FINANCIAL SECTOR IN IRAQ

Outlook and Development challenges

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EXECUTIVE SUMMARY

Iraq in 1990 was ranked 50 on the Human Development Index of the UNDP versus 126 just over10 years later. The setback is accentuated by the fact that the per capita income in 1990 was considerably lower than the level of 1980 in real terms.

The performance of the Iraqi economy over the last years has been sharply improved. First, and most importantly, growth rebounded since the year 2004 lifting the per capita GDP to a bout $ 4000 in 2008. This growing prosperity, in spite of perceived inequality and the human conditions of the households under poverty line, is an excellent achievement after along period of living standers decline as a result of wars and sanctions.

In spite of diversified resource base, Iraq's economy is dominated by the petroleum sector. Exports of crud oil have traditionally provided more than 95% of foreign exchange. Furthermore, the government budget is dependent on oil by more than 90% of its resources. The share of non – oil production sectors has systematically declined in its GDP contribution and employment.

At the moment, the problems are mainly reflected in the shrinking productive capacity of manufacturing, under developed agriculture shown by increasing dependency on imported food, and limited capability of building and construction. The employment of these sectors has become minimal relative to the total supply of labor. As a result, economically active population crowded in non–commodity activities, mainly informal private and over staffed government services.

The economy remains extremely sensitive to oil revenue. This is why the management of oil, and gas, resources is a major concern, and will be

The focus in the near future, and have implications for the long term social and political stability in Iraq.

The government seeks to increase average crude oil production and exports to p/d 3.2 million and b/p/d 2.5 million, respectively, by the year 2012. Achieving the oil target will be sufficient to avoid unmanageable fiscal deficit. The five-year plan adopted 9.4% rate of growth of GDP while memorandum of economic and financial policies submitted to the IMF to the next two years expected the real GDP growth to be 7.8 percent. The memorandum promised to keep inflation at around 5% - 6% the coming years. The reserves held at the CBI and the government balances abroad was expected to remain the same level in 2011 and 2012 around $ 46 billion.

For the period since the beginning of 2006 till the end of July 2910,$ 108 billion sold to the private sector, $ 30 billion used as CBI's reserves, and $ 41 billion dispersed by the government, mainly , for imports.

The functional relationships between monetary and fiscal operations affect the determination of macroeconomic stability, growth and social well being. These hidden links need to be scrutinized. Excess supply of foreign exchange facilitates accumulation of the CBI's international reserves along with nominal appreciation of ID against US dollar. However, since the first quarter of 2009 the ID has been defacto pegged to US dollar at the ongoing rate of ID1170 per US dollar. It is clear that government expenditure in ID mainly financed by selling FX to the CBI. The positive difference between the $ amounts handed over to the CBI and CBI's sales to the private sector increases its foreign reserve, And monetary base.

The intended reform of the public finance would require changing the rules of budgeting, accounting, and reporting procedures. Raising allocation to public investment out of budget and oil revenue has been considered the main challenging target. This is why the current expenditure needs to be restricted so as not exceed a maximum ratio of total expenditure and oil revenue. In this regard, total salaries and related allowances would be thoroughly revised.

In Iraq, public expenditure is the major determinant of aggregate effective demand. Therefore, we can only ensure stability by including supply side in the process of formulating and implementing the government budget.

Establishing a multi-purpose reserve fund managed by the MoF will also serve the function of withstanding potential fluctuations of crude oil prices. The fund will also maintain the minimum required of public spending and foreign exchange supply to the private sector in the periods of extraordinary export shock due to non-markets reasons. The fund would enable Iraq maintaining steady growth of government expenditure over the phase of saturation level of oil revenue. These conservations are required until the non-oil taxable income of enough relative size would exist, and non-oil source of foreign exchange would become a reality.

A program of action to expand absorptive capacity is suggested, because the economy can not respond to the huge backlog of infrastructure and public service basic needs unless it has the built-in ability to absorb large and growing public expenditure without inflationary pressures.

The said program of action has many dimensions; nevertheless the public investment could be the core for mainstreaming. The prevailing management of public investment projects needs to be reconsidered.

In this regard all the resources of the relevant organizations could be pooled together for restructuring into a new set of companies, so as to handle the process from preliminary studies to contracting. Furthermore, establishing a number of auditing units would assert integrity, cost effectiveness and engineering and legal compliance.

The private sector would be assisted to form large joint stock companies in the activities of building and construction and consultancy firms. In this regard, merger with and acquisition of government and foreign companies are possible to meet the target.

Plans of electricity and refineries are relevant to the expansion of production and cost reduction. The context will extend to incorporate mining and manufacturing of construction materials, railways network, and sea ports.

It should be made clear that monetary policy could not have meaningful effects unless the financial sector reaches a certain level of development measured by the total value of assets relative to GDP. The ratio in Iraq, now, is about 10%, while in the world, on average reached 440%, and in Euro area 558% in 2007. Worth noting, that it has become 272% in emerging economies the same year.

Financial system in Iraq is banking-based, as the banking sector dominates the stock market by 89.8% of the total trading volume and 85.2% of the total value of the trading volume. Nevertheless, this can not preclude the vital importance of the equity and debt markets.

The problems in credit and banking services have been serious, and negligence or do nothing attitudes would deprive Iraq of opportunities to push the private business into the fore front of economic development.

Total credits to private sector surged in 2009 and increased to about ID 11 in 2010. It was a significant achievement in comparison with the 2008 when the total credits less than ID 4 trillion.

A well functioning financial sector is critical for economic growth and developing the non –bank segment of Iraq's financial industry, particularly debt markets and insurance, needs to be addressed beside a program of action aiming at enlarging of the corporate sector. The process could be coordinated with the anticipated rehabilitation and privatization of about 190 public enterprises.

In this respect Iraq could benefit from the successful experience of emerging market economies to make a lot of difference. Although Iraq weathered the recent financial storm , the anticipated financial development in the country necessitate adopting realistic perspective to ensure some sort of decoupling averting credit crises and sudden drop in asset market . Reaping the benefits of oil service contracts will depend on to what extent that Iraq will have capable organizations and policies to raise investment relative to GDP and sustain transformation process to join the group of high income economies of sizeable non-oil productive base.

Also, the large investment programs in crude oil and other sectors call on government to start immediate intervention to ensure better government services in general, and spontaneous trade finance and international payments in particular.

Bankers are in need to change their credit and risk management as much as they need more resources to cope with the increasing size of market and the aggregate level of investment. Also, good governance should be considered as one of the most strategic issue for the banking sector functioning and the overall economic performance.

Considering the liberalization of trade and finance as an ongoing and irreversible process, Iraq does not have other choice but to upgrade our capability to make the process more responsive to development and stability.

As the security situation has, and will be more, improved a business environment conducive to active private investment will be started to create growth.

Launching a high – profile anti – corruption campaign would be imperative to take steadfast action in improving government administration.

The governance structures of Iraqi financial insinuations, and non financial corporations, need substantial improvement to function effectively. While the board structures have been assumed the full management authority in the banks and corporations, they are not conducive to an effective checks and balances.

ECONOMY OF IRAQ: OVERVIEW

Following the 2003 invasion, the economy, to a great extent, collapsed and revived gradually from the damages of war and rampant crime.

However, like many other countries, the prospect of sustainable growth, at least in the long run, hinges on its economic structure. At the moment, the structural problems are mainly reflected in the shrinking productive capacity of manufacturing, under developed agriculture shown by increasing dependency on imported food, and limited capability of building and construction. The employment of these sectors has become minimal relative to the total supply of labor. As a result, economically active population crowded in non–commodity activities, mainly informal private and over staffed government services. This contraction structure, accentuated by chronic and built–in inflationary pressures, should be the main focus of any successful development strategy in Iraq. The takeoff of economic development has been delayed due to deficiencies in infrastructure in general, and sever shortage of electricity in particular which has contributed significantly to cost increasing.

Economically active population in non-oil commodity sector (agriculture and industry) represent 36%-42% of total labor force, and the total labor force estimated as 26% of total population. These indicators disclose the structural weakness of the economy considering that the above mentioned labor force includes unemployment which has been declined to 15.2% of the labor force in 2008. Sanctions imposed in august 1990 and military action in 1991 drastically reduced economic activity. The implementation of the UN'S oil for food program has improved economic condition since December 1996. And per capita food and medicine have increased steadily, particularly after December 1999 when UN Security Council authorized Iraq exports as much oil as required.

Large scale industries were mainly in public sector, while the private activities were dominated by small scale and individual firms. Until 1984 the government inclined to expand heavy industries to boost its military stance. In addition to industries that closely connected to the oil, like petroleum refinery and petrochemical, a broad based construction, mechanical and engineering large manufacturing factories established. Also projects specified and technical studies conducted to establish car and tractor industries along with 18 feeding related activities. Since 1985 public sector industrial investment ceased and technological decay made the manufacturing sector in Iraq about to obsolete. The lifting of sanctions in 2003 allowed repairs and replacement, and technological advancement to start but nothing significant has been achieved. It is widely under stood that private capital in collaborating with foreign investment could revive industrial sector in Iraq. In agriculture the cultivated area with its prevailing low level of yield can not satisfy the domestic demand. More over, due to high cost of production, Iraq has no comparative advantage to compete in the regional agricultural market. Agriculture is urgently in need to a very costly program of investment to redesign and implementing a new network of irrigation , in parallel with land reclamation and overall national wide drainage system . The shortage of electricity is the main obstacle to restore the normal state of the economy. Increasing the price of oil products and the severe shortage of electricity contributed significantly in inflation and rising cost of production.

About 80% percent of Iraq's power generation and distribution system were destroyed in the war of 1991.The generating capacity was 9000 megawatts reduced to 2200 megawatts with sever damage of transmission system included 17700 kilometers of line. The generating capacity to date can not meet the minimum demand, for household sector and necessary services, estimated as 7500 megawatts. The potential demand might be 15000megawatts, given restoring production and investment activities. The demand would exceed 25000 megawatts a decade from now.

Iraqi economy has been fully liberalized by legislation making private enterprise as the main instrument in a free market economy. Investment laws enacted to attract foreign investors and repatriating Iraqi capital. Among these legislations the law for investment in oil manufacturing activities to establish large enough capacity in refining sector for domestic demand and export. Protection of property rights, and distinguished preferences and exceptions has been given to foreign investors. Free economic areas have delineated and new seven areas legally established to be equipped with excellent infrastructure to attract investor, service providers, and licensing would be facilitated up to best practices.

Although full privatizations plan was not implemented yet, but the 190 state-owned enterprises have not retained its previous role in production and investment, awaiting a well designed arrangement of privatization. In spite of civil war, private sector has resumed business in real state, construction, wholesales and retail trades. Registered companies in Iraq have increased many folds. Car ownership has surged to a level was not imagined, in addition to mobile phone, household durable goods, computers and communications. Further more, household per capita of disposable income has been rising significantly as a result of high government expenditure and salaries.

GDP per capita reached its peak in the years 1979-1980 about $ 4000 per capita output, the level has not been regained in real terms. GNP and per capita income has been growing in a rapid manner since the year 2004.

In 2007 GDP in Iraq estimated as ID 107.8 trillion, mounted to ID 155.6 trillion in 2008,based on a preliminary data, which equivalent to $130.3 billion as the average exchange rate through over the year was ID I193 per $US . The contribution of manufacturing and agriculture is about ID 7.7 trillion ($ 6.5 billion) i.e. the share of the two sectors in GDP is 5.1%.

GDP by Main Sectors (Billion ID)

Sectors	2007	%o total of GDP	2008	% of total GDP
Agriculture	5454	5.1	5399	3.5
Oil	58203	54.0	87538	56.2
Manufacturing	1818	1.7	2332	1.5
Commodity Activities	70537.4	65.4	102852	66.1
Commodity activities with out oil	12334.4	11.4	15314	9.8
Other sectors	37291.1	34.6	52784	33.9
Total GDP	107829	100	155636	100
Non – oil GDP	49626	46	68098	44

In 2003 GDP drop to $ 13.9 billion from $20.5 billion in 2002. However, GDP and GDP per capita reached $ 130.3 billion and $ 4330 in 2008 boosted by oil boom. Moreover, standard of living improved significantly as the share of food declined to 35.6% of average monthly household expenditure while was 61.7% in 1993.

However, fixed capital formation is lower than minimum due to security and limited implementing capacity of government apparatus. In addition, under developed construction and contracting sector has a clear negative effect on the course of implementation.

Therefore, the shortage of capacities is accumulating everywhere, including irrigation networks and drainage in agriculture land. Pollution, mainly water, has been increasing beyond the acceptable standards.

Clean water supply and urban sewerage are also in need for more resources. About 30% of urban population is connected to a sewerage system but more than 90% of urban settlements have access to piped water. Shortage of building for social services, mainly education, has increased substantially in recent years; given the demand growth has out paced the expansion of supply. The basic needs for housing request at least 6% of GDP (about 20% of fixed capital formation). But, the housing sector, practically, can not be isolated from the integrated urban system.

Headline inflation fell to 6.8 percent by end 2008. Inflation was well below 6% in 2009, mainly because of a further decline in fuel prices and core inflations excluding fuel and transportations ended at 6% dawn from 12% end-2008. Exchange rate has been stable since beginning of 2009 at 1170 ID although it is fluctuated against other currencies as much as the US dollar has. The central Bank rate has been reduced gradually to 5%.

The relationship between fiscal and monetary operations needs to be highly considered with deep insight into the characteristics of the oil economy. In this respect the dualism of budget deficit and foreign exchange surplus should be resolved thoroughly. Definitely, Iraq has to adapt its system of public finance to the new level of oil revenue. Otherwise, macroeconomic performance will be severely constrained by bottlenecks. Containing the supply side within the government budgeting , and public finance management , is a first step to address the chronic illness of limited a ability to invest and avoiding potential inflationary pressure.

Economic growth, beyond the crude oil sector, Exceeding 7% annually in terms of GDP requires high level of investment, may be no less than 30% of GDP. That could be achieved by a policy mix reducing the perceived risk and increasing the expected return on investment.

Iraq's, new five-year national Development plan (2010-2014), targets annual economic growth of 9.4 percent. The plan has estimated requirement of fixed investment as $186 billion includes $100 billion of public investment. These estimates are analytically calculated based on its growth target and capital - output ratio. It is quite possible that public investment exceeds the very conservative calculated investment.

Over the next five years the economic administration of Iraq should work hard to stay a head of developments, to refine legislations and regulations, and to ensure good governance. In this regard rebuilding administrative body and action oriented management is an essential prerequisite to move forward.

Anticorruption efforts are being stepped up. But, additional measures are required. Rather the overall institutional frameworks for fighting corruption to be strengthened.

The macroeconomic risk is negligible since the government budget is the main determinant of total effective demand and fluctuations in oil revenue can be mitigated through stabilization buffer accumulated out of unintended surplus. Political noise cans not affect the international commitments of the government and the foreign partners of Iraq have to get this with certainty as a concrete fact in Iraq. The implication of political risk on domestic economic performance is just not worth worrying about. It was obvious that all political ruling powers in Iraq accepted free market economy irreversibly and well prepared to support effective enforcement of the relevant legislations and contracts. Political and bureaucratic decisions are subject to continuous reviewing assessment, auditing and investigation. Nevertheless effective accountability similar to that in mature democratic societies is unattainable yet.

Also, information systems are not supporting good governance including the timing and periodicity of financial statements and their objectivity in expressing the actual conditions. The institutions of concern have yet to develop clear distinction between front, middle, and back offices.

PUBLIC FINANCE AND BUDGETING

Oil Revenue and foreign Exchange:

The problem of public finance started since 1983 caused by massive expenditures in the war with Iran after depletion of International reserves which had been accumulated in the seventies up to $40 billion. Shrinking of oil exports then, enforced the government to adopt austerity measures reflected, mainly, in the suspension and /or abandoning public program of investments. Heavily borrowing during the years 1984-1980 burdened the economy with the problem of foreign debt. Prior to the out break of Iran –Iraq war in September 1980 oil production had reached 3.5 million barrels per day and exports about 3.2 million barrels per day .

DFF is a unique international arrangement, to control oil revenue and Outlays, was founded by the UNSCR no.1483 in 2003. The DFI system comprising the oil proceeds receipt account, DFI account, and DFI sub- accounts opened in the FRBNY.

The DFT main account receives 95% of the oil precedes receipts and 5% delivered to the special account of war reparations. The payments of the DFI funds are authorized by prime minister together with the minister of finance or their representatives.

The DFI accounting records are based on information obtained from the CBI.

A complete set of accounting records for all DFI approved transactions that are reconciled with bank statements from the CBI.

Payment orders through the DFI account issued by the ministry of finance are carried out by the investment directorate in the CBI. The prevailing procedures have proved to be acceptable. Receipts and payments are properly recorded and classified in accordance with the presentation of the DFI annual financial statement.

Most likely the established system will, practically, be conserved. But the legal mandate of the UNSC shall terminate. By the end of 2005 the balance of DFI at Federal Reserve Bank of New York was about $ 4 billion. The said balance was $ 11billion as of 31 of July 2010. The receipts of DFI for the Period January 1, 2006 to July 31, 2010 accumulated to $185547 or $ 186 billion. Accordingly the outflow of DFI was:

186 + 4 – 11 = 179 $ billion.

The process of financing implies selling $ 138 billion to the CBI for the said period.

The private sector via banks bought $ 108 billion and the CBI kept $ 30 billion added to its international reserves. The MoF received ID 160 trillion in exchange for that sum. It is clear that the major source of ID for public expenditure is the exchange of $ for ID.

Category of allocation	Amount billion	Ratio %
Sales to the private sector	108	60
Addition to the international resaves of CBI	30	17
Government imports , its international Payment , and other uses	41	23
Total	179	100%

The public finance and budgeting system in Iraq is not well articulated to manage this very essential process effectively and efficiently. No doubt, and with out exaggeration, the reform of Iraqi public finance should start from the ongoing fiscal and financial operations and the underlying necessary technical relationships:

→ Crude oil sales → Government oil revenue...

→ Sales to the CBI → Sales to the private sector…

→ ID Proceeds to financing government domestic expenditure.

The financial buffers built through accumulation of surplus since the year 2005 play an essential role in absorbing much of the adverse impact of the external shocks. CBI's foreign exchange sales to the private sector rose from $6108 million in 2004 reaching $33992 million in the year 2009. The annual rate of growth was 41% but the annual percentage change is decreasing.

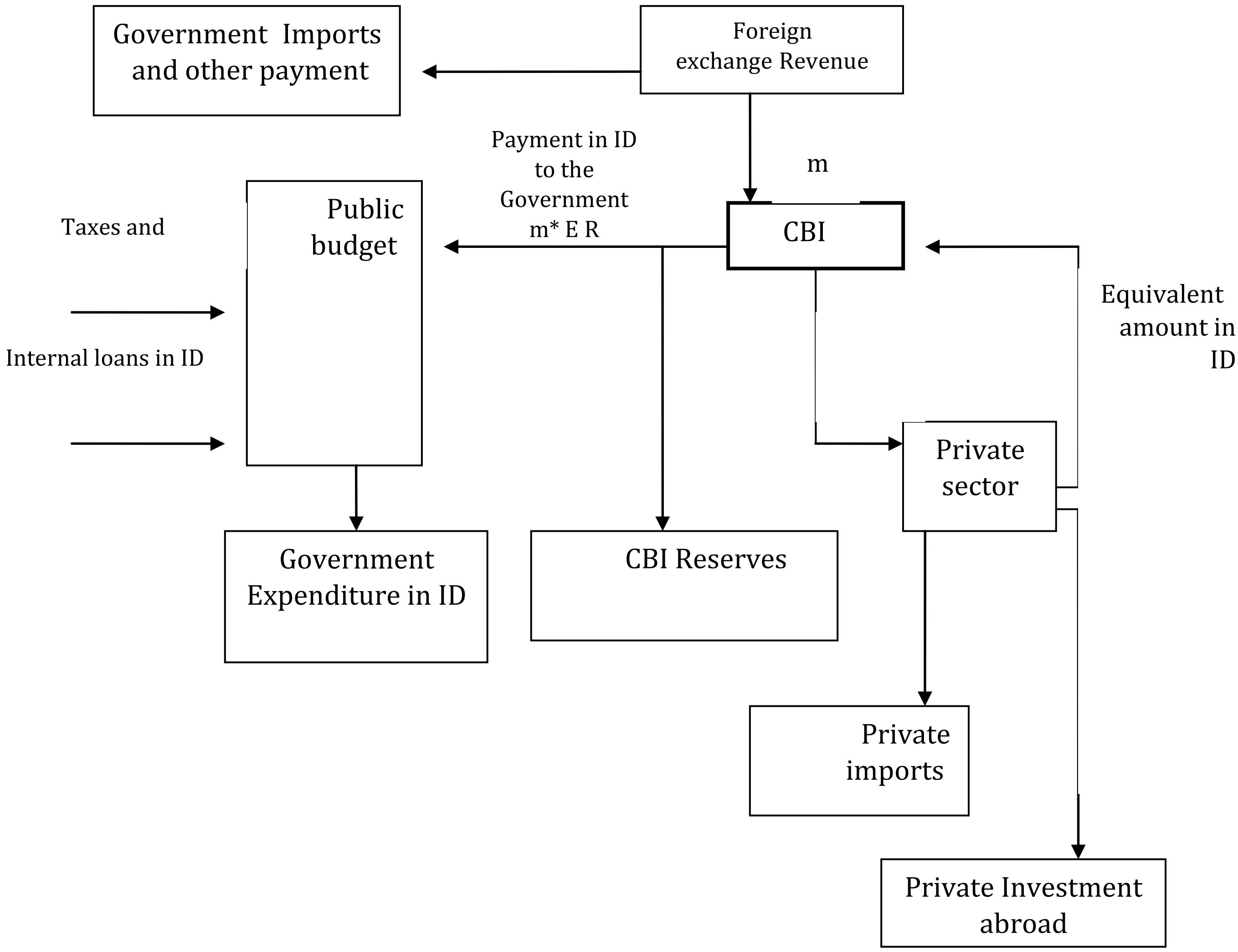
Growing demand for foreign exchange interpreted by income effect, price effect, and the situation of real sector in Iraq i.e. limited supply of tradable good. The shrinking of non – oil commodity activities in Iraq , and rising cost with trade openness contributed in fueling demand for foreign exchange .

Income has changed by more than four folds between 2003 and 2008. Other things being equal, the shifting up of the income should have a strong push up on the level of demand for foreign exchange. Regarding the price effect Iraqi dinar has become over valued in terms of US dollar. US dollar has perceived as very cheap in Iraq and this perception is congruent with the principle of purchasing power parity between the internal and external real value of ID. The internal purchasing content of ID has been systematically decreasing because of inflation, but the external purchasing power of its foreign exchange equivalent was stable or increasing.

Selling foreign exchange to the private sector, as a source of financing domestic government expenditure, is intrinsically different from just getting amount of ID in return for foreign exchange used by the CBI as international reserves. The latter is a process of financing government expenditure by pure monetary expansion, while the former is a process of real, non – inflationary financing since the proceeds are deducted from the current of private income. Even important to differentiate between the parts of FX purchased by the private sector invested abroad, and the other part funding imports which would become major constituent of total supply. Foreign exchange reserves of CBI are increasing in parallel with unlimited supply of FX responding to the demand of the private sector without restriction. Therefore the CBI had not in needed to enact prudential or administrative measures in order to achieve the ongoing rate of exchange.

The allocation of foreign exchange resources as displayed by the previous table reflects the state of the economy. Also, the failure of public finance policies in the last four decades in their efforts to create non oil source of funds, i.e. taxes and other sovereign revenue, adds more to the dysfunction of the whole financial system.

The relationship between public budget and financial sector could be presented by the following flow chart.



The recorded tax revenue was ID 986 billion in 2008 compared with ID 70124 billion the oil revenue which reflects to what extent the public budget has become oil dependant.

Considering what the banks could provide of debt to the government, it depends on the total deposits they acquire which are now no more than ID 13 trillion. Government borrowing from banking sector deprives the private investment of very essential source of funds, the situation called crowding out effect.

Public Finance Reform and Government Budget:

The problem which has been over looked by the offices of concern is that the government foreign borrowing would not be a realistic solution to the structural deficit originated from very limited size of taxation. The government has surplus in foreign exchange but deficit in Iraqi dinar. The anticipated reform should find a solution to the problem of insufficiency of ID in parallel with expanding the very limited capacity to assimilate efficiently more oil revenue.

Plainly speaking, to ensure better use, and benefit from oil, it is required to:

1- Removing the most binding constrains in infrastructure and non tradable supplies.

2- Create sustainable and increasing source of finance in ID to absorb more and more oil revenue.

Disbursement of capital spending in 2009 fell short of budgeted amounts, due to slow procedures of import and severe disruptions of administrative capacity. Poor quality of project implementation in public sector needs to be addressed comprehensively by a restructuring of administrative units that handle the processes of project management: Formulation, and engineering auditing, contracting, and supervising of execution. Specialized contracting companies mainly for building and construction need to be established in private sector.

The government budget, of 2010, sets federal spending at around 72.4 billion dollars. It is conservatively based on an average price of $ 62.5 per barrel for Iraqi oil export revenues turn out to be higher than projected. Current spending curtailed to maximum ID 62.9 trillion and capital budget to ID 25.8 trillion to spend mainly on electricity, water and sanitation, health, and agriculture. And the planned deficit will be ID 17.9 trillion 19 percent of GDP. The actual deficit could be lesser than estimated.

The government has intended to adopt the required policies concerning public finance starting by comprehensive reconsideration of spending needs. That is to reduce current (operation) expenditure to be ceiled in proportion with the total government expenditures. Also, salaries and related allowance would be considered in detail. The government aims to contain the government's wage bill by refraining from new civil recruiting but in specific areas. And

Seek to target the benefit of the in – kind public distribution system (PPS) to poorest Iraqis. In addition, it has been decided to reduce the number and volume of goods distributed under the PPS System. The offices of concern plan to expand the targeted cash receivers system. The transfers to state – owned enterprises will be reducing.

The process of budget preparation has to be changed, and the management of public expenditure be improved. That beside better reporting and cash management so as to reduce the idle balances in spending unit's accounts to the minimum. Moreover, the accounts in the banking system will be reviewed and reconciled with treasury records.

Internal audit and control system will be re examined and the largest investment projects need to be reviewed by the supreme Audit. Further more, the ministry of finance committed to submit to the counsel of representatives the final accounts for each fiscal year no later than September 30 of the following year.

Fiscal aspects and related financial services of oil sector investments:

Contractors are entitled to petroleum cost, supplementary cost, and remuneration. They start charging petroleum cost to the operating account as from the effective date. From the date of first commercial production contractors shall become entitled to remuneration. The remuneration shall be an amount equal to the sum of the product of the remuneration fee and net production subject to the performance adjustment factor called R-factor.

R-Factor equals the aggregate cash proceeds divided by total expenses. Both of the remunerator and denominator are accumulations from the effective date up to the end of the preceding calendar year. Aggregate expenditure includes: petroleum costs, signature bonus, plus other costs like training and scholarship. The apparent inconsistency between adjustment factor formula and contracted fee needs further clarification. According to the R- Factor, remuneration fee (RF) shall be declining to 0.2 of the maximum contracted RF When R-Factor equal 2 i.e. total expenditure represents %50 of the total receipts.

Inevitably the R-Factor will exceed 2 at the beginning of the plateau production period in which the calculated fee using the R-factor shall, be lower than the contracted fee.

If the additional production capacity could be BOE/day 9 million and average investment cost for BOE capacity $ 12000, the total investment cost would be $ 108 billion. Also, assuming that the average increment of actual production, for the period from effective date of commercial production up to the starting date of the plateau, could be BOE/day 4.5million, the total operations outlay would be $158 billion.

Then the total investment plus operation costs accumulated at the beginning of the plateau period would be $ 266 billion the total expenditure including supplementary cost could be $ 280 billion.

Assuming $60 per BOE the total receipts could be $591 billion and the R-Factor would be 2.1 which may reduce the remuneration fee to less than $ 1 per BOE from the beginning of the plateau period onward. The calculations presented here should be considered as very preliminary just indicating to the order of magnitude rather than proper costing. The total cost could be totally covered by the starting phase of the plateau production.

The net revenue of the government shall be the total proceeds reduced by operations expenses plus remunerations and some supplementary expenses at insignificant amount.

Contractors shall pay tax defined as %35 of their realized net income arising under the contract and reported in accordance with the procedures and standards of accounting and auditing as stipulated by the relevant laws and regulations mentioned by guidelines of development and production service contract.

Regarding article 21, the right to availability, free possession use of, and internal and external disposal of currency, is asserted by legislations and regulations to all residents of Iraq and foreigners without potential exceptional restrictions. But all financial operation needs to be in full compliance with the law of anti money laundering and criminal financing. in this respect , all the stake holders better be remind that the said compliance is internationally required and emphasized furthermore , the right to open and operate accounts in foreign banks and make payments out of that accounts is openly recognized and practiced with out reservation .

The banking community in Iraq has made considerable improvements in regarding their capabilities to encourage contractors and sub-contractors of oil investment to open such accounts in foreign and /or local currencies. But, sorry to say, that foreign partners are still unreasonably reluctant to open such accounts.

The companies of oil service contracts shall obtain and maintain insurances.

The Iraqi insurance companies have been given clear preference to benefit from this newly created and promising market. The companies of concern may raise their net retention to cope with the expected exposure.

FINANCIAL SECTOR

The situation of financial sector:

The last three decades had been a time of radical change in the financial markets and institutions, and the process continues to undergo large transformation around the globe. Iraq still lags behind middle income economies in the size and diversifications of its financial sector. The economy of Iraqis financially shallow in terms of total financial assets to its GDP which about 10%, compared with 272% in emerging economies and 440% the world average.

Traditionally, public sector was the sole provider of financial services for the period 1964-1990. The financial institutions were mainly banks and insurance companies. During nineties of the twentieth century, equity market established and private banks licensed. Since 2003 the sector has been liberalized and internationally opened. There is no secondary markets for debt securities yet and no organized exchange of commodities. There are private exchange shops, transfer payments companies, and small scale investment companies. Developing secondary markets require a deep and divers investor base. Equity market, although the capitalization ratio is among the lowest in the world, about 4% of GDP, is suffering of insufficient liquidity. Pension is not developed into an investment fund yet. And money market funds are absent. Future and forward contracts are informal and risky. Furthermore, interbank repo market has not created to date.

Financial markets underdevelopment, in Iraq, makes the deficit financing a difficult task. In this situation banks become the only source of credit to government and corporations. Secondary financial markets are supporting the issuance of government bills and bonds. That is with out pressing to tap central bank direct financing. The main lesson arising from the world wide experience that monetary policy can not work fully with out secondary markets to use its instruments.

Effective monetary policy needs out right secondary purchases and sales of government securities for liquidity management.

The CBI is responsible for conducting primary bills auctions on behalf of the MoF. The resulting yields might be not market clearing. Because of huge government deposits held by state-owned banks compete with true private funds. Also, are not really downward flexible since the deposit facility rate of the CBI represents the floor for opportunity cost of the funds.

Private sector credit market has only recently begun to expand. Recent growth rate have been comparable to other emerging and transitional economies, but the initial level was insignificant.

Financial development is a multifaceted change through positive interaction with central banking and public finance, corporate sector expansion, regulation and supervision, competition, strength of properly rights, diversity, of market products. All these aspects are urgently important components that should be handled by a program of action to rebuilding the financial sector in Iraq. Towards higher investment, for growth, and rising living standard, and the government would find the arrangements and policies that feasible and desirable for deepening and diversification. Changing the domestic financial sector that way creates an environment conducive to serious economic advancements and, potentially, new risks to be mitigated by prudential intervention. The private sector should play its role in the wide spectrum of financial institutions and markets. That is to prepare the ground to meet the anticipated explosive growth of international financial transactions through the next five years.

Experience from financial sector development in Asian and other emerging economies offer many lessons to be considered in Iraq like:

1. A sound fiscal policy is a precondition for a well- functioning financial system a long with public confidence regarding protection of property rights and contract enforcement.

   Needless to say that such environment cannot be created with out establishing the rule of law and robust legal / judicial system.

2. It is necessary to upgrade financial market infrastructure, pro international standards accountings and auditing, efficient credit analysis and marketing. Also, sound governance principles and strong market discipline. Moreover, encouraging consolidation and large enterprise orientation to achieve economies of scale and scope that lead to continues deepening and competition is a key deriving force in this regard.

3. Licensing procedure should avoid both excessive strict entry regulations and lax entry requirement.

Banking Sector and Intermediation:

There are, currently, 7 state-owned Banks , and 32 working private sector commercial banks were authorized in Iraq .That puts the number of chartered banking institutions at 39 , with Rafidain remaining the largest commercial bank in terms of total assets. Private Banks represents the primary component of the Iraqi financial system and corporate sector, as shown by the following table.

No. of registered companies and market value of corporations in Iraq end June 2010.

Sector	No of corporation	No. of shares (million) At 30/6/2010	Market value (ID million)
Banks	12	1331092	2181919
Insurance	5	5900	9996
Investment	9	138	11935
Services	11	2318	103112
Tourisms and Hotels	10	16757	392271
Industry	28	242494	331690
Agriculture	7	9175	33214
Total	91	1642402	3064137

The private banks dominate the stock market by 89.8% of the total trading volume and 85.2% of the total value of the trading volume.

Commercial bank's shares were under valued because insufficient liquidity directed to stock market the same phenomenon at work regarding the shares of other sectors including hotels and tourism. This is why that banker's community feels unsatisfied and strongly reserve on CBI decision raising the minimum capital to ID 250 billion. It seems that foreign investors aware of this excellent opportunity accordingly increasing foreign demand for Iraqi stocks are expected.

The RTGS which has been introduced in 2005 is the interlinked system for making clearing and settlement of payments, and the banking system has equipped with efficient mechanism of electronic transfers.

Although banks lack the broader safety net of insurance to safeguards against failures, the central bank is well prepared to protect the banking sector against systemic failure. Furthermore, entrusted and efficient banking sector will participate, significantly, in reducing the size of informal international payments. The process will support faster transformations from the traditional cash based society to a financially advanced market economy.

Foreign investors are searching for Iraqi financial partners. The starting step foreign companies and their national affiliates have to open accounts in US$ and Iraqi dinar with Iraqi banks. In addition, implementation of investment projects will raise the demand for international trade banking services .The services of L/C and related tasks are vital to the whole process of investment. Also, the banking services which participate to the efficiency of investment have many well known characteristics among them the process should be friendly and spontaneously responding to the timing and scheduling of project implementation. The deposits associated with L/C and cost of trade finance has been subject to continuous discussion and disputes over the last previous period. Compliance with the law of antimony laundering and criminal financing faces so many challenges, for new technologies make it increasingly difficult to control either inward or outward formal international financial flows. In the same time informal transactions still represent significant size in Iraq as reflected, indirectly, by the huge use of cash.

Also, commercial banks need to attract increasing resources for considerable contribution in economic revival through enhancing domestic credits to private investment.

Among the main component of the required banking reform and the related action plan is the restructuring of the two states –owned commercial banks, Rafidain Bank and Rasheed Bank, which account for more than 80 percent of the banking system capabilities. It is intended to raise the capital of the two state owned banks to ID 500 billion and ID 400 billion respectively and this if realized will raise their ability to external credits to private sector up to ID 7 trillion. But, practically the two banks credits exceeded that norm, due to implicit government guaranty. Further more, the supreme audit has conducted financial and operational audits for the three specialized state – owned banks and has proposed strategies to be considered by a restructuring committee to implement the recombination.

Some progress has been made to date in terms of the institutional and financial improvement of the commercial banks. But better business organization, upgrading of the information technology, accounting more compatible with international standards and financial reporting are pressing for more constructive intervention. Non performing loans are awaiting corrective decision.

Total credits extended to private sector were ID 2388 billion and ID 3978 billion for the years 2007 and 2008 respectively. The total credits were suddenly increased to more than ID 10 trillion in 2010. This considerable change interpreted by radical reorientation of the MOF which control the state –owned banks. Banking sector intermediation is small in terms of total credits as percentage of GDP It could grow from its current level of about 7% of GDP to over 40% of GDP. In this case the capital and liabilities of the banks will be the major obstacle to reach the said target. The private banks are reluctant to offer loans with more than one year maturity. No doubt that credit and operational risks restrict activities of commercial banks. Reducing the said risks entails well defined initiative to establish new institutions with enough resources could handle bad debts and create secondary debt market. Also, these suggested institutions can provide guaranties to large and long term credit. Enhancing credit market in Iraq would accelerated by strengthening the units of risk management and credit assessment .These units need to be well equipped with competent staff skillful in project evaluation and market financial analysis.

The liquid, government and central bank, assets was important investment instrument to use resources of the commercial banks, particularly since the inception of stand by arrangements with the IMF. The commercial banks of Iraq are lacking the resource base compatible with the acceptable level of private investment to GDP.

The banking system is dominated by state – owned banks which account for more than 85% of the banking systems total assets. The state-owned banks are still encumbered with foreign debt which is used as a pretext for restriction of their activities. Therefore they can not perform trade finance and international payments.

The state- owned banks reform could imply that their ownership structure be opened up to private, national and international, interests.

The sector compares favorably with banking sectors in the region in terms of the numbers of banks and branches. A few bankers have established outstanding track record of innovation, growth and value creation. However, improved governance, improvements in credit and risk management remain limited to a small part of it.

The cost of banking intermediation and services in Iraq is higher than in other markets. Penetration of banks in the whole economic system is far lower than what is required. The role of banks in international payments and trade finance is awaiting radical intervention. Iraq's banking industry must expand and strengthened significantly to support private investment, trade, and capital intensive and, funds demanding, manufacturing and services sectors.

Although, CBI and MOF, and other related government enteritis have essential role to play. The major responsibility of the changes lies with banks management and the beneficiaries of the business organizations. Enabling policy and regulatory framework will be critical to the success of banks. But the market discipline, contract enfacement, and removing of non-performing assets will reduce expected risks and encourage credits to the private sector. Enhancing market based financial activities will help compensate the weakness characterized the banking business in Iraq to date.

Banks will no longer enjoy windfall CBI gains considering secular decline in CBI interest rate offered to banks deposits at the CBI and its bills, this will expose banks more to the credit risks they need to cope with. Moreover considering changes in household's income and wealth, consumers will increasingly demand better financial capabilities to provide them with more diversified banking services of higher quality with acceptable cost.

Banks Assets and Liabilities:

The bank's total liabilities reached about ID 48 trillion, of which about ID 30 trillion government's deposits and ID 14 private deposits. As the table below shows, the state-owned banks held 62% of private deposits, and 85% of total liabilities.

Banking sector Deposits and Total Liabilities July 2010 ID million

Bank	Government deposits	Private deposits	Total deposits	Total liabilities
Total state – owned banks	30,239,683	9,479,269	39,718,952	41,107,191
Total private banks	127,017	4,501,624	4,628,641	6,642,606
Grand Total	30,366,700	13,980,893	44,347,593	47,749,797

The amount of total assets is about ID 28 trillion, and the state-owned banks have 86% of the assets, as the following table shows.

Banking sector Assets 2010 ID million

Bank	CBI instruments	MoF bills	Total liquidity Investment in	Banks reserves at the CBI	Reserves and liquidity assets	Credits to the private sector	Total
Total state – owned banks	1,348,090	7,306,380	8,654,470	6,320,533	14,975,003	8,050,453	24,192,038
Total private banks	583320	427,130	1,010,450	767,120	1,777,570	2,209,022	4,196,844
Grand Total	1931410	7,733,510	9,664,920	7,087,653	16,752,573	10,259,475	28,388,882

Private deposits at commercial banks have increased surprisingly in congruence with government expenditure, since the latter is the major constituent of national and household income. The following table shows the accelerated growth of the private deposits.

Development of Private Deposits

Year	ID billion
2005	3690
2006	4751
2007	9403
2008	11606
July 2010	13981

It might be relevant to remind that all private deposits are from domestic source, the banks have no foreign liabilities but equity holding.

The banking system is over flooded by government deposits. The ratio of government deposits to GDP in Iraq ranged within 20%-25%, while the ratio is 4%, the maximum average, in the Middle East, North Africa, and Central Asia region. The total deposits with the state - owned banks mounted to ID 39.7 trillion including ID 30.2 trillion government deposits. Traditionally government deposits are not considered as Lendable funds and accordingly excluded from the definition of money. The government deposits with the private banks are very small in size and mainly come from the operating balances of independent public enterprises. The total deposits with the private bank mounted to ID 4.6 trillion including only ID 127 billion governments' deposits. The total liabilities of the state – owned banks about ID 41.1 trillion but only about ID 10.9 trillion considered loan able , including capital and other net worth components while the liabilities of the private bank totaled to ID 6.6 trillion and of which ID 6.5 considered lendable.

Banking sector Assets and liabilities ID billion

Banks category	Total lendable liabilities (TLL)	Total Assets (TA)	Liquid Assets (LA)	Total credits TC	$\frac{LA}{TA}$ %	$\frac{TA}{TLL}$ %	$\frac{TC}{TA}$ %	$\frac{TC}{TLL}$ %
Rafidain	5703	14215	4572	4445	32.2	249	31.3	77.9
Rashid	2490	5628	2333	1879	41.5	226	33.4	75.5
TBI	2152	2622	1312	586	50.0	122	22.3	27.2
Total state- owned banks	10868	24192	8654	8050	35.8	223	33.3	74.1
Private banks	6516	4199	1010	2209	23.1	64.4	52.6	33.9
Grand Total	17383	28389	9665	10259	34.0	163.3	36.1	59.0
Private banks Contribution	37.5	14.7	10.5	21.5%				

Regarding that the total assets include required reserves, that should be held at the CBI and currency preserved in their volts. The sector provides credits to the private business commensurate with the available resources in the state – owned banks. But, it seems that the private banks still below the acceptable level in performing their function of intermediation. The credits extended to private sector from private banks represent about 52.6% of total assets and only 33.0% of total lendable liabilities. Lending from state – owned banks was directed toward certain sectors of socio – political priority such as housing, consumer credits, and agriculture. Lending to private manufacturing sector by state – owned industrial bank is restrained by its very small capital which is the main component of its lendable liability. Private Banks have engaged in safe working capital finance and similar short term commercial. They also invested part of their capital in stock and real state assets. Rafidain and rasheed banks delivered 78.6% of the credits extended by state- owned banks and 21.4% from specialized banks. The private bank's credits to the private sector are 21.5% of the total credits.

The private banks responded to the CBI decision to raise minimum capital up to ID 250 billion. The available data shows that 26 private banks their total capital about ID 1433 billion have made significant increments to their capital which increased by about ID 1177 billion to reach ID 2610 billion by June 2010.

The market is opened to foreign bankers for active merger and acquisition and to create brand new banking companies. The participation of foreign partners in the overall performance is less than expected, hoping that improvement in security could encourage foreign banks to play different role.

If the CBI order be implemented, the minimum capital of the private banks will reach ID 9 trillion, and according to the criteria of capital adequacy stipulated in the banking law this will allow the total credits extended to the private sector by private banks to mount ID 72 trillion. But this norm is hard to be achieved.

That is because the private banks are constrained by total liabilities of which fixed and current deposits the main components. Deposits will depend on saving of household and business sectors and most likely can not exceed 20% of the disposable income. If the lendable liabilities could increase annually by 7% we need 20 years to reach ID 68 trillion which is short of the said implicit target previously mentioned. This is why that the reasonable financial development strategy should start from the very economic reality and the macroeconomic analysis is the essential element of a practical reform insight. The private banks have no other choice but to rely more on banking services. In this regards off balance sheet activities need to be boosted by a well designed government intervention. Trade finance , guaranties to contracting industry , management of funds to the private business and households , and facilitate better national and international transactions to foreign and national companies, are the main lines of expansion the banking community has to pursue in their future strategies .

With the pace quickened to open the domestic financial sector to foreign competition, Iraq has started since 2003 allowing foreign investors to establish banking companies. Also, they have been invited to buy stakes in domestic financial institutions and become participants in the domestic stock market.

In this regards 7 banks has been changed into joint venture companies with regional and international banks and the share of foreign capital as follows:

The Bank	The share of foreign capital %
1- Commercial bank	49
2- Dar Assalam	70
3- Iraqi credit (Al eaatim)	85
4- National Iraqi (Alahli)	59
5- Baghdad	49
6- Al Mansour Investment bank	23.20
7- Regional cooperation for Development and investment	74

Banks have been branching extensively the total number of branches has become 868 by September 2010. Out of these banking units, 6 are opened by foreign banks, and 62 branches Islamic, 362 branches for the typical private banking. The state – owned branches are 438 which 352 managed by Rafidain and Rashid banks, 9 for Trade bank of Iraq TBI, and 77 branches for specialized stat – owned banks.

The banks are eager to make their services accessible; this is why they opened 100 branches just in the 8 months of 2010. But they need more technical advancement to ensure real time and communications between branches and head offices.