# IRAQ ECONOMIC MONITOR

## Reemerging Pressures: Iraq's Recovery at Risk

Spring/Summer 2023

THE WORLD BANK
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Middle East & North Africa

# Iraq Economic Monitor

## Reemerging Pressures:
## Iraq's Recovery at Risk

### With a Special Focus on
### Financial Intermediation in Iraq

Spring/Summer 2023

Middle East and North Africa Region

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# ACRONYMS

| | |
|---|---|
| ACH | Automated Clearing House |
| AML/CFT | Anti-Money Laundering and Countering Financing of Terrorism |
| ATMs | Automated Teller Machines |
| bbl | Barrel for Crude Oil |
| Bpd | Barrel Per Day |
| BIS | Bank for International Settlements |
| CAB | Current Account Balance |
| CBI | Central Bank of Iraq |
| COSIT | Central Organization for Statistics and Information Technology |
| COVID-19 | Coronavirus Disease 2019 |
| DFS | Digital Financial Services |
| FAO | Food and Agriculture Organization |
| FDI | Foreign Direct Investment |
| FINDEX | Financial Inclusion Database |
| FSB | Financial Stability Board |
| FSI | Financial Sector Indicators |
| FX | Foreign Exchange |
| GDP | Gross Domestic Product |
| GHG | Greenhouse Gas |
| GIESW | Global Information and Early Warning System |
| GoI | Government of Iraq |
| IEA | International Energy Agency |
| IEM | Iraq Economic Monitor |
| IFS | International Financial Statistics |
| ILO | International Labour Organization |
| IMF | International Monetary Fund |
| IQD | Iraqi Dinar |
| IT | Information Technology |
| KRG | Kurdistan Regional Government |
| KRI | Kurdistan Region of Iraq |
| KYC | Know Your Customer |
| LHS | Left Hand Side |
| M2 | Broad Money |
| mbpd | Million barrel per day |
| MENA | Middle East and North Africa |
| MFI | Micro Finance |
| MoF | Ministry of Finance |
| MoO | Ministry of Oil |
| NBFIs | Non-Banking Financial Institutions |
| NIM | Net Interest Margin |
| NGO | Non-Profit Organization |
| MSMEs | Micro, and Small Medium Enterprises |
| NFIS | National Financial Inclusion Strategy |
| NPLs | Non-Performing Loans |
| NRS | National Risk Assessment |
| OPEC | Organization of the Petroleum Exporting Countries |
| PIM | Public Investment Management System |
| PIP | Public Investment Policy |
| POS | Point of Sale |
| pp | Percentage Points |
| PPP | Public Private Partnership |
| PSPs | Payment System Providers |
| RHS | Right Hand Side |
| RTGS | Real Time Gross Settlement |

| | | | |
|---|---|---|---|
| SDGs | Sustainable Development Goals | WDI | World Development Indicators |
| SOBs | State-Owned Banks | UMICs | Upper Middle-Income Countries |
| SOMO | Iraq State Oil Marketing Organization | USD | United States Dollar |
| WB(G) | World Bank (Group) | y/y | year-on-year |

# ACKNOWLEDGMENTS

The Iraq Economic Monitor provides an update on key economic developments and policies over the previous six months and presents findings from recent World Bank work on Iraq, placing them in a longer-term and global context and assessing the implications of these developments and other changes in policy regarding the outlook for Iraq. Its coverage ranges from the macro-economy to business environment and private sector 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.

The Iraq Economic Monitor is a product of the Middle East and North Africa (MENA) unit in the Macroeconomics, Trade & Investment (MTI) Global Practice of the World Bank Group. The report was written by Majid Kazemi (Economist), Ashwaq Maseeh (Economist), and Zeina Alsharkas (Economist).

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# EXECUTIVE SUMMARY

## Recent Economic and Policy Developments

**Iraq's economy continued its recovery after the sharp, pandemic-induced recession in 2020 but growth constraints in the oil sector have reemerged.** Real gross domestic product (GDP) growth accelerated to 7.0 percent in 2022 driven by the tapering of OPEC+ production cuts in the first nine months of 2022. Oil GDP, accounting for 61 percent of real GDP in 2022, grew by 12.1 percent despite the OPEC+ agreement in the last quarter of the year. In contrast, non-oil GDP growth was muted as non-oil industries stagnated and agriculture activities contracted due to the drought and associated water shortages. The recent growth spurt pushed per capita GDP growth to 5.4 percent in 2022, however, as the capital-intensive oil sector drove the rebound, the positive impact on the labor market was limited. Iraq's rapid population growth (2.4 percent per annum) highlights a need for higher growth to improve welfare outcomes and to close the growing income gap with peers. Oil GDP, the main driver of recent growth has been constrained by new crude oil production limits announced in late 2022 and extended in April 2023. As a result, GDP growth fell to 2.6 percent (year-on-year) in the first quarter of 2023.

**After moderating in 2022, consumer price inflation ticked up in early 2023, fueled by the depreciation of the Iraqi dinar in the parallel market.** The June 2022 emergency law for urgent needs for food security and energy imports helped curb headline and core inflation to 5.0 and 4.3 percent in 2022, respectively. Tighter enforcement of financial reporting standards for Central Bank of Iraq (CBI) dollar auctions since November 2022 caused supply-demand mismatch of dollars and led to the depreciation of the dinar in the parallel market, pushing inflation to 7.2 percent year-on-year in January 2023. In response to the currency depreciation, the CBI revalued the dinar in February 2023 to IQD1,300/USD, up by 10.3 percent. Inflation and the parallel market rate depreciation have since moderated but the gap over the official rate remains significant, highlighting persisting exchange rate pressures.

**Fiscal and external account balances benefitted from the oil windfall in 2022 but this trend significantly moderated in early 2023.** Total government revenues surged by 48.2 percent in 2022, spurred by higher oil prices and export volumes. Total expenditures grew less than revenues (by 20.5 percent). Growth in the former was the result of the passing of the Emergency Food Security Law

(June 2022), before which expenditures had been constrained to their 2021 (nominal) levels due to a lack of an approved budget for the year. As a result, the fiscal balance recorded a significant surplus of 11.7 percent of GDP and debt-to GDP moderated to 53.8 percent. Despite rising imports, the current account registered a sizeable surplus of 20.7 percent of GDP (US$55 billion) in 2022, as exports (dominated by oil) increased by 74 percent. The favorable oil market dynamics brought total reserves excluding gold up to US$89.0 billion (covering 14.7 months of imports). However, this trend in reserve accumulation slowed in early 2023 as external account pressures resurfaced with the lower oil prices, leading reserves to start declining in May 2023.

**The new budget is excessively expansionary, and lacks the structural reforms that Iraq needs to develop a vibrant and sustainable economy.** Two decades after the 2003 war, Iraq's highly oil dependent development model is set to endure. The drive for fiscal reforms to address budget rigidities and to mobilize non-oil revenues has yet to materialize. The current government, formed in October 2022 after a year-long political stalemate, proposed a budget covering a three-year 2023-2025 horizon which was only ratified in June 2023 and signals a significant expansionary fiscal stance. Expenditures, heavily skewed toward recurrent spending, are set to increase by 59 percent notably due to a sharp increase in the wage bill, which will likely crowd out much-needed investments. The budget does not sufficiently address longstanding structural challenges, including on economic diversification, improving public financial management, addressing fiscal rigidities, and boosting domestic revenue mobilization. With revenues dominated by oil, the budget assumes an oil price of US$70/bbl and 3.5 mbpd of exports whereas the breakeven oil price to cover all expenditures actually stands at US$112/bbl (almost double 2022). This will result in a fiscal deficit of US$39.7 billion representing 14.3 percent of GDP and equivalent to almost half of the record reserves accumulated following the 2021-2022 oil boom. If fully executed, the highly procyclical budget could lead to a rapid depletion of the recent oil windfall and renewed fiscal pressures, especially given the recent and pronounced dip in global oil prices to US$71/bbl in May 2023 and extension of production quotas.

**Iraq's economic outlook in the medium term continues to hinge on oil sector developments.** Overall GDP is forecast to contract by 1.1 percent in 2023 driven by a projected 4.4 percent contraction of oil GDP (assuming oil production is bound by the April 2023 OPEC+ production quotas). By contrast, non-oil GDP growth is projected to accelerate in 2023, partly assisted by the budget expansion. Limited linkage between oil and non-oil sectors coupled with public sector dominance in formal employment is projected to continue to result in a stunted and largely informal private sector. Low appetite for reforms, even amid softening oil prices, and modest non-oil growth potential, in part due to a deteriorating business environment and continued widespread corruption, are expected to constrain long-term economic growth. Higher public expenditures and imports will weigh on both the fiscal and current account balances, with the former turning into a deficit. The revaluation of the dinar is expected to reduce dinar-denominated oil revenues while expenditures are set to increase significantly with the budget. A stronger dinar is expected to also lead to higher imports and undermine export competitiveness.

**The economic outlook remains subject to significant risks, largely due to deep structural challenges.** High dependence on oil leaves the economy vulnerable to shocks in oil markets and global demand as highlighted by the recent softening of oil prices. Pre-existing drivers of fragility, including a high prevalence of corruption, low labor force participation, especially females, high private sector informality, the lack of job opportunities, financial sector imbalances, poor service delivery, and security risks remain key challenges. Heightened climate change vulnerabilities and further commodity price volatility associated with the Russian invasion of Ukraine would intensify existing poverty trends and raise food insecurity. The recent spike in inflation has also highlighted the exchange rate market as a source of risk that had been previously contained with the currency peg. On the upside, the improvements in domestic political tensions regarding government formation can pave the way for further investment in the economy and boost potential GDP. Furthermore, the prospects of reduced regional geopolitical tensions could boost regional trade and FDI opportunities for Iraq.

**Urgent implementation of financial sector reforms and modernization of its banking sector architecture, currently major barriers to economic diversification, are a critical condition to bolster the private sector and unlock much-needed job creation.** Financial access in Iraq is amongst the lowest in the world, with only 19 percent of adults owning a bank account, highlighting a significant underutilized source of financing. Crucially, lack of financing remains the top constraints for small and medium enterprises and firms operating in the informal sector, undermining private sector-led growth and job creation. As this report's Special Focus highlights, this is in part due to the banking sector structure and operations, which is dominated by undercapitalized state-owned banks with weak institutional capacities that primarily provide financing to public sector entities and state-owned enterprises. The private commercial banking sector is weak and has limited capacity to support financial intermediation and is geared towards maximizing revenues from the foreign exchange auctions. Furthermore, the non-banking financial sector is nascent with small and underdeveloped capital markets, unregulated Micro Finance Institutions, and an underdeveloped insurance sector. To tackle these challenges, the sector's reform priorities include institutional reforms in state-owned banks, and incentivizing digital financial services so as to increase financial intermediation and promote financial inclusion in Iraq. The full implementation of these reforms can help restore public confidence in the financial sector and help mobilize Iraq's wealth towards solving the pressing development challenges of the country.

# ملخّص تنفيذي

## أحدث التطورات على صعيد الاقتصاد والسياسات العامة

**واصل الاقتصاد العراقي تعافيه بعد الركود الحاد الناجم عن جائحة فيروس كورونا في عام 2020، لكن القيود على النمو في قطاع النفط برزت مجددا.** وتسارع نمو إجمالي الناتج المحلي الحقيقي إلى 7.0% في عام 2022 مدفوعاً بتقليص تخفيضات الإنتاج التي قررتها أوبك والمنتجون من خارجها في الأشهر التسعة الأولى من عام 2022. ونما إجمالي الناتج المحلي النفطي، الذي شكل 61% من إجمالي الناتج المحلي الحقيقي في عام 2022، بنسبة 12.1% بالرغم من اتفاق أوبك والمنتجين من خارجها في الربع الأخير من نفس العام. وعلى النقيض من ذلك، فقد سجل إجمالي الناتج المحلي غير النفطي نمواً ضعيفاً حيث أصيبت الصناعات غير النفطية بالركود وانكمشت الأنشطة الزراعية بسبب الجفاف وما ارتبط به من نقصٍ في المياه. وقادت الطفرة الأخيرة في النمو إلى ارتفاع معدل نمو نصيب الفرد من إجمالي الناتج المحلي في عام 2022 ليصل إلى 5.4%، ومع ذلك، ونظراً لأن قطاع النفط الذي يتسم بكثافة رأس المال هو الذي دفع هذا الانتعاش، فقد كان التأثير الإيجابي على سوق العمل محدوداً. ويبرز النمو السكاني السريع في العراق (2.4% سنوياً) الحاجةَ إلى زيادة النمو لتحسين نواتج الرفاهة وسد فجوة الدخل المتنامية مع البلدان النظيرة. وقد واجه إجمالي الناتج المحلي النفطي، وهو المحرك الرئيسي للنمو الأخير، قيوداً بسبب السقوف الجديدة لإنتاج النفط الخام التي أعلن عنها في أواخر عام 2022 وتم تمديدها في أبريل/نيسان 2023. ونتيجة لذلك، فقد تراجع نمو إجمالي الناتج المحلي إلى 2.6% (على أساس سنوي) في الربع الأول من عام 2023.

**بعد التراجع الذي شهده عام 2022، ارتفع تضخم أسعار المستهلكين في أوائل عام 2023، مدفوعاً بانخفاض قيمة الدينار العراقي في السوق الموازية.** وساعد قانون الطوارئ الصادر في يونيو/حزيران 2022 بشأن الاحتياجات العاجلة للأمن الغذائي وواردات الطاقة على الحد من التضخم الكلي والتضخم الأساسي ليصلا إلى 5.0% و4.3% في عام 2022، على الترتيب. وتسبب التشدد في تطبيق معايير التقارير المالية لمزادات الدولار للبنك المركزي العراقي منذ نوفمبر/تشرين الثاني 2022 في عدم تطابق جانبي العرض والطلب على الدولار وانخفاض قيمة الدينار في السوق الموازية، مما دفع التضخم ليصل إلى 7.2% على أساس سنوي في يناير/كانون الثاني 2023. واستجابة لخفض قيمة العملة، أعاد البنك المركزي العراقي تقييم الدينار في فبراير/شباط 2023 إلى 1300 دينار عراقي/دولار، بزيادة قدرها 10.3%. وقد تراجع معدل التضخم وانخفض سعر الصرف في السوق الموازية منذ ذلك الحين، لكن الفجوة عن السعر الرسمي لا تزال كبيرة، مما يعكس استمرار ضغوط سعر الصرف.

**استفادت أرصدة حسابات المالية العامة والمعاملات الخارجية من الإيرادات النفطية غير المتوقعة في عام 2022، لكن هذا الاتجاه خف بشدة في أوائل عام 2023.** وارتفع إجمالي الإيرادات الحكومية بنسبة 48.2% في عام 2022، مدفوعاً بارتفاع أسعار النفط وحجم الصادرات. كما قلت الزيادة في إجمالي النفقات عن الإيرادات (بنسبة 20.5%). ويرجع النمو في الأولى إلى إقرار قانون الأمن الغذائي الطارئ (يونيو/حزيران 2022)، والذي كانت النفقات قبله مقيدة عند مستوياتها (الاسمية) لعام 2021 بسبب عدم وجود موازنة معتمدة لذلك العام. ونتيجة لذلك، سجل رصيد المالية العامة فائضاً كبيراً بنسبة 11.7% من إجمالي الناتج المحلي، كما تراجعت نسبة الدين إلى إجمالي الناتج المحلي لتصل إلى 53.8%. وبالرغم من ارتفاع الواردات، فقد سجل حساب المعاملات الجارية فائضاً كبيراً بنسبة 20.7% من إجمالي الناتج المحلي (55 مليار دولار) في عام 2022، حيث زادت الصادرات (التي تخضع لهيمنة النفط) بنسبة 74%. وأدت ديناميكيات سوق النفط المواتية إلى ارتفاع إجمالي الاحتياطيات باستثناء الذهب إلى 89 مليار دولار (تغطي 14.7 شهراً من الواردات). غير أن هذا الاتجاه في تراكم الاحتياطيات تباطأ في أوائل عام 2023 مع عودة الضغوط على حساب المعاملات الخارجية إلى الظهور مع انخفاض أسعار النفط، مما أدى إلى بدء تراجع الاحتياطيات في مايو/أيار 2023.

**تتسم الموازنة الجديدة بكونها توسعية بشكل مفرط ، وتفتقر إلى الإصلاحات الهيكلية التي يحتاجها العراق لتطوير اقتصاد حيوي ومستدام.** وبعد عقدين من حرب عام 2003، من المتوقع أن يستمر نموذج التنمية الذي يعتمد بشكل كبير على النفط في العراق. و لم يتحقق السعي الى اجراء اصلاحات مالية لمعالجة اوجه الجمود في الموازنة وتعبئة الإيرادات غير النفطية لغاية الان. واقترحت الحكومة الحالية، التي

تشكلت في أكتوبر/تشرين الأول 2022 بعد مخاض سياسي طويل دام عاماً كاملاً، موازنة تغطي أفقاً زمنياً يمتد لثلاث سنوات من 2023 إلى 2025، تم التصديق عليها بحلول يونيو/حزيران 2023 والتي تؤشر سياسة مالية عامة توسعية بشكل كبير. ومن المتوقع أن تزداد النفقات، التي تميل بشدة نحو الإنفاق المتكرر، بنسبة 59%، لا سيما بسبب الزيادة الحادة في فاتورة الأجور، والتي من المرجح أن تؤدي إلى مزاحمة الاستثمارات الملحة. ولاتعالج الموازنة بشكل كافي التحديات الهيكلية القائمة منذ وقت طويل، ومنها التحديات المتعلقة بتنويع النشاط الاقتصادي، وتحسين إدارة المالية العامة، ومعالجة أوجه الجمود في المالية العامة، وتعزيز تعبئة الإيرادات المحلية. ومع هيمنة النفط على الإيرادات، تفترض الموازنة سعراً للنفط قدره 70 دولاراً للبرميل و3.5 ملايين برميل يومياً من الصادرات، في حين أن سعر التعادل للنفط لتغطية جميع النفقات يقف فعليًا عند 112 دولارًا للبرميل (أي ضعف عام 2022 تقريبًا). ان ذلك من شأنه ان يؤدي إلى عجز في الموازنة قدره 39.7 مليار دولار وهو ما يمثل 14.3% من إجمالي الناتج المحلي وما يعادل تقريباً نصفَ الاحتياطيات القياسية المتراكمة في أعقاب الطفرة النفطية في السنتين (2022–2021). إذا تم تنفيذها بشكل كامل، يمكن أن تؤدي الموازنة المسايرة للتقلبات الدورية إلى استنزاف سريع لمكاسب النفط المفاجئة الأخيرة وتجدد الضغوط المالية، لا سيما بالنظر إلى الانخفاض الأخير والواضح في أسعار النفط العالمية إلى 71 دولاراً للبرميل في مايو 2023 وتمديد العمل بحصص الإنتاج الحالية.

**لا تزال الآفاق الاقتصادية للعراق على المدى المتوسط مرهونةً بتطورات قطاع النفط.** ومن المتوقع أن ينكمش إجمالي الناتج المحلي الكلي بنسبة 1.1% في عام 2023 مدفوعاً بانكماشٍ متوقعٍ بنسبة 4.4% في إجمالي الناتج المحلي النفطي (بافتراض تقيد البلاد بحصص إنتاج النفط وفقاً لاتفاق منظمة أوبك والمنتجين من خارجها في أبريل/نيسان 2023). وعلى النقيض من ذلك، من المتوقع أن يتسارع نمو إجمالي الناتج المحلي غير النفطي في عام 2023، مدعوماً بالتوسع في الموازنة بشكل جزئي. ومن المتوقع أن تستمر الروابط المحدودة بين القطاعات النفطية وغير النفطية، مقترنة بهيمنة القطاع العام على التوظيف في القطاع الرسمي، في خلق قطاع خاص متعثر وغير رسمي إلى حد كبير. ومن المتوقع أن يؤدي انخفاض الرغبة في الإصلاحات، حتى في ظل تراجع أسعار النفط، وضعف إمكانات نمو القطاع غير النفطي، وهو ما يرجع جزئياً إلى تدهور بيئة الأعمال واستمرار تفشي الفساد، إلى تقييد النمو الاقتصادي على المدى الطويل. وسيؤثر ارتفاع النفقات العامة والواردات على أرصدة حسابات المالية العامة والمعاملات الجارية، مع تحول الأولى إلى عجز. ومن المتوقع أن تؤدي إعادة تقييم الدينار إلى تقليص عائدات النفط المقومة بالدينار، بينما من المتوقع أن تزيد النفقات بشكل كبير في ضوء الموازنة. ومن المتوقع أن يؤدي ارتفاع قيمة الدينار أيضاً إلى زيادة الواردات وتقويض القدرة التنافسية للصادرات.

**لا تزال آفاق المستقبل الاقتصادي للعراق عرضة لمخاطر كبيرة، ويرجع ذلك في الأساس إلى التحديات الهيكلية العميقة.** ويؤدي الاعتماد الكبير على النفط إلى جعل الاقتصاد عرضةً للصدمات في أسواق النفط والطلب العالمي كما يتضح من تراجع أسعار النفط في الآونة الأخيرة. ولا تزال العوامل المحركة للهشاشة القائمة من قبل، ومنها ارتفاع معدل انتشار الفساد، وانخفاض المشاركة في القوى العاملة، لا سيما الإناث، وارتفاع نسبة القطاع الخاص غير الرسمي، ونقص فرص العمل، واختلالات القطاع المالي، وسوء تقديم الخدمات، والمخاطر الأمنية، تشكل تحدياتٍ رئيسية للبلاد. ومن شأن ارتفاع قابلية التأثر بمخاطر تغيُّر المناخ وزيادة تقلب أسعار السلع الأولية المرتبطة بغزو روسيا لأوكرانيا أن تكثف من اتجاهات الفقر الحالية وأن تعمق من مستوى انعدام الأمن الغذائي. وقد أبرز الارتفاع الأخير في التضخم أيضاً سوقَ سعر الصرف كمصدر للخطر الذي كان يتم احتواؤه في السابق بربط سعر العملة الوطنية. أما على الجانب الإيجابي، فيمكن أن يؤدي انخفاض مستوى التوترات السياسية الداخلية فيما يتعلق بتشكيل الحكومة إلى تمهيد الطريق لمزيد من الاستثمار في الاقتصاد وتعزيز إجمالي الناتج المحلي المحتمل. علاوة على ذلك، فإن احتمالات انحسار التوترات الجيوسياسية الإقليمية يمكن أن تعزز التجارة الإقليمية وفرص الاستثمار الأجنبي المباشر بالنسبة للعراق.

**يعد التنفيذ العاجل لإصلاحات القطاع المالي وتحديث بنية القطاع المصرفي، والتي تشكل حاليًا حواجز رئيسية أمام التنويع الاقتصادي، شرطًا مهمًا لتعزيز القطاع الخاص وإطلاق العنان لخلق فرص العمل الملحة.** يعتبر الوصول المالي في العراق من بين أدنى المعدلات في العالم ، حيث يمتلك 19 بالمائة فقط من البالغين حسابًا مصرفيًا ، مما يسلط الضوء على مصدر تمويل كبير غير مستغل بالكامل. وبشكل حاسم ، لا يزال نقص التمويل يمثل أكبر القيود التي تواجه الشركات الصغيرة والمتوسطة والشركات العاملة في القطاع غير الرسمي ، مما يضعف النمو الذي يقوده القطاع الخاص وخلق فرص العمل. كما يبرز القسم الخاص في هذا التقرير ، يرجع ذلك جزئيًا إلى هيكل وعمليات القطاع المصرفي القديمة ، التي تهيمن عليها البنوك المملوكة للدولة ذات رأس المال المنخفض والتي تتمتع بقدرات مؤسسية ضعيفة حيث توفر التمويل في المقام الأول لكيانات القطاع العام والشركات المملوكة للدولة. القطاع المصرفي التجاري الخاص ضعيف ولديه قدرة محدودة على دعم الوساطة المالية وموجه نحو تعظيم الإيرادات من مزادات الصرف الأجنبي. علاوة على ذلك ، فإن القطاع المالي غير المصرفي ناشئ بأسواق رأس المال الصغيرة والغير متطورة ، ومؤسسات التمويل الصغرى غير المنظمة ، وقطاع التأمين الغير متطور. لمواجهة هذه التحديات ، تشمل أولويات إصلاح القطاع الإصلاحات المؤسسية في البنوك المملوكة للدولة ، وتحفيز الخدمات المالية الرقمية لزيادة الوساطة المالية وتعزيز الشمول المالي في العراق. يمكن أن يساعد التنفيذ الكامل لهذه الإصلاحات في استعادة ثقة الجمهور في القطاع المالي والمساعدة في تعبئة ثروة العراق من أجل حل تحديات التنمية الملحة في البلاد.

1

# RECENT ECONOMIC AND POLICY DEVELOPMENTS

## Output and Demand

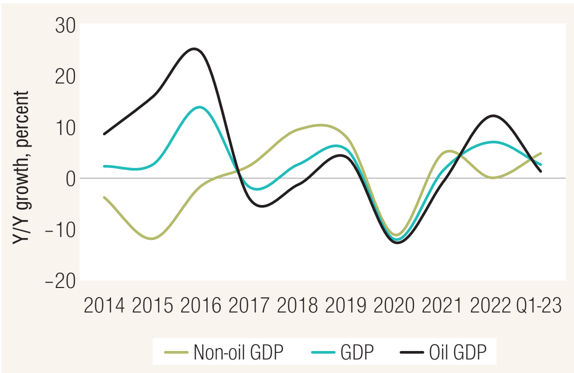
**Iraq's economy grew rapidly in 2022, driven by a strong expansion of the oil sector, but started to weaken markedly in 2023.** Real gross domestic product (GDP) growth accelerated to 7 percent in 2022, in line with oil market developments (Figure 1). Growth was driven by the tapering of OPEC+ production cuts in the first nine months of 2022 (9M-22). Oil GDP, accounting for 61 percent of real GDP in 2022, grew by 12.1 percent despite the OPEC+ agreement in the last quarter of the year, curtailing output. In contrast, non-oil GDP growth was muted owing primarily to the contraction in agriculture activities impacted by water shortage and as non-oil industries stagnated. However, GDP growth decelerated to 2.6 percent in the first quarter 2023 (Q1-23) year-on-year (y/y) as OPEC+ production cuts (see oil and gas section below) and the oil export dispute with Türkiye led oil GDP growth to fall to 1.3 percent y/y. The economic rebound in 2022 helped increase Iraq's per capita GDP growth to 5.4 percent (Figure 2). However, Iraq's rapid population growth (2.4 percent per annum) highlights the need for higher growth to improve welfare outcomes and closing the previous years' growing gap with peers.

**On the supply side, growth was led by the oil sector and contact-intensive services in 2022, and by non-oil sector in Q1-23.** The oil sector growth was driven by improved oil market conditions (see oil and gas developments section). Services edges up, driven by personal services, trade and hotels, and transport services, in line with stronger domestic demand and the rebound in religious tourism (Figure 3).[1] However, agriculture production contracted, as unfavorable rainfall volume and distribution constrained domestic production from rainfed areas in 2022 (Figure 4).[2] This

[1] It is estimated that 21 million pilgrims have visited Iraq in 2022, https://www.aljazeera.com/gallery/2022/9/17/millions-of-shia-pilgrims-mark-arbaeen.

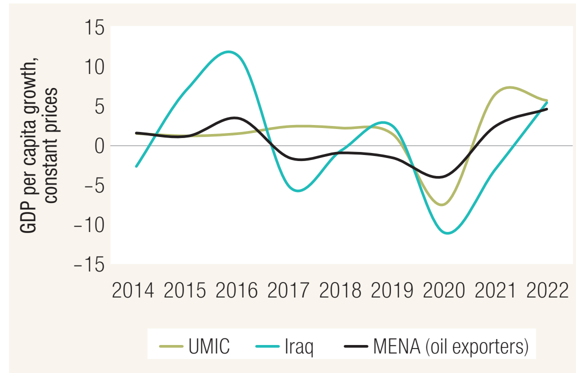
[2] This is in addition to the policy decision to halve the area planted with irrigated crops to reduce water demand. Cereal harvest is estimated to have declined by 40 percent (y/y), with the production of wheat and barley, Iraq's main staples, falling by 46 and 35 percent in 2022 (y/y), respectively (FAO, Global Information and Early Warning System (GIESW), February 2023).

FIGURE 1 • The Economy Strongly Rebounded in 2022…



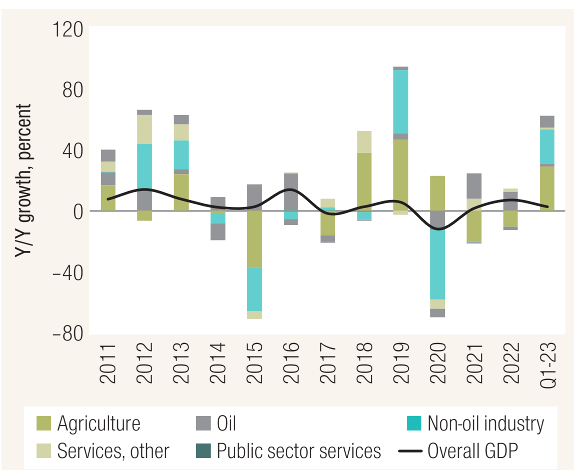

*Source*: Iraqi Central Organization for Statistics and Information Technology (COSIT) and World Bank staff calculations.

FIGURE 2 • …Bringing Per Capita GDP Growth in Line with other Peers



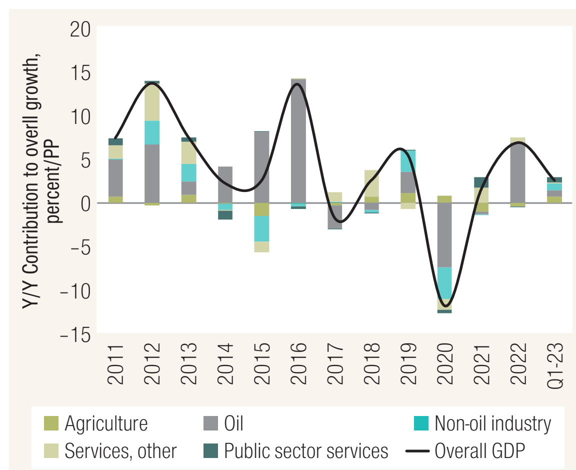

*Source*: COSIT, World Development Indicators (WDI), and World Bank staff calculations.

FIGURE 3 • The Economic Rebound Was Driven by the Oil Sector…




*Source*: COSIT, WDI, and World Bank staff calculations.

FIGURE 4 • …while Agriculture Contracted, and Non-Oil Industries Stagnated




*Source*: COSIT, WDI, and World Bank staff calculations.

contraction highlights Iraq's food security risks and come despite the provisions in the Emergency Law for Food Security and Development which allocated funds to meet urgent demand for staples.[3] Underperformance of the labor intensive agriculture sector adds to the challenge of high unemployment and reinforces high level of rural-urban migration and informality (see Box 1 on urban informality in Iraq). In Q1-23, growth was primarily driven by non-oil industries and agriculture (Figure 4). Output in the latter increased with better rainfall, resulting in favorable yields and increased production for winter crops, including wheat and barley.

**On the demand side, growth was driven by consumption, aided by higher public spending.** Although public consumption was initially weakened following the delays in budget approval, the Emergency Law enacted in June 2022,[4] drove up government spend-

3 In June 2022, the parliament passed an Emergency Law for Food Security and Development that allowed the government to transfer public funds to meet urgent needs for food security, energy imports, social security transfers, job creation, and essential development projects, among others.

4 The law authorized additional spending on social assistance, conversion of daily workers to contractual employees, and food and energy subsidies, among others.

## BOX 1 IRAQ: DRIVERS OF THE INFORMAL SECTOR (FINDINGS FROM AN ENTERPRISE SURVEY)[a]

A recent World Bank survey finds that the dominance of the public sector in the economy, legacies of conflict and political tensions, corruption, and weak business environment are major drivers that push Iraqis into informal businesses. An integrated approach is needed to address the underlying drivers of informality and promote the transition to the formal economy, with particular attention to women, youth, and forcibly displaced populations. This may include: a) Strengthening governance (strengthen legal environment and investment climate, and fight corruption), b) Reducing barriers to formalization (streamline registration and raise awareness among firms and workers about their rights and obligations under the relevant legislation), and c) Creating incentives for formalization (e.g., through improved access and quality of services for workers and businesses or integrating social security access with formal employment).[b]

Between August 2021 and February 2022, the World Bank conducted a novel survey to understand urban informal businesses and the people who work in them. Recognizing that the lack of a sample frame for informal businesses is a key issue, the survey used an innovative adaptive clustering approach. Other surveys in Iraq that captured the informal sector in detail used the household as the primary unit of data collection, instead of the business itself.

The survey enumerated a total of 3,008 blocks across the four cities, consisting of 5,193 informal businesses (Table B1.1). The final sample consisted of 1,996 interviews.

### Key findings

- The large public sector presence including in the labor market has limited the opportunities for the private sector, which remains largely informal and stunted. Informal businesses in Iraq are relatively small, with 2.2 workers per business on average, including the owner, and most often a family member. In contrast to most countries where informal businesses are often female headed, 93% of businesses are owned by men in Iraq. The business owner is 39 years old on average and has 6.6 years of experience. Businesses headed by females had no co-owners. More than 80% of owners were the only breadwinners of the family, highlighting the importance of the business to the welfare of the family, which on average, consisted of 6 members (in line with the national average).
- An unconducive business environment and years of conflict and political unrest have driven informality. Owners often cited work-hour flexibility as well as the inability to find another source of income as reasons for starting the business. A third of owners were still actively looking for a wage job at the same time. About 80% of the main owners started their business during the pandemic due to the absence of another source of income.
- Lack of access to credit and resources remain a persistent challenge. Informal businesses were on average young, about 6 years old. In terms of sectoral distribution, about 53% operated in wholesale and retail trade, 12% in manufacturing (mostly bakeries and similar) and the remaining in services. More than 80% had used the owners' own savings to start the business, and 13% borrowed from family or friends, especially among women-owned businesses. These businesses rarely use a bank account to conduct daily activities. The average value of sales in the month prior to the survey was not high—around IQD1.5 million (equivalent to about US$1,028). Around 63% of businesses reported having a profit, while 19% broke even and 18% reported having a loss.
- Widespread corruption increased the hurdles of registering a business. The most cited reason for not registering with the Ministry of Trade relates to government-related obligations. More than two-thirds of the owners mentioned wanting to avoid taxes, and almost two-thirds also reported wanting to avoid informal payments (corruption) associated with formalization. Another common reason is to circumvent inspections by government officials, especially for businesses operating from home (likely also related to bribe demands).

TABLE B1.1 • Informal Businesses Interviewed

| City[c] | Universe of Block | Starting Blocks Enumerated | Threshold Number of Informal Businesses | Total Number of Blocks Enumerated | Informal Business Units Enumerated | Interviews Completed |
|---|---|---|---|---|---|---|
| **Baghdad** | 28,296 | 1,272 | 13 | 1,352 | 2,282 | 680 |
| **Basra** | 11,645 | 520 | 16 | 554 | 1,609 | 599 |
| **Sulaymaniyah** | 6,013 | 470 | 4 | 760 | 871 | 294 |
| **Najaf** | 3,950 | 317 | 1 | 342 | 431 | 423 |
| **Total** | **49,904** | **2,579** | **–** | **3,008** | **5,193** | **1,996** |

[a] Source. Abdel Ahad, J. and Dalal Moosa and Vanessa Moreira May 31, 2023). Understanding Urban Informal Business and the People who Work in Them: Findings from the Iraq Informal Sector Informal Survey. World Bank: D.C. Available at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099071223153030174/p1716390bd039e07d0996e09fadf7d2b515.

[b] A diagnostic of the informal economy in Iraq, ILO, November 2021, https://www.ilo.org/wcmsp5/groups/public/—arabstates/—ro-beirut/documents/publication/wcms_830086.pdf.

[c] The city of Baghdad covers 204.2 $Km^2$ and has a population of 7.5 million. The city of Basra covers 181 $Km^2$ and has a population of 1.4 million. The city of Sulaymaniyah covers 20.1 $Km^2$ and has a population of 780 thousand. The city of Najaf has a population of 930 thousand.

ing. As a result, primary government spending (i.e., recurrent expenditures excluding interest payments) rose by 23.5 percent in 2022 in nominal terms, including a 31 percent increase in social welfare expenditures. Higher government spending coupled with easing inflation, in 2022, improved household purchasing power and drove up private consumption. Higher purchasing power of the dinar following the devaluation and the spillovers from the significant fiscal expansion are expected to drive consumption to grow further in 2023.

**The contribution of investment to overall growth remained limited.** Public investment was constrained by the lack of an approved budget, which hindered the use of oil windfalls for new investments. As a result, government investment expenditures contracted by 9.8 percent in 2022 (nominal terms). Meanwhile, Iraq's investment climate remains poor, including due to a lack of business-friendly legislation, a volatile security environment, administrative inefficiencies, and systemic corruption. Moreover, infrastructure gaps, lack of access to finances, and the excessively large role of State-Owned Enterprises (SOEs) in Iraq's economy undermine the competitive landscape. This suboptimal investment condition constrains growth and undermines the country's reconstruction drive, which add to social grievances. The Government of Iraq's (GoI) program announced in October 2022 aims to improve the investment environment and support investors. As with similar earlier programs, implementation is likely to be challenging. Iraq's draft budget for 2023 aims to ramp up investment expenditures to almost US$37 billion annually, more than triple 2022 actual spending.

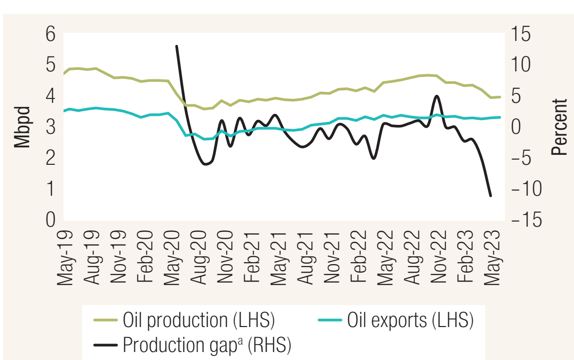
## Oil and Gas Sector Developments

**Oil production climbed strongly before being curtailed by new OPEC+ production limits starting in the last quarter of 2022.** The strong rebound in global oil demand and the resulting tapering of OPEC+ production quotas boosted Iraq's oil output to an average of 4.45 million barrel per day (mbpd) in 2022 (Figure 5). Since November 2022, new OPEC+ production cuts announced in response to declining prices led crude production to fall in the fourth quarter of 2022 (Q4-22) to an average of 4.5 mbpd and to 4.15 mbpd in the first five months 2023 (5M-23).[5] In the latter period, production volumes were on average 278,000 bpd below the quota due to a combination of maintenance in the giant southern oil terminal and disruptions to exports in the north (see below).

**Oil export revenues also surged in 2022 buoyed by higher oil export volumes and prices but started softening in early 2023 as both softened.** Higher oil production boosted crude oil export volumes

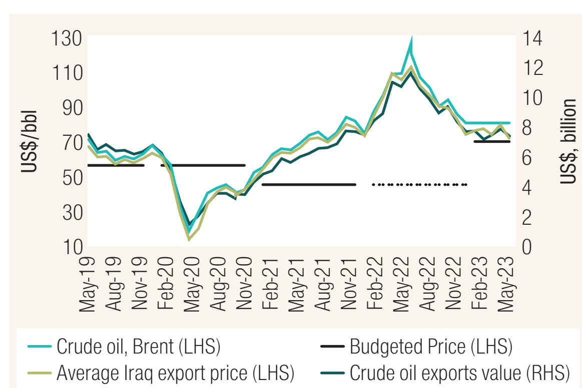
[5] As part of OPEC+ members announced production cuts in April 2023, Iraq production would fall by 211,000 bpd starting May 2023 and maintained constant through to the end of the year.

FIGURE 5 • Oil Production and Export Volumes Increased with Higher Demand…




*Source*: Iraq's Ministry of Oil (MoO) and World Bank staff calculations.
*Notes*: [a] Crude oil production gap relative to OPEC+ quota.

FIGURE 6 • …while Oil Export Prices Declined after Reaching a Multi-year High



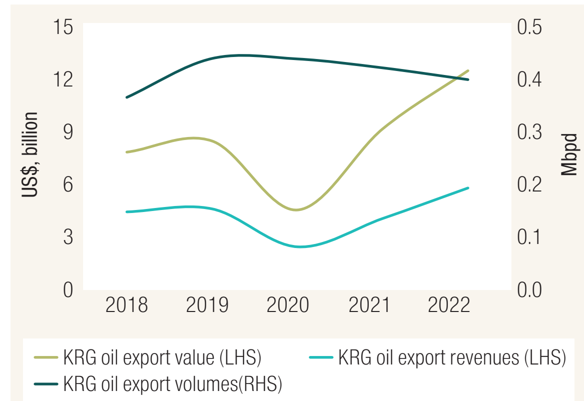

*Source*: MoO, Iraq's Ministry of Finance (MoF) and World Bank staff calculations.

to an average of 3.3 mbpd in 2022, up by 9.7 percent. Average oil export prices also rose by 40 percent to US$95.6/bbl in 2022 (Figure 6). As a result, crude oil exports receipts soared to a record US$115.7 billion in 2022, growing by 53 percent compared to 2021. However, oil exports volumes and prices fell in 5M-23 in line with the OPEC+ agreements for 2023 and the halting of exports (0.45 mbpd) via the oil pipeline through Türkiye, following the ruling of an arbitration case with the International Chamber of Commerce between Iraq and Türkiye.

**Higher oil prices in 2022 also mitigated pressures on the Kurdistan Regional Government (KRG) finances but pressures re-emerged in 2023.** As a result of the uncertainties caused by the legal dispute between the Federal Government and KRG, oil export volumes from the Region declined to an average of 0.4 mbpd in 2022 (Figure 7).[6] However, a 43 percent surge in KRG oil prices, provided a more than offsetting gain.[7] Higher oil revenues allowed the authorities to meet pressing obligations towards public sector salaries and International Oil Companies (IOCs). However, in 2023 the halting of oil exports through Türkiye since March 2023 and softening oil prices, have added to fiscal pressures, despite new transfers (through loans due to legal limitations) from the federal government.

**The GoI sets ambitious goals for increasing crude oil production capacity and upgrading the energy sector but needs to invest more in climate resilience.** Crude oil production has undergone a three-fold increase since 2003, and authorities have set a target to ramp up oil production capacity to 8 mbpd by 2028. Meanwhile, a series of investment project contracts have been agreed in recent years to raise crude oil production capacity and reduce reliance on gas imports through increasing the capture of associated gas and increasing solar power generation. However, these plans have often faced delays owing to several reasons including delays in budget ratification, security challenges, inadequate infrastructure, and political instability. The successful implementation of energy projects and achieving the desired outcomes hinges on strong institutional and governance arrangements to improve efficiency and accountability of operations. Energy sector investments also need to be consistent with Iraq's Nationally Determined Contributions (NDCs). Furthermore, as global demand for fossil fuel could

FIGURE 7 • Higher Oil Prices in 2022 Boosted KRG Oil Revenues




*Source*: Deloitte, KRG Department of Media and Information, and World Bank staff calculations.

fall from almost four-fifths of total energy supply today to slightly over one-fifth by 2050[8], Iraq would need to shift its oil and energy development model entirely. It is therefore more urgent than ever for Iraq to address the intertwined climate and development challenges of Iraq most notably through the development of renewable energy sources and the elimination of gas flaring.[9]

6 KRG oil exports in 2022 were impacted after Iraq's Federal Supreme Court in February 2022 ruled that current oil exports from the region were illegal, which reduced the list of buyers willing to lift KRG crude oil. The Federal Government and KRG signed a deal on April 4, 2023, to restart northern exports with Iraq's State Oil Marketing Organization (SOMO) marketing the crude oil in coordination with the KRG but has yet to be fully operationalized, mainly due to Türkiye's halting of these exports at the port of Ceyhan. Bilateral discussions regarding resumption of exports were ongoing as of mid-June 2023.

7 KRG exports its oil at a lower price compared to the rest of Iraq despite having the same quality, largely due to risks associated with operations, contracts, and other geopolitical factors. This gap was almost US$11 per barrel in 2022. Furthermore, total gross oil revenue in 2022 reached over US$12 billion, but the net revenues were only US$5.7 billion, after deductions for international oil companies, loans, transport, and storage fees.

8 IEA "Net Zero by 2050 A Roadmap for the Global Energy Sector" May 2021.

9 Accessible at https://openknowledge.worldbank.org/handle/10986/38250. See the Special Focus chapter of the previous IEM (Fall 2022) for a summary.

## Public Finance

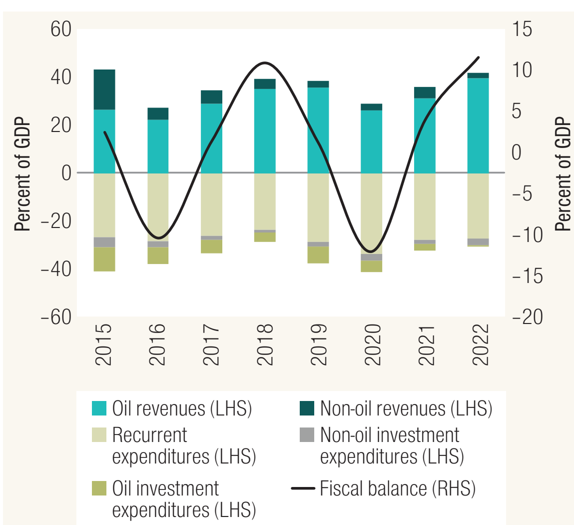
**Rising oil revenues improved Iraq's fiscal position considerably in 2022, but their softening throughout early 2023 raised concerns.** Total government revenues surged by 48.2 percent in 2022, spurred by the oil windfall. Total expenditures grew more moderately by 20.5 percent, driven by the passing of the Emergency Food Security Law in June 2022, before which expenditures had been constrained to their 2021 levels due to a lack of an approved budget for the year. As a result, the fiscal account recorded a significant surplus of 11.7 percent of GDP (Figure 8). Iraq's fiscal accounts would be less favorable on accrual basis due to significant unaccounted domestic and external arears.[10] A combination of oil supply disruptions and weaker global demand resulting in a decline in oil prices in the second half of 2022 and the recent OPEC+ quotas cuts in October 2022 and April 2023, have renewed pressures on Iraq's public finances due to their overdependence on oil revenues. Total revenues declined in 4M-23 by 23.3 percent y/y, as oil revenues fell by 18.3 percent y/y. This fiscal procyclicality once again highlights the necessity of prudent fiscal policy and underscore the need for implementation of fiscal reforms to reduce budget rigidities and boost domestic revenue mobilization.

**Government revenues remained dominated by oil proceeds, while non-oil revenues declined.** Oil revenues grew by over 61 percent and accounted for 95 percent of total government revenues in 2022 but their share is estimated to have declined to 92.5 percent in 4M-23 following the fall in oil export prices by 22.2 percent y/y. Implementation of measures introduced in 2021 to increase non-oil revenues has been limited while enacting new efforts were hindered by both implementation challenges and limited legislative authority of the caretaker government in 2022, leading non-oil revenues to decline by 41.5 percent in 2022 (Figure 8). Recent progress with digitalization of customs procedures needs to be complemented with stricter enforcement of customs rules and some degree of autonomy to the revenue authorities to collect additional revenues. Diversifying government revenues is in line with the new government priorities to reduce reliance on oil revenues in funding the state budget by reforming tax and customs systems.[11] This is crucial to reduce

[10] Most of the domestic arrears are owed to domestic banks and the Central Bank of Iraq, and external arrears relate to payments to international oil companies.

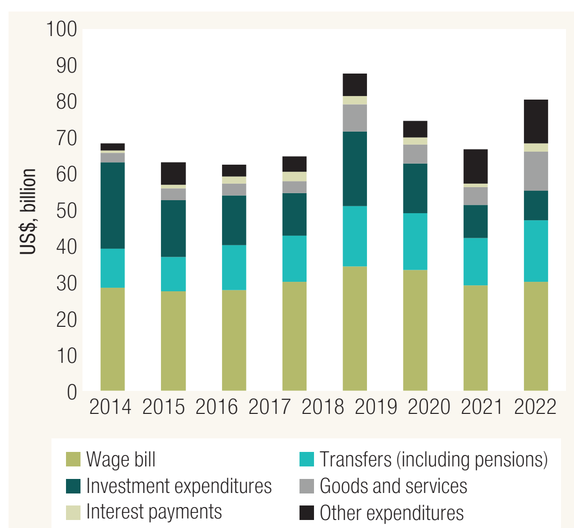
[11] The new government agenda sets a target to reduce reliance on oil revenue in funding the state budget to 80 percent in 3 years by diversifying and maximizing the non-oil revenue.

FIGURE 8 • Higher Oil Revenues Improved Iraq's Fiscal Balance in 2022…




*Source*: MoF and World Bank staff calculations.

FIGURE 9 • …but Wage Bill and Transfers Remain a Significant Share of Expenditures




*Source*: MoF and World Bank staff calculations.

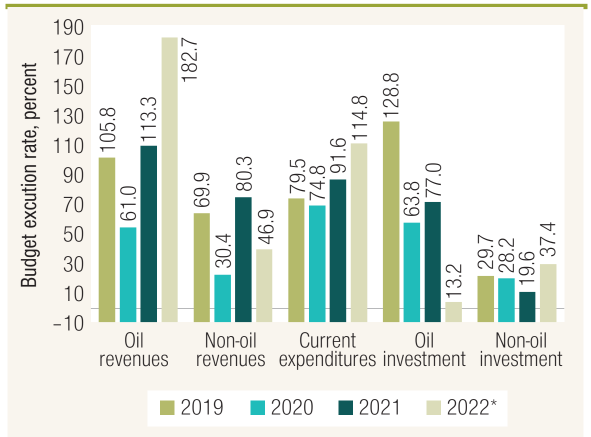
exposure to oil revenue volatility and to create fiscal space for investments in human and physical capital.

**While the procyclicality of fiscal policy was partly moderated due to legal restrictions, expenditure rigidities persist.**[12] Recurrent expenditures grew by 25.3 percent in 2022, accounting for almost 90 percent of total budget. This was primarily due to large wage bill and transfers allocations (Figure 9) and as the "Emergency Law for Food Security and Development" bill in June 2022 allocated IQD25 trillion (US$17.2 billion or 6 percent of GDP) of funding for urgent food security and development needs. In Q1-23, expenditures edged up by 0.9 percent y/y, as the approval of the budget for 2023 faced delays thereby restricting spending. Despite being OPEC's second largest oil producer, Iraq imports most of its refined oil products due to a growing shortfall in refining capacity.[13] Energy subsidies also remained high estimated at 6.4 percent of GDP in 2022 in line with higher oil prices and overconsumption.[14] Rightsizing current expenditures, including the wage bill and energy subsidies, will help generate fiscal space for other development needs. In addition, adopting fiscal rules to protect the finite oil wealth will be key to promote a more sustainable economic development model for Iraq and buffer against future shocks.

**The lack of an approved budget for 2022 limited new investments and impacted the execution of existing projects.** The supplementary financing, approved by the parliament in June 2022, allocated only a small portion, under IQD10 trillion (US$6.9 billion or 2.6 percent of GDP), for development projects. In Q1-23, however, investments more than doubled (y/y) driven by the previous year's accumulated surplus and in lined with the government plans in the 2023 budget. Nonetheless, significant investment needs remain, including in infrastructure and provision of other public services, following persistent under-realization of budget investment targets in recent years (Figure 10). In addition, inefficiencies in public investment management and corruption further inhibit the impact of existing levels of investment spending.

**The improving fiscal balance helped reduce the debt-to-GDP ratio in 2022.** Iraq's public debt-to GDP ratio is estimated to have declined

FIGURE 10 • Public Investment Remained Low and Under-Executed vis-a-vis Recurrent Spending




*Source*: MoF and World Bank staff calculations
*Note*: * The realization rate in 2022 is calculated based on the 2021 budget targets.

to 53.8 percent in 2022, from 55.1 percent in 2021. The decline reflects non-policy factors related to the large fiscal surplus of oil revenues and large price effects driving the nominal GDP growth (27.2 percent y/y). The record oil revenues have also allowed the government to clear some external arrears for energy imports from Iran, further contributing to total debt reduction.[15] Other debt sustainability risks

12 In the absence of an approved budget for 2022, government spending for 2022 was restricted by *Article 13* of the Financial Management Law No. 6 of 2019 (amended), which stipulates that the disbursement of funds is limited to one-twelfth of actual expenditures in the previous year.

13 Imports rose from less than US$4 billion in 2021 to over US$6 billion in 2022. In response, Iraq's MoO is looking to develop the refining sector. Latest news indicates that commercial production of the much-delayed Karbala oil refinery has finally begun. The refinery has the capacity to refine 140,000 barrels per day to help meet growing domestic demand for petrol, kerosene and heating oil, while reducing imports.

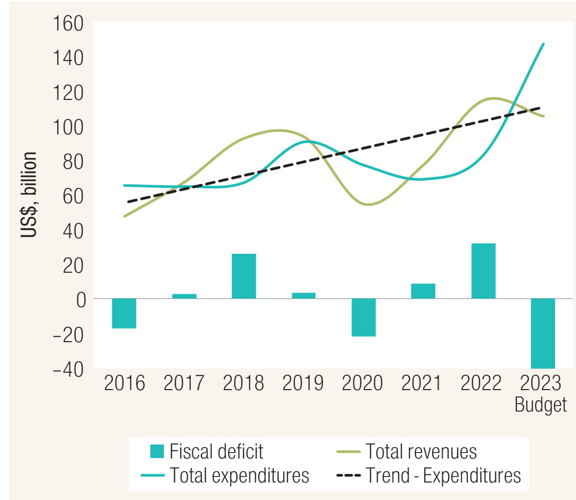
14 IMF, Fossil Fuel Subsidy Database.

15 The government is reported to have cleared US$1.6 billion in debt to Iran for gas and electricity imports following the passage of the emergency bill in 2022. In June 2023, Iraq also announced that it would pay US$2.76 billion of debt to Iran, following the issuance of a waiver of sanctions by the US.

include those related to service guarantees to electricity sector[16] and contingent liabilities related to restructuring of the two largest state-owned banks (SOBs). The adoption of a medium-term debt management strategy would help mitigate part of these risks through evaluating cost-risk trade-offs, while maintaining cash or reserve buffers, or establishing committed lines of credit.

**The budget for 2023 is strongly procyclical, excessively expansionary, and lacks the structural reforms that Iraq needs to develop a vibrant and sustainable economy.** The approved budget[17] envisages an annual spending of IQD199 trillion (US$153 billion), an expansion of 59 percent compared to 2022 actual expenditures and implying an almost doubling of the breakeven oil price to US$112/bbl.[18] Expenditures are heavily skewed toward recurrent spending, which account for 74.3 percent of the total spending envelop, notably due to a sharp increase in the wage bill. Revenues are envisaged to remain dominated by oil, based on an oil price assumption of US$70/bbl and 3.5 mbpd of exports. Even with these ambitious assumptions, this will result in a large fiscal deficit of IQD51.6 trillion (US$39.7 billion or 14.3 percent of GDP), equivalent to more than half of the recent record reserves accumulated following the 2021-22 oil boom and dwarfing the deficit at the peak of the pandemic in 2020 (Figure 11). The deficit is to be financed through the surplus from oil sales or domestic and external borrowing. The budget bill includes an agreement with KRG to transfer 12.7 percent of the federal budget to the region in return for 0.4 mbpd of crude oil. The budget proposes the establishment of new funds, including the Iraq Fund for Development to boost investments with a capital of IQD1 trillion (US$0.8 billion). While establishing a mechanism to invest the oil wealth is crucial, such measures need to be closely coordinated with fiscal and monetary policy.[19] The fiscal risks related to the highly procyclical budget and over reliance on oil have already partly materialized considering the recent oil export price and extension of production quotas. The budget's the three-year horizon of the budget (covering 2023-25) mitigates previously experienced budget uncertainties for subsequent years, its significant expansion poses it

FIGURE 11 • The Budget for 2023 Amplifies the Previous Trend of Fiscal Expansion




*Source*: MoF and World Bank staff calculations.

extends the loose fiscal stance for the following two years. The budget also fails to tackle longstanding structural challenges, including on economic diversification, improving public financial management, addressing expenditure rigidities, and boosting domestic revenue mobilization. The latter is even more crucial as the decision to revalue the Iraqi dinar up by 10.3 percent would also result in lower dinar-denominated oil revenues (see Box 2 on the impact of dinar revaluation).

16 These are estimated at over US$21 billion in 2017 (7.8 percent of the 2022 GDP) but are not included in public debt. IMF, Article IV, February 2023.

17 The draft budget was submitted to the parliament, with delay, in March 2023 and the budget was approved in June with minor amendments.

18 The expansion partly owes to several issues including: overdue ministry projects, extra employment opportunities provided by the public sector for new graduates, and debt obligations—external and internal.

19 See Box 2 of WB Iraq Economic Monitor Spring 2022 on fiscal rules (https://www.worldbank.org/en/country/iraq/publication/iraq-economic-monitor-spring-2022-harnessing-the-oil-windfall-for-sustainable-growth) and the WB handbook on Strategic Investment Funds (https://openknowledge.worldbank.org/entities/publication/476738d1-22f0-51a0-abdf-4de5fa353392).

## Monetary Policy and Prices

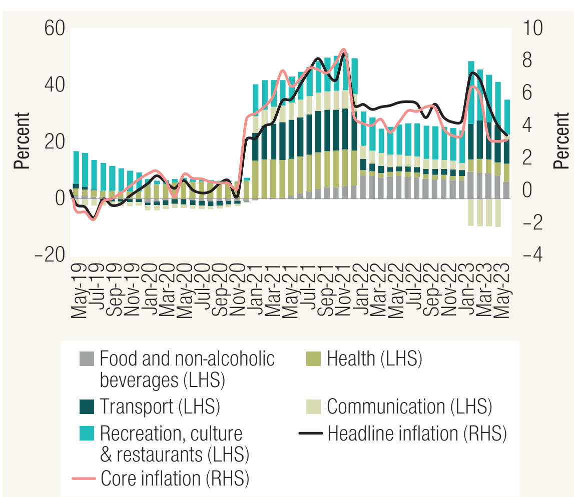
**After moderating in 2022, the depreciation of the Iraqi dinar in the parallel market in early 2023 fueled consumer price inflation.** The passage of the emergency law in June 2022 to meet urgent needs for food security, energy imports and existing subsidies contributed to easing of the headline and core inflation, at 5.0 and 4.3 percent in 2022, respectively (Figure 12).[20] However, the depreciation of the dinar in the parallel market since November 2022 (see Box 2 below) led to a surge in headline and core inflation in January 2023. High reliance on imported essential products, alongside limited domestic production, further exposes the economy to exchange rate volatilities, adding to price pressures for food and transportation (Figure 13). Measures to control the depreciation of the dinar helped ease price pressures in February to April (see below).

**In response to the currency depreciation, the Central Bank of Iraq (CBI) revalued the dinar upward by 10.3 percent in February 2023.** Closer enforcement of due diligence measures and financial reporting standards for transactions through the CBI dollar auctions since November 2022 led to a sharp decline in daily traded volumes. As a result, part of the demand for dollars was redirected to the parallel market, reducing the volumes of the USD credits and remittances sold for dinar (see Figure B2.2). This supply-demand mismatch resulted in the depreciation of the dinar against the dollar. To curb the impact on inflation and reduce the gap between the official and the parallel market exchange rates, in February 2023, the CBI set the dinar to dollar exchange rate at IQD1,300/USD from IQD1,450/USD. Following the announcement, the parallel market rate remained elevated at IQD1,588/USD in February 2023, but eased thereafter to an average of IQD1,452/USD in May. The CBI has not changed its policy rate despite the increase in global interest rates especially the US Federal Reserve Board considering the dollar peg, which also led to capital outflows.

**Notwithstanding the revaluation of the dinar, the central bank of Iraq pursued a strongly procyclical stance amid a global and domestic context of rising inflation.** To curb inflationary pressures arising in 2022, the CBI: (1) raised its capital from 3 trillion dinars (approximately US$2 billion) to 5 trillion dinars, and its gold reserves by 35 percent in May 2022; and (2) extended the maturity for some of its financial

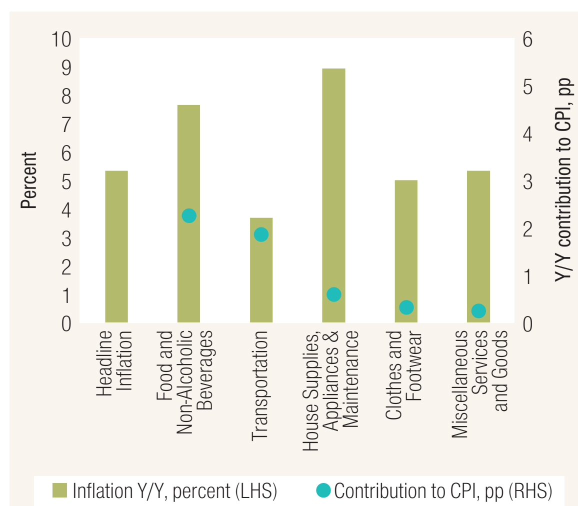
[20] Headline inflation in Kurdistan Region of Iraq remained higher in 2022 at 7.1 percent, driven by higher food, utilities, and transport prices.

FIGURE 12 • Inflationary Pressures Resurfaced in Early 2023 Following Exchange Rate Pressures…




*Source*: COSIT and World Bank staff calculations.

FIGURE 13 • …Driving Up Inflation in 4M-23 due to High Import Dependence of Consumer Goods




*Source*: COSIT and World Bank staff calculations.

products. These measures aimed to strengthen the CBI balance sheets to allow interventions in curbing liquidity growth. Meanwhile, the policy rate remained unchanged at 4 percent, and broad money (M2) grew steadily throughout 2022 and early-2023 (Figure 15). Monetary policy thereby was not only accommodative but strongly procyclical given the strong real GDP growth, all the while inflation was accelerating. The growth of credit to the private sector accelerated in 2022 thanks to CBI's initiative to allocate financial resources to the private sector, as well as agricultural, housing, and renewable energy projects (Figure 14).[21] However, with the expiry of some the CBI sectoral initiatives credit growth declined in early 2023.

**Iraq remains a cash-based economy, despite some reform initiatives.** In Q1-23, the deposit-to-M2 ratio amounted to 49 percent, against 51 percent currency in circulation. CBI has adopted several retail payment systems, but their effectiveness is limited as they do not support transacting between bank accounts and mobile wallets. In August 2022, the CBI raised the upper limit of the electronic payment cards by 27 percent. The new Iraqi Government announced several initiatives in January 2023 to facilitate the usage of Electronic Payments. The CBI issued circulars to mandate the usage of POS in financial transactions, such as reducing the merchant fees, mandating linkage of bank accounts and introducing incentives to promote POS usages. However, Iraq remains a cash-based society despite the increasing availability of digital payment mechanisms. Only 14 percent of adults reported making or receiving a digital payment, approximately 25 percentage points behind MENA average (Global Findex, 2021). Lack of trust in the banking system, limited availability of e-payments infrastructure (ATM, POS) and lack of financial literacy are the main constraints holding back the digital transformation that will facilitate e-Payments (see the Special Focus on the financial sector).

**The CBI introduced new measures to enhance the legal and regulatory framework and financial inclusion, including the equal provision of financial and banking services for women.** Improvements include developing legal and regulatory frameworks for licensing of payment service providers, modernization of payments system, and strengthening of consumer protection. To improve women's financial inclusion, the CBI issued a circular to prohibit gender-based discrimination in access to financial services, which contributed to improving Iraq's 2023 Women, Business, and the Law Index. The CBI has also conducted a survey on commercial banks with gender-disaggregated indicators. The KRG has also adopted a new labor law that mandates equal pay for work of equal value, prohibiting sexual harassment in the workplace (see the Special Focus on the financial sector). In response to the heightened due diligence measures adopted by correspondent banks that resulted in widening of the FX spreads and eventual devaluation, CBI tightened financial reporting of remittances and transfers and implemented enhanced anti-money laundering controls. These efforts have borne fruit as Iraqi banks have established several new correspondent relationships. CBI's efforts to improve transparency in the banking sector are another positive step towards reducing avenues for corrupt actors in advance of Iraq's upcoming Financial Action Task Force (FATF) review. Broader anti-corruption efforts need to continue, including through the implementation of the 2021-24 National Integrity and Anti-Corruption Strategy, recommendations of the approved National Risk Assessment, establishing a Treasury single account, and the digital transformation of the economy for greater accountability and transparency.

**Notwithstanding CBI's efforts, the financial sector continues to face several regulatory, supply-, and demand-side challenges, which hamper progress towards greater financial inclusion.** According to Global Findex Database 2021, around 20 million adults in Iraq remain financially excluded, with women making up more than half of the unbanked population (52 percent). Lack of sufficient funds, high cost of financial services, and lack of trust in financial institutions remain the leading barriers to account ownership. CBI data reveals that account ownership among adult was at 26 percent in 2022, up from 24 percent in 2021. The national coverage of financial access points for various financial institutional categories remains

[21] In June 2022, CBI increased the financial allocation for private sector projects and housing loans and extended the repayment of loans granted to the agriculture and manufacturing sectors until end-2022.

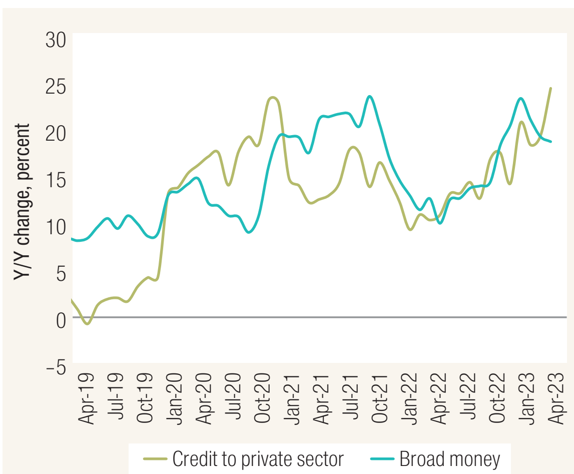
scant, with only four bank branches and five Automated Teller Machines (ATMs) per 100,000 adults. CBI's general collateral requirements and strict conditions to access loans, such as the requirement of having a public employee as a guarantor tend to affect women more than men as they have a smaller network and less access to collateral.[22]

**Limited access to financing exacerbates challenges faced by SMEs in Iraq, which hinders private sector development.** Only 9 percent of the total lending reaches SMEs, mainly through the One Trillion Dinar Initiative, with the National Bank of Iraq being the dominant provider. Private banks remain small with limited capital to support private sector. Around 90 percent of banks' credit in Iraq is held by seven public banks. Based on a survey conducted on 608,500 SMEs in 2021, the total demand for SMEs finance for the median loan size (equivalent to US$35,000) was US$11.1 billion (6.6 percent of GDP), but only a part was met, leaving a US$6 billion funding gap.[23] Lack of SME-oriented financing incentivizes SMEs to rely on informal sources for finance.

[22] In partnership with the World Bank, the Iraqi Private Banks League launched a small loan initiative with eased conditions for female entrepreneurs.

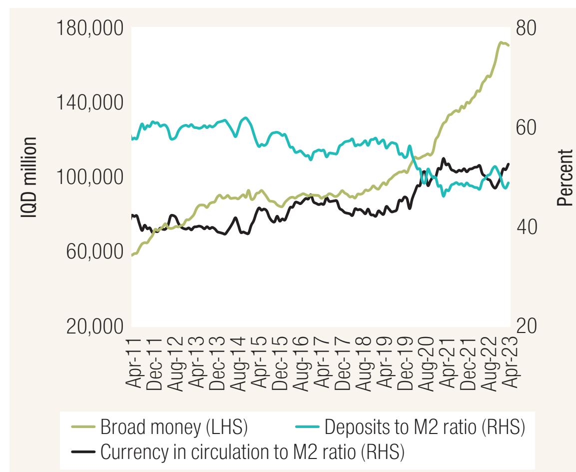
[23] Source. International Finance Corporation (IFC), November 2022. Market Bite Iraq – Economic Recovery Creates Opportunity to Invest in Small and Medium Businesses.

FIGURE 14 • The Credit to Private Sector Steadily Accelerated throughout 2022




*Source*: CBI and World Bank staff calculations.

FIGURE 15 • The Economy Remains Cash-Based, despite Modest Improvements




*Source*: CBI and World Bank staff calculations.

## BOX 2 IMPACT OF THE DINAR REVALUATION ON IRAQ'S ECONOMY

**Background.** In February 2023, the GoI announced a 10.3 percent revaluation of dinar, adjusting the peg to the dollar from 1,450 IQD/USD to 1,300 IQD/USD, marking a partial reversal of the 22.7 percent devaluation of December 2020 (Figure B2.1). The policy aimed to stabilize foreign exchange market volatility and the resulting spike in inflation (see the second paragraph in the monetary section for more details).

The macroeconomic impact of the revaluation on Iraq's economy comes through the following key channels:

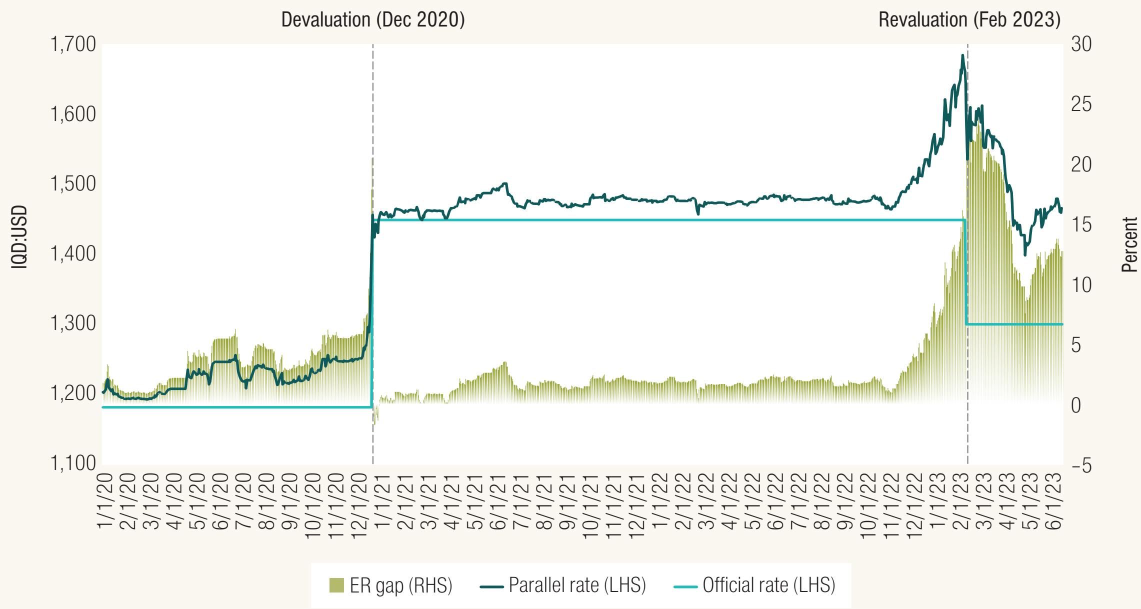
**Growth.** A stronger dinar could lead to higher purchasing power and thus higher consumption. However, this additional demand is likely to be met through higher imports. Crucially, the devaluation lowers the competitiveness of exports, all of which will affect economic growth.

**Inflation.** Given Iraq's high dependence on imports to meet the demand for food and raw materials, a stronger currency could curb the rise in inflation, especially through the retail prices of essential items. The value of the Survival Minimum Expenditure Basket (SMEB) which includes key basic commodities increased by 19 percent compared to the value before the devaluation of the currency (UNOCHA, 2022). However, with the current revaluation, this response could be weaker. Empirical studies show that appreciations in developing countries

*(continued on next page)*

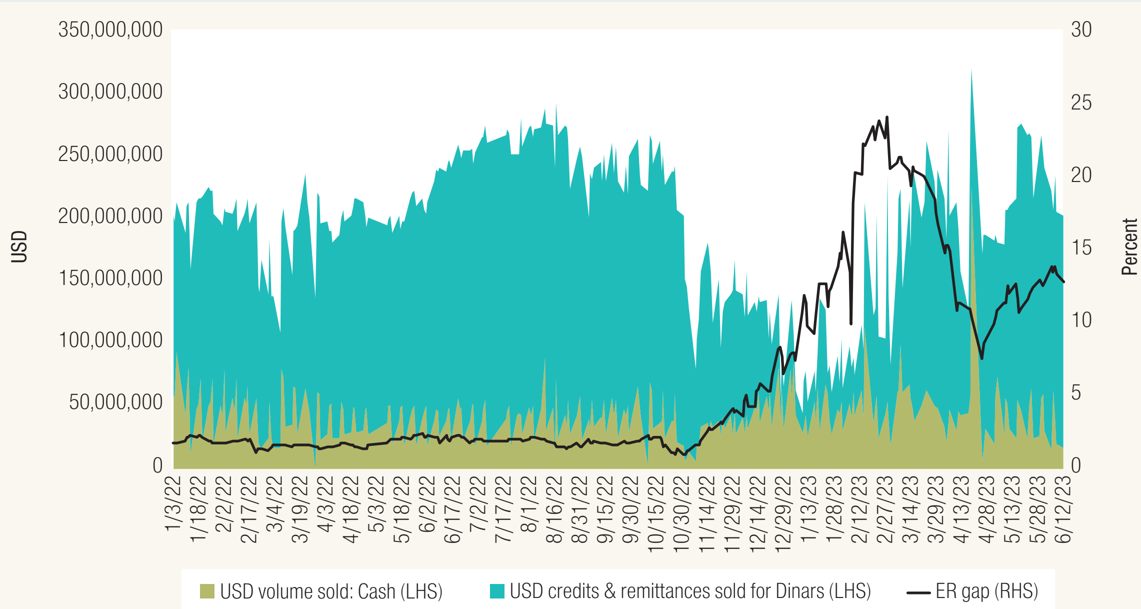
## BOX 2 IMPACT OF THE DINAR REVALUATION ON IRAQ'S ECONOMY *(continued)*

### FIGURE B2.1 • Parallel Market and Official Rate, IQD:USD




*Source*: CBI, media, and World Bank staff calculations.
*Notes*: The exchange rate gap is defined as the deviation of the parallel market rate relative to the official rate.

### FIGURE B2.2 • CBI Daily Auctions and Exchange Rate Gaps




*Source*: CBI, media, and World Bank staff calculations.
*Notes*: The exchange rate gap is defined as the deviation of the parallel market rate relative to the official rate.

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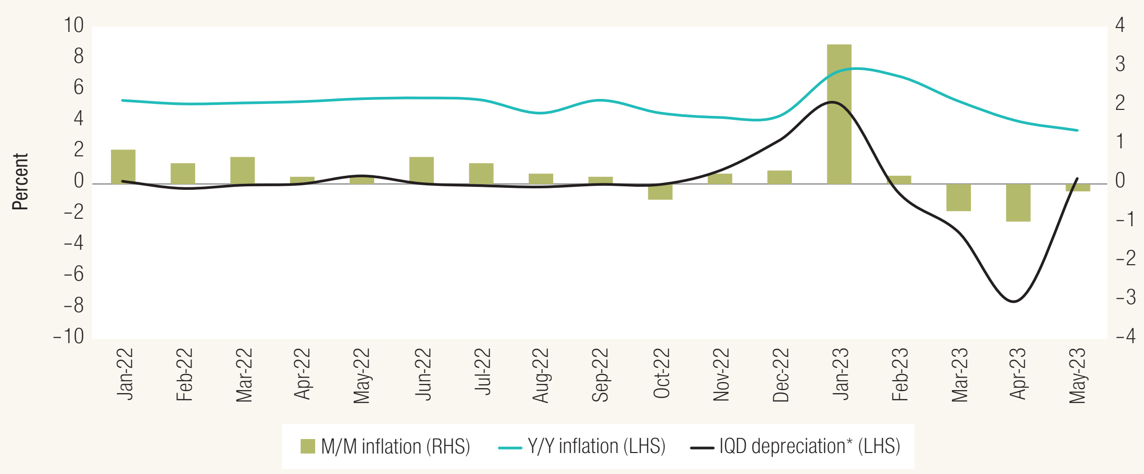
BOX 2 IMPACT OF THE DINAR REVALUATION ON IRAQ'S ECONOMY *(continued)*

FIGURE B2.3 • Exchange Rate and CPI Inflation




*Source*: COSIT, CBI, media, and World Bank staff calculations.
*Notes*: *Positive values show dinar's depreciation against the dollar in the parallel market.

induce a weaker response from imports and consumer prices compared to similar-sized depreciations.[a] Nonlinearities in the relationship between exchange rate movements in developing countries have also been observed (Caselli and Roitman, 2016). Given that the exchange rate system in Iraq is a peg to the dollar, movements of exchange rates could be captured by the gap between the official and parallel exchange rates and whether this gap translates into a domestic shock.[b] Figure B2.3 shows that the gap reached its peak in February, but inflationary pressures started to ease off as the gap started to narrow in response to the revaluation announcement.

**External.** A stronger dinar is expected to lead to a surge in imports, while exports become less competitive, adding pressure on existing reserves and fiscal buffers.[c] Following the devaluation of the Iraqi dinar in December 2020, imports declined by 16 percent in 2021 (y/y) driven by private imports' downward adjustment following the measure. Given the previously exhibited responsiveness of imports to exchange rate changes the revalued currency in 2023, will make it even harder for the capacity-constrained domestic production to compete with imported goods.[d] On the exports side, a stronger currency is projected to reduce the export competitiveness of already weak non-oil exports and the broader goal of diversifying the economy away from oil. However, given that non-oil exports constitute only 4 percent of total trade, the direct impact of appreciation on exports the external account is expected to be modest. Another channels through which the currency revaluation could affect the external sector is through outflows, as tourism outside Iraq becomes relatively cheaper. As the appreciation reduces the dinar value of remittances, it could also lead to an increase in their value as expats try to support families in Iraq.

**Fiscal.** The main impact of the revaluation is the direct impact of lowering the dinar-denominated value of oil revenues. Accordingly, at the revalued exchange rate of IQD1,300/USD, oil revenues are estimated to be 6 percent lower, and the primary budget balance lower by IQD12 trillion compared to without the revaluation. Furthermore, the approved budget for 2023 expands the recurrent expenditures by 32.2 percent compared to 2022, which could potentially exacerbate the effects of the exchange rate revaluation depending on the component of goods and services of government expenditures and the correspondent government import bill. However, the stronger currency will also have a direct revaluation effect in reducing the dinar value of external debt stock and servicing cost.

Overall, while the exchange rate revaluation has managed to curb some of the short-term inflationary pressures, the macroeconomic impacts are mixed. This is especially the case in the negative impact of the revaluation on export competitiveness of domestic production, a necessary condition for economic diversification, which had already been negatively impacted by consecutive appreciations of the dinar over the years relative to main trading partners. This highlights the importance of macroeconomic policy coordination. Crucially, a sustainable response to macroeconomic imbalances is the implementation of structural reforms, including in the financial sector as outlined in the Special Focus chapter, towards economic diversification.

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## BOX 2 IMPACT OF THE DINAR REVALUATION ON IRAQ'S ECONOMY *(continued)*


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[a] See Brun-Aguerre, Fuertes, and Greenwood (2017) for more details. The median values of +0.02 for appreciations of between 5 and 10 percent, and only slightly higher for appreciations of between 10 and 20 percent.
[b] Kose et al. (2019) show that the median pass-through associated with large currency depreciations in emerging and developing countries is higher in countries with less flexible exchange regimes and without inflation targeting central banks.
[c] The government imports amounted to 30 percent of total import in 2022. The expansionary budget of 2023 is likely to increase the reliance on imports to execute the 2023 budget, which in turn affects economic growth.
[d] Based on Iraq's quarterly data, imports and exports are inelastic in response to exchange rates shocks as measured by widening gap between official and parallel exchange rates (insignificant – 0.02, and significant 0.2, respectively).

## External Sector

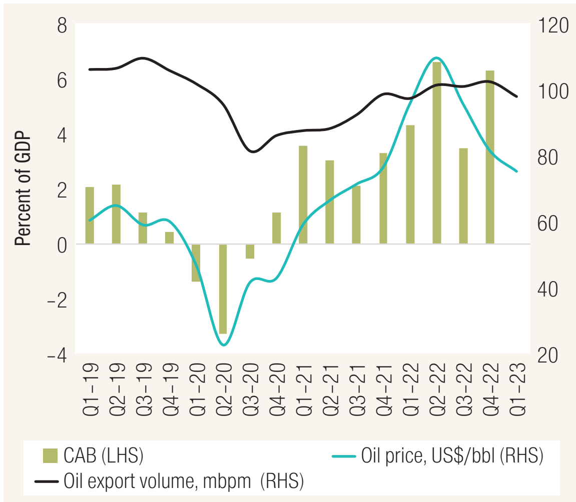
**Iraq's external account continued to benefit from higher oil exports in 2022 but this trend reversed with declining oil exports in early 2023.** Driven by higher oil exports, the current account registered a sizeable surplus of 20.7 percent of GDP (US$55 billion) (Figure 15). The goods trade balance reached 25.7 percent of GDP (US$68 billion), driven by higher exports and despite rising imports (Figure 16). The sharp increase in exports was supported by both soaring oil prices and production volumes. However, oil exports were constrained again in Q4-22 with the new OPEC+ agreement, and further weaknesses continued into the first half of 2023 as both volumes and prices continued to soften. Monthly, oil export revenues fell from an average of US$9.6 in 2022 to US$7.4 billion in 5M-23, which together with rising imports are expected to have significantly reduced the current account surplus.

**In line with the economic recovery, import growth accelerated.** Public imports surged by 66 percent in 2022 due to a sharp rise in consumption and capital imports due to rising import prices financed through the Emergency Law Food Security. Private imports, which constitute 64 percent of total imports, also increased by 24.4 percent, owing to the rise in both construction and capital imports, in part aided by the CBI's housing sector initiative. The financing of imports faced challenges towards the end of 2022 and early 2023 following the volatility in the parallel exchange market. To compensate for the dollar shortage, the CBI took measures including introducing a new electronic platform to disclose information about financial transfers and end users and revalued the dinar against the dollar to curb inflation (see Box 2). In addition, the CBI also announced that it would start allowing imports from China in yuan. The expansionary fiscal policy and the stronger dinar are expected to drive a sharp growth in imports in 2023.

**Despite weakening net foreign investment flows, CBI's international reserves surged through late 2022 but have since ebbed, following oil-related developments of the trade balance (Figure 17).** The surge in oil exports pushed readily accessible official reserves (i.e., excluding gold) to record levels of US$89 billion in 2022 (covering 14.7 months of imports) (Figure 18). This accumulation of reserves was also supported by improvements in the financial accounts as portfolio and net official investments improved. Net official investment flows also recovered to US$8.5 billion in 2022 due to sustained recovery of trade credits and claims held abroad. Nonetheless, recurrent security challenges and weak regulatory environment drove net FDI flows to decline and amount to only 0.9 percent of GDP in 2022. In 2023, the accumulation of official reserves (excluding gold) slowed before starting to decline in May to US$92.8 billion, as external account financing pressures reemerged.

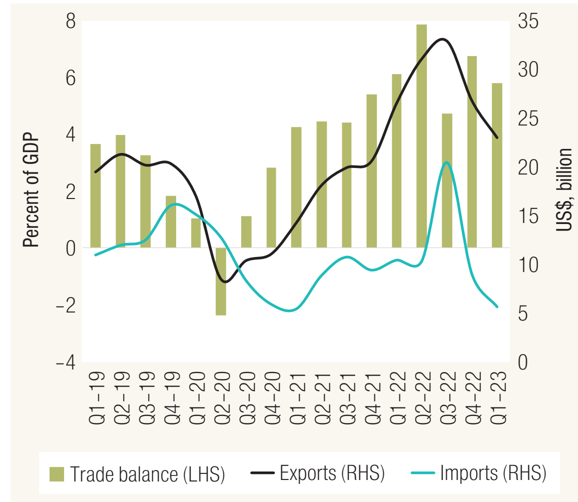
**GoI has unveiled plans to undertake steps towards improving tariff collection, but structural bottlenecks remain substantial.** The budget

FIGURE 16 • The Current Account Surplus Strengthened in H1-22 before Deteriorating Again



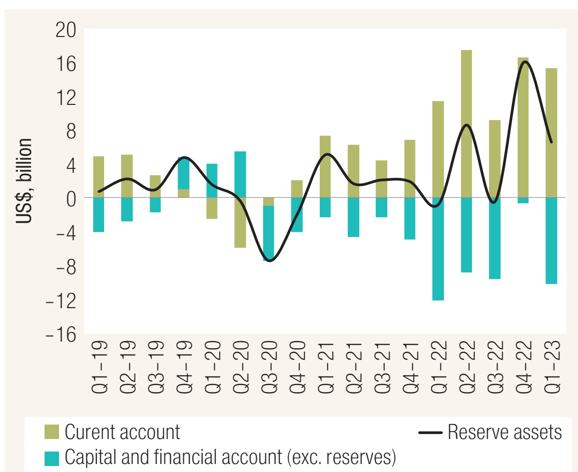

*Source*: CBI, MoO, and World Bank staff calculations.

FIGURE 17 • Higher Oil Exports Drove Up the Trade Balance despite Higher Imports



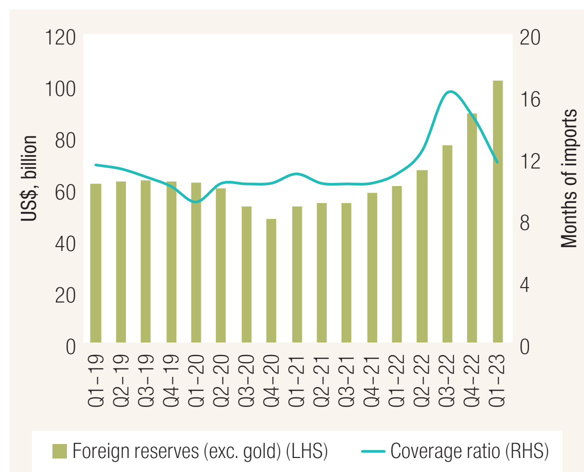

*Source*: CBI and World Bank staff calculations.

FIGURE 18 • The Current Account and the Financial Account Improved in 2022…




*Source*: CBI and World Bank staff calculations.

FIGURE 19 • …Leading to a Surge in Reserves but Pressures Reemerged in 2023




*Source*: CBI and World Bank staff calculations.

law 2023 stipulates the implementation of electronic and automated systems to collect customs aims to increase non-oil revenues. However, additional measures were not introduced and an article in the budget bill introducing modest duty fees on energy products was dropped in the budget law. Moreover, other structural challenges on domestic revenue mobilization were not adequately addressed. Regarding customs, trade procedures are cumbersome, costly, and time-consuming, and trade facilitation and policy reforms remain lagging. Unharmonized tariff between KRI and the rest of Iraq creates incentives for misreporting and smuggling (Figure 19).

2

# OUTLOOK, RISKS, AND OPPORTUNITIES

## Outlook

**Given its sheer lack of diversification, Iraq's economic outlook is predominantly tied to that of the oil sector.** Overall GDP is forecast to contract by 1.1 percent in 2023 driven by a projected 4.4 percent contraction of oil GDP under the assumption that oil production matches the OPEC+ production quotas agreed in April 2023. Non-oil GDP growth is, however, projected to partly offset the contraction in the oil-GDP: it is forecast to expand by 4.0 percent in 2023. This growth is mostly driven by the large fiscal expansion. In 2024-25, overall GDP growth is forecast to rebound as oil production steadily grows, recovering to its 2022 peak by mid-2024 and growing thereafter in line with a gradual increase in production capacity. Limited linkage between oil and no-oil sectors coupled with public sector dominance in formal employment will likely continue to result in a stunted and largely informal private sector. An environment of low appetite for reforms amid high oil prices, and Iraq's modest non-oil growth potential constrain long-term economic growth.

**Higher expenditures and imports will weigh on both the fiscal and current account balances, with the former turning into a deficit.** The revaluation of the dinar will result in lower dinar-denominated oil revenues for the government while expenditures are expected to increase significantly in line with the expansionary budget. However, the latter is projected to be underrealized relative to the budget target (especially for the investment component) as oil prices are expected to remain well below the breakeven oil price of US$112/bbl that the approved budget would require. As a result, the fiscal account balance is forecast to register a deficit starting from 2023, which is expected to slightly moderate in 2024 with projected higher oil revenues before widening again in 2025. The growing fiscal pressures are projected to lead to an increase in public debt. The current account surplus is forecast to moderate significantly to an average of 1.9 percent of GDP in 2023-25, driven by an average oil price projection of US$80.2/bbl, and higher government expenditures and a stronger dinar drive a surge in imports and undermine export competitiveness. All these factors collectively, in turn, add pressures on international reserves and the exchange rate peg.

## Risks and Opportunities

**Iraq's economic outlook remains subject to significant risks, not least that of a material fall in oil**

**prices, especially if combined with lower oil production.** The economy's high dependence on oil leaves it vulnerable to volatilities in the oil market and fluctuations in global demand as highlighted by the decline in oil prices in 5M-23. Heightened climate change vulnerabilities, further commodity price volatility associated with the Russian invasion of Ukraine would intensify pre-existing poverty trends and raise food insecurity. The recent spike in inflation has also highlighted a new source of risks that had been previously contained due to appreciation of the dinar relative to neighboring countries. In addition, long-standing sources of risk related to broader security challenges, high level of corruption, and social grievances due to poor public service delivery and lack of employment opportunities could further impact economic outcomes. On the upside, the improvements on domestic political tensions regarding government formation can pave the way for further investment in the economy to improve potential GDP growth. Furthermore, the prospects of reduced regional geopolitical tensions could pave the way for boosting regional trade and FDI opportunities for Iraq.

**Risks to global economic growth and oil markets could significantly impact the economic outlook.** Any change in global growth trajectory from the current assumption of moderately weaker global growth would materially impact Iraq's economy. For example, under a scenario in which global growth is slower and only recovers more gradually to the 2022 peak by end of 2023, Iraq's GDP growth would be lower by 0.2 pp. On the other hand, if for example global growth recovers more quickly starting in the last quarter of 2023 this could increase Iraq's GDP growth by as much as 0.7 pp. Similarly, through the price channel and at projected production levels in 2023, every US$1 reduction in oil prices would directly reduce oil revenues by US$1.1 billion, equivalent to 0.4 percent of GDP downward impact on fiscal and external balances. These sensitivities highlight the potential risks for Iraq's economy especially under a downside scenario of prices and quantities relative to the outlook assumptions, the risks of which have increased in the first half of 2023. In addition to global demand aspects, a further source of oil-related risks facing Iraqi oil exports is the competition in export markets, including with the heavily discounted Russian oil in the main Asian markets (China and India). While the agreement between the Federal Government and KRG have improved prospects of revenue sharing, a prolonged disruption to oil exports from KRI could add to these oil sector related risks to Iraq's economy.

**Iraq's significant development challenges require the full implementation of comprehensive economic reforms as previously identified.**[24] Fiscal reforms need to be two-pronged: (i) maintain sustainability of expenditures through rightsizing of current expenditures including the wage bill, pensions, and subsidies and (ii) improve oil revenue management through utilization of fiscal rules and enhanced non-oil revenue mobilization. These reforms rely on improved public financial management, including, the roll out of the treasury single account and regular reporting to facilitate economic planning and improve transparency. While Iraq's significant developmental challenges call for more investment, namely in energy and infrastructure, public investment needs to crowd in private financing, taking into account absorption capacity constraints and other externalities, notably climate change issues.[25] A more proactive monetary policy, including responsiveness to recent global financing conditions, will help curb inflationary pressures while providing enough financing to maintain economic growth and protect CBI reserves supporting the currency peg. Financial sector reforms related to reforms of SOBs and improving financial intermediation will be a necessary condition for promotion of SMEs and private sector driven growth (see the Special Focus). These reforms need to be complemented with better targeted social protection measures to mitigate any possible impact on vulnerable households.

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[24] See Box 1.1 in Iraq Economic Monitor Fall 2020 for an overview of the previous comprehensive reform plan, http://documents.worldbank.org/curated/en/981071637593726857/Iraq-Economic-Monitor-The-Slippery-Road-to-Economic-Recovery.

[25] Climate-informed investment management can be considered in two phases: upstream public investment policy (PIP) and downstream implementation of those policies through public investment management (PIM). See the recent World Bank Reference Guide for Climate-Smart Public Investment for more information, http://hdl.handle.net/10986/38390.

TABLE 1 • Iraq: Selected Economic and Financial Indicators, 2020-2025

| | 2020 | 2021 | 2022 | 2023e | 2024p | 2025p |
|---|---|---|---|---|---|---|
| | (Percent of GDP unless otherwise noted) | | | | | |
| **GDP and Prices** | | | | | | |
| Real GDP (percentage change) | −12.0 | 1.6 | 7.0 | −1.1 | 6.0 | 3.7 |
| Real oil GDP (percentage change) | −12.6 | −0.7 | 12.1 | −4.4 | 7.7 | 4.1 |
| Real non-oil GDP (percentage change) | −11.2 | 4.9 | 0.0 | 4.0 | 3.5 | 3.0 |
| GDP per capita (US$) | 4,498 | 5,044 | 6,265 | 6,384 | 6,909 | 7,099 |
| GDP (IQD trillion) | 215.7 | 301.2 | 383.1 | 361.7 | 396.8 | 417.0 |
| Non-oil GDP (IQD trillion) | 152.3 | 163.6 | 163.7 | 190.5 | 208.0 | 224.1 |
| GDP (US$ billion) | 180.9 | 207.7 | 264.2 | n.a. | n.a. | n.a. |
| Oil production (mbpd) | 4.00 | 3.97 | 4.45 | 4.26 | 4.58 | 4.77 |
| Oil exports (mbpd) | 2.99 | 3.02 | 3.31 | 3.24 | 3.53 | 3.69 |
| Iraq oil export prices (US$/bbl) | 38.4 | 68.4 | 95.6 | 79.4 | 81.3 | 79.8 |
| Iraq break even oil price, expenditures (US$/bbl) | 68.2 | 60.7 | 66.7 | 88.0 | 85.4 | 86.8 |
| Consumer price inflation (percentage change; average) | 0.6 | 6.0 | 5.0 | 6.7 | 5.5 | 4.6 |
| **Public Finance** | | | | | | |
| Government revenue and grants | 29.3 | 36.2 | 42.2 | 34.7 | 34.8 | 33.9 |
| Government oil revenue | 26.5 | 31.6 | 40.1 | 32.3 | 32.6 | 31.8 |
| Government non-oil revenue | 2.8 | 4.6 | 2.1 | 2.3 | 2.2 | 2.1 |
| Expenditures | 41.4 | 32.2 | 30.5 | 37.7 | 36.0 | 36.4 |
| Current expenditure | 33.8 | 27.8 | 27.4 | 33.0 | 31.5 | 31.4 |
| Wages and salaries | 18.6 | 14.1 | 11.4 | 15.4 | 14.8 | 14.7 |
| Goods and service | 2.9 | 2.3 | 4.0 | 4.6 | 4.4 | 4.4 |
| Interest payment | 1.0 | 0.5 | 0.9 | 0.6 | 0.5 | 0.5 |
| Other | 11.2 | 10.9 | 11.1 | 12.4 | 11.9 | 11.9 |
| Investment expenditure | 7.6 | 4.4 | 3.1 | 4.7 | 4.5 | 5.0 |
| Oil investment | 4.7 | 2.6 | 0.3 | 2.7 | 2.6 | 2.9 |
| Non-oil investment | 2.9 | 1.9 | 2.8 | 2.0 | 1.9 | 2.1 |
| Primary fiscal balance | −11.0 | 4.5 | 12.6 | −2.5 | −0.7 | −2.0 |
| Budget balance | −12.1 | 4.0 | 11.7 | −3.1 | −1.3 | −2.5 |
| Gross budget financing needs | −14.6 | 2.1 | 9.6 | −6.3 | −4.3 | −5.3 |
| **Public Debt** | | | | | | |
| Total government debt | 77.4 | 55.1 | 53.8 | 58.3 | 55.7 | 56.7 |
| External government debt | 40.0 | 28.5 | 18.4 | 20.0 | 19.1 | 19.4 |
| Total government debt (US$ billion) | 115.2 | 114.5 | 142.0 | n.a. | n.a. | n.a. |
| External government debt (US$ billion) | 72.4 | 59.2 | 48.6 | n.a. | n.a. | n.a. |

*(continued on next page)*

**TABLE 1 • Iraq: Selected Economic and Financial Indicators, 2020–2025** *(continued)*

| | 2020 | 2021 | 2022 | 2023e | 2024p | 2025p |
|---|---|---|---|---|---|---|
| **Monetary Indicators** | | | | | | |
| Growth in broad money (percentage change) | 15.9 | 16.7 | 20.2 | n.a. | n.a. | n.a. |
| Policy interest rate (e.o.p., percent) | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| **External Sector** | | | | | | |
| Current account | −4.0 | 12.0 | 20.7 | 1.7 | 2.5 | 1.5 |
| Trade balance | 2.7 | 18.7 | 25.7 | 8.8 | 9.5 | 8.6 |
| Exports of goods | 25.9 | 35.2 | 44.7 | 35.8 | 36.4 | 35.5 |
| Imports of goods | 23.2 | 16.5 | 19.0 | 27.0 | 26.8 | 26.9 |
| Gross reserves (US$ billion, excl. gold) | 48.1 | 58.2 | 89.0 | 62.9 | 38.7 | 11.2 |
| In months of imports of goods and services (excl. gold) | 10.3 | 13.9 | 14.7 | 7.2 | 4.1 | 1.1 |
| Exchange rate (IQD per US$; e.o.p.) | 1,450 | 1,450 | 1,450 | n.a. | n.a. | n.a. |
| Exchange rate (IQD per US$; average) | 1,192 | 1,450 | 1,450 | n.a. | n.a. | n.a. |

*Source*: Iraqi authorities and World Bank staff estimates and projections.

# SPECIAL FOCUS: ENHANCING FINANCIAL INTERMEDIATION IN IRAQ: TRANSFORMATIONAL REFORMS NEEDED TO DEVELOP AN EFFECTIVE AND EFFICIENT FINANCIAL SYSTEM

*Iraq has a potential to develop an effective and efficient financial system, however, it hinges on implementation of challenging reforms of state-owned banks, development of enabling financial infrastructure, implementation and enforcement of AML/CFT measures, incentivizing digital financial services, as well as carrying out broader macro-fiscal adjustments to foster economic growth. These reforms are critical to increase financial intermediation and promote financial inclusion in Iraq. Priorities include restructuring state-owned banks, consolidating private banks and promoting and incentivizing payments through digital channels.*

*Some progress was made by CBI to improve and enhance the legal and regulatory framework and financial inclusion. Notable improvements include developing legal and regulatory frameworks for licensing of payment service providers, modernization of payments system, strengthening of consumer protection including the equal provision of financial and banking services for women.*

*However, in spite of these improvements, Iraq's financial sector remains dominated by undercapitalized state-owned banks with weak governance and institutional capacities. These banks primarily provide financing to public sector entities and state-owned* *enterprises. Against the backdrop of a non-conducive industrial organization of the banking sector, the private commercial banking is weak and has limited capacity to support financial intermediation and is geared towards maximizing revenues from the FX auctions. Furthermore, the non-banking financial sector is nascent with small and underdeveloped capital markets, unregulated micro finance institutions (MFIs), and an underdeveloped insurance sector.*

## Sector Challenges: A Non-Conducive Industrial Organization of the Financial Sector (Figure 20)

**The existing health of financial intermediation in Iraq is well below as compared to other regions in all indicators, covering financial access, depth, efficiency, and stability.** This is driven by several underlying constraints, as discussed below, underpinned by inadequate progress in reforms, and weak institutional capacity. The financial system in Iraq remains fragile both on efficiency and stability indicators due to heavy reliance on state owned enterprises (SOEs), low net interest margins (NIM), and high non performing loans (NPLs).

### Constraint: Dominance of undercapitalized and inefficient state-owned banks (SOBs)

**The financial intermediation is constrained by the predominance of SOBs** that are undercapitalized, inefficient, have weak corporate governance and lack modern financial infrastructure that hinders interoperability with other banks, exacerbated by the absence of core banking systems. The financial sector is largely dominated by seven under-capitalized and under-provisioned SOBs, which collectively own over 80 percent of total assets and account for about 70 percent of the total credit in the economy.

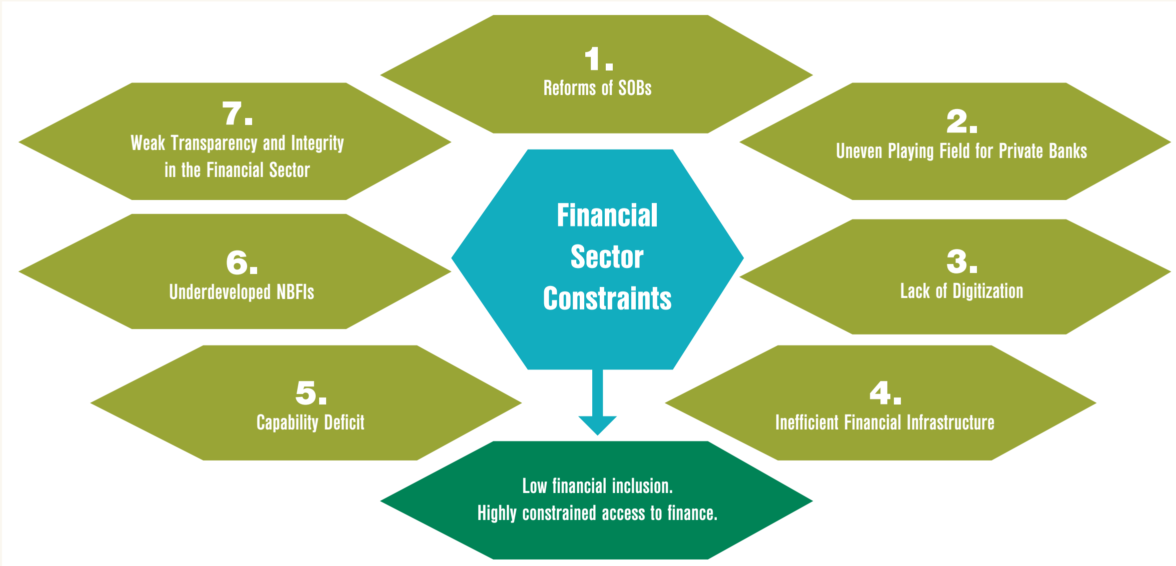
**SOBs are primarily geared to provide financing to the public sector entities and support quasi-fiscal financing directed at supporting SOEs**, which distorts the risk and return characteristics of SOBs' balance sheet, weakening loan performance and adding to potential insolvency. The availability and accuracy of data including key Financial Sector Indicators (FSI) precludes an accurate assessment of the financial health/solvency of SOB's given the absence of updated and audited financial statements (last audited in 2014) of the two largest SOBs Rasheed and Rafidain Bank who continue to operate without core banking systems. Both banks are in the process of implementing core banking systems, but implementation progress is onerous and subject to delays. Exposure of SOBs to SOEs is also assumed to be problematic given their weak asset quality with reported understated NPLs of 17.2%.[26] NPL's at SOB's are likely understated for the above-mentioned reasons. Similarly, NPL's at private Banks increased to 37% at 2021. Additionally, the SOBs are characterized by poor governance practices, weak internal controls, and limited risk and financial management capacity, as well as lacking modern core-banking systems and auxiliary automated control and reporting systems, which often jeopardize the accuracy, timeliness, and efficiency of financial and operational reporting.

### Constraint: Ill-equipped and weakly governed private banking sector operating in the uneven playing field

**Linked to the previous challenge, private banks suffer from an uneven playing field that favors state-owned banks.** While CBI encouraged private banks to support government agencies by providing banking services to them, the lack of public trust and the limited range of retail products significantly con-

[26] The Iraqi economy is characterized by a significantly large and dominant presence of the public sector, represented by SOEs which have a complicated and inconclusive effect on government's finances. These SOEs are regularly utilized as vehicles to achieve political and social objectives at the expense of their productivity and profitability. Around 80 percent of the exposure is with the SOEs, and three-fourths of these are deemed nonviable. Whereas the private sector is very small, largely informal, politically disadvantaged, and has limited means to grow and contribute to the economy. Consequently, due to inefficacies of both demand and supply side the role of the financial sector in intermediating credit to the private sector remained small and ineffective.

FIGURE 20 • Key Constraints in the Iraqi Financial Sector




*Source*: World Bank Staff.

TABLE 2 • Iraqi Banking Sector Market Structure (December 2019)

| | Rafidain Bank | Rasheed Bank | Trade Bank of Iraq | Small SOBs | SOBs | Private | Total |
|---|---|---|---|---|---|---|---|
| Number of banks | – | – | – | 4 | 7 | 69 | 76 |
| Size (assets US$ mill.) | 33,946 | 16,018 | 29,699 | 6,335 | 85,998 | 20,630 | 106,628 |
| Assets (share) | 32% | 15% | 28% | 5% | 80% | 20% | 100% |
| Capital (share) | 9% | 0.8% | 24% | 2% | 36% | 64% | 100% |
| Deposits (share) | 44% | 19% | 21% | 3% | 88% | 12% | 100% |
| Branches | 170 | 162 | 24 | 74 | 430 | 413 | 843 |
| Branches (share) | 20% | 19% | 3% | 9% | 51% | 49% | 100% |
| Staff | 8,879 | 7,257 | 1,256 | 3,400 | 20,792 | 9,715 | 30,507 |

*Source*: CBI data.

strained their scale. For example, the routing of the salaries of civil servants through private banks is only 5 percent, with the rest going through SOBs. GOI and CBI have issued circulars to enable SOEs and government entities to open banking relations with private banks for financing imports. CBI has also defined qualification criteria for private banks to offer these services including a strong rating and the existence of correspondence relations. However, the dominant role of SOBs and internal government bureaucracy have limited the uptake of this line of business for private banks. Most recently, in 2020, CBI has allowed foreign banks operating in Iraq to confirm letters of credit for Iraq's oil exports to encourage these foreign banks to maintain a presence and operations in the country. This initiative is in the early stage, and it is too early to assess the related uptake and transaction volume. Independently of the results of all these initiatives, a vibrant financial sector would still require resolving the underlying constraints linked to leveling the playing field, developing financial infrastructure, and so on. At present, private banks' operations are mainly limited to the provision of short-term loans for wholesale and retail trade, wire transfers, and currency exchange.

**Private commercial banks are not an effective conduit for financial intermediation and economic diversification on account of their weak balance sheets and inherent asset-liability mismatch (Table 3).** Private banks account for only 20 percent of the total banking sector assets, and the sector is highly fragmented with 65 weakly governed private banks, unsustainable business models, and limited capacity. The largest five private banks account for only about one-fifth of the private sector's total assets and some 5 percent of the overall banking system assets. Several private banks do not appear to have sustainable business models, beyond traditionally engaging in foreign currency transactions and some trade financing and other commission-based services. Credit/total assets only average about 28 percent. Given the low level of intermediation, the liquidity/assets ratio is significant at 49 percent. Furthermore, the available data point to significant operational inefficiencies with an estimated average cost/income ratio of 74 percent. Roughly half of the private banks were converted from legacy FX exchange bureaus, and they have maintained relatively low capital levels. These banks therefore lack the credit appetite and are not equipped to provide sufficient credit intermediation to the Iraqi economy. Consequently, the role of the banking system in intermediating credit to the economy remains limited, with private sector credit accounting for only 13.4% of GDP and playing a highly limited role as an engine for economic growth and financial intermediation.

## Constraint: Lack of digitization, weak enabling environment for digital payments and lack of trust in banks

**Modern, convenient, and functioning electronic payment channels have yet to be developed and made available in Iraq.** While the world is gradually adopting digital finance, Iraq largely remains a cash-based economy, which is driven both by weak enabling environment as well as lack of trust among general public for more innovative payment solutions. The primary constraint preventing Iraqi citizens from greater usage of digital payment channels (such as ATMs, Point of Sales Terminals, and the proliferation of Payment System Providers (PSPs) that leverage off the great penetration and usage of smartphones) is a combination of their continuing lack of trust in the banking system, lack of widespread availability of digital payments infrastructure (ATM, POS) and weak levels of financial literacy. According to the Global Findex (2021), only 14 percent of adults reported making or receiving a digital payment, approximately 25 percentage points behind the MENA average.

**The COVID-19 pandemic made digital finance a global urgency, yet there is no specific payment system law in Iraq that defines crucial concepts including netting, finality, or irrevocability of payments in Iraq.** A draft Payments Law duly incorporating the fundamental concepts (such as netting, finality or irrevocability of payments) has been drafted and is awaiting approval. CBI has adopted several retail payment systems, but their effectiveness and viability are still limited as they do not support transacting between bank accounts and mobile wallets. The coverage and availability of physical financial access points, a critical pillar of the payments' ecosystem, also remains limited across the country. The number of physical branches and ATMs per 100,000 adults compares unfavorably to regional peers. For every 100,000 adults, there are only 4 bank branches. The number of ATMs and POS per capita is low. These factors combined are the main constraints holding back the digital transformation that will facilitate e-Payments.

**However, financial access point networks have been growing significantly in the last few years.** Moreover, the authorities have promulgated a series of initiatives and orders in January 2023 that incentivize and foster electronic payments. Among others, public institutions must open accounts and accept electronic payments, and private enterprises will be required to show proof of accepting digital payments to obtain their commercial license renewal. Recent policies issued by the CBI and the Government of Iraq aimed at promoting digital payments are due for implementation by mid-2023. Taking cognizance of the delays in the passage of the Payments System Law, the new Iraqi Government has identified the issue of digital payments and issued a directive in January 2023 announcing several initiatives facilitating the usage of Electronic Payments and the Central Bank of Iraq has recently issued circulars promoting/mandating the usage of POS in financial transactions through a combination of measures including reductions in merchant fees, mandating linkage of bank accounts and incentives to promote POS usages. Additionally, CBI has undertaken a series of initiatives to strengthen the financial sector, including developing legal and regulatory frameworks for licensing of payment service providers, modernization of payments system, and strengthening of consumer protection function at the CBI level. Notwithstanding these efforts, the financial sector continues to face several regulatory, supply, and demand-side challenges which hamper progress towards greater financial inclusion and increase access to finance.

### Constraint: Inefficient financial infrastructure, low coverage of credit reporting and registry systems

**Whereas the Central Bank of Iraq implemented functioning payment system infrastructure, like the Automated Clearing House (ACH) and the Real Time Gross Settlement (RTGS), the Iraqi financial sector lacks vital supportive infrastructure,** such as a well-functioning credit reporting and collateral registry systems, which are still in their initial adoption phase with low coverage, limited usage, lack of value-added services, and limited human resources. The existing credit reporting system only covers 1.3 percent of adults which is significantly lower than MENA average of 15.8 percent. Similarly, there is limited institutional support and resources available, including lack of a moveable collateral registry which if present would facilitate a sizeable demand for credit from borrowers like small-scale households and micro, and small medium enterprises (MSMEs), which are likely to have minimal immoveable collateral.

### Constraint: Capability deficit

**Significant capability gaps exist across the financial system from the regulators to financial institutions.** CBI's regulatory and supervisory capacity needs to be significantly enhanced to improve judgement and decision-making based on sufficient information. This requires building an integrated Information Technology (IT) system for banking supervision. Similarly, public, and private financial institutions lack needed personnel and skillset to improve their market product offering to provide liquidity to potential clients currently classified as "un-bankable". Lastly, as discussed above, there is a significant lack of knowledge in the supporting structures, such as collateral registry and property valuators, to provide timely and accurate priced inputs to lenders.

### Constraint: Weak transparency and integrity in the financial sector

**Continuing efforts are required to improve transparency and integrity in the financial sector with authorities recommended to focus their attention on implementation and enforcement of AML/CFT regulations.**

CBI has tightened financial reporting of remittances and transfers and implemented enhanced anti-money laundering controls in response to the heightened DD measures adopted by correspondent banks that resulted in widening of the FX spreads and eventual devaluation. These efforts have borne fruit as Iraqi banks have established several new correspondent relationships.

CBI's efforts to improve transparency in the banking sector are another positive step towards reducing avenues for corrupt actors in advance of Iraq's upcoming Financial Action Task Force (FATF) review. Broader anti-corruption efforts need to continue, including through the implementation of the 2021-24 National Integrity and Anti-Corruption Strategy, recommendations of the approved NRA, establishing a Treasury single account, and the digital transformation of the economy for greater accountability and transparency.

### Constraint: Underdeveloped non-banking financial sector

**The non-banking financial sector is at a nascent stage of development, with small and under-developed capital markets and MFI sector.** Debt markets are largely fueled by government borrowing to meet the increasing financing needs of the government. The

Iraq stock market is still small and growing with a total market cap of roughly US$ 10 billion as of May 2020, resulting in a market cap to GDP ratio of just over 5 percent. This is materially lower than other countries in the MENA region, ranging from 25 to 90 percent. Just like banking, the insurance sector is dominated by state-owned insurance companies which, due to favorable government policies, lack public trust and have limited product offerings. In order to encourage the development of the Insurance and Capital Markets, authorities are recommended to undertake diagnostic assessment of the current legal and regulatory framework with the support of their international partners with the aim to identify gaps and proceed to address and mitigate the identified gaps.

**The MFI sector is one of the smallest and least developed in the region, with a total portfolio size of just US$108 million as of 2020.** A comparison of regional data in 2015, placed Iraq third-to-last in a group of 10 regional peer countries, with a coverage of 0.26 percent, only exceeding coverage ratios in Sudan and Syria, and significantly underperforming with respect to the overall regional average ratio of 1.1 percent. The MFI sector in Iraq has stagnated in outreach and significance, with contracting market share, sluggish portfolio growth and a reduction in the number of active operators. The MFI sector lacks a comprehensive regulatory and legal framework which limits its potential for mobilizing credit to the MSMEs in Iraq. The microfinance sector is currently under the administrative oversight of the Non-Profit Organization (NGO) Directorate which is not geared to regulate and supervise financial institutions. The current operational modalities recognize MFIs as not-for-profit and non-governmental organizations instead of commercial entities with clear corporate governance arrangements, and the number of MFIs has fallen from 12 in 2010 to a reported 8 to-date.

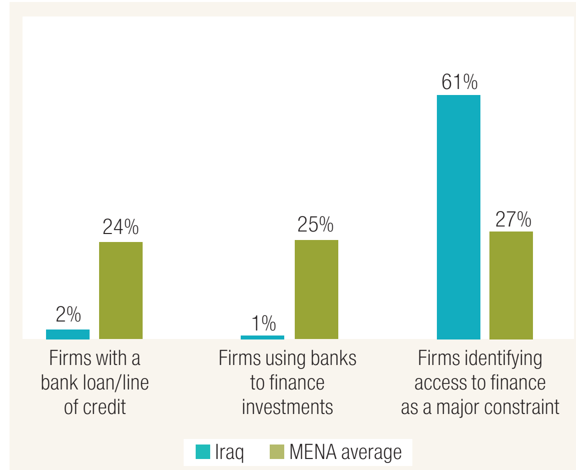
## Consequence of financial sector constraints—low financial inclusion and weak access to finance

### *Low access to finance for private sector*

**The Iraqi private sector lacks access to a sustainable and inclusive source of financing, as fewer than 5 percent of MSMEs have been able to secure bank lending (Figure 21).** Over 80 percent of MSMEs are estimated to be Micro-enterprises with individual ownership and limited to no assets to meet collateral requirements and, therefore, rely on funding either through their own savings or through family/friends. On the other hand, banks have little experience in lending to MSMEs and lack the necessary skills to analyze credit risks and to carry out cash flow analyses. They instead rely on tangible assets for collateral purposes and often have higher collateral requirements, up to 150 percent or more in some instances. The lack of an enabling legal and regulatory framework hampered the development of the Micro-Finance (MFI) sector, further constraining credit availability, especially to smaller firms. Consequently, access to credit is a key constraint to economic growth and job creation in Iraq primarily for women and youth as young entrepreneurs end up receiving only 3–5 percent of their financing needs through formal financial institutions.

**Similarly, financial markets lack the needed depth and liquidity to drive the private sector development** as private sector credits accounts for only 9 percent of GDP. Whereas the stock market also does not fill the financing gap and remains small with total capitalization of less than 5 percent of GDP.

FIGURE 21 • Selected Access to Finance Indicators in Iraq Compared to MENA Average, Based on Enterprise Survey (2022)




*Source*: Iraq Enterprise Survey, 2022.

*Financial inclusion significantly behind regional average*

**Financial inclusion is a building block for poverty reduction and economic growth**. Financial services, starting with the entry point of basic transaction accounts, are a critical tool for individuals and firms to mitigate risks, manage shocks, build resilience, and invest in the future. At the macroeconomic level, financial inclusion helps enable and accelerate improved financial health, job creation, and economic development. Because of its potential, and the fact that Digital Financial Services (DFS) enable seven of the 17 Sustainable Development Goals (SDGs), DFS is now viewed as catalytic to financial inclusion at the last mile.

**The World Bank Global Findex Database 2021 found that around 20 million adults in Iraq remain financially excluded, with women and youth being overrepresented therein**. Addressing this requires significant national efforts, including spurring policy reforms and private sector innovation while also ensuring financial consumer protection, stability, and integrity, along with major financial sector reforms indicated above.

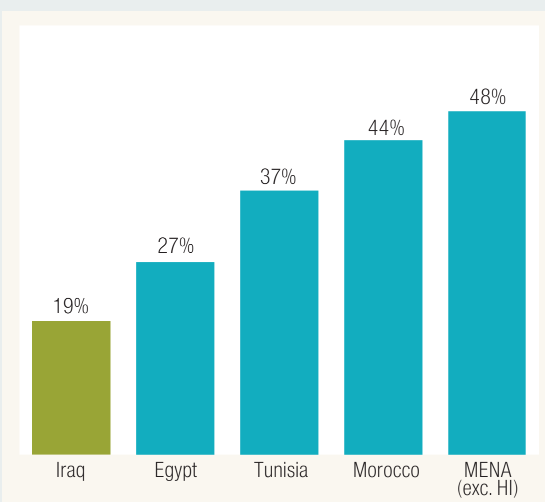
**The data around financial access shows that overall progress was made between 2014 and 2017**, with access for adults rising from 11 percent to 23 percent in 2017 (Figure 22). The trend between 2017 and 2021, however, is less positive, with access having declined to 19 percent. Given such a low base of financial inclusion to begin with, it is critical that this decline be arrested. Account ownership in Iraq is lagging approximately 29 percentage points behind the regional average of 48 percent for MENA region (excluding high-income countries) (see Box 3).

**According to Findex, the gap in access between men and women is also notable**, having been eight percentage points in 2014, then dropping to six percentage points in 2017 before rising again slightly to seven percentage points in 2021. Though this gap does need to be addressed, compared to

### BOX 3 SELECTED FINANCIAL SECTOR INDICATORS-REGIONAL BENCHMARKS, 2021

**Financial Access**

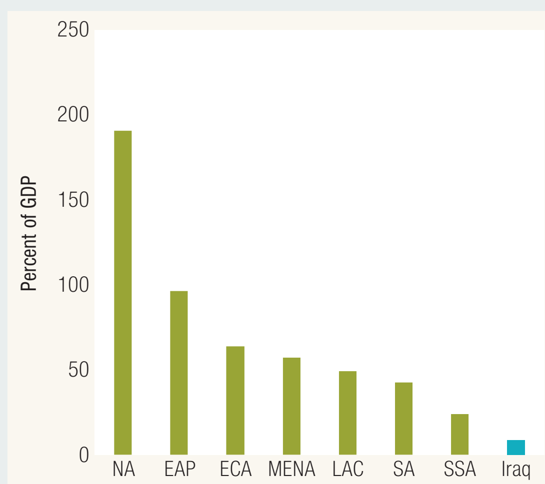
FIGURE B3.1 • Bank Account Ownership (Regional Comparison)-2021




*Source*: Global Findex Database, World Bank.

**Capital Markets Depth**

FIGURE B3.2 • Domestic Credit to the Private Sector



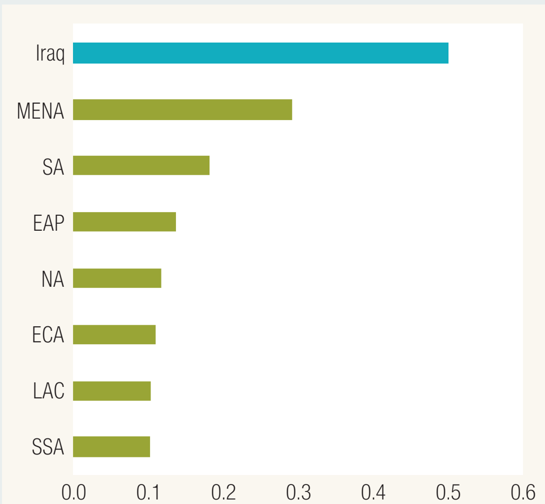

*Source*: International Monetary Fund, International Financial Statistics, data files, World and Bank and OECD GDP estimates.

*(continued on next page)*

## BOX 3 SELECTED FINANCIAL SECTOR INDICATORS-REGIONAL BENCHMARKS, 2021 *(continued)*

### Operational Efficiency

FIGURE B3.3 • Credit to SOEs




*Source*: The World Bank Development Indicators (WDI); and CBI.

### Sector Stability

FIGURE B3.4 • Bank Nonperforming Loans to Gross Loans

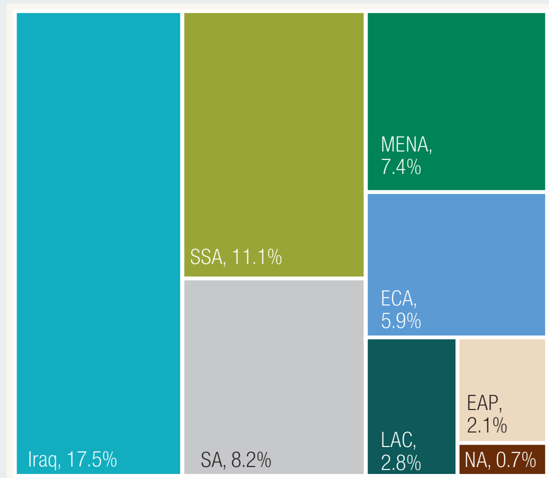
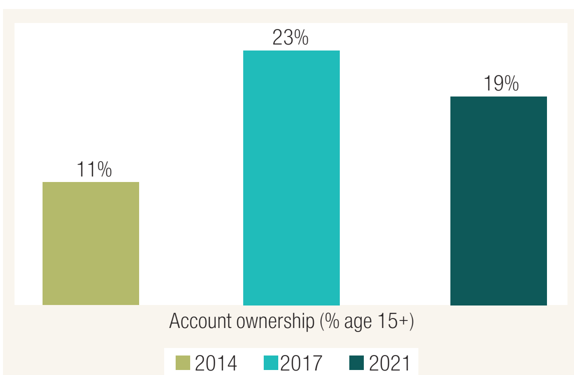
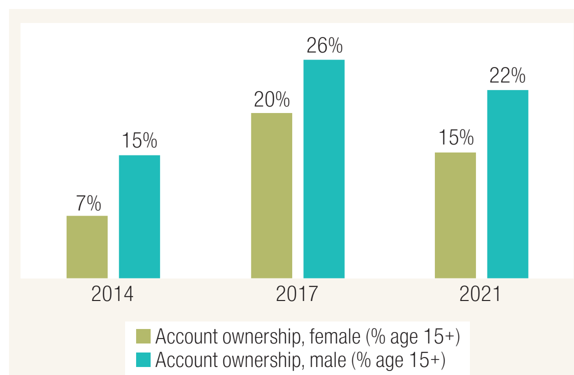



FIGURE 22 • Progress on Financial Access




*Source*: World Bank Global Findex 2021.

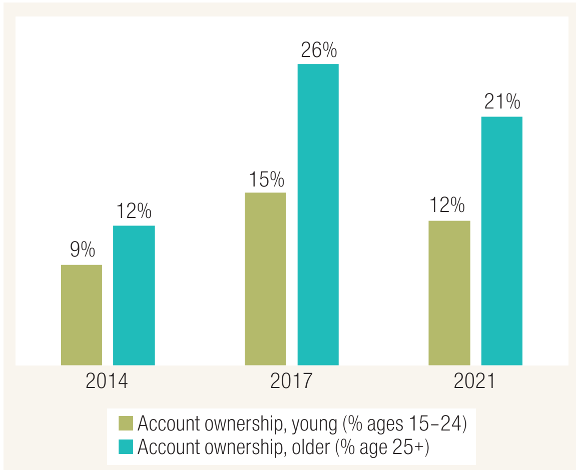
FIGURE 23 • Gender Gap in Financial Access




*Source*: World Bank Global Findex 2021.

the average gender gap across the MENA region of 13 percentage points, Iraq is performing better, though this should be seen in the context of an overall very low financial inclusion across the board. As national efforts to increase access progress, an important goal will be to ensure that the gender gap does not widen. In this connection an important milestone was reached when CBI issued a circular in 2022 to prohibit gender-based discrimination in access to financial services. This was counted as a positive reform under the 2023 Women, Business and the Law Index (Figure 22). In addition to gaps along gender lines, Iraq also has a lag in access along the lines of age, with younger citizens (aged between 15 and 25) enjoying lower levels of access (Figure 23 and Figure 24). Inefficient financial sector, weak overall enabling environment and

FIGURE 24 • Age Gap in Financial Access




*Source*: World Bank Global Findex 2021.

financial infrastructure, contributing to low trust for financial institutions among general public, can be seen as major constraints behind low financial inclusion in Iraq.

## Way Forward: Institutional and Regulatory Reforms, Digital Finance, and Innovation

**Well-functioning financial intermediation in Iraq requires a major transformation across each segment of the value-chain starting from re-strategizing the role of regulators and institutions.** The reform methodology can be envisaged as a phased process with key improvements to be made over a short-, medium-, and long-term horizon.

### Reform State-Owned Banks

**Given their dominance and systemic importance, the priority of developing and implementing a comprehensive reform program for the state-owned banks cannot be overemphasized,** particularly alarming when the SOBs hold over 80 percent of banking assets, and all seven SOBs are deemed to be grossly undercapitalized. The SOB's have large legacy assets (primarily loans to SOEs) as a result of past directed lending practices that were compounded by weak corporate governance, absence of core banking systems leading to challenges in preparing financial statements. An immediate priority is to undertake meaningful reforms including implementing corporate governance measures including the passage of corporate governance bylaws that are awaiting approval, conducting an Asset Quality Review (AQR) to identify the capital deficiency of the two largest SOBs. The GOI can leverage AQR findings to establish a strategy for SOBs which should clearly identify and address current imbalances, including the resolution of any capital deficiency, and set policies that prevent any further accumulation of contingent fiscal liabilities, while ensuring the financial sustainability of institutions going forward. Potential restructuring approaches could include reform of the SOBs as going concerns or their liquidation, divestiture or crowding in adequate private capital. Additionally, it is recommended to also take measures to expedite the implementation of Core Banking Systems in Rasheed and Rafidain and to develop Bank Resolution Framework and plans.

### Consolidate and rationalize Private Banks

**In addition to the reforms of the SOB's, it is crucial to also review and rationalize the private sector banks to ensure that only viable and sustainable private banks that meet the CBI's prudential requirements continue to operate.** Going forward, capital intermediated by private banks will be crucial to the deepening of the financial system, especially in mobilizing capital to MSMEs and households, and to the development and resilience of the Iraqi economy. Out of the 65 private banks, roughly half of the banks were converted from exchange bureaus into full-fledged private banks and most of these converted entities have non-viable business models, are barely financially sustainable, and may pose risks in as much as they are associated with affiliated groups or holding structures. To mitigate this risk, CBI is recommended to introduce regulations on definitions of connected parties and large exposures. It is also recommended that CBI conducts an assessment of private banks with a view to assess their compliance with its prudential and supervisory standards and in the event of non-compliance set clear timelines to achieve compliance. Additionally, CBI may consider introducing an incentive structure for voluntary mergers of private banks that are not compliant with CBI prudential and supervisory requirements. The rationalization of the private banks through prudential measures is expected to improve their credit intermediation and facilitate access to finance for MSMEs and Non-Banking Financial Institutions (NBFIs). The operationalization of the Deposit Insurance and the strengthening of credit guarantee mechanisms will also mitigate constraints to access to finance through increased credit intermediation.

## Enhance Credit Infrastructure Framework

**Another critical area impeding the credit intermediation and access to finance is the absence of a robust credit infrastructure framework.** CBI is recommended to enact laws and regulations to foster an enabling environment for private sector by enacting laws/regulations on credit reporting and secured transactions, insolvency regimes, and consumer protection. There is a need to modernize the credit registry to increase the efficiency of its operations and to expand the scope of value-added services, such as benchmarking, scoring, and automated decision-making. Similarly, a thorough review of the collateral regulation and enforcement framework should be undertaken to support the prompt realization of claims on secured assets in the event of default. This assessment and review will identify the existing gaps and bottlenecks and help design the required reforms. Additionally, there is a need for financial institutions to enhance their capabilities to use the modernized credit information system and newly introduced collateral registry.

## Implement NBFIs' regulatory reform

**Bring MFIs under the CBI's regulatory purview and establish adequate regulatory capacity within the CBI to supervise NBFIs.** The lack of a pathway for transforming MFIs into investable entities, with defined ownership structures and responsibilities, constrains their growth and hampers growth in access to finance. Currently, regulation and oversight of the MFIs has been performed by the NGO Directorate, which lacks both the experience and capacity to adequately monitor performance and enhance the development of financial intermediaries. CBI is in the process of establishing a new regulatory framework for NBFI providing for the licensing of MFIs, Leasing and Factoring companies and strengthen the supervisory capacity of CBI through developing Supervisor training program strengthening the recently established SOB supervision unit and consider implementing Risk Based Supervision with concurrent alignment of supervisory and regulatory framework with Bank for International Settlements/Financial Stability Board (BIS/FSB) standards. Authorities are recommended to continue implementing the recommendations of the joint WBG/IMF Financial Sector Assessment Program (FSAP) and the recommendations of the recently completed National Risk Assessment (NRS) on Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT).

## Enhance financial sector capacity

**CBI is recommended to work closely with the international developmental institutions such as the WBG and IMF, standard setting bodies (Basel Committee and Financial Stability Board) and the banking industry to develop a comprehensive framework to enhance the sector's capacity.** This framework will need to focus on continuous learning and training to address competency and knowledge gaps, including developing skills to assess and underwrite credit risks, improving financial product offerings and to support development of sound banking operations. The framework should include a program that mandates the accreditation of banking professionals in middle and top management through dedicated banking and risk management training, particularly to introduce and streamline the implementation of IFRS and global auditing standards.

## Implement financial inclusion measures

**Recognizing the immense challenge ahead, the Central Bank of Iraq has embarked on devel-**

**oping a National Financial Inclusion Strategy (2024–2028)** as a means of systematically stimulating financial access and usage from both a demand- and supply-side perspective. In this venture, Iraq joins the 63 jurisdictions around the world that have a National Financial Inclusion Strategy (NFIS) in place or under development. The development and implementation of the NFIS with its focus on increasing access to finance for the citizens including women and children when combined with measures to increase financial awareness and literacy and incentivizing digital payments channels is expected to reduce the citizens lack of trust in the banking sector and contribute to economic development and resilience.

**Developing an NFIS aligns with the broader developmental priorities of the Iraqi government.** GoI's Iraq Vision 2030 aims to empower its citizens through poverty alleviation, inclusive growth, and good governance. Concentrating efforts to advance financial inclusion is also a key recommendation in the CBI's National Payments Strategy, which identifies increased access to transaction accounts and mobile money accounts, expanded network of agents and ATMs, and simplified Know Your Customer (KYC) requirements as critical enablers for successful adoption of digital payments in Iraq. The strategy also advocates for banking sector reforms and enhanced financial literacy efforts among Iraqis to build their confidence and trust in the financial sector.

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