic necessities and increases in their prices. Available data and analysis suggest a weak relationship between economic growth and welfare. The resumption of growth alone will not suffice to restore welfare and livelihoods. Estimates covering the crisis period suggest that welfare is getting eroded a lot faster than it was built up, and that many of the new poor have fallen from closer to the high end to the middle of the distribution. This vulnerability to poverty and shocks will remain an enduring challenge during the crisis period. Large existing human capital deficit and lack of access to infrastructure and services further limit coping strategies and resilience to these shocks.

In the short term, the dominant effect of the renewed insurgency on poverty is not through slower growth, but displacement. IDPs will have lost access to whatever employment they had, along with their access to PDS rations, as well as the basic social services needed to maintain their quality of life. Insecurity will further deter the creation of formal private sector jobs, which would have provided an alternative path out of poverty. Preliminary projections of poverty for 2014 and 2015 only take into account the slowdown in GDP per capita growth and suggest an increase in poverty by 5 to 6 percentage points. While this does not take into account internal displacement, insecurity and loss of livelihoods, it provides a rough lower bound—one that already eliminates the small gains of the past.

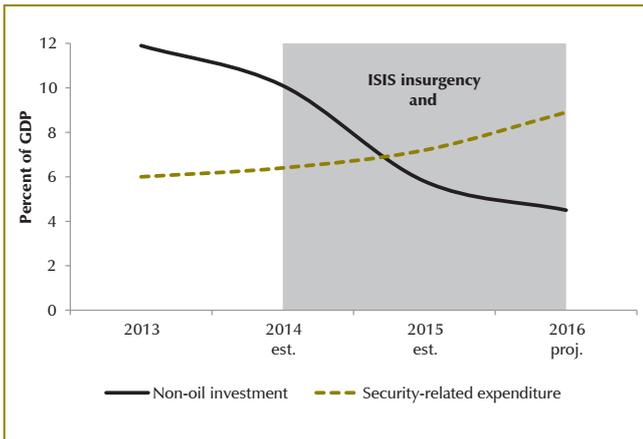


FIGURE 11. Increase in security-related expenditure led to decline in non-oil investment

Sources: Iraq Ministry of Finance, and World Bank.

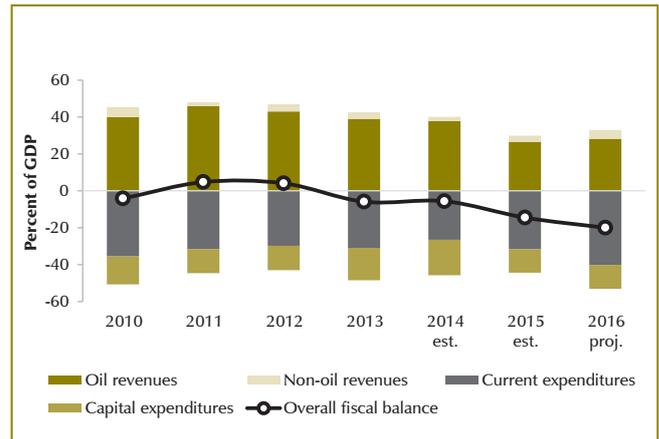


FIGURE 12. Overall fiscal balance deteriorated due to lower oil revenues

Sources: Iraq Ministry of Finance, and World Bank.

13. Further worsening in oil prices throughout 2015 widened the fiscal deficit, despite fiscal consolidation efforts. The decline in oil prices since the second half of 2014 led to more than 40 percent decline in oil export revenues. Lower oil revenues, in addition to higher humanitarian and security-related expenditure, led fiscal deficit reaching 5.6 percent of GDP in 2014. To address the crisis-led fiscal deficit, the 2015 budget law introduced fiscal consolidation measures and the Government also under-executed budget spending, in particular on non-oil capital investment, leading to a marked improvement in non-oil primary balance (Figure 11). The wage bill

in the public sector and military jobs consume a large part of the recurrent budget, making Iraq an outlier in terms of the wage bill (as a share of GDP) worldwide—even among oil exporting countries. As a result of the fiscal consolidation measures since mid-2015, the wage bill is expected to decline from 16 percent of GDP in 2015 to 14 percent in 2016. While the fiscal adjustment measures successfully reduced the deficit initially projected at 18.4 percent of GDP, it remains unsustainable at an estimated 14.5 percent of GDP in 2015 (Figure 12).

BOX 3. The regional conflict and fiscal crisis hindered public services delivery

The Iraq’s current security and fiscal situation has affected the Government’s capability to provide basic services, and spending priorities. The scale and speed of the displacement crisis created a major challenge for both the Baghdad and Erbil governments. Many Iraqi IDPs and Syrian refugees reside in the same host communities, placing strains on the local economy and access to public services. Shelter and food security are of particular concern. Other issues relate to access to clean water, power cuts, and a severe shortage of fuel. Electricity demand has sharply increased in host communities. Significant upgrades to the electricity sector would be needed to supply additional power.

Iraq’s economy was already seeing supply side strains in public service delivery prior to the crisis. Fragile network infrastructure and electricity shortages in Iraq are binding constraints on the quality of life and private sector development. The security situation made it difficult for the Government to focus on reconstruction, especially for the water and electricity network infrastructure. Lack of sanitation and inadequate electricity are the most prevalent deprivations in Iraq. A recent World Bank poverty assessment shows that almost all households are connected to the public electricity grid, but that connection is no guarantee of electricity supply (World Bank, 2014). In fact, on average, electricity supply is rarely higher than 12 hours per day. Baghdad is by far the worst hit in terms of electricity, with more than three-quarters of all households in the capital receiving less than 8 hours of electricity a day. Garbage collection and the availability of sewage services have increased over time, but are still very limited overall, reaching less than 50 percent of the population. In particular, rural areas seem to have almost no garbage collection and sewage services, and the North, Center and the South are also underserved. Similar to the other services, the quality of sanitation does not appear to be satisfactory. Access to water continues to be significantly lower in rural areas: while access is above 90 percent in urban areas, it falls to 63 percent in rural areas.

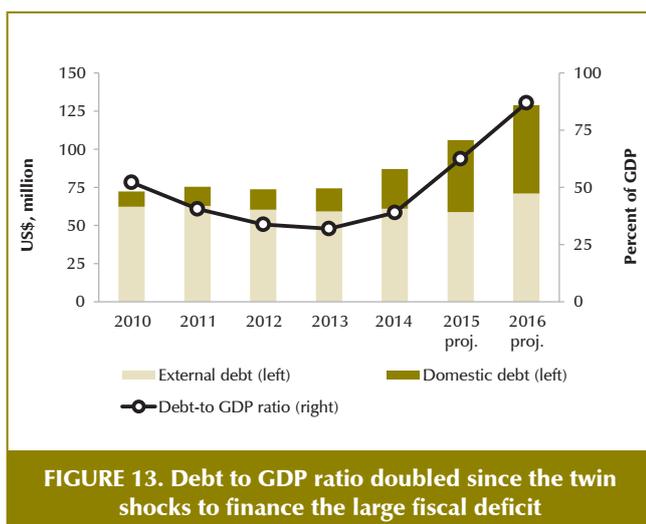


FIGURE 13. Debt to GDP ratio doubled since the twin shocks to finance the large fiscal deficit

Source: Iraq Ministry of Finance, and World Bank.

14. The large fiscal deficit was mostly financed domestically, with some notable external financing. Identified sources of financing include borrowing from state-owned banks, partly through a modification of the reserve requirement and indirect central bank financing, the accumulation of domestic arrears and external financing. The IMF supports Iraq through a disbursement under the Rapid Financing Instrument (RFI) in the amount of US\$1.2 billion. The IMF concluded the 2015 Article IV consultation with Iraq, and the Executive Board approved the RFI on July 29, 2015. In addition, to safeguard economic stability and basic service delivery, the World Bank disbursed another US\$1.2 billion of the Development Policy Financing (DPF). Access under the IMF's RFI and the World Bank's DPF helped address part of Iraq's urgent balance of payments and budget needs.

15. The Parliament approved the 2016 budget in December 2015, with a sizeable deficit to be financed externally. Reflecting unfavorable market sentiments, the Government amended the 2016 draft budget in December 2015 to reduce reliance on external financing. The size of the approved budget is ID 103.1 trillion (US\$88.4 billion) with a deficit of ID 21.4 trillion (US\$18.4 billion). Revenue is estimated to reach ID 81.7 trillion (US\$70.1 billion)—based on an assumed oil price of US\$45 per barrel and average oil production of 3.6 million bpd. The Government plans on closing the financing gap through diverse sources, including borrowing from international financial institutions (IFIs), and

from a Eurobond issue of US\$2 billion. The latter was initially scheduled in 2015, but postponed due to the lack of appetite towards Iraq's Eurobonds.³ The budget also envisages significant domestic financing but the capacity of domestic banks to subscribe to large Treasury bills subscription is limited outside of the Central Bank of Iraq (CBI) discounting large volume of such government securities.

16. The large deficit financing has more than doubled Iraq's public debt-to-GDP ratio. Prior to the crisis, Iraq's gross public debt-to-GDP ratio was moderate, averaging 35.2 percent of GDP in the three years to 2014 (Figure 13). Starting in 2015, however, the debt ratio has been increasing. The stock of domestic debt increased from 11.6 percent of GDP in 2014 to 27.8 percent of GDP in 2015, in part linked to indirect financing of the deficit by the CBI (as it is rediscounting Treasury Bills bought by the state-owned banks). Loans from the IFIs increased external debt to 34.7 percent of GDP in 2015, up from 27.3 percent of GDP in 2014. While Iraq's debt outlook remains vulnerable to adverse shocks, they are unlikely to put the debt on an unsustainable path, given the implementation of programmed fiscal consolidations, a rebound in economic activity, and Iraq's substantial underground wealth.

INFLATION, MONEY AND BANKING: LOW INFLATION AMID ECONOMIC DECELERATION

Inflation remained low, at least in the areas where data are available, while inflation in conflict-affected areas is likely high due to supply disruption. Both reserve and broad money contracted in the second

³ In February 2016, Standard & Poor's rated Iraq's long-term foreign debt as 'B-' and short-term foreign and domestic debt as 'B.'

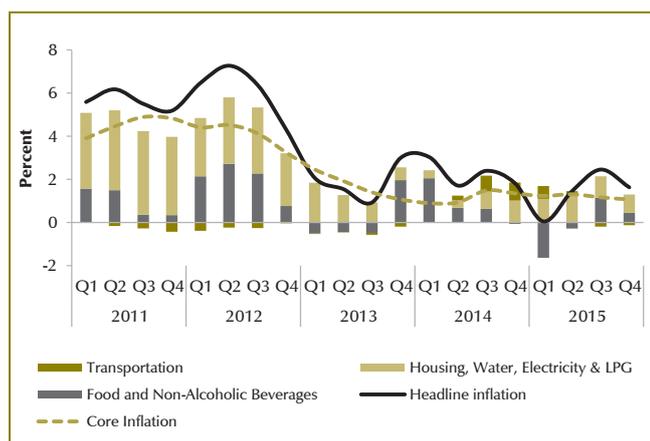


FIGURE 14. Inflation has been subdued (Year-on-year growth)

Source: CSO.

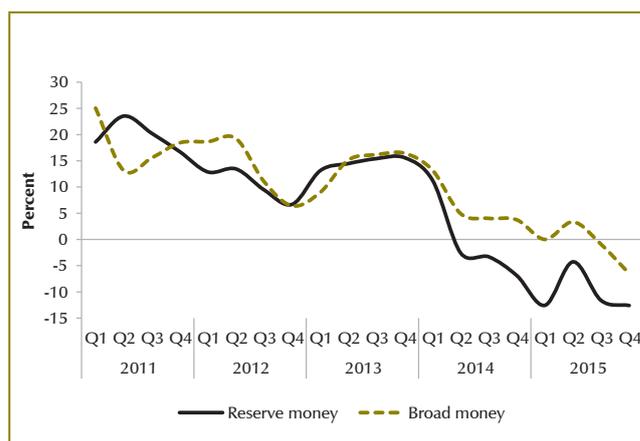


FIGURE 15. Contracting monetary aggregate reflects fiscal consolidation and weak non-oil sector (Year-on-year growth).

Source: Central Bank of Iraq.

BOX 4. Banking sector remains weak, but reforms are taking place

The effectiveness of monetary policy in Iraq continues to be hampered by the weakness of the monetary transmission channels due to an inefficient banking sector. The challenging fiscal situation has resulted in an increase in directed lending that the leading state-owned banks (Rasheed and Al-Rafidain) have provided to state-owned enterprises, mostly to cover current operating costs (e.g., wages), as well as the Government deficit. Banking supervision remains weak, including regulatory forbearance with Rasheed and Al-Rafidain.

Amid a weak banking sector, the Central Bank of Iraq is pressing ahead with reforms and is tightening supervision. The CBI has gained some momentum to clean-up of the balance sheets of these banks from pre-2003 assets and large valuation losses. The Iraqi authorities are taking steps to open government business to private banks. The CBI is strengthening banking supervision and is pushing ahead with financial sector reforms through the planned introduction of a deposit insurance scheme, a credit information bureau, and with the restructuring of Rasheed and Al-Rafidain. The authorities are also promoting growth and lower distortions in the banking sector by improving the playing field between public and private banks. The rise in insecurity, however, may deter foreign banks from entering Iraq or prompt those already there to leave, thus slowing the development of the sector.

half of 2015, likely due to the fiscal consolidations and decelerated non-oil economy. The ISIS insurgency not only slowed credit growth due to disruption in economic activity, but also destroyed the physical assets of some banks and of their clients.

17. Inflation remained low in 2015. Following a peak at over 50 percent in 2006, inflation has markedly declined since. Headline inflation, measured as year-on-year change in the consumer price index, continued to remain low at 1.4 percent in 2015, compared to 2.2 percent in 2014, at least in areas of the country where data are available (Figure 14).⁴ In the second half of 2015, the disruption in

trade and food supply moderately boosted food inflation, to an average rate of 5.5 percent. Inflation is likely higher in conflict-affected areas, due to supply disruption, although data in occupied cities are not available. Meanwhile, food prices increased especially in the northern governorates that host a large number of IDPs and Syrian refugees though this is expected to be a temporary price pressure as local supplies are expected to adjust to increased local demands. Both reserve and broad money contracted in the second half of 2015, likely reflecting the fiscal consolidation efforts and the contraction in non-oil economic activity (Figure 15).

18. The ISIS insurgency not only decelerated credit growth, reflecting decelerated economic

⁴ Data for Al-Anbar, Nineveh and Salahuddin is not available due to the current security situation.

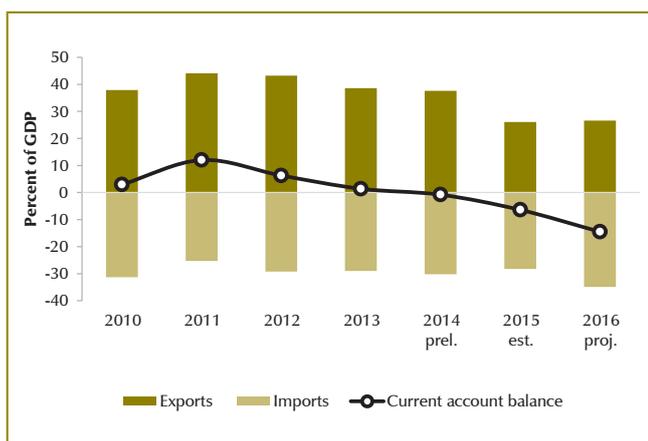


FIGURE 16. Current account deficit is deteriorating due to low oil price

Sources: Iraqi authorities; IMF and World Bank projections.

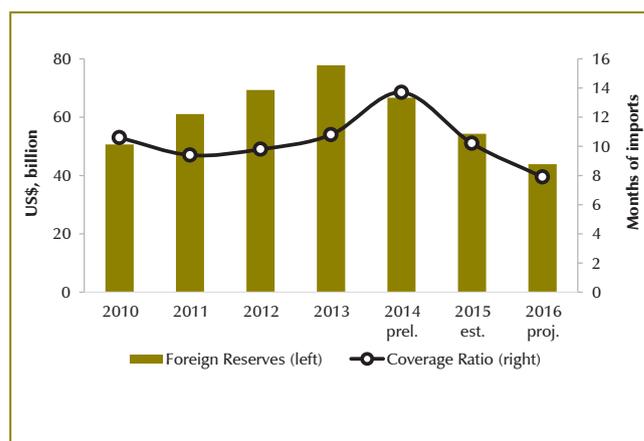


FIGURE 17. International reserves have been falling to finance the current account deficit

Sources: Iraqi authorities; IMF and World Bank projections.

growth but also destroyed the physical assets of banks. Credit growth to the private sector is impacted due to the decline in public investment. Credit growth to the private sector decelerated from 16 percent in 2013 to only 5 percent in 2014 and further decelerated in 2015. Non-performing loans ratios increased from 6.7 percent in 2013 to 7.6 percent in 2015 because of the ISIS activities and reduced private sector activity. The ISIS insurgency not only disrupted daily economic activity, but also destroyed the physical assets of some banks and of their clients. In addition, trade disruption led to a fall in import financing, and the risk of money laundering and terrorist financing has increased.

THE EXTERNAL SECTOR: EXPANDING CURRENT ACCOUNT DEFICIT

The twin crisis has led to worsening of the current account deficit, reflecting a sharp drop in oil export revenues and high imports of military-related equipment. Despite the fiscal consolidation efforts reducing goods imports, the current account deficit deteriorated from 0.7 percent of GDP in 2014 to 6.6 percent in 2015. The widened current account deficit was mostly financed by the use of international reserves.

19. Iraq's current account deficit has widened due to continued decline in oil prices. After slipping into a deficit in 2014, partly due to the decline in oil revenues and also because of the high imports of military-related equipment to combat the ISIS, the current account deficit worsened in 2015. With oil prices declining from US\$97 per barrel in 2014 to US\$48 per barrel in 2015, oil export revenues almost halved from US\$84 billion in 2014 to US\$44 billion in 2015. As a result, the current account deficit deteriorated from 0.7 percent of GDP in 2014 to 6.6 percent of GDP in 2015 (Figure 16). However, the fiscal consolidation efforts, in particular the tightening of non-oil investment expenditure, have mitigated somewhat further deterioration of the current account deficit as imports of goods have been subdued.

20. The current account deficit was mostly financed by the use of international reserves. International reserves of the CBI have declined from US\$67 billion at end-2014 to US\$54 billion at end-2015 because of the decline in oil revenues (Figure 17). In terms of months of imports, it is expected that the coverage ratio declined from 13.7 months of imports at end-2014 to 10.2 months at end-2015.

ECONOMIC OUTLOOK AND RISKS: CRITICALLY DEPENDING ON THE ISIS AND OIL PRICES

Given favorable assumptions on the ISIS insurgency and oil prices, the economy is projected to recover from a low base, growing at 7.2 percent in 2016 and to hover around 5 percent in the next few years. With the Iraqi selling oil price is projected at US\$30, fiscal and external positions are expected to remain under pressure. Higher-than-projected oil price would improve both the fiscal and external balances.

21. The economic outlook for 2016-18 is improving though critically depending on assumptions regarding ISIS and oil prices. Under the assumption of a ramp up in oil production, an increase in oil-related FDIs, structural reforms, implementation of the IMF program, and a lessening of the incremental impact of the ISIS insurgency going forward, the economy is projected to recover from a low base in 2016 with a growth rate of 7.2 percent and to hover around 5 percent in the next few years, despite the ongoing fiscal consolidations

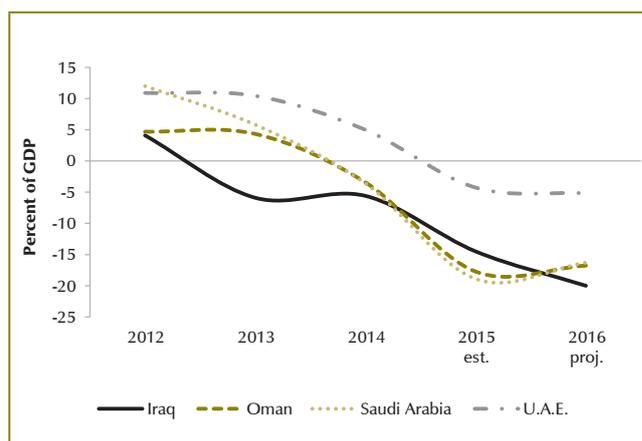


FIGURE 18. Security-related expenditure will impose additional burden on Iraq's fiscal deficit

Source: World Bank projections.

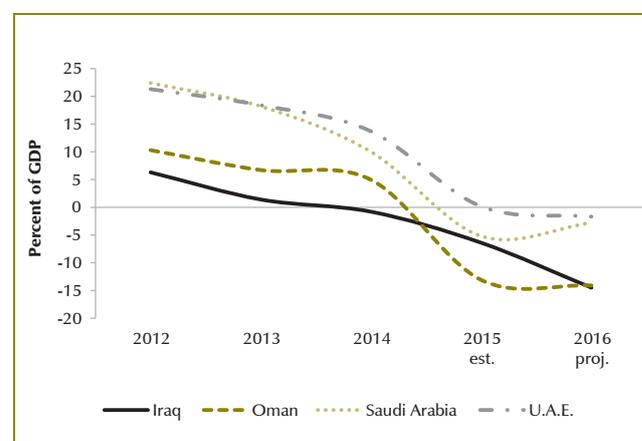


FIGURE 19. Security-related imports will also push Iraq's current account deficit further down

Source: World Bank projections.

BOX 5. Global oil prices are projected to gradually recover

For 2016, crude oil prices are projected to average US\$37 per barrel, a 27 percent decline from the 2015 average. Oil prices are expected to gradually recover from their current lows over the course of the year, resulting from a number of factors. First, part of the sharp oil price drop in early 2016, which does not reflect fundamentals of oil demand and supply, is likely to reverse. Second, high-cost oil producers are expected to sustain persistent losses and increasingly implement production cuts that are likely to exceed any additional capacity coming to the market. Third, demand is expected to strengthen somewhat, along with a modest pickup in global growth.

The magnitude of expected recovery in oil prices would be smaller than the rebounds that followed sharp drops in 2008, 1998, and 1986. In these declines, prices rebounded from their troughs by around 50 percent within a six months, and approximately doubled after twelve months. In 1998 and 2008, significant OPEC production cuts contributed to the price recovery, while in 1986 OPEC sought to regain its market share, somewhat similar to its current intent on defending its share. The currently expected price recovery over the course of 2016 is less than that in the previous episodes owing to large stocks and prospects for continued ample supplies (including from OPEC) and anemic demand.

On balance, the price outlook remains subject to considerable downside risks. These include a larger-than-expected increase in Iran's exports and a possible recovery of exports from Libya. Short-cycle U.S. shale production may again turn out to be more resilient than currently anticipated if companies achieve further productivity gains. Ample supply would particularly weigh on prices if global demand were to also weaken more than expected. Prices may thus have to fall further to reduce production and investment, especially for short-cycle U.S. shale production.

BOX 6. Global and regional economies are expected to pick up but at a slower pace

2016 global growth is expected to pick up, though at a slower pace than previously projected, reaching 2.9 percent in 2016 and 3.1 percent in 2017-18. A modest upturn in global activity in 2016 and beyond is predicated on a continued recovery in major high-income countries, a gradual slowdown and rebalancing in China, a stabilization of commodity prices, and an increase in global interest rates that is gradual and stays well contained.

Growth forecast for high-income countries is projected to show some improvement in 2016 in light of gradual tightening cycle of the U.S. Federal Reserve, and continued accommodative policy stance in the euro area and Japan. Conditions for a continued but fragile upturn in the euro area still appear in place, despite soft external demand and rising geopolitical concerns. Though gradually dissipating, legacies from the global financial crisis continue to be felt across high-income countries, limiting both aggregate demand and the underlying growth potential of these economies.

The modest pickup in growth in developing countries is expected in 2016 and 2017, thanks to continued growth momentum in high-income countries, stabilization of commodity prices, still-accommodative monetary policy in major economies, and a steady process of rebalancing in China. With stabilizing commodity prices, growth in commodity exporters is expected to resume. Among low-income countries, growth is mostly steady or rising. However, forecasts for 2016 have been downgraded for some countries from previous projections, reflecting lower commodity prices and rising security and political tensions in some countries. Also, developing countries will likely face rising borrowing costs. In particular, countries with large borrowing needs and high levels of dollar-denominated debt could be adversely impacted by rising U.S. interest rates.

A combination of low oil prices, currently estimated at US\$37 per barrel in 2016, several major conflicts and subdued global economic recovery is expected to keep economic growth in the MENA region low at 3 percent in 2016. Since 2013, MENA has not been able to escape the spiral of slow growth for a variety of reasons including the incidence of war and conflict. These factors are expected to dampen the short-term economic prospects in the region, unless there is some progress in the peace talks. If the recent truce in Syria and the ongoing peace talks in Yemen and Libya materialize, which in turn reduces the spread of insecurity and conflict elsewhere in the region, economic growth in MENA could improve over the medium term. But the base case estimate is that real GDP in the MENA region will grow close to 4 percent in 2017 and 2018, still low by historical standards.

slowing the non-oil sector growth. Among the drivers of this gradual recovery is the ongoing ramp up in oil production, expected to reach 5 million bpd by 2019.

22. The Iraqi selling oil price projected at US\$30, significantly below the budgeted price at US\$45, will result in the continued twin deficits. On the fiscal side, despite the ongoing fiscal consolidation efforts, the overall fiscal deficit is projected to expand to 20 percent of GDP, with a large financing gap urging further fiscal consolidations and external financing. The additional deficit financing will increase the stock of public debt sharply to 87 percent of GDP in 2016. On the external side, the current account deficit is projected to worsen to 15.3 percent of GDP in 2016. The worsening current account deficit will be financed by use of the international reserves, falling to US\$44 billion in 2016.

23. The marked deterioration in the twin deficit in the short term is attributable to the

ISIS insurgency. Given stabilization of oil prices, the twin deficits in regional oil exporters are expected to moderate in 2016 (Figures 18 and 19). On the contrary, despite the fiscal consolidation efforts, higher humanitarian and security-related expenditure and higher imports of military-related equipment are expected to push Iraq's twin deficits further down in 2016.

24. Given gradual recovery in oil prices, increase in oil production and successful implementation of fiscal consolidations, the twin deficits are projected to switch to surpluses by 2020. Similarly, the non-oil primary deficit (as a percent of non-oil GDP) is projected to improve from 53.3 percent in 2016 to 39.3 percent in 2020; such a deficit remains slightly higher than the sustainable level of consumption of Iraq's oil wealth (33 percent of non-oil GDP). This fiscal improvement returns the debt-to-GDP ratio on a downward path starting in 2018, and the international reserves would hit US\$32 billion in 2019.

CHALLENGES: REMAINING VULNERABLE TO THE SECURITY PROBLEMS

Any worsening of the ISIS insurgency would materially and negatively impact Iraq's economy. Poverty and unemployment are expected to increase due to conflict and displacement. Public services delivery has been insufficient, and urges new programs to address the vulnerable delivery of public services. Iraq's economy is highly dependent on the capital-intensive oil sector, leaving non-oil private sector small and unemployment high. Fight against long-lasting corruption has made slow progress due to strong oppositions.

25. Iraq's economy remains extremely vulnerable to the country's ongoing security problems, which impede investment and the ability to manage oil resources effectively. Poverty and unemployment are expected to continue rising with higher influx of the IDPs. Aggravation of social instability risks is high especially in host communities. Iraq's economy was already suffering from severe structural weakness such as a small non-oil sector, high unemployment, large public sector, and a weak business environment—all of which are needed for greater resilience to conflict. Among Iraq's current challenges is to maintain delivery of even the prior level of services and public works, which were insufficient to the needs of the country. New programs will need to be put into place to address the vulnerabilities created by the current crisis.

26. Unemployment is high, and is expected to increase due to conflict and displacement. Unemployment is officially estimated at 11 percent in 2011, although actual levels, particularly among the youth, are likely to be considerably higher. Demographic pressure is strong, with 41 percent of the population under 15 years. Labor market participation remains exceedingly low for women as

well. Only 15 percent of Iraqi women of working age participate in the labor force, well below the already low rates of female labor force participation in the Middle East and North Africa region of around 25 percent. The labor force lacks basic skills due to years of war and sanctions, and massive emigration since 2003. There are also considerable differences in the unemployment rates across provinces. In some provinces, notably in the Sunni-majority ones like Anbar, the unemployment rate is estimated to be twice the national rate.

27. The role of private sector is marginal. The public sector in Iraq continues to dominate the economy, and is mostly inefficient and low performing. The size of the public sector in Iraq—measured by public spending-to-GDP ratio is one of the highest in the region (61.1 percent of GDP). Government and state-owned enterprises employ approximately half of the labor force. There are limited employment opportunities outside the large public sector. Decades of state-driven economic policy have not encouraged private sector to grow. The challenges are compounded by limited credit systems and access to finance, an underdeveloped financial sector dominated by state-owned banks, and weak financial regulations misaligned with international standards. This overall economic situation calls for a dedicated effort of the national government, local authorities and their international partners to stimulating development in non-oil sectors of the Iraqi economy (see the special focus section of this report on Iraq's investment climate for detailed arguments).

28. Iraq suffers from extensive, pervasive, corruption across all levels of government and across all sectors. Iraq continually scores among the worst countries in the world in various governance and corruption indicators. The extent of public and private sector corruption has eroded public institutions, prevented effective basic service delivery and undermined state security (see the special focus section of this report on Iraq's water security and management for detailed arguments). According to Transparency International's Corruption Perception Index 2015, Iraq ranked 161 of 167 countries. It scored 16 on a scale where 0

means that a country is perceived to be highly corrupt and 100 is where a country is perceived to be very clean. Only Afghanistan, Angola, Libya, North Korea, South Sudan, Sudan, and Somalia scored worse. Corruption in Iraq exists at the highest levels. The Commission for Integrity revealed that in 2012, of the 2,667 orders of arrest which were issued, nine involved ministers and 99 were against 61 heads of departments or equivalent. Bureaucratic corruption in Iraq is driven by weak institutions, a lack of experienced staff, confusing legal framework and weak oversight, which provide incentives and opportunities for corruption. The existing anti-corruption framework is ineffective. In August 2015, Prime Minister al-Abadi announced actions to fight corruption and money-laundering including plans for institutional and administration reform, and the adoption of 'E-Government' to reduce corruption risk. Implementation of the reforms has suffered a setback due to constitutional constraints and systemic resistance to changes. By end-2015, the Government closed six ministries, consolidated others and cut more than 300 senior officials. Social tensions are growing among both those negatively affected by the reforms and those frustrated against delayed implementation of the reforms.

SPECIAL FOCUS. BUILDING IRAQ'S INVESTMENT CLIMATE

The 'investment climate' is the collective term for the many and varied contextual factors that can influence a given investment decision. It is a prerequisite for economic growth and poverty reduction. Iraq has recently made some important steps towards strengthening its investment climate, but much remains to be done. This section explores the different aspects of the investment climate in order to better understand their importance, and discusses Iraq's investment climate and recent efforts to strengthen it. Priorities for improving Iraq's investment climate going forward are also discussed.

INTRODUCTION: INVESTMENT CLIMATE FOR ALL

29. The investment climate is integral to economic growth and poverty reduction, and encompasses all factors that can affect an investment decision. Fundamentally, the term refers to '...the set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs, and expand' (World Bank, 2004). While the full range of issues that affect the investment climate includes factors such as geography, security, market size, and consumer preferences, our primary focus here is on a smaller set of issues linked that can be readily impacted by government policies such as, infrastructure, laws, regulations, and institutional capacities and . Firms operating in the private sector are at the heart of the development process in market economies: as part of their search for profit they innovate, invest, and employ, collectively driving economic growth and

underpinning the growth in incomes that enables poverty reduction. By some estimates, more than 90 percent of jobs in developing countries are created through private sector firms and self-employment. Taxation of private firms and employees also contributes to the payment for public sector employees and the goods and services they provide.

30. An attractive investment climate benefits society as a whole, not just firms. A key task of government is to balance the interests of society and individual firms: a stronger investment climate does not equate with a more comfortable life for individual firms. For example, given the choice, an individual firm is likely to desire less taxation, less regulation, and less competition than is optimal for society as a whole. Government must manage these trade-offs: global analysis of the World Bank's investment climate surveys shows that firms facing strong competition are on average 50 percent more likely to innovate than firms reporting no such pressure. Innovation, in turn, is a key ingredient for productivity improvement.

31. A poor investment climate can raise the cost of investment and hiring, resulting in less of both. Costs associated with enforcing contracts, poor infrastructure, crime, corruption, poor regulation and weak regulatory administration can cost up to a quarter of sales revenue in some countries. Time also costs money, and delays in connecting telephones and electricity, or clearing goods through ports also add to costs, and limit and reduce the range of possible investment opportunities that will be taken up. On the employment front, a recent evaluation of investment climate reform programs in Burkina Faso, Liberia, Rwanda, and Sierra Leone – all countries that originally had very poor investment climates – estimated that over 50,000 jobs had been created. In Brazil, reform of the tax system in 1996

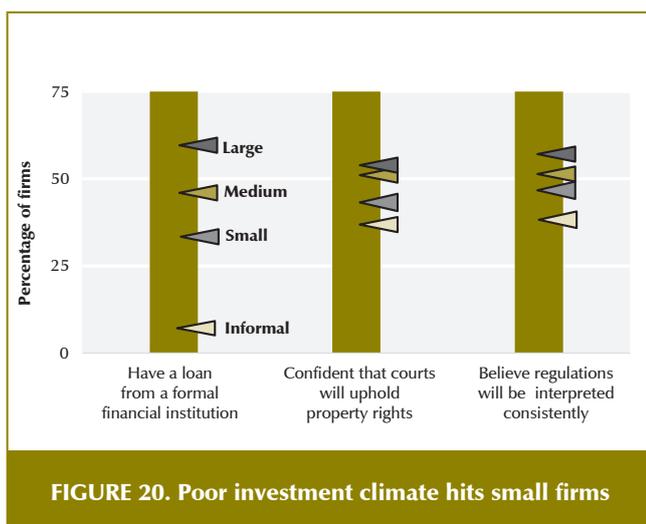


FIGURE 20. Poor investment climate hits small firms

Sources: World Bank Investment Climate Surveys and WDR Surveys on Micro and Informal Firms.

Note: Based on 10 countries for which formal and informal surveys were conducted, controlling for industry, country, ownership, and firm age.

led to a 12 percent increase in employment (IFC, 2013).

32. A bad investment climate hurts small firms' more than large ones. Large firms often have the resources, existing networks and political clout to navigate their way through even the poorest regulatory environments if they perceive the potential return as worth the effort. For small and informal firms, however, poor regulation, and unpredictable and predatory officials can often prove insurmountable barriers (Figure 20). In fact, over 90 percent of firms in developing countries report an 'implementation gap' between what a policy or law says, and what the officials charged with administering it actually do.

33. Improving the investment climate indeed drives growth. Much evidence now exists to support the link between improving investment climates and growth, but two of the most compelling case studies are China and India. In the early 1980s, China began its transformation towards a market economy with the introduction of a basic system of property rights and private enterprise, along with the commencement of trade and investment liberalization as part of a broad and sustained drive to improve the investment climate. A few years later, India moved to reduce its tariffs and licensing requirements, and followed this up with further trade

liberalization and regulatory reform in the 1990s. The results were impressive: private investment as a share of GDP almost doubled in both countries, and for the period 1980-2002, China's per capita GDP rose tenfold, while India's quadrupled. Poverty rates fell in tandem – from almost 60 per cent to around 20 per cent in China, and from over 50 per cent to under 40 per cent for India (World Bank, 2004).

THE INVESTMENT CLIMATE IN IRAQ: PROGRESS MADE BUT MUCH REMAINING TO BE DONE

34. Iraq's investment climate remains a work in progress, but advances have been made. Several important pieces of legislation have been drafted with the support of international partners including the Economic Reform Law and PPP law. These are currently under review by the Government. In 2013-14 reforms to reduce the cost of registering a business were implemented but these were outside the scope of the Starting a Business indicator and therefore did not affect Iraq's Doing Business ranking. Several important SOE reforms were implemented between 2010 and 2014 with the support of World Bank Group, including implementation of one PPP (i.e., the State Drug Industries) and several administrative reforms to improve the commercial viability of SOEs. These reforms included commencing the transfer of inactive workers to ministerial departments for retraining and reassignment and aligning and integrating SOE business planning with annual strategic plans prepared by ministries and also the annual budget planning cycle.

35. Reform efforts accelerated in the second half of 2015. In February 2016 the Government established a Task Force within the Council of Ministers Secretariat to operate a Regulatory Impact

BOX 7. Iraq's Doing Business reform highlights

From 2014 to 2015 Iraq retreated from 146 to 156 in ease of doing business according to the World Bank Doing Business Report. That put the country near the very bottom of the Middle East and North Africa. The nations that did the best were the United Arab Emirates at 22 out of 189 countries, followed by Saudi Arabia at 49, and Qatar at 50. The remainders were in the bottom half and included Iraq at 156, Syria at 175, and Libya at 188. Iraq has regularly been at the wrong end of that spectrum due to its lack of reforms to promote business post 2003. The topics that Iraq did the best back then were construction permits and paying taxes. Getting construction permits took eight steps, and approximately 119 days which put it in the top of the ranked economies at 9 out of 189 in this topic. In the region only the United Arab Emirates at 4 did better, with Saudi Arabia at 21, and Oman at 49. Paying taxes Iraq ranked 52 which put it in middle of the region with the UAE, 1, Saudi Arabia, 3, Oman, 10, and Jordan, 45, doing better, while Iran, 124, and Egypt, 149 did worse.

The 2016 Doing Business report changed its methodology which makes it challenging to compare some date directly with previous years. However, the report ranked Iraq at 161 out of 189 countries. Iraq performs particularly well in one Doing Business indicator: ranking 59 out of 189 economies on the ease of Paying Taxes. In spite of sustained reform efforts over the past years, in several of the other areas measured by Doing Business, Iraq compare less favorably including Enforcing Contracts (122nd), Resolving Insolvency (189th), Getting Credits (181st), Starting a Business (154th), Trading across Borders (178th), dealing with construction permits (147th) and Protecting Minority Investors (115th).

Analysis (RIA) process to strengthen evidence based policy advice in Submissions to the Council of Ministers. A broader strategy to develop the private sector is also in preparation that will support the ongoing transition towards a market economy by encouraging domestic and foreign investment. The Parliament has previously approved a revised investment law in 2009 allowing, among other things, foreign ownership of land for housing projects. In 2010, the Cabinet approved an authorizing framework for the National Investment Commission (NIC): the Commission will be responsible for implementing a multi-billion dollar Public-Private Partnership (PPP) infrastructure package, and overseeing a 'one-stop shop' for foreign investors to "facilitate the processing of the investment licenses applications, issuing the license, allocating the land, securing tax exemptions, and facilitating the entry and exit of investors and their employees."

36. A Task Force for Economic Reforms and Private Sector Capacity (TFER) was established in 2008. The taskforce is mandated to lead a wide range of reforms, and was headed by the Prime Minister's Chief Advisor until 2015. Seven technical working groups were created on: (1) legislative reform; (2) SOEs restructuring; (3) SME development; (4) investment policy; (5) social

dialogue; (6) land reforms; and (7) tax policies. Between 2008 and 2016, several reforms in some of these areas were implemented including the Council of Representatives passing a new Labor Law. In addition, several important reforms to SOEs were implemented over this period, focusing on commercialization and managing inactive workers. In 2016, the scope of work of TFER was reduced including responsibility for leading SOE reforms in Iraq being passed on to the Ministry of Industry and Minerals.

37. Nevertheless, the overall investment climate remains poor. A range of composite governance indicators that report perceptions about important aspects of the investment climate show that Iraq is significantly below the global average (Figure 21).⁵ Even regionally, Iraq's performance is poor as evidenced, in particular, in the worst performance of stability and absence of violence in the region. Control of corruption is also a critical issue, with perceptions of the degree to which public power is exercised for private gain in Iraq, as well as 'capture' of the state by elites and private concerns being worse than for all regional comparators with the exception

⁵ The World Wide Governance Indicators aggregate several hundred variables measuring perceptions of a range of governance from over 30 different data sources.

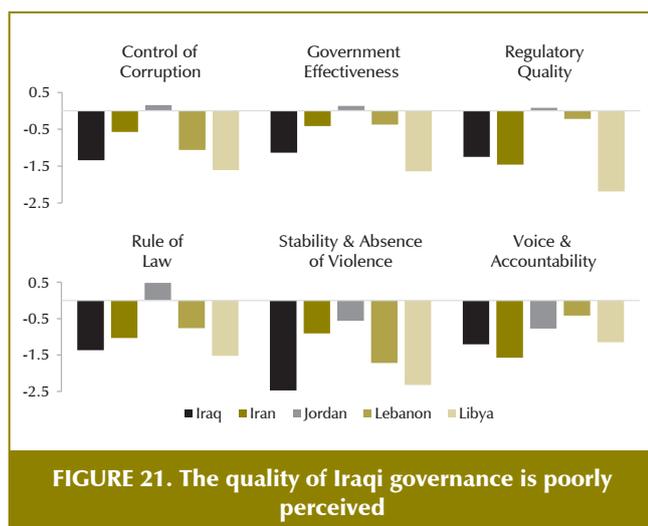


FIGURE 21. The quality of Iraqi governance is poorly perceived

Source: World Bank Worldwide Governance Indicators.

of Yemen. So too for government effectiveness, which reflects perceptions of the quality of public services, the quality of government officials and their relative independence from political pressures, the quality of policy development and implementation, and degree of credibility that government commitment to its stated policies has.

38. The difficult security situation has further undermined the investment climate. Violent conflict can severely damage the economy—both directly and through the negative impact on investor sentiment. As security risks increase, the rate of return firms will require to invest increases, and their planning horizon shortens. As a result, realized investments shift from longer-term endeavors that can collectively build a country's economic capacity, to shorter-term trading opportunities that enable capital to be cycled quickly. Understandably, government attention is also focused first and foremost upon security. The funding needed to sustain the security effort—coupled with revenue loss from falling oil prices—also means that spending on economic infrastructure and public services are substantially less than they otherwise would have been (see section 1.5 of this report).

39. The poor security environment since 2003 has contributed to the growth of informality. 'Informality' in this context refers to firms and entrepreneurs that operate outside the legal framework of business. It thrives where governments cannot provide adequate policy certainty or where

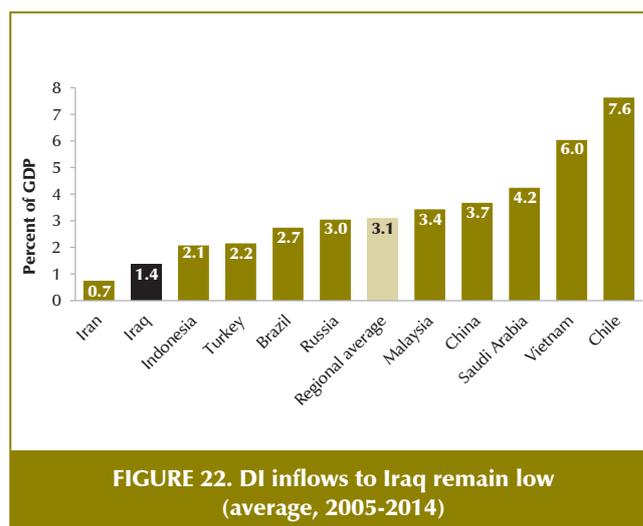


FIGURE 22. DI inflows to Iraq remain low (average, 2005-2014)

Source: World Bank World Development Indicators.

public agencies tend to discretionary rent seeking rather than administering effective, transparent and unbiased regulation. A poor security environment can also raise the threat of appropriation of firm assets, which can encourage entrepreneurs to 'keep a low' profile by remaining less visible in the informal economy. While costs in the informal sector can often be reduced by evading government regulation and the tax net, opportunities to grow are also reduced through the inability to access formal financial services, bid for government work, or enter formal contractual arrangements with other firms. In 2012, it was estimated that almost 67 percent of workers were employed in the informal sector,⁶ across a range of sectors including construction, transport, manufacturing and agriculture.

40. The poor investment climate is reflected to low level of foreign direct investment (FDI) in Iraq outside the energy sector. Iraq's FDI net inflows, at 1.4 percent of GDP, is low among both its regional and income-level counterparts (Figure 22). While this is perhaps not surprising given the security challenges that Iraq has faced, the practical reality is that Iraq is missing out on both a potentially important source of finance to grow its economy, but perhaps even more importantly from the 'spillover' benefits from foreign investment that can lift productivity in the rest of the economy.

41. Iraq also has much to do to improve the

⁶ The informal sector is defined as those without access to social security benefits.

quality of its legal and regulatory environment.

Of the 29,000 laws and regulations in Iraq, around 4,000 impact directly or have a significant indirect impact on the private sector, investment and business environment. The laws and regulations that apply to specific regulatory transactions and approvals affecting business are often unclear and non-transparent. Furthermore, laws and regulations often conflict or contradict each other, giving officials' wide discretion to interpret and apply different laws to identical or similar regulatory transaction or approvals. This increases the cost and risks of doing business in Iraq and also generates scope for corruption. The World Bank's Doing Business 2016 publication ranked Iraq 161st out of 189 countries in 2015. Iraq's ranking is significantly behind regional peers such as United Arab Emirates (31), Bahrain (64), Qatar (68), and Oman (70). The composite 'distance to frontier', based on 10 topics included in this year's aggregate ranking, shows that Iraq has made the shortest progress among the regional comparators towards the best performing benchmark economies (Figure 23).⁷ Iraq ranks 142nd for starting a business and 189th for resolving insolvency—the worst score in the world—because it is not possible to legally close a business. In Iraq, there are at least 5 procedures and it takes around 51 days to register a property. Rampant corruption and soaring costs due to electricity shortages and deteriorating security also complicate running a business in Iraq.

42. Labor and land regulation can be particularly prominent impediments for businesses. Unclear land ownership titles, laws and regulations undermine make investing in property a high-risk activity for business. Similarly, Iraq's labor regulations severely limit the ability of firms to hire directly, which in terms undermines the ability of the labor market to allocate human resources find their most productive use.

⁷ The topics included are: starting a business; construction permits; getting electricity; registering property; getting credit; protecting investors; paying taxes; trading across border; enforcing contracts; resolving insolvency. An economy's distance to frontier score is indicated on a scale from 0 to 100, where zero represents the worst performance and 100 the best-practice frontier.

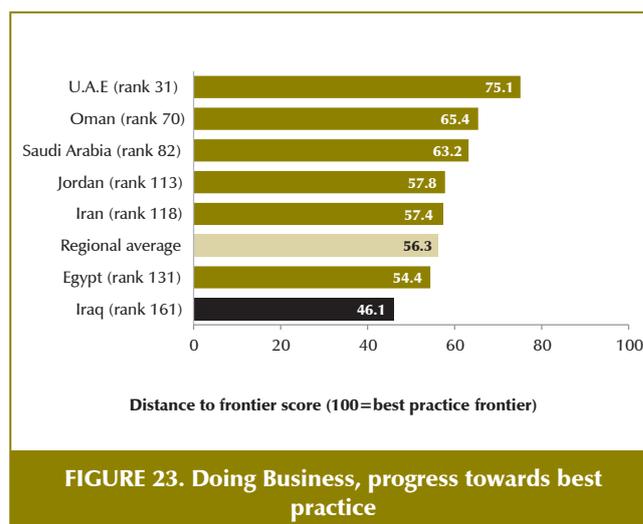


FIGURE 23. Doing Business, progress towards best practice

Source: World Bank Doing Business 2016 (2015).

43. Important steps have been taken to improve in the construction permitting process. The needs of reconstruction and a fact-growing population mean that there will be much construction activity for the foreseeable future. The Iraq Construction Permits Reform Project was launched in May 2013 and has helped re-engineer the construction permitting process in Baghdad, Erbil, and Basra. Other aspects of the project include training municipal employees, and introducing new software that will partially automate the permitting process. The project also supports the Government to implement its recently developed Green Building Code.

44. Government is building mechanisms that will deliver better regulations. In February 2016, a high level Regulation Reform Committee was established within the Council of Ministers Secretariat. The objective of this Committee is to improve the quality of proposed laws and regulations. The Committee is empowered to ensure policy proposals received by Cabinet are based on hard evidence, and clear logical arguments and analysis. The Committee will use 'Regulatory Impact Analysis' and will coordinate the preparation and provide quality control over regulatory impact documentation by ministries.

45. Iraqi firms have identified electricity supply as a particularly important constraint. The most recent World Bank Enterprise Survey for Iraq was undertaken in 2011, and almost 20 percent

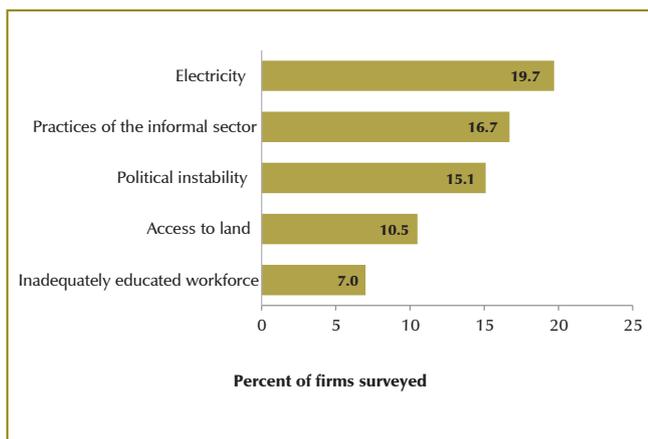


FIGURE 24. Electricity is the foremost binding constraint

Source: World Bank Enterprise Survey, 2011.

of firms at that time identified electricity problems as the number one constraint facing their business (Figure 24). Iraq faces a severe deficit in the amount of electricity it can generate, and high technical and non-technical losses of the electricity that it does generate. In 2011 Iraqi firms were experiencing 41 power outages a month on average, compared to only 6 globally. While many firms rely of generators to fill the gap created by unreliable electricity supplies, these are expensive and generate a range of other costs such as high levels of air pollution in major cities. Iraq’s Integrated Energy Strategy estimated that the cost of outages to the economy was around US\$40 billion in 2013. Competition from informal sector firms (those that operate outside the regulatory and tax systems) and political instability were also notable constraints.

46. Iraq’s under-developed financial sector is another major constraint for private sector development. The ability of the investment climate to support the intermediation of funds from savers to lenders to investors is critical for development. Total banking assets in Iraq are estimated at 77 percent of GDP, compared to 130 percent in the Middle East and North Africa region, and total credit is about 29 percent of GDP, compared to 55 percent in the region. However, the headline credit figures reflect in large part loans and trade credit extended from state-owned banks to state-owned enterprises (SOEs). Provision of credit to the private sector fell to just 7 percent of GDP in 2014, one of the lowest rates in the world. This is partly explained by Iraq’s

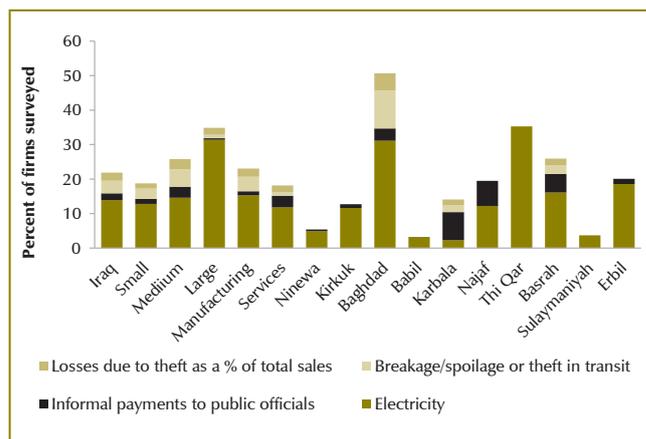


FIGURE 25. Electricity problems cloud investment climate in Baghdad

Source: Iraq Investment Climate Assessment (2012).

under-developed financial sector, with banking dominated by state banks (86 percent of assets), and smaller private banks concentrating primarily on wholesale and retail trade. Leasing and insurance are also under-developed. Iraq lacks important institutions that can facilitate lending to SMEs such as a credit bureau (which allows lenders to better manage risk through better knowledge of borrower credit history). Similarly, the absence of a moveable property registry means that firms cannot borrow using assets such as machinery and equipment as collateral. While substantial progress has been made in developing a modern payments system in Iraq, addressing ongoing gaps—notably very limited access to transaction accounts and limited automation and centralization of customer account management of the large state owned banks—could further contribute to improving the ‘ease of banking.’ A concerted effort is also needed to build the trust of Iraqis in the private banking system. In addition to general security concerns, ongoing weaknesses in the ‘anti-money laundering/combating the financing of terrorism’ regime pose risks for international banks and other businesses that might otherwise invest in Iraq.

47. The costs of weaknesses in the investment climate vary widely across the country. In 2011 the problematic investment climate cost firms in Baghdad, with losses attributable to electricity problems among the highest in the country, and losses due to compliance with regulations the highest in the country (Figure 25).

48. Access to finance for firms in Kurdistan Region is very difficult. Despite the KRG's effort to streamline business start-up process,⁸ a dispute between the central and regional governments on budget transfers has resulted in the banking system in Kurdistan becoming isolated from the rest of the country. As a result, banks in Kurdistan Region are even more liquidity-constrained than in those elsewhere in Iraq, and private banks operate under conditions of competitive disadvantage compared to public banks. When coupled with the lack of key financial infrastructure such as a credit bureau and collateral registry, lending to the private sector has almost ground to a halt.

49. The Government of Basra is reforming its investment policy and promotion regime. A reform program has commenced that will review regulations and processes relevant to investment, strengthen investor protections and grievance channels, and support the institutional strengthening of the Basra Investment Commission.

FUTURE PRIORITIES: STRENGTHENING THE INVESTMENT CLIMATE FOR JOBS

50. Reforms that support job creation should be prioritized going forward. At almost 3 percent a year, population growth in Iraq was the ninth fastest in the world in 2015. With a labor force growing at this pace the creation of new jobs will be a key to future stability. Sustainable economic growth is the only way to deliver these jobs, and the only way to generate this growth in turn will be through a larger and stronger private sector.

⁸ The KRG has streamlined business start-up process by reducing the time taken to start a company by 13 days, and the cost by US\$1,100.

51. The best way to support the private sector is to strengthen the investment climate. One of the key strategic priorities set down by Prime Minister al-Abadi has been to encourage a shift towards enabling the private sector. Iraq's relatively high oil dependency makes it much more vulnerable to oil price fluctuations than producers with a more diversified and resilient economic base. A stronger investment climate—particularly one that levels the playing field between state and private companies—will help broaden the economic base into sectors that have higher job creation intensity than hydrocarbons.

Key principles

52. Strengthening the investment climate requires more than just policy changes. Reform efforts are usefully grounded upon the following principles:

- **Reduce corruption and rent-seeking.** Aside from the direct costs of corruption, high-level corruption can lead to elite capture that can distort the entire policy direction of government to the interests of a few at the expense of the many.
- **Build policy credibility for investor confidence.** Countries as disparate as the United Arab Emirates, Morocco, Rwanda and Georgia have used a strong commitment to investment climate reform to send a signal to domestic and international investors that the country was 'open for business.'
- **Foster public trust and understanding of reform.** The stronger the consensus for reform is, the more sustainable the outcome. In advanced economies the linkages between private sector growth, jobs and prosperity are well understood, but this is not necessarily the case in a country like Iraq with a long statist tradition. Improved service delivery is fundamental to building public trust. Beyond this, educating and explaining the

need for reform is the responsibility of both government and the private sector.

- **Craft global lessons for Iraqi conditions.** Iraq does not have the resources or institutions of developed countries, and so transplanting such a system without tailoring to the realities of Iraq will fail.

Proposed action areas

53. Further reform of Iraq's SOE portfolio should be a key objective. A pervasive role in the economy coupled with generally poor governance standards means Iraq's SOE portfolio leaks significant fiscal resources through corruption and rent-seeking. In addition to the broader dynamic loss to the economy that occurs with such a large public sector, a lack of competitive neutrality (i.e., some SOEs compete 'unfairly' with the private sector) undermine investor confidence. As part of its program to restructure and reform its SOEs the government has established an Asset Valuation Unit within the Ministry of Finance with a mandate to inventory SOE assets and help determine their market value. A number of SOEs have been identified as commercially viable or having potential for public-private partnerships (the State Company for Drug Industries has already entered into a PPP with Jordanian company).

54. Growing the share of the formal private sector in the economy is essential. With a large SOE sector on one hand, and a large informal sector on the other, building a robust private sector is challenging. Iraq's demographic and economic structure means that informality will take time to reduce. A policy package shaped to encourage firms to formalize over the medium term would include the following:

- Reduce regulatory burden of entry into the formal sector by streamlining registration and licensing procedures;

- Create incentives, through access to finance and business support mechanisms, for the informal sector to formally compete;⁹
- Examine tax and regulatory regimes to assure easy entry and compliance for smallest firms; and
- Expand support for microfinance.

55. A sustained effort is needed to improve the quality of regulations and the capacity of regulators. Iraq suffers from poorly crafted regulations as well as regulatory gaps. A range of tools such as the World Bank's Doing Business indicators are able to assist in targeting regulatory reform efforts. Addressing these issues without strengthening the capacity and culture of Iraqi regulatory institutions, however, will only serve to perpetuate the gap between what regulations say and what regulators do. The larger the gap, the lower is investor confidence. Strengthening the capacities of regulatory institutions to operate in an effective, transparent and predictable manner through improved governance, regulatory reforms and public-private dialogue is therefore essential.

56. A number of actions could improve financial access for the private sector. An important step would be to level the playing field between state-owned and private banks. Compelling state banks to operate under conditions of competitive neutrality would both improve credit allocation and drive efficiency in the banking sector. Access to improved finance data—including through the establishment of credit bureaus and moveable asset registries—could facilitate better evidence-based decision-making by lenders, and improved oversight and targeting by regulators. Finally, once government succeeds in reversing the growth of debt as a share of GDP, a shift in debt composition from internal to external sources could reduce the degree to which Iraqi firms are 'crowded out' of local credit markets.

⁹ In 2015, the central bank launched a \$1.5 billion SME financing initiative.

APPENDIX: SELECTED DATA ON IRAQ

TABLE 1. Selected Macroeconomic Indicators

	2013	2014	2015e	2016p	2017p	2018p
	Projections					
Economic growth and prices						
Nominal GDP (US\$ billion)	232.5	223.5	169.5	148.4	162.4	176.7
Real GDP (% change)	6.6	-2.1	2.4	7.2	4.7	5.2
<i>of which non-oil GDP (% change)</i>	10.2	-8.8	-9.0	-5.0	0.0	2.0
GDP per capita (US dollars)	6957.0	6520.0	4819.0	4115.0	4389.0	4656.0
Oil production (million bpd)	3.0	3.1	3.5	4.1	4.4	4.7
Oil exports (million bpd)	2.4	2.5	3.0	3.6	3.8	4.0
Consumer price index, average (% change)	1.9	2.2	1.4	2.0	2.0	2.0
National accounts (in percent of GDP)						
Gross domestic investment	27.0	26.3	21.4	22.4	22.2	21.3
of which public	17.6	19.2	12.7	12.9	13.5	13.0
Gross domestic consumption	69.4	72.8	84.8	91.6	85.6	82.5
of which: public	21.2	19.0	24.5	31.4	26.3	24.2
Gross national savings	28.3	25.6	15.0	7.9	10.8	16.6
of which public	11.5	13.9	-1.7	-7.2	-0.9	6.7
Saving-investment balance	1.4	-0.8	-6.4	-14.5	-11.4	-4.6
Fiscal and oil sector accounts (in percent of GDP)						
Revenues and grants	42.9	40.4	30.4	32.1	36.5	39.7
of which oil revenues ¹	39.0	37.8	26.6	28.2	32.7	35.2
Expenditures	48.4	45.6	44.4	53.1	51.5	46.1
Current expenditures	30.9	26.4	31.7	40.2	38.1	33.1
Capital expenditures	17.6	19.2	12.7	12.9	13.5	13.0
Overall fiscal balance (including grants)	-5.7	-5.6	-14.5	-20.0	-14.2	-6.3
Balance of payments (in percent of GDP unless otherwise indicated)						
Current account balance	1.3	-0.7	-6.6	-15.3	-9.0	-3.9
Trade balance	9.7	7.4	-2.1	-8.2	-1.8	1.9
Merchandise exports	38.6	37.6	26.1	26.6	30.8	33.2
<i>of which oil (in percent of total exports)</i>	99.6	99.4	99.5	99.6	99.6	99.4
Merchandise imports	29.0	30.2	28.2	34.9	32.6	31.3
External public debt						
Total external debt (US\$ billion)	59.2	61.0	58.8	71.0	80.6	84.7
<i>(in percent of GDP)</i>	25.5	27.3	34.7	47.9	49.7	47.9
<i>(in percent of exports)</i>	65.9	72.6	132.7	179.7	160.9	144.5
Memorandum Items						
Iraqi oil price (US\$ per barrel)	102.9	97.0	48.3	30.0	35.8	39.7
IMF crude oil price forecast, average (US\$ per barrel) ²						
<i>Differential between Iraqi oil price and IMF forecast</i>						
Gross reserves (US\$ billion)	77.8	66.7	54.3	43.9	36.8	35.4
<i>Gross reserves in months of imports</i>	10.8	13.7	10.2	7.9	6.4	5.9
Non-oil primary fiscal balance (in percent of GDP)	-36.9	-32.1	-33.3	-38.3	-33.5	-30.6
Exchange rate, ID per US\$1 (period average)	1,166	1,166	1,166	1,182	..	..

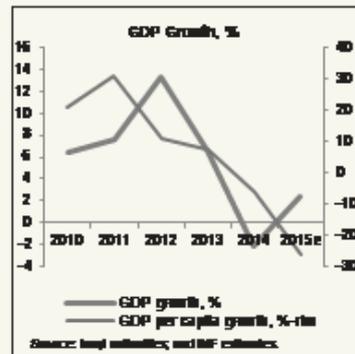
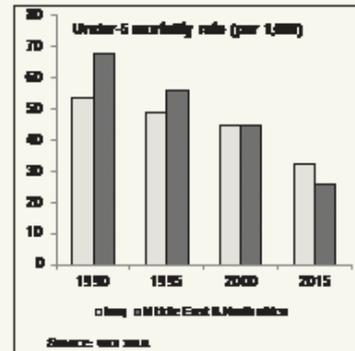
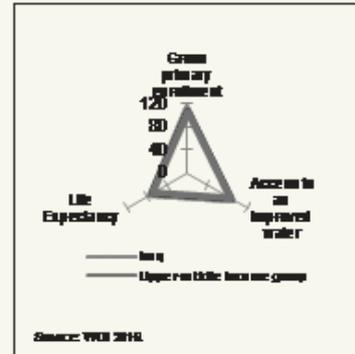
Sources: Iraq authorities, IMF and World Bank estimates and projections.

(1) Including revenues of oil-related public enterprises.

TABLE 2. Iraq at a Glance

Iraq at a glance

Key Development Indicators	Iraq	M. East & North Africa	Upper middle income	
2015				
Population, mid-year (millions)	35.7	357	2,361	
Surface area (thousand sq. km)	435	8,775	416	
Population growth (%)	2.8	1.9	0.8	
Urban population (% of total population)	69	64	62	
GNI (Atlas method, US\$ billions)	228	1,145	18,654	
GNI per capita (Atlas method, US\$)	6,500	3,464	7,901	
GNI per capita (PPP, international \$)	15,030	12,432	14,179	
GDP growth %	2.4	1.5	4.6	
GDP per capita growth (%)	-26.1	-0.4	3.7	
<i>(most recent estimate, 2005–2013)</i>				
Poverty gap at \$ 1.90 a day (2011 PPP) (%)	..	2.7	<2	
Poverty gap at \$ 3.10 a day (2011 PPP) (%)	..	16	5	
Life expectancy at birth (years)	70	73	74	
Infant mortality (per 1,000 live births)	27	21	16	
Child malnutrition (% of children under 5)	9	6	3	
Adult literacy, male (% of ages 15 and older) (*)	86	80	96	
Adult literacy, female (% of ages 15 and older) (*)	73	70	92	
Gross primary enrollment, male (% of gross)	116	113	117	
Gross primary enrollment, female (% of gross)	98	107	114	
Access to an improved water source (% of population)	87	93	93	
Access to improved sanitation facilities (% of population)	86	91	95	
Net Aid Flows				
(US\$ millions)	1980	1990	2000	2015
Net ODA and official aid	9	63	102	1541
Top 3 donors (as of 2012):				
United States	-1	0	0	484
Japan	2	-20	0	701
European Union Institutions	0	0	7	84
Aid (% of GNI)	0.0	0.1	..	0.7
Aid per capita (US\$)	1	3	4	46
Long-Term Economic Trends				
Consumer prices (annual % change)	4.9	14
GDP implicit deflator (annual % change)	47.4	-26.0
Exchange rate (annual average, local per US\$)	0.3	0.3	1930	1,166
Terms of trade index (2000 = 100)	76.3
Population, mid-year (millions)	14.1	18.9	25.1	35.7
GDP (US\$ millions)	53,061	48,422	26,093	169,500
(% of GDP)				
Agriculture	4.7	8.0	4.6	5.6
Industry	73.3	70.3	89.3	51.5
Services	22.0	21.7	6.1	42.9
Household final consumption expenditure	32.9	67.0
General govt final consumption expenditure	11.8	15.0
Gross capital formation*	2.9	29.0
Exports of goods	55.3	79.4	78.1	26.1
Imports of goods	37.7	37.8	15.4	28.2
Gross savings	55.2	15.0
(average annual growth %)				
1980–90	1990–2000	2000–15		
2.8	2.9	2.8		
7.5	13.5	5.1		
11.4	13.4	5.6		
48.2	64.9	64.3		
40.4	21.7	30.1		
..	39.3	43.0		
..	8.8	18.0		
..	3.9	14.3		
..	27.7	45.6		
..	19.9	48.9		
..	..	27.7		



Note: Indicators in italics are for years other than those specified. .. indicates data are not available. (*) Preliminary results for 2014.

TABLE 2. Iraq at a Glance (continued)

Iraq

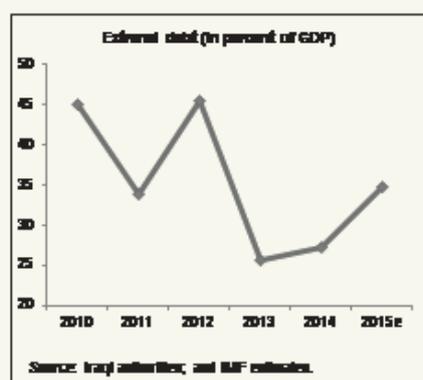
Balance of Payments and Trade	2014	2015
<i>(US\$ millions)</i>		
Total merchandise exports (fob)	84,000	44,300
Total merchandise imports (cif)	67,400	47,800
Net trade in goods and services	16,600	-3,500
Current account balance	-1,565	-11,187
as a % of GDP	-0.7	-6.6
Wages and Salaries (in US\$ millions)	27,267	26,951
Reserves, including gold	66,700	54,300

Central Government Finance

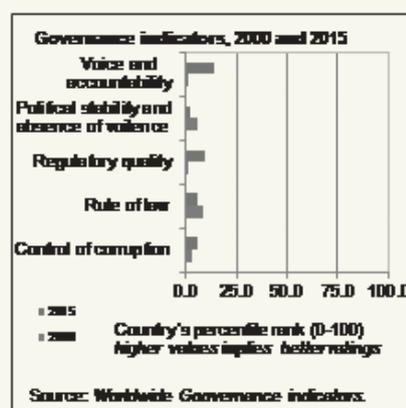
<i>(% of GDP)</i>		
Current revenue (including grants)	40.1	29.9
Tax revenue	1.1	2.6
Current expenditure	26.4	31.7
Overall surplus/deficit	-5.6	-14.5
Highest marginal tax rate (%)		
Individual	..	..
Corporate	..	..

External Debt and Resource Flows

<i>(US\$ millions)</i>		
Total debt outstanding and disbursed	61,000	58,800
Total Debt Service*	5,505	5,507
Debt relief (HIPC, M DRI)	6.2	10.2
Total debt (% of GDP)	27.3	34.7
Total debt service (% of exports)*	2.2	2.4
Foreign direct investment (net inflows)	4,600	2,500
Portfolio equity (net inflows)	0.0	0.0



Private Sector Development	2000	2015
Time required to start a business (days)	..	29
Cost to start a business (% of GNI per capita)	..	39.8
Time required to register property (days)	..	51
Ranked as a major constraint to business (% of managers surveyed who agreed)	2000	2015
n.a.	..	..
n.a.	..	..
Stock market index (change in US\$ value, % annual)*	..	-314
Banking assets to GDP (%)**	..	86.9



Technology and Infrastructure	2000	2015
Paved roads (% of total)	84.3	..
Fixed line and mobile phone subscribers (per 100 people)	3	100.5
High technology exports* (% of manufactured exports)	..	0.1

Environment

Agricultural land (% of land area)*	213	213
Forest area (% of land area)	19	19
Terrestrial protected areas (% of land area)*	0.1	0.4
Freshwater resources per capita (cu. meters)*	1376	1042
Freshwater withdrawal (billion cubic meters)*	66.0	66.0
CO2 emissions per capita (mt)*	3.0	4.2
GDP per unit of energy use* (2005 PPP \$ per kg of oil equivalent)	4.4	10.8
Energy use per capita (kg of oil equivalent)*	1044	1374

World Bank Group portfolio

<i>(US\$ millions)</i>		
IBRD		
Total debt outstanding and disbursed	..	605
Disbursements	..	250
Principal repayments	..	0
Interest payments	..	3
IDA		
Total debt outstanding and disbursed	..	504
Disbursements	..	341
Total debt service	..	0
IFC (fiscal year)		
Total disbursed and outstanding portfolio of which IFC own account	..	242
Disbursements for IFC own account	..	172
Portfolio sales, prepayments and repayments for IFC own account	..	0
MIGA		
Gross exposure	..	3
New guarantees	-	3

Note: Figures in italics are for years other than those specified.

.. indicates data are not available.

* Debt service and SEI data are from EIU-Feb. 2016.

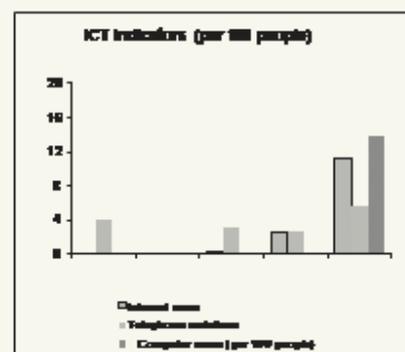
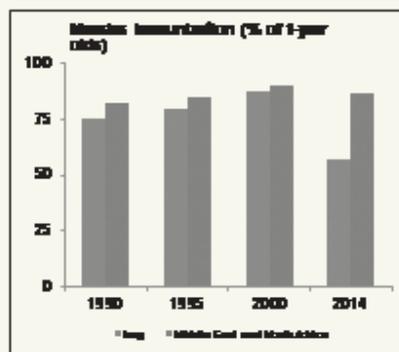
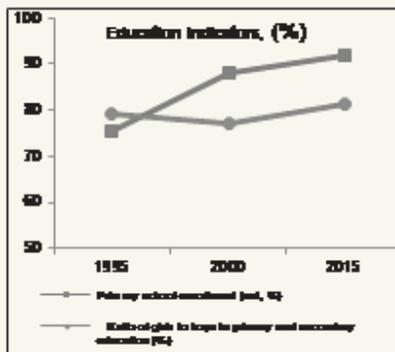
** 2014 estimation.

TABLE 3. Millennium Development Goals

Millennium Development Goals

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Iraq			
	1990	1995	2000	2015
Goal 1: halve the rates for extreme poverty and malnutrition				
Poverty headcount ratio at \$1.25 a day (PPP, % of population)	..	..	..	..
Poverty headcount ratio at national poverty line (% of population) (**)	..	..	..	22.5
Share of income or consumption to the poorest quintile (%) (*)	..	..	..	8.8
Prevalence of malnutrition (% of children under 5)	10.4	..	12.9	22.6
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %) (**)	90	75	88	92
Primary completion rate (% of relevant age group)	59	59	56	56
Secondary school enrollment (gross, %)	47	39	37	53
Youth literacy rate (% of people ages 15-24) (**)	..	..	85	82
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	77	79	77	81
Women employed in the non agricultural sector (% of non agricultural employment)*	..	..	..	12
Proportion of seats held by women in national parliament (%)	11	6	8	27
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	53	49	45	32
Infant mortality rate (per 1,000 live births)	42	39	38	27
Immunization, measles (% of children ages 12-23 months)	75	80	88	57
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	110	84	71	50
Births attended by skilled health staff (% of total)	54	..	72	91
Contraceptive prevalence (% of women ages 15-49)*	14	..	44	53
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	..
Incidence of tuberculosis (per 100,000 people)*	54	53	50	43
Tuberculosis case detection rate (% all forms)	100	90	81	54
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	78	78	80	87
Access to improved sanitation facilities (% of population)	67	72	75	86
Forest area (% of land area)	18	19	19	19
Terrestrial protected areas (% of land area)	0.1	0.1	0.1	0.4
CO2 emissions (metric tons per capita)	3.0	3.8	3.0	4.2
GDP per unit of energy use (constant 2005 PPP \$ per kg of oil equivalent)	9.2	8.2	8.7	10.8
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	4.0	3.1	2.8	5.6
Mobile phone subscribers (per 100 people)**	0.0	0.0	3.0	94.9
Internet users (per 100 people)**	0.0	0.1	2.6	11.3
Computer users (per 100 people)	0.0	0.1	0.1	13.8



Source: World Development Indicators (WDI), 2016.

Note: Figures in italics are for years other than those specified. .. indicates data are not available.

cif = cost, insurance, and freight; CO2 = carbon dioxide; fob = free on board; GDP = gross domestic product; GNI = gross national income; HIPC = Heavily Indebted Poor Countries Initiative; IBRD = International Bank for Reconstruction and Development; ICT = information and communication technology; IDA = International Development Association; IFC = International Finance Corporation; ODA = official development assistance; MDRI = Multilateral Debt Relief Initiative; PPP = purchasing power parity.

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