

Five Priorities for Economic Reform in Iraq

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Abstract

Even amidst an uncertain political and security environment, there is much to be gained from analysis of present and future growth prospects for Iraq's economy. Various institutions and governments are working on multiple economic initiatives, but these programs largely lack cohesion and prioritization. To take full advantage of the present window for reform, Iraq must identify key economic objectives. In order for Iraq to strengthen its slowly rebounding GDP and encourage improvement in the difficult labor market, this paper recommends action steps for the short, medium, and long term that focus on the following five priorities: (1) rebuilding oil infrastructure, including metering, pipeline maintenance and legal frameworks; (2) careful management of short term deficits and medium term surpluses; (3) strengthening and modernizing the banking sector; (4) deploying capital effectively for private sector development; and (5) revitalizing agriculture for economic diversification. To be most effective, Iraq will need a detailed program of reform that is continually updated to respond to shifts in institutional and political capacity constraints, as well as to developments in the security environment.

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Introduction

While there is no doubt that the future of Iraq depends upon sustained progress for its political and security environments, there is also much to be gained from analysis of present and future growth prospects for Iraq's economy. Various institutions are working on multiple economic initiatives and much progress has been made in recent months. However, existing programs largely lack cohesion and prioritization. While some efforts are hindered by the lack of security, other reforms can be implemented even in the absence of improved security. In order to take advantage of the present opportunity, Iraq must identify key economic priorities to guide a detailed program of reform that is continually updated to respond to shifts in institutional and political capacity constraints, as well as developments in the security environment.

In particular, to strengthen its slowly rebounding GDP and encourage improvement in the difficult labor market, this paper recommends action steps for the short, medium, and long term that focus on the following five priorities: (1) rebuilding oil infrastructure, including metering, pipeline maintenance and legal frameworks; (2) careful management of short term deficits and medium term surpluses; (3) strengthening and modernizing the banking sector; (4) deploying capital effectively for private sector development; and (5) revitalizing agriculture for economic diversification.

Current Situation: An Overview of GDP, Risks to Growth, and Labor Market Environment

Since 2003, Iraq's economy has shown mixed performance. Iraq has yet to fully recover from the 33% decline in real GDP caused by the economic shock of invasion and the resulting fall in oil production in 2003. Market activity and provision of services grow rapidly in small islands of security. For example, in the Kurdish region, the relative security has allowed for

investment from companies in Baghdad, Turkey, and Iran. In addition, market activity returned to Baghdad relatively quickly after the surge made progress in improving security. However, lack of broader stability prevents large-scale growth and investment, especially in oil and industry. Though statistics are imprecise due to insecurity and weak statistical capacity in Iraq, available estimates show that after the initial bounce-back in 2004, GDP growth has been volatile, ranging from 6.2% in 2006 to an estimated 1.3% in 2007 and projected 7.1% in 2008. Real GDP in 2007 was still only 91% of its pre-war level (see Figure 1).²

Another indicator of the weak economic environment is the poor labor market situation. Though data is difficult to collect, the most recent official estimate for unemployment is 17.6%, while underemployment is 38.1%.³ Since these statistics only include those individuals who are either employed or actively seeking work, they fail to capture those individuals who have become “discouraged workers,” and may be waiting for conditions to improve before trying to re-enter the workforce. To capture the magnitude of these discouraged workers along with the unemployed, we can characterize labor market conditions using the employment rate, which is the percent of the working-age population that is employed. In Iraq, that number is only 36%, compared to 41-42% for Iran and Turkey, and 60% for the United States (see Figure 2).⁴ In order to improve the employment situation, Iraq must focus on economic diversification and growth in non-oil sectors, such as agriculture or manufacturing, which are relatively more labor intensive and will encourage productive use of the human capital and labor available. Relieving unemployment is especially important as it disproportionately affects the young and inexperienced. As Iraq’s young population continues to mature to working-age, employment can

² International Monetary Fund, 2008.

³ Department of Defense, 2008.

⁴ Central Intelligence Agency, 2008; Department of Defense, June 2008.

provide increased stability and livelihood that is independent of oil money and government handouts.

Iraq's natural resource wealth provides the country with great potential for rapid development through investment in both private and public projects. In particular, the lifting of sanctions should provide Iraq with many avenues for economic expansion and diversification. While any growth in economic activity or employment amidst the current instability is an achievement, recent gains have been beneath expectations, demonstrating that reform efforts in the economic arena must continue. In 2007, the non-oil sector did not show real growth.⁵ The history of sanctions and a state-run economy have created inefficiencies that run deep, and we should not expect a growth miracle immediately. In addition, major risks to long term growth include oil wealth corruption and repeated conflict. If Iraq overcomes these obstacles, sustained growth is possible, but it would still need several decades to reach middle-income living standards. For these reasons, it is all the more important that Iraq take advantage of the vast technical expertise available through the various United States government programs and International Monetary Fund advice as it generates and implements new institutions and policies for reform.

Priority 1: Rebuilding Oil Infrastructure: Metering, Pipelines, and Legal Framework

The importance of the oil sector to Iraq's economy cannot be overstated. In 2007, the oil sector provided 65% of GDP and 95% of non-grant government revenue.⁶ International Monetary Fund projections for economic growth of between 7 and 10% per year through 2012 depend upon steady growth in oil production of around 10% per year, from the current 2.4

⁵ International Monetary Fund, 2008

⁶ International Monetary Fund, 2007; International Monetary Fund, 2008.

million barrels per day (mbpd) to 3.3 mbpd in 2012 (see Figures 3 and 4).⁷ In the alternative projection developed by the International Monetary Fund, oil production stays constant at 2.1 mbpd and annual GDP growth never rises above 3.2%. Though oil dependence puts the economy at risk in the event of negative price shocks or declines in global demand, the size of the oil sector and its large potential for growth leaves no doubt that oil sector development is crucial.

The oil sector is a potential engine for growth in Iraq not only because of its size relative to the entire economy, but also because its current state is far below its potential. In the past, the oil industry suffered from lack of investment and deterioration of oil extraction and transport infrastructure. Under Oil-for-Food, production increased but repairs were difficult because Iraq was not able to import spare parts or new technology. Now, while Iraq has 115 billion barrels of proven reserves, which is the third largest store in the world after Saudi Arabia and Iran, its production remains low. Saudi Arabia, with a little over twice the reserves of Iraq, has four times the production capacity.⁸ Though oil production has seen improvement since late 2007, the rate of increase until recently has been below initial projections, mostly because the security situation has been less stable than anticipated. Only with new investment will oil production in Iraq climb from current values of 2.4 million bpd to the projected 3.3 mbpd in 2012, or even higher, past the previous peak of almost 3.5 mbpd in 1979.⁹

Recently, Iraq has finally begun to see production increases of the size projected for the next five years. In order to continue growing at the projected pace, Iraq's oil sector would benefit from major progress in addressing the same two obstacles that hinder investment generally: lack of security and an uncertain legal environment. The lack of security prevents

⁷ International Monetary Fund, 2008.

⁸ Central Intelligence Agency, 2008.

⁹ Organization of the Petroleum Exporting Countries, 2007.

both public and private investment in the oil sector, as oil companies are wary of sending personnel and expensive technology into unstable areas. Lack of security also results in delayed completion of projects and increased costs. The second obstacle is the uncertainty surrounding legal reforms. Oil investors are likely to move into Iraq when they can secure contracts, which requires familiarity with and confidence in the controlling authorities. In addition, with political instability, it is important for oil companies to have a legal framework that ensures property rights in the long term.

While both security and a clear legal framework will encourage investment in Iraq's oil sector, it is important to note that as with other investments, neither obstacle totally precludes oil company action. Many companies have invested in the Kurdish region already, likely because of the greater security and clearer legal framework that allows companies to work with the governing authorities more easily. However, the legality of contracts with the Kurdish Regional Government may be disputed in the future as the national oil laws continue to be shaped. It is possible that oil companies will also enter the rest of Iraq in the absence of legislative progress if they are able to make contracts with some governing authority. For example, the Government of Iraq has already begun preparations to solicit bids for technical and production services contracts.

Even if progress can be made in their absence, it is clear that improved security and legal infrastructure will aid industry growth. In addition, there are many other reforms which can help the Iraqi oil sector. In the short term, improvement of metering technology will help Iraq track its production, catch problems in production and transport at an early stage, and prevent corruption and oil interdiction. In the medium term, oil pipeline maintenance, rehabilitation and construction will help move oil to markets, though it will not increase production. Finally,

careful consideration of the rights and incentives for extraction, production, and revenue distribution will be important in establishing economic and political precedents for the long term. In particular, although settlement of the revenue distribution question will require great political compromise between regional and central government interests, it will ensure not only growth in the oil sector, but also the transformation of the oil sector into an engine of growth for the entire economy.

Priority 2: Managing Short Term Deficits, Medium Term Surpluses

The three most important issues concerning Iraq's fiscal situation are debt relief, management of the medium term annual budget outlook, and budget execution capabilities. Initial debt relief was led by the Paris Club, the group of nineteen countries which provides debt relief and restructuring to indebted countries. The agreement with the Paris Club called for an 80% debt reduction to be carried out in three stages, each tied to Iraq's performance in meeting goals set by the International Monetary Fund. After the third debt reduction, Iraq's Paris Club debt will be reduced from \$37 billion to about \$8 billion. Non-Paris Club countries, which hold the majority of Iraq's debt, have been encouraged to follow the same terms of debt reduction. While Russia signed the final Paris Club bilateral debt agreement in early 2008, the recent debt forgiveness of almost \$7 billion from the UAE marks the first Gulf Arab country to forgive all of Iraq's debt. Saudi Arabia has publicly stated it will make concessions in line with the 80% debt reduction given by the Paris Club, but is still engaged in formal negotiations concerning the amount owed, the principal amount of which is valued around \$15.5 billion. Meanwhile, debt negotiations with Kuwait remain stalled.

Even with massive debt reduction, Iraq's budget outlook remains fragile. In the short term, the large investment outlays required to rebuild deteriorating infrastructure are projected to exceed annual revenues to the government, resulting in projected deficits as high as \$7.6 billion in 2008.¹⁰ In addition, medium-term surpluses are projected as soon as 2010, as the economy grows and oil exports increase (see Figure 5).¹¹ Given the delicate fiscal balance, it is important that Iraq avoid the mismanagement of public money and politically favorable payouts that are common in resource-rich countries and instead make investments that will pay off in the future. For example, recent pension reform and pending implementation of means testing for the welfare system are politically unpopular, but they will both reduce the fiscal burden and help bring the budget into balance in the medium term.

Finally, while budget deficits in the short term require extreme attention to government spending, it is important that Iraq improve budget execution in order to make investments at this critical time. Budget execution improved from 2006 to 2007, but surpluses that took the place of projected deficits in 2005, 2006, and 2007 indicate inability to carry out investment in infrastructure. The lack of security remains a significant obstacle because it threatens physical investments such as oil pipelines, refineries, and electricity lines, and it hinders personnel from executing projects to improve delivery of government services. In one case, the implementation of an automated financial management information system for the government was significantly delayed after five USAID contractors working on the project were kidnapped. While in some cases, the government must wait until increased security allows more certain returns to investment, it is clear that there are also other obstacles to budget execution, including lack of trained personnel for government capacity, outdated financial systems, and corruption within the

¹⁰ Department of State, 2008c.

¹¹ International Monetary Fund, 2008.

government. In fact, the same anti-corruption laws that were meant to prevent graft and revenue extraction have resulted in red tape that hinder government effectiveness. For Iraq to take this opportunity to invest in its future, it must continue training personnel to increase government capacity and simplify the bureaucratic procedures that hinder expenditure.

Priority 3: Modernizing the Banking Sector

Perhaps the most impressive macroeconomic success in Iraq recently has been control of inflation. Through careful, coordinated action, the Central Bank of Iraq slowed inflation from a high of 76.6% in August 2006 to 4.7% in December 2007 and has maintained inflation below 10% since then (see Figure 6).¹² Though continued vigilance is required, the decline and subsequent relative stability of inflation can be considered a great success. It was achieved mainly through appreciation of the dinar during the daily foreign currency auctions (see Figure 7). Supporting policies included an increase in the policy interest rate to 20%, a reduction in current government spending on wages and pensions, and the legalization of private fuel importation. As a result, fuel shortages declined, dollarization decreased as confidence in the Iraqi dinar rose, and inflation fell considerably.

Though the Central Bank has had recent successes in improving banking infrastructure, remaining major concerns include its weak supervisory role, the negligible regulatory authority exercised by the Central Bank branches, and limits on data collection and reporting by the Central Bank branches in the Kurdish region. In fact, the Central Bank currently does not receive data on prices or money supply from the two branches in the Kurdish region.¹³ These banks are reportedly under the control of the Kurdish Regional Government's Ministry of

¹² Central Bank of Iraq, 2008.

¹³ International Monetary Fund, 2008.

Finance and can hardly be considered independent.¹⁴ Reform in this area may be subject to political concerns regarding Kurdish regional autonomy. With regard to regulation and supervision, improvement is necessary if the state-owned and private banks are to expand the services provided to a growing economy. Additionally, Rafidain and Rasheed, the two largest state-owned banks, which together hold about 70% of the banking assets in the country, are insolvent.¹⁵ The government of Iraq is in the process of auditing and restructuring these banks and expects to adopt restructuring programs by September 2008.¹⁶ Once the restructuring is complete, the Central Bank will need to supervise and regulate these state-owned banks to ensure continued compliance. Recent improvements in infrastructure include implementation of the automatic payments clearing system, training personnel to use modern banking practices, and progress towards the use of electronic funds transfers, debit cards, credit cards, and ATMs. Continued efforts to expand these services in the banking sector should remain a priority for the Iraqi government, as they will allow for more efficient economic activity across all sectors of the economy.

Priority 4: Deploying Capital Effectively

Because Iraq is a resource-rich country, it has a large amount of financial capital relative to labor. In fact, the oil industry provides less than 2% of employment but comprises 65% of GDP and 95% of government revenue.¹⁷ Oil revenues accumulating in the Development Fund for Iraq, an account held at the Federal Reserve Bank of New York, reached \$9.9 billion as of

¹⁴ Ernst & Young, 2007.

¹⁵ International Monetary Fund, 2007.

¹⁶ Government of Iraq, 2008.

¹⁷ World Bank, 2006.

December 2007.¹⁸ As Iraq develops the legislative frameworks for the oil sector, it faces several options for revenue distribution: individual dividend payments, federal or regional control, creation of an investment fund to support private and public enterprise, or establishment of a stabilization fund to protect against oil market fluctuations. After years of sanctions and inability to invest in infrastructure, the government now has a large number of opportunities for profitable deployment of capital, including rebuilding of infrastructure for electricity, water, sewage, and transportation, and provision of social services such as health care and education.

Though potential government projects abound, relying on public provision of services may lead to less efficient use of resources and increases the risk that oil wealth will lead to corruption and economic stagnation. Instead, increasing financial intermediation can encourage private market activity and increase employment opportunities by making loans accessible to small business owners. In the past, bank loans usually required property or other physical assets as collateral, making it difficult for many to secure capital. In addition, banks currently lack knowledge of risk assessment and accounting practices, and they do not have the trained employees necessary to expand programs for small and medium sized loans. One final problem is that while banks usually charge 14-15% interest on one-year loans, they are guaranteed high returns of 15-17% on short term deposits at the Central Bank.¹⁹ With such high risk-free rates, banks do not find lending to be a profitable enterprise. In order to promote lending, the Central Bank should continue to lower rates on short-term deposits and encourage banks to increase their loan to asset ratios. In addition, banks should continue expanding capacity in their loan departments through hiring and training.

¹⁸ Ernst & Young, 2008.

¹⁹ Central Bank of Iraq, 2008; Department of State 2008a.

Three government programs have begun to deploy capital for private enterprise. One USAID effort has funded microfinance institutions and trained loan officers throughout Iraq. Given that repayment rates on microfinance loans have been as high as 98%, and that microfinance institutions are being started by NGOs and indigenous groups throughout the country, microfinance may become an important instrument for growth in the private sector. Since 2004, over 70,000 loans have been made, totaling \$150 million.²⁰ While the recent successes of microfinance in Iraq are promising, with small loans averaging only \$1,400, this type of lending is insufficient to support small and medium sized businesses.²¹ Two other programs aim to support the needs of these businesses. After the success of a pilot program for small and medium sized loans in Baghdad, the Ministry of Industry and Minerals along with the Ministry for Labor and Social Affairs have announced a \$1 billion program to provide subsidized bank loans for small and medium enterprises, to be dispersed across all governorates.²² Finally, the government has been encouraging private bank lending covered by the Iraq Corporation for Bank Guarantees, which is a new facility supported by USAID. Through March 2008, the loan guarantee program had supported 38 loans worth almost \$1.3 million.²³

Priority 5: Revitalizing Agriculture through Trade, Technology, and Training

Though it is not usually considered a primary avenue for development, agriculture in Iraq has experienced prolonged neglect and has the potential to grow into a thriving industry. Despite the prevalence of fertile lands in Iraq, agriculture suffered during the 1980s and 1990s due to a number of policy failures. Under sanctions, and especially under the Oil-for-Food Program, oil

²⁰ Department of State, 2008a.

²¹ Department of State, 2008a.

²² Government of Iraq, 2008.

²³ Department of State, 2008b.

exports were exchanged for agricultural imports, which were distributed to everyone in the form of food rations. This regime both illegalized agricultural exports and depressed local demand for agricultural products. Over time, knowledge of agriculture dissipated, and after years without maintenance, investments depreciated and became outdated. With an infusion of investment, technology, and training, the agricultural sector could experience a revival. USDA scientists have already begun performing soil analysis to inform the choices of farming inputs and crop selection. In addition, USAID has begun training farmers in fertilizer application, irrigation, and the effective use of new seed varieties. In order to promote supply chain and agribusiness development, the USAID *Inma* program is forming linkages between farmers, financial services, and domestic and international markets, and it has supported the formation of the Small Farmers Lending Fund, which provides loans with subsidized interest rates through private banks and non-governmental organizations.

Currently, trade policies prohibit the export of wheat and rice. When coupled with the continued presence of the Public Distribution System, which delivers wheat, rice, and flour rations to all Iraqis, these trade restrictions heavily restrict the demand for agricultural products. The government is beginning to reform these policies in order to stimulate demand for agricultural products. For example, the government has increased local content in the ration baskets and has encouraged growth of the agricultural supply chain by allowing private contractors to supply some of the rations.²⁴ Announcements in late 2007 indicated that the government plans to reduce both the amount and number of items in the ration baskets in 2008.²⁵ Furthermore, the Minister of Finance has said that eventually, individuals with incomes over 1

²⁴ Government of Iraq, 2008.

²⁵ Government of Iraq, 2008.

million Iraqi dinars will stop receiving rations.²⁶ Though the move away from the ration system and towards means-tested aid will be politically difficult, it will be an improvement in public finances and will encourage market activity. Increased agricultural activity can also stimulate related industries, including food processing and wholesale and retail trade. Finally, since agriculture is a labor-intensive industry, it could provide employment opportunities. Agriculture currently comprises 5% of GDP and 15% of employment.²⁷ With such significant numbers even after years of neglect, renewed emphasis on increasing trade, training, and adoption of new technology can help the agricultural sector become a driver of growth in Iraq that contributes to productivity gains, job creation, and economic diversification.

Conclusion

Iraq's economy faces major obstacles to growth for the short and long term. It is subject to a number of challenges that pose long-term risks to development, including dependence on oil wealth that lends itself to corruption, the legacy of a state-run economy, and a history of conflict that makes future conflict more likely. In the short term, lack of security is the most obvious impediment to economic activity, as it restrains economic activity and discourages investment. Lack of security also amplifies Iraq's second major economic difficulty: the lack of intermediation that prevents productive use of available capital and labor resources. Iraq suffers from a lack of financial infrastructure that prevents effective deployment of capital. Despite the abundance of public and private opportunities for investment, capital remains tied up in government and private sector bank balances. On the labor market side, the large numbers of

²⁶ Al-Sabaah, 2007.

²⁷ International Monetary Fund, 2007. United Nations Development Programme, 2004.

unemployed Iraqis face financial hardship, while hospitals, schools, government ministries and private banks all lack the trained staff to carry out normal functions.

As in any developing country, possibilities for economic reform and improvement abound. However, when hundreds of these steps were identified in the International Compact with Iraq, the result was a seemingly endless list of objectives, without coherence or prioritization. To take advantage of the present window for reform, Iraq must organize the reform agenda. Making even limited progress on rebuilding oil infrastructure, managing public finance, modernizing the banking sector, deploying capital effectively, and revitalizing agriculture can have a potentially large impact.

In the long run, Iraq has far to go before reaching middle income status. Even with sustained annual growth of per capita income at 5%, Iraq would attain the current level of per capita income in Turkey only after almost 25 years. Because it faces many risks to growth, Iraq has a treacherous path ahead. Furthermore, reforms in institutional structures will not take place overnight, and will require sustained efforts for improvement.

Iraq has already made progress both in organizing its reform agenda and in carrying out some of its steps. The first annual review of the International Compact for Iraq itemizes reform achievements, describes progress, and specifies target dates for current and future efforts. Some recent positive steps include installation of oil metering at the port of Basra, passage of the 2008 budget to include greater oil revenue distribution to the provinces and focus on infrastructure investment, participation in the automatic payments clearing system by 19 financial institutions, growth of both capital and capacity for loan subsidy programs, and training for farmers in new technology for the restoration of agriculture.²⁸ Despite its many downside risks, with plentiful oil reserves awaiting increases in extraction, potential investment of increased revenues, fertile

²⁸ Government of Iraq, 2008.

land for the growth of agriculture, and mostly untapped labor and human capital, Iraq has resources that make its potential for growth enormous. Iraq will remain a developing country for the near future. However, with a coordinated plan focused on prioritizing efforts for economic reform, sustained growth is possible.

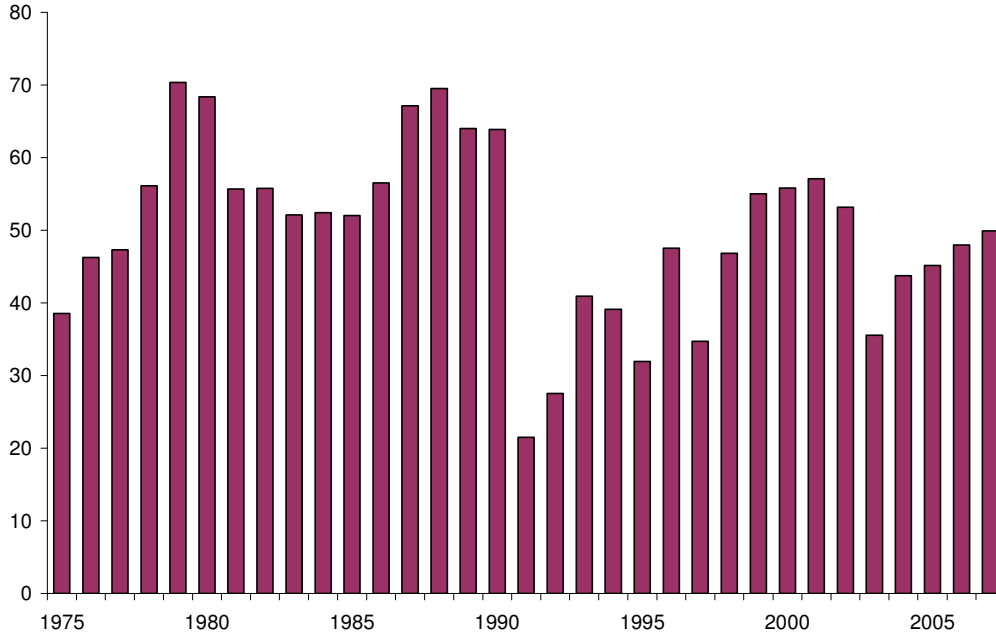
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Appendix

Figure 1. Real GDP

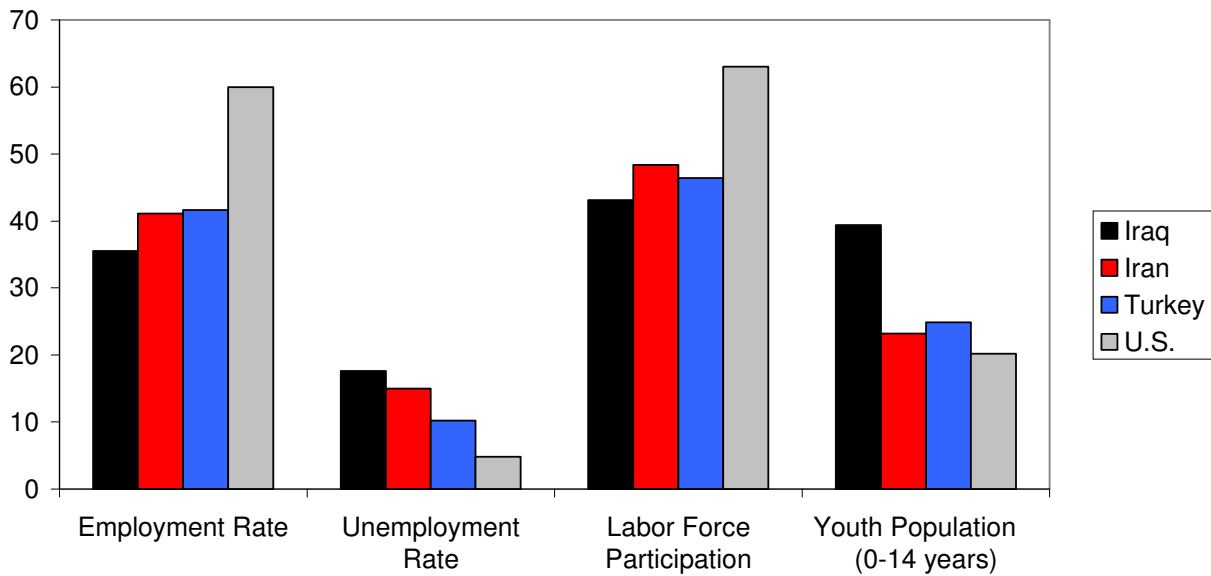
Billion US\$ (constant, 2006)



Source: United Nations, International Monetary Fund

Figure 2. Comparative Labor Market Indicators

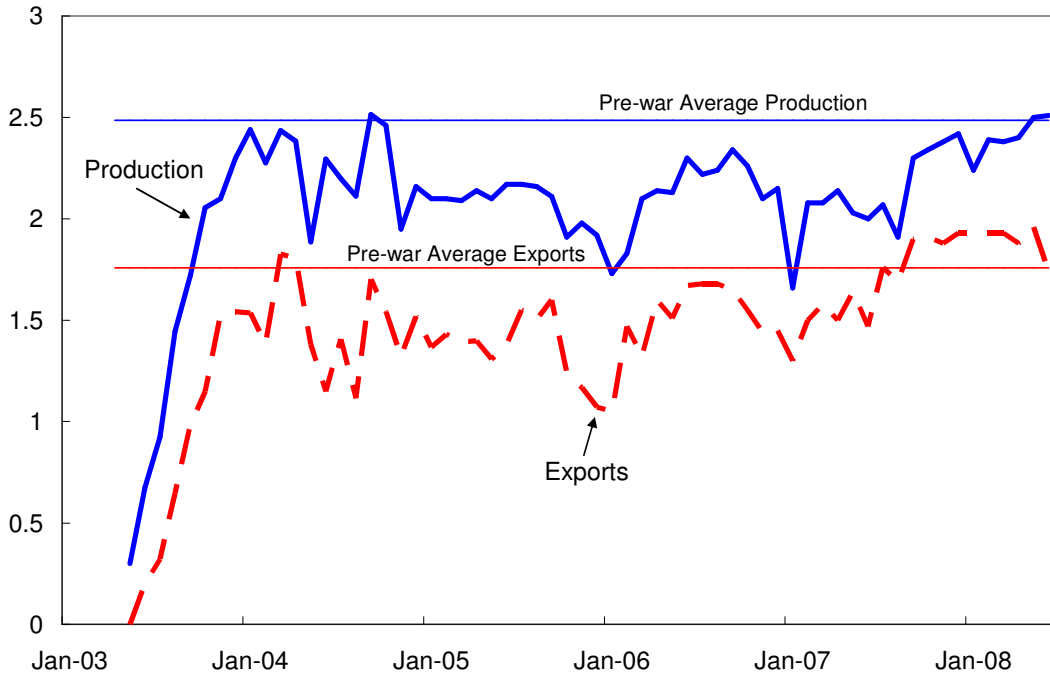
Percentage



Sources: CIA World Factbook, Iraq's Central Organization for Statistics and Information Technology

Figure 3. Crude Oil Production and Exports

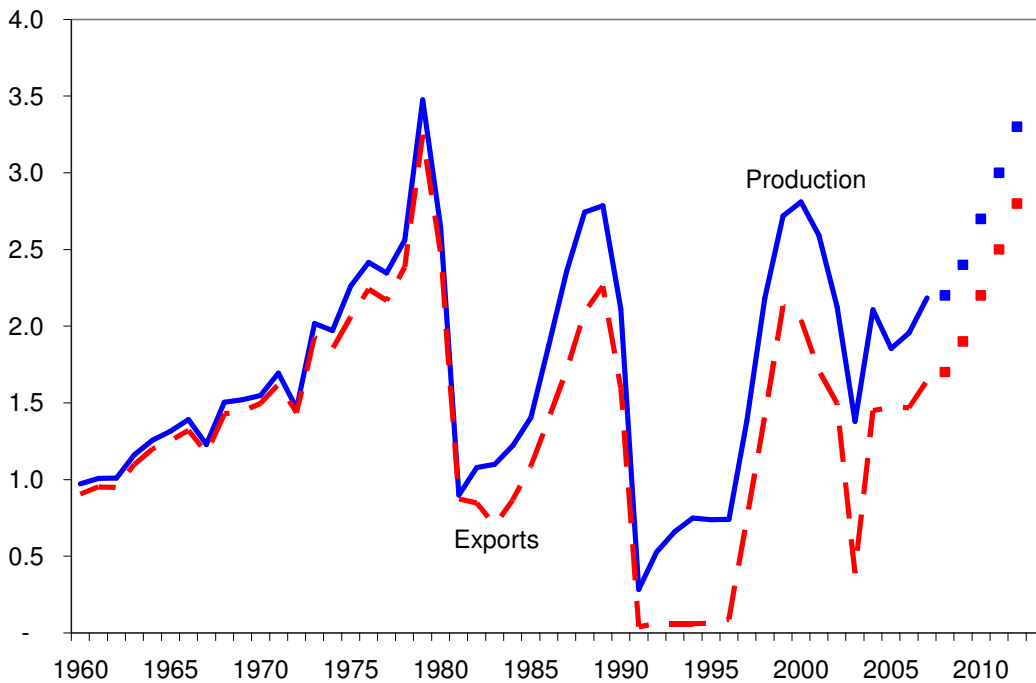
Million Barrels per Day



Sources: Brookings Iraq Index, OPEC Annual Statistical Bulletin

Figure 4. Crude Oil Production and Exports

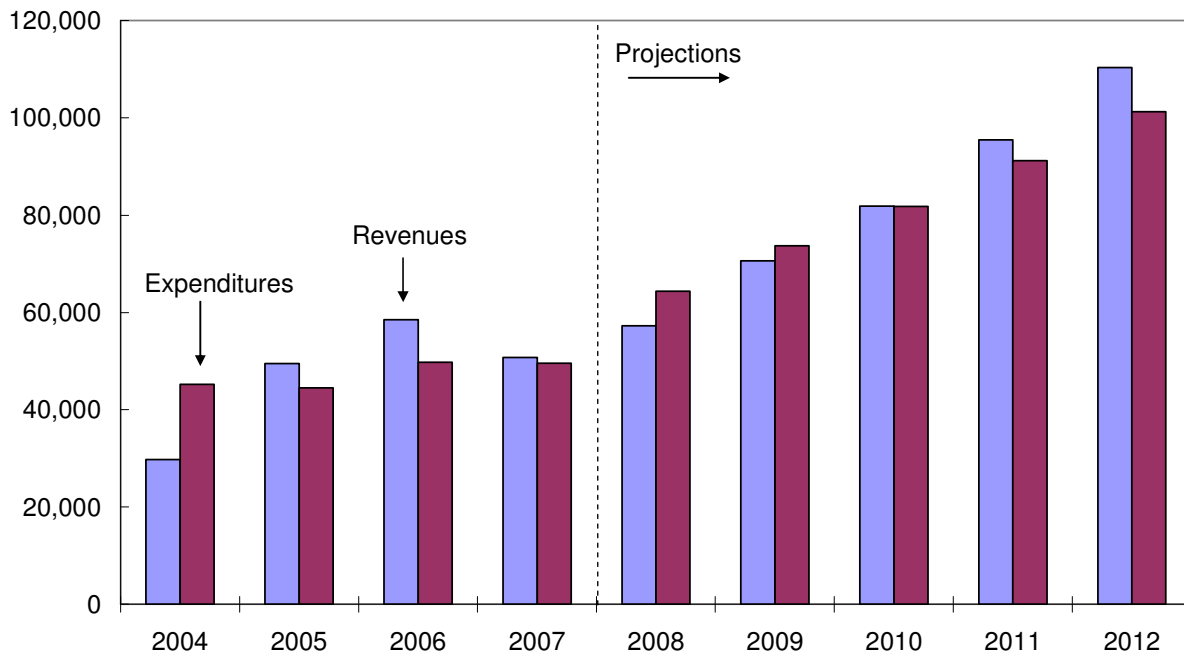
Million Barrels per Day



Source: OPEC Annual Statistical Bulletin, International Monetary Fund

Figure 5. Iraq Revenues and Expenditures, 2004-2012

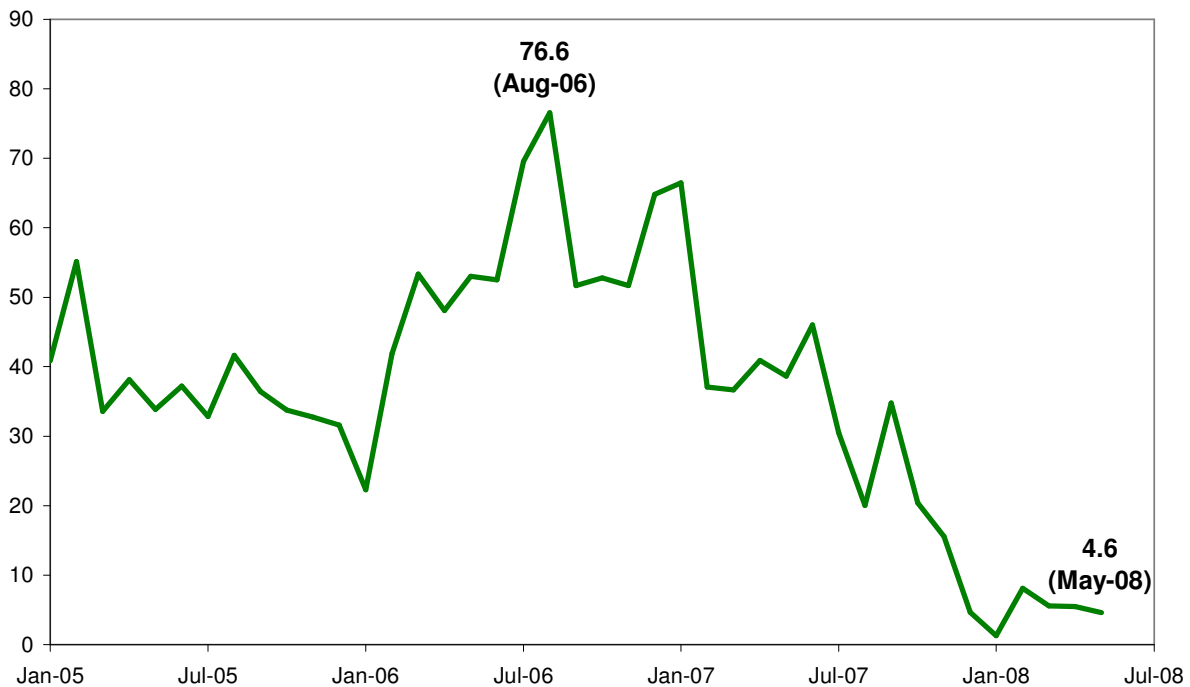
Billions of Iraqi Dinars



Source: International Monetary Fund staff estimates and projections.

Figure 6. Iraq Inflation

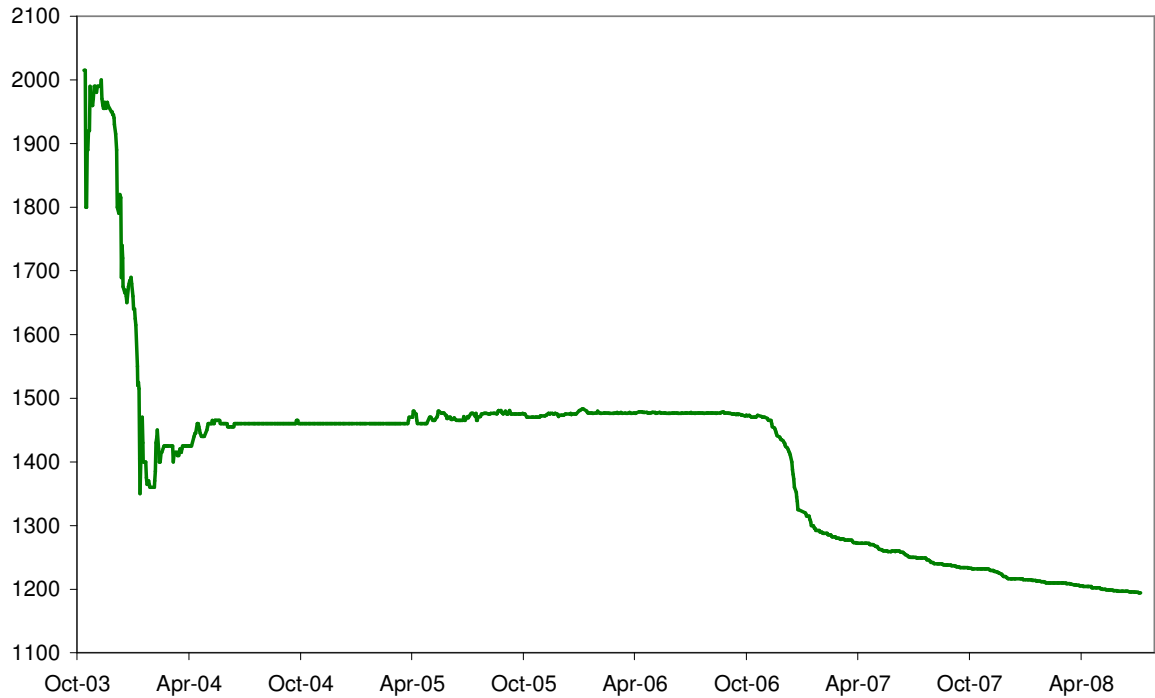
12 Month Change in CPI, Percent, Not Seasonally Adjusted



Source: Central Bank of Iraq

Figure 7. New Iraqi Dinar (IQD) per U.S. Dollar (USD) Exchange Rate

IQD/USD



Source: Central Bank of Iraq