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**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
AND INTERNATIONAL DEVELOPMENT ASSOCIATION
AND INTERNATIONAL FINANCE CORPORATION**

SECOND INTERIM STRATEGY NOTE

FOR

THE REPUBLIC OF IRAQ

FOR THE PERIOD FY06-07

August 23, 2005

Middle East and North Africa Region

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CURRENCY EQUIVALENTS

(Exchange Rate Effective August 1, 2005)

Currency Unit = Iraqi Dinar (ID)

US\$1.00 = 1476 ID

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	JBIC	Japan Bank for International Cooperation
bpd	Barrels per day	LSMS	Living Standards Measurement Survey
CEM	Country Economic Memorandum	MDGs	Millennium Development Goals
COSIT	Center of Statistics and Information Technology	MIGA	Multilateral Investment Guarantee Agency
DFI	Development Fund for Iraq	MoPDC	Ministry of Planning and Development Cooperation
EPCA	Emergency Post-Conflict Assistance (IMF)	NBK	National Bank of Kuwait
ESW	Economic and Sector Work	NDS	National Development Strategy
FY	Fiscal Year	NGO	Non-Governmental Organization
FDI	Foreign Direct Investment	OP	Operational Policy
GDP	Gross Domestic Product	PEP-MENA	Private Enterprise Partnership for the Middle East and North Africa
IAMB	International Advisory and Monitoring Board	PMT	Project Management Team
IBRD	International Bank for Reconstruction and Development	PSD	Private Sector Development
ID	Iraqi Dinar	PDS	Public (food) Distribution System
IDA	International Development Association	SDR	Standard Drawing Right
IFC	International Finance Corporation	SME	Small and medium enterprise
IRFFI	International Reconstruction Fund Facility for Iraq	SOE	State-Owned Enterprise
IRFO	Iraqi Reconstruction Forum	TA	Technical Assistance
ISBFF	Iraqi Small Business Financing Facility (IFC)	TAL	Transitional Administrative Law
ISRB	Iraqi Strategic Review Board	UN	United Nations
ITF	Iraq Trust Fund (World Bank)	UNDP	United Nations Development Program
IMF	International Monetary Fund	UNSCR	United Nations Security Council Resolution
INB	Iraq National Bank	US	United States

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**SECOND INTERIM STRATEGY NOTE
FOR THE REPUBLIC OF IRAQ**

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EXECUTIVE SUMMARY

i. **Political Developments.** Iraq has had two political transitions over the past year, taking steps toward a constitutionally-elected government. Nevertheless, the country faces a violent insurgency that is impeding reconstruction and economic recovery. Immediate challenges are to restore rule of law, establish political legitimacy, and begin to build credible and inclusive institutions. The ability of the Iraqi Transitional Government to include ethnic and religious groups in the political process over the coming months will be important in determining whether a future constitutionally-elected government will improve security and stability, which are preconditions for successful reconstruction.

ii. **Economic Developments.** After hitting a low in the wake of the 2003 invasion, real GDP rose by about 47 percent in 2004, reflecting strong oil prices and partial recovery of the oil sector. Income per capita—about US\$940—is still only a quarter of what Iraqis enjoyed twenty-five years ago. Although data remain unreliable, surveys suggest that poverty has worsened in recent years; and unemployment is estimated to be at least 30 percent. The government continues to provide large untargeted subsidies for food, fuel, and utilities, amounting in total to about 50 percent of GDP. Although the subsidies provide important support for the poor and vulnerable, they distort markets, disproportionately benefit the wealthy, encourage black markets and smuggling, and burden the budget, crowding out potentially more efficient spending on targeted social programs.

iii. **Economic Prospects.** Real GDP growth is projected at about 3.7 percent in 2005 due to stagnating oil production and exports. Growth is expected to accelerate to 17 percent in 2006, predicated on increased security and political stability, higher oil production and exports, and continued strong world oil prices. Strong growth also depends on introducing targeted safety nets and implementing structural reforms—including a gradual reduction in subsidies—to contain recurrent spending and allow for sufficient investment and reconstruction. Iraq's overriding challenge—for both stability and economic sustainability—is to improve the management and transparency of oil revenues.

iv. **The Government's Strategy and the International Response.** Iraq's National Development Strategy (NDS), which emphasizes good governance, private sector-led growth, and strong social safety nets, provides a framework for donor assistance. Although donors pledged US\$32 billion at the International Conference for Iraq in Madrid in October 2003, continued lack of security has complicated delivery of donor assistance and lessened its impact on the ground. Donors have deposited about US\$1 billion in the International Reconstruction Fund Facility for Iraq (IRFFI), which consists of two trust funds, one administered by the World Bank and another by the United Nations. Nearly all donor deposits to IRFFI have been allocated to projects that are ongoing. Most aid to Iraq takes the form of bilateral assistance, mainly from the United States. Japan is the second largest donor.

v. **Progress under the World Bank's First Interim Strategy.** The First Interim Strategy, discussed by the Executive Directors in January 2004 and originally intended to cover nine months, was designed to rely on the World Bank Iraq Trust Fund (ITF) within the IRFFI to finance projects. Between March and December 2004, the Bank approved and launched nine emergency projects amounting in total to US\$366 million. A first capacity building project is completed, an emergency textbook project is nearly completed, and seven additional operations are under implementation, addressing capacity building, healthcare,

private sector development, rural infrastructure, school construction, urban upgrading, and water supply and sanitation. The ITF portfolio balances immediate needs and near-term employment with medium-term interventions to improve service delivery. The Bank, using its own budget, is also helping to lay the groundwork for Iraq's medium-term program through analytical and advisory activities (AAA).

vi. **Objectives.** The Bank's overarching objective is **to help Iraq build efficient, inclusive, transparent, and accountable institutions** as needed for stability, good governance, and sustainable economic prosperity. Better institutional frameworks, policies, and systems will improve the efficiency and effectiveness of both national expenditures and international aid. Under the umbrella of institution building, the Bank Group's work program is organized into four pillars, supporting government efforts to: (1) **restore basic service delivery**; (2) **enable private sector development**; (3) **strengthen social safety nets**; and (4) **improve public sector governance**. Investment projects fall under Pillar 1: Restore Basic Services. Pillars 2, 3, and 4 are mainly supported by AAA.

vii. **Lending Program.** The Second Interim Strategy Note provides the framework for up to US\$500 million from IDA and additional resources from the ITF. To provide a continuum of resources, up to US\$500 million of IBRD lending could supplement the IDA and ITF envelope, assuming critical progress regarding IBRD creditworthiness. Iraqi authorities have asked the Bank to initiate IDA lending in four key sectors: **education; electricity; transport (roads); and water supply and sanitation**. The Bank is already providing support in two of these areas through the ITF and will build on its experience to deepen its support. Projects will be designed to maximize local ownership, local content, and near-term employment. Projects will be clustered geographically to facilitate implementation, institution building, and impact.

viii. **Non-Lending Program.** AAA, including capacity building, policy advice, and economic and sector work, will be a key vehicle of Bank assistance over the next twenty-four months. AAA will continue to be clustered into three themes: (i) economic reform and transition; (ii) poverty, safety nets, and social development; and (iii) public sector governance, particularly public resource management. It will aim to lay out options available to Iraqi policymakers and discuss trade-offs under each option.

ix. **Risks.** There are high and unprecedented risks to working in Iraq. The situation is still evolving—it could improve or deteriorate. Consequently, the strategy emphasizes flexibility and the Bank will adjust the level of its activities as appropriate. Given the current inability of international Bank staff to travel within the country, ensuring adherence to core fiduciary and safeguard requirements will remain challenging under the circumstances. Residual risks are substantial despite the Bank's mitigating measures, which include intensive capacity building, contracting local oversight capacity, and prudent disbursement procedures.

x. The following issues are suggested for **Board discussion**:

- Is the strategy sufficiently flexible and does it appropriately balance emergency needs with institution building? Is the mix of analytical work and financial support appropriate?
- Does the strategy adequately describe, take into consideration, and mitigate risks to the extent possible?

SECOND INTERIM STRATEGY NOTE FOR THE REPUBLIC OF IRAQ

I. INTRODUCTION

1. On January 29, 2004, the World Bank's Executive Directors discussed a First Interim Strategy Note of the World Bank Group for the Republic of Iraq and authorized the Bank to act as Administrator of the World Bank Iraq Trust Fund (ITF) within the International Reconstruction Fund Facility for Iraq (IRFFI). The First Interim Strategy Note was designed to rely on the ITF to finance emergency operations and on the Bank's own budget to finance analytical and advisory services.

2. Over the past twenty months, the Bank has worked within the framework of the First Interim Strategy Note, focusing on building Iraqi institutional capacity, preparing and starting to implement emergency operations, and laying the groundwork for Iraq's medium-term reconstruction and development program. Between March and December 2004, the Bank approved and launched nine emergency projects at a total value of about US\$366 million, thereby committing nearly all donor deposits in the ITF. In addition, the Bank has used its own budget to provide policy advice on urgent reform issues and to undertake diagnostic and analytical sector work.

3. **This Second Interim Strategy Note outlines the World Bank Group's work program for Iraq for the next twenty-four months, providing a framework for World Bank lending and additional ITF resources in addition to non-lending services.** It draws on the lessons and experience of the First Interim Strategy and emphasizes flexibility given the continued uncertain and fluid environment. Core principles for engagement are: local ownership, near-term employment, local impact, and institutional impact for sustainability.

II. COUNTRY CONTEXT

A. Recent Political and Security Developments

4. **Iraq has had two political transitions over the past year, taking steps towards a constitutionally-elected government.** The political process is outlined in the Law of Administration for the State of Iraq for the Transitional Period (known as the Transitional Administrative Law or TAL), an interim constitution approved by the former Iraqi Governing Council in March 2004 after long debate. United Nations (UN) Security Council Resolution 1546 of June 8, 2004, endorsed the political process; and on June 28, 2004, the Coalition Provisional Authority transferred authority to an Iraqi Interim Government. Despite a worsening security situation, national elections for a 275-member Transitional National Assembly took place as planned on January 30, 2005.¹ Voter turnout was high, a notable achievement considering the circumstances, except among Sunni Arabs, who largely boycotted the elections or stayed home for fear of attacks. After months of political deadlock, a cabinet was sworn into office in May 2005, resulting in a new yet fragile Iraqi Transitional Government.

5. **A third political transition is expected by the end of 2005,** according to the time schedule outlined in the TAL. In addition to serving as the legislature, the Transitional National Assembly is responsible for drafting and ratifying a permanent Iraqi constitution to be submitted for public referendum by October 2005. If the constitution is approved in the referendum, elections for a government operating under the permanent constitution will be held at the end of 2005.

¹ Voters also elected Governorate Councils and a Kurdistan National Assembly.

6. **Despite these steps, a violent and persistent insurgency continues, hindering reconstruction, economic recovery, and systemic reform.** The violence has been most intense in the center of Iraq, although attacks have occurred in all major cities. Criminality, including kidnappings of Iraqi civilians for ransom, is also high, causing many Iraqi professionals to leave the country. The violence has impeded private investment, slowed physical reconstruction, and increased security costs; and sabotage has disrupted the output of oil and electricity. As a result, there are continued problems in delivering basic services and unemployment remains high. Substantial GDP growth in 2004 mainly reflects the partial recovery of the oil sector from the near total standstill in 2003 and strong oil prices (see para. 9-10). The former Iraqi Interim Government maintained a prudent fiscal and monetary stance but did not implement major economic reforms. Both the former Iraqi Interim Government and the subsequent Iraqi Transitional Government elaborated National Development Strategies (see paras. 20-22).

7. **Building political legitimacy and credible and inclusive institutions remains a main challenge,** especially given Iraq's history of patronage and use of violence to suppress dissent since the founding of the Iraqi state in the 1920s. The sources of Iraq's conflict are complex, but the country does have three classic risk factors: ethnic dominance, economic decline, and dependence on large natural resource rents. Lessons from oil-producing countries, particularly those experiencing conflict, suggest that priority should be given to transparent governance of Iraq's oil revenues, steps toward economic diversification, capacity building for policy and institutional reform, and policies that contribute to social inclusion (see Annex 1: Lessons Learned from Post-Conflict Reconstruction). International experience also indicates that electoral democracy *per se* does not reduce the risk of conflict; and elections can sometimes increase conflict risk. The ability of the Iraqi Transitional Government to include ethnic and religious groups in the political process will be important in determining whether a future constitutionally-elected government will improve security and stability, which are conditions for successful reconstruction and sustainable economic development.

B. Economic Developments and Prospects

8. **Continued insecurity, political uncertainties, and weak public institutional capacity have resulted in mixed economic results and slower than expected reconstruction over the past twenty months.** Oil production remains the mainstay of the economy but has not yet reached pre-2003 levels. Regional disparities remain large, unemployment is a major concern, and most basic services have not recovered to pre-2003 levels. Predicated upon better security and more inclusive political institutions, economic reform priorities include addressing reconstruction and basic service delivery; private sector development for jobs; reforms to address fuel, electricity and food subsidies; strengthening and improving targeting of safety nets; and better public sector governance.

9. **There was substantial economic growth in 2004 though measured from a low base** (see Table 1). After hitting a low of US\$13.6 billion in the wake of the 2003 invasion, real GDP rose to an estimated US\$25.5 billion, with income per capita reaching about US\$940—still merely a quarter of what Iraqis enjoyed twenty-five years ago. GDP growth is projected to be 3.7 percent in 2005, because continued sabotage of oil infrastructure has led to stagnating oil production and exports. Consumer prices were stable after the successful introduction of the new Iraqi Dinar in early 2004 but accelerated beginning in mid-2004, driven by fuel shortages, increasing security costs, and rising public spending. Inflation subsided again in spring 2005, reflecting the easing of supply constraints, but is expected to remain in the double-digit range for the year as a whole.

Table 1: GDP Estimates and Projections, 2002-2006

	2002	2003	2004	2005p	2006p
Population (million)	25.5	26.3	27.1	27.9	28.6
Nominal GDP (in US\$ billion)	20.5	13.6	25.5	29.3	39.0
Of which non-oil GDP (% of GDP)	32	32	33	37	32
Real GDP Growth Rate (%)	-7.8	-41.4	46.5	3.7	17
Per Capita GDP (US\$)	802	518	942	1,051	1,357
Consumer Price Inflation (annual average)	19	34	32	20	12
Iraqi Oil Export Price (US\$ per barrel)	20.5	26	31.6	36	40.5

Source: World Bank and IMF staff estimates.

Note: Iraqi Oil Export Price shown for 2005 and 2006 reflect assumptions in the Iraqi budget.

10. **Dependency on oil remains high.** The oil sector accounts for about two-thirds of GDP and over 98 percent of exports and budget receipts. Oil production and exports in 2004 reached on average 2 and 1.5 million barrels per day (bpd), respectively, falling short of plans and the pre-2003 level due to sabotage and dilapidated infrastructure. Oil revenues, however, exceeded projections due to exceptionally high world oil prices in 2004. Continued high oil prices in 2005 are again resulting in oil revenues that exceed projected levels (by some US\$2-2.5 billion as of August 1). In the short term, the level of oil exports can grow only if the vulnerable northern pipeline is kept operational.

11. **Growth in the non-oil sectors was slower than expected, reflecting high insecurity.**² There is likely a shift to subsistence and informal activities less reliant upon other parts of the economy, as typical in conflict-affected environments. Most of Iraq's 192 state-owned enterprises (SOEs) are idle because of damage from war and looting; salaries of the SOE workers, estimated to number about 500,000, are covered by the budget. Iraq's agricultural sector remains an important employer despite its current low productivity; and the sector could play a key role in diversifying the economy.

Box 1: Data Quality Issues in Iraq

A dearth of reliable data and economic information remains a serious problem that limits analysis (see Annex 2: Iraq at a Glance; and Annex 3: Iraq vis-à-vis the Millennium Development Goals). Despite efforts by the Center for Statistics and Information Technology (COSIT) in the Ministry of Planning and Development Cooperation, economic estimates and projections are still unreliable and will need to be revised as better data become available. Elsewhere in the government, statistical capacity remains limited. For example, balance of payments and fiscal data remain incomplete.

Building modern systems for data collection and dissemination is essential for providing policymakers with reliable information on which to base their decisions. The Bank has organized several workshops with COSIT and the inter-ministerial Committee for the Improvement of Statistics to assess the existing statistical systems and prioritize improvements. One priority is to coordinate the statistical systems of the northern governorates with the rest of Iraq.

In coordination with the UN, the Bank will support improved systems for collecting and utilizing reliable data, including the design and implementation of the first full income and expenditure household survey since 1993 (see para. 75).

² Data on non-oil sectors remain scarce. These figures are based on World Bank and IMF staff estimates.

Box 2: The Development Fund for Iraq and the International Advisory and Monitoring Board

United Nations Security Council Resolution (UNSCR) 1483 (May 2003) established the **Development Fund for Iraq** (DFI) to receive and administer oil export proceeds and to hold seized assets held abroad and remaining cash balances from the UN's Oil-for-Food Program. Under UNSCR 1483, 95 percent of proceeds from export sales of petroleum and petroleum products must be deposited in the DFI, with the remaining 5 percent to be deposited in the UN Compensation Fund for Kuwait.

UNSCR 1483 also led to the establishment of the **International Advisory and Monitoring Board (IAMB)**, which began operations in December 2003 to help ensure that the DFI is used in a transparent manner and that Iraq's export sales of petroleum, petroleum products, and natural gas are made consistent with prevailing international market best practices. For this purpose, the IAMB functions akin to an audit oversight board.

Until its dissolution on June 28, 2004, the Coalition Provisional Authority, in consultation with Iraqi authorities, directed the DFI. As set forth in UNSCR 1546 (June 2004), the Iraqi Interim Government assumed responsibility for the DFI on June 29, 2004, and the IAMB continued its function, working with the Iraqi Interim Government until May 2005 and now with the Iraqi Transitional Government.

Audits commissioned by the IAMB have found very weak financial management practices and irregularities in the use of DFI resources, including incomplete accounting of the DFI; the absence of an oil-metering system to monitor production, local consumption, and exports of petroleum and petroleum products; barter transactions that bypass the requirements of UNSCR 1483; and the use of the DFI for non-governmental payments.

The Iraqi Transitional Government is considering measures to strengthen DFI accountability and transparency. A joint IMF/World Bank public expenditure mission (February 2005) recommended setting up a committee to examine DFI operations and to enhance the transparency of tracing Iraq's oil resources and other spending. In the short to medium term, it will be important to develop an accounting manual, including accounting concepts, rules, and procedures, for the DFI and other bank accounts, oil assets, letters of credit, and investments.

The most recent audit, covering June 29 to December 31, 2004, still flagged the same types of irregularities as were identified in prior audit reports. In short, different governing regimes have all been beset by fiduciary challenges in managing Iraqi oil revenues.

12. **2004 budget revenues were higher than planned due to the increasing price of oil, but non-oil revenues fell short of projections.** Overall, government revenues reached US\$18.3 billion (71 percent of GDP), while foreign grants amounted to a further US\$2.3 billion (9 percent of GDP). Current spending grew strongly, driven primarily by security spending, as well as salaries and pensions, which rose sharply from low pre-2003 levels. Capital spending, hampered by insecurity and weak implementation capacity, reached only 22 percent of GDP. The deficit was covered mainly by a drawdown on assets held abroad and by letters of credit financed under the oil-for-food program. These fiscal trends broadly continue into 2005, with government revenues projected to top US\$20 billion for the year and foreign grants to reach another US\$6 billion. The government will finance US\$24.5 billion in operating expenditures and US\$9.3 billion in investment expenditures, including reconstruction spending by international donors. Residual deficits will again be covered by a drawdown on assets held abroad.

13. **The Iraqi budget system appears to have weakened further in the past year due to ongoing conflict and difficulties in communications.** Consequently, the government's current ability to allocate resources effectively and to track spending and outcomes is limited. Recent audits commissioned by the International Advisory and Monitoring Board (IAMB) underscore the need to improve the management and transparency of oil revenues, particularly the Development Fund for Iraq (see Boxes 2 and 3).

Box 3: The Key Challenge: Transparent Oil Revenue Generation and Management

Iraq's oil wealth can drive the country's sustainable economic growth—or, if not managed properly, it can cause stagnation and instability. Countries overly dependent on natural resources have tended to underperform economically, suffer from poor governance, and have a higher incidence of conflict. Effective oil revenue generation and management involves the following:

(i) **A transparent and predictable incentive framework for oil production and investment.** This requires a clear legal and regulatory framework, clarity on the roles of different actors (ministries, state agencies, and the private sector), and a predictable negotiating environment for contracts. These elements would allow much-needed investment in the rehabilitation of existing oilfields, the exploration and development of new fields, and the rehabilitation and construction of oil-related infrastructure. In turn, this will generate the oil revenues that Iraq needs.

(ii) **Transparency in collecting, monitoring, and reporting revenues.** Generally recognized minimum standards include:

- *Undertake annual independent audits.* Audits should cover revenues generated by the oil sector and financial flows between the producers and marketers of crude oil and refined oil products, including the national oil company, and the government. It is advisable to extend the audit to all actors (national as well as international oil companies, if the latter are involved in the sector). The results of the audit should be published.
- *Involve civil society.* Parliament and other civil society institutions should be engaged in scrutiny and oversight of financial and operational results in the oil sector.
- *Develop and implement a sustainable program for transparency.* Activities include strengthening tax administration and strengthening corporate governance of the national oil company, the Central Bank, and other institutions involved in receiving and managing oil revenues.

The Bank, jointly with the IMF, organized a workshop with Iraqi authorities in January 2005 on the petroleum sector in Iraq covering some of these issues, and stands ready to provide further support in these areas, as requested.

14. **Iraq is reintegrating into the international financial system.** It gained observer status in the World Trade Organization and submitted a request for full membership. In September 2004, the International Monetary Fund (IMF) approved an Emergency Post-Conflict Assistance (EPCA) program of SDR 297 million (about US\$436 million), opening the way for negotiations to restructure Iraq's massive external debt. At the end of 2004, before debt reduction, the debt was estimated at about US\$114 billion, or 445 percent of GDP.³ In November 2004, Paris Club creditors agreed to reschedule Iraq's debt on highly concessional terms—writing off 80 percent in net present value terms in three steps. The agreement is tied to Iraq's performance under the EPCA program and an IMF-supported stand-by agreement envisaged in 2005. Iraq has begun to negotiate bilateral implementation agreements with individual Paris Club creditors. Simultaneously, it is conducting talks with other creditors regarding comparable treatment of their debt claims. The realization of debt relief should eventually allow a significant reduction of Iraq's debt ratios. Generous debt relief, substantial improvement in economic performance, and the stabilization of the political and security situation are the most critical elements for restoring Iraq's creditworthiness for access to IBRD lending and, more broadly, to the international financial markets.

Poverty and Vulnerability

15. **Although data remain unreliable, surveys suggest that both monetary and non-monetary aspects of poverty have worsened in recent years.**⁴ Iraq is now further away from the Millennium Development Goals (MDGs) than it was twenty years ago (see Annex 3). It is estimated

³ Of which US\$37 billion was owed to Paris Club creditors. Of the remainder, US\$61 billion is claimed by non-Paris Club governments, and debt to private creditors is estimated at US\$15 billion.

⁴ Iraq does not have a national poverty line. Household surveys conducted in 2004 suggest that absolute poverty could be as high as 10 percent, but these estimates are preliminary. Collection of poverty data is only beginning.

that at least 2 million are unemployed—about 30 percent of the total workforce—and underemployment is also high. More than half of young urban males are unemployed, and women’s labor participation is very low even by regional standards. Basic services—education, healthcare, power, and water supply and sanitation—are inadequate. Income inequality is growing and could exacerbate social tensions. Ongoing insecurity further increases poverty and vulnerability: lack of access to work and social services will cause temporary hardship for a large segment of the population, and the death of household wage earners, loss of livelihoods, and disruption of education could increase long-term, chronic poverty.

16. **As a short-term response to these social pressures, the government continues to provide large untargeted subsidies for key consumer items, including food, fuel, and utilities.** Domestic fuel subsidies are the costliest, amounting to about 30 percent of GDP. The main social safety net in Iraq is the Public Distribution System (PDS), a monthly food ration that is intended to supply nearly all of daily caloric needs.⁵ Iraq’s subsidy system provides important support to the poor, with an estimated 25 percent of the population dependent on the PDS. Yet, these programs are expensive and inefficient: the budgetary cost of food, fuel, and utility subsidies (about 50 percent of GDP) crowds out potentially more efficient spending on targeted social programs. The subsidies also distort domestic markets and production and lead to corruption, a flourishing black market, and cross-border smuggling. In the case of fuel, smuggling has caused periodic domestic shortages. Moreover, a large share of subsidies goes to wealthier Iraqis rather than to those who need them most.

17. **Once the preconditions of security and stability are in place, sustainable medium-term growth needed to prevent poverty depends on creating a diversified market economy that encourages investment and creates jobs.** To do this, Iraq needs to develop tax and regulatory frameworks favorable to investment, enact labor market legislation for a more flexible labor market, and reform SOEs and banks. Iraq also needs to shift from universal subsidies that burden the budget and cause major market distortions to targeted safety nets for the most vulnerable groups. These reforms need to be carefully paced, sequenced, and accompanied by safety net measures to protect vulnerable groups. The reforms are predicated on building political legitimacy and social cohesion.

Economic Prospects

18. **Iraq’s medium-term economic outlook hinges on improving security, progress in the political transition, recovery in oil production and exports, and continued strong world oil prices.** Provided oil production exceeds the pre-2003 levels and rises to 2.4 million bpd in 2006 and further to 3.5 million bpd by 2010, real GDP growth is expected to reach 17 percent in 2006 and then decline slowly to 7 percent by 2010. Non-oil real GDP growth is projected to remain strong and inflation is expected to fall to single digits over the medium term as shortages end. The budgetary stance should be sustainable, provided that revenues do not fall and the authorities contain the growth of recurrent expenditures.

19. **This scenario, however, allows no space for slippages in fiscal discipline or declines in oil prices.** These are considerable risks, particularly because insecurity remains high and oil prices are potentially volatile. The scenario also depends on structural reform to contain recurrent spending and allow for sufficient investment and reconstruction. Specific measures needed include a ceiling on further increases in the wage and pension bill, a gradual reform of the fuel and food subsidies, the introduction of targeted safety nets, and the restructuring and eventual privatization of public banks and enterprises.

⁵ Apart from the PDS, formal safety nets, such as pensions, cover less than 15 percent of the working population.

III. IRAQ'S RECONSTRUCTION AGENDA AND THE INTERNATIONAL RESPONSE

A. The National Development Strategy

20. **In July 2005, the Iraqi Transitional Government presented a National Development Strategy (NDS), the first produced by a democratically elected government of Iraq.**⁶ Overall, the NDS stresses good governance, private sector-led growth, and strong social safety nets, placing Iraq on a course towards a diversified market-based economy with less dependency on oil. It articulates four pillars:

- (i) **Strengthening the foundations of economic growth** (including maintaining macroeconomic stability and prudent fiscal policy; strengthening financial management; and pursuing policies that will diversify the economy);
- (ii) **Revitalizing the private sector as the engine of growth and job creation** (including establishing an enabling and transparent legal and institutional framework; laying the groundwork for eventual privatization of SOEs; and restructuring state-owned banks to encourage consolidation and privatization);
- (iii) **Improving the quality of life** (including improving access to clean water and sanitation, high-quality medical care, and affordable housing; investing in education and training; and establishing a social safety net for the poor and vulnerable, including through reforming and monetizing the PDS food basket); and
- (iv) **Strengthening good governance and improving security** (including strengthening anti-corruption institutions; implementing new public procurement regulations; increasing representation of women and minorities in both legislative and executive branches; and improving the judicial system).

21. **The NDS gives priority in the short term to restoring basic services and to creating employment.** It also emphasizes the need to involve local and regional governments in reconstruction and for eventual fiscal decentralization. A key contribution of the NDS is its outline of a new Iraqi-led donor coordination mechanism (see para. 87). The NDS was endorsed by the High Economic Committee and the Cabinet, and presented to donors at the IRFFI Donor Committee Meeting on the Dead Sea in Jordan. Iraqi authorities intend to present the NDS to the Transitional National Assembly, and have stressed that it is a “living document” that will continue to be improved and revised.

22. **The NDS is a useful indicator of overall policy and helps provide a country-led framework for donor funding.** However, work will be needed to render the NDS into meaningful sector strategies and specific plans for implementation. Linking the NDS to a medium-term budget process would operationalize government strategies through public expenditures. Once there is a more stable environment, a periodic NDS-type process involving public participation, perhaps at the governorate level, could help build social consensus on reform priorities and trade-offs, as well as to increase transparency and accountability in the policy-making process. The fundamental challenge remains to devise a coherent reconstruction strategy that focuses on immediate material improvement while also setting the foundation for longer-term institution building. The Bank will continue to offer its support to the government in this area.

⁶ Iraq's National Development Strategy is available at: IRFFI.org. A previous National Development Strategy elaborated by the former Interim Iraqi Government was presented to donors at the IRFFI Donor Committee Meeting in Tokyo in October 2004.

B. International Assistance to Iraq

23. **More than eighty countries and organizations gathered at an Iraq International Conference held in Brussels in June 2005** to express strong and united support for Iraq's political transition process, its economic recovery and reconstruction, and its efforts to improve rule of law and public order. The conference also called on donors to expedite disbursement of the US\$32 billion pledged at the October 2003 Donor Conference in Madrid toward Iraq's estimated US\$55 billion in four-year reconstruction needs.⁷ Eleven donors and the World Bank and IMF account for 99 percent of the total amount pledged at Madrid; and the United States alone accounts for 43 percent of the total amount pledged (see Annex 4). Excluding assistance from the United States, pledges comprise about US\$9 billion in loans and US\$4 billion in grants.

24. **Continued lack of security has complicated and slowed disbursement of donor assistance and has lessened its impact on the ground.** International assistance was predicated on assumptions that security would improve in the near term, permitting international finance organizations, bilateral development agencies, and international non-government organizations to return to Iraq. Instead, the security situation worsened, leading to the evacuation of nearly all remaining international aid workers in 2004. Iraqi ministerial staff at all levels is the target of attacks. Foreign aid workers and contractors remaining in Iraq operate under extraordinary security constraints that limit their effectiveness. As a result, security and insurance costs consume a substantial percentage of assistance,⁸ and foreign aid moved more slowly than originally expected in 2003, 2004, and the first half of 2005.

25. **It is relevant to note the role of aid in other conflict-affected environments,** which contrasts with expectations of high donor disbursements in Iraq. Even in true post-conflict settings, it typically takes several years for international assistance to reach its maximum effectiveness due to limited aid absorption capacity during the early post-conflict years (see Box 4: The Role of Aid in Post-Conflict Recovery). During the middle four or five years of the first post-conflict decade, international aid is highly effective in raising growth; but aid effectiveness is dependent on the quality of policy, institutions, and governance. In early years, aid should focus on improving policy, institutions, and governance, and special attention should be given to building credible institutions of social inclusion.

The International Reconstruction Fund Facility for Iraq

26. **Donors have deposited about US\$1 billion in the IRFFI, which coordinates donor assistance, reducing transaction costs for Iraq.** The IRFFI encompasses two trust funds: the World Bank Iraq Trust Fund administered by the World Bank, and the UN Development Group Trust Fund administered by the United Nations Development Program on behalf of itself and participating UN organizations. The IRFFI is designed to ensure close cooperation and avoid duplication through a common governance structure, including a UN/World Bank Facility Coordination Committee and a joint IRFFI Donor Committee.

⁷ This comprises US\$35.8 billion estimated by the Bank and the UN for the fourteen sectors covered in the Joint Needs Assessment and US\$19.4 billion estimated separately by the Coalition Provisional Authority for areas outside the fourteen sectors, including security and oil. These figures do not represent the financing gap, because Iraq's investment needs are expected to be increasingly covered by Iraqi government revenues or private sector financing.

⁸ Ranging from 20 to 40 percent of contracts, by some estimates.

Box 4: The Role of Aid in Post-Conflict Recovery

Studies show that international aid is highly effective in raising growth in post-conflict situations. It is about nine times more effective in post-conflict environments than in normal environments.

However, this effect is highest during the middle four or five years of the first post-conflict decade. Aid is not especially effective in the early post-conflict years, when, although needs are great, capacities to spend aid effectively are limited.

To maximize its effectiveness, aid should taper in during the first few years and peak at the mid-decade. However, aid typically does the opposite: it peaks at the onset of peace, when international publicity and goodwill are high but the institutional capacity to use aid is low; and it tapers off by mid-decade, when aid absorption capacity has doubled. Given this mistiming of aid, experts advise to lengthen the period between the political commitment of post-conflict aid and its disbursement.

The enhanced growth effect of aid depends on the quality of policy, institutions, and governance, especially in post-conflict situations. Normally, policies, institutions, and governance improve quite rapidly during the post-conflict decade. Therefore, aid should ramp up rather than taper off, and international attention should focus on improvements in these areas.

Neither aid nor policy reform can be expected to deliver peace during the early post-conflict years. The earliest that economic recovery can realistically contribute to peace is in the middle of the first post-conflict decade. Beyond the first decade, the challenge of reducing the risk of renewed conflict passes to the country's government.

Source: Breaking the Conflict Trap: Civil War and Development Policy. World Bank Policy Research Report. 2003.

27. **Nearly all donor deposits have been allocated to projects.** To date, seventeen donors have pledged about US\$455 million to the World Bank Iraq Trust Fund (ITF), of which US\$400 million have been deposited by sixteen donors. Deposits are allocated to nine projects to build capacity, improve education and healthcare, rehabilitate water supply and sanitation, upgrade urban infrastructure, rehabilitate rural water infrastructure, and facilitate private sector development (see Section V for details on the status of the World Bank ITF). To date, twenty-two donors have deposited about US\$660 million in the UN Development Group Trust Fund, which have been allocated to eleven clusters covering agriculture, water resources, and environment; education and culture; food security; governance and civil society; health; infrastructure and housing; internally displaced persons and refugees; mine action; water and sanitation; poverty reduction and human development; and support to the electoral process. Detailed information on IRFFI operations is also available on the website: www.irffi.org.

28. **A fourth IRFFI Donor Committee Meeting to assess progress took place on the Dead Sea, Jordan in July 2005,** following up on the strong political support expressed at the Iraqi International Conference held in Brussels in June 2005.⁹ Iraq's authorities emphasized the importance of Iraqi ownership of the reconstruction process and the need to speed up implementation on the ground. Prior to the meeting on the Dead Sea, the IRFFI Donor Committee met in Dubai, Doha, and Tokyo in 2004 under the leadership of Japan, which chaired the committee during the first year. Canada assumed the chairmanship of the Donor Committee in February 2005.

⁹ The Donor Committee consists of sixteen donors that have contributed US\$10 million or more to IRFFI as well as two representatives of smaller donors (rotating members). Current members are Australia, Canada, Denmark, European Commission, India, Islamic Republic of Iran, Italy, Japan, Republic of Korea, Kuwait, Norway, Qatar, Spain, Sweden, United Kingdom, United States of America, Finland (rotating member), and Turkey (rotating member).

Bilateral Assistance

29. **Most international aid to Iraq takes the form of bilateral assistance, mainly from the United States.** The US Congress appropriated US\$2.5 billion in April 2003 and an additional US\$18.4 billion in emergency supplemental funds in November 2004 for the Iraq Relief and Reconstruction Fund. Of the US\$18.4 billion, US\$13.6 billion are obligated and US\$6.3 billion were disbursed as of June 2005.¹⁰ The US has periodically reallocated parts of the US\$18.4 billion to shift funds—totaling about US\$4.7 billion—from electricity and water projects to security, economic development, and smaller immediate-impact projects. As a result, the US\$18.4 billion are distributed as follows: US\$7.2 billion for security and justice; US\$4.3 billion for electricity; US\$2.1 billion for water and sanitation; US\$1.7 billion for oil; US\$0.8 billion for transport and telecommunications; US\$0.8 billion for health; US\$0.8 billion for private sector development; and US\$0.6 billion for education, human rights, and administrative costs.

30. **Japan, which pledged US\$5 billion in Madrid, is the second largest bilateral donor.** Japan's assistance includes about US\$1 billion in bilateral grants focused on education, electricity, health, and water supply and sanitation, especially in Al-Muthanna Governorate in the south of Iraq. Japan also plans to provide US\$3.5 billion in concessional yen loans and is in close contact with Bank teams working on projects to be financed through IDA. The United Kingdom is providing about US\$175 million in bilateral support for economic reform, governance and civil society, and capacity building and service delivery in the south of Iraq.

The Role of the World Bank

31. **In delivering assistance to Iraq, the Bank's comparative advantage is to emphasize Iraqi ownership, sector-wide approaches, and coherent expenditure frameworks, and to implement operations through Iraqi institutions.** Through its support, the Bank helps strengthen institutions essential for Iraq's stability and economic sustainability. More effective institutions and policy frameworks will result in better use of all resources—donor contributions as well as Iraq's own budget funds. Many other external partners channel assistance quite differently—to particular projects through private contractors, external agencies, or non-governmental organizations. By contrast, the Bank combines its financing with analytical and advisory services not only to address emergency needs, but also to ensure that emergency investments are sustainable. Also, through its global reach, the Bank provides the Iraqi authorities with access to international best practice. The Bank will support Iraq in building a comprehensive framework for sector-wide approaches and close partnerships, which will help the Bank develop an increasingly selective work program during the period beyond this Second Interim Strategy Note.

¹⁰ According to the US Department of State, Section 2207 Report to Congress on Iraq Relief and Reconstruction, July 2005.

IV. PROGRESS UNDER THE FIRST INTERIM STRATEGY AND LESSONS LEARNED

32. **The First Interim Strategy Note of the World Bank Group built on the Bank's work during 2003:** the preparation of Watching Briefs in key sectors and the elaboration of a Joint Needs Assessment in close collaboration with the UN. The strategy aimed to support Iraq's reconstruction and development to the extent possible during the uncertain interim period. To this end, the First Interim Strategy Note supported an incremental approach based on the Needs Assessment and on what practically could be done.

33. **The interim work program initiated activity on three tracks:** (i) *Build Iraqi institutional capacity*, especially to establish mechanisms of transparency and accountability urgently needed for utilizing external funding for Iraq's reconstruction; (ii) *Prepare and start implementing emergency operations to address urgent needs*, especially to generate employment and kick-start economic activity and to restore essential infrastructure and services; and (iii) *Lay the groundwork for Iraq's medium-term reconstruction and development program* and begin assisting in the transition from central planning to a market-driven economy, through policy advice and analytical work.

The World Bank Iraq Trust Fund

34. **The First Interim Strategy was designed to rely on the World Bank ITF to finance emergency projects.** At that time, Iraq did not yet meet the conditions necessary to access the full range of Bank services (see para. 77). On January 29, 2004, the World Bank Executive Directors approved the Bank's role as Administrator of the ITF within the IRFFI. The ITF became effective upon the receipt of the first deposit on March 30, 2004. By the end of 2004, the Bank and Iraqi authorities had prepared, approved, and signed nine projects amounting to US\$366 million, thereby exhausting nearly all ITF deposits. An ITF-financed Capacity Building Project is completed, an Emergency Textbook Provision Project is nearly completed, and seven additional projects are being implemented (see paras. 35-37). The ITF portfolio reflects Iraqi priorities and sectoral preferences specified by donors: more than two-thirds of the funds provided to the ITF were allocated to projects in line with donors' identified sectoral preferences. (ITF procedures are described in Box 5.)

Box 5: World Bank Iraq Trust Fund Procedures

Eligible Sectors. The World Bank Iraq Trust Fund (ITF) finances eligible operations in all sectors and cross-cutting themes identified in the Joint Needs Assessment, with the exception of mine action. The ITF does not finance humanitarian relief, peacekeepers, or other security, military, or political interventions. Donors may specify a sectoral preference.

Recipients. Recipients of grants from the ITF need to meet the World Bank's eligibility criteria, including financial viability. Recipient entities responsible for implementing activities financed from the ITF can include Iraqi ministries, governorates and municipalities, private entities, non-governmental organizations, UN agencies, and international financial institutions. So far, recipient entities have included Iraqi ministries and the Municipality of Baghdad.

Grant Processing Procedures.

- Potential recipients, in consultation with World Bank staff, submit project proposals for approval to the Iraqi Strategic Review Board (ISRB), which determines whether proposals are consistent with high-priority needs.
- Following ISRB approval, the World Bank proceeds to appraise the project. Iraqi project teams are fully involved in the project's final design, which includes feasibility studies, setting up implementation arrangements, and preparation of bidding documents.
- For satisfactorily appraised operations, the Bank, as the ITF Administrator, and the recipient negotiate and sign a Grant Agreement that spells out the terms and conditions under which funds will be made available to the recipient. The Grant Agreement governs the actual use and disbursement of funds. It specifies measurable indicators to monitor implementation progress, and it contains detailed financial management, procurement, monitoring, and other fiduciary arrangements to ensure that funds are used for eligible expenditures.

35. **A first Capacity Building Project helped pave the way for emergency operations.** From February to August 2004, it financed workshops and seminars to build Iraqi capacity critical for reconstruction: project management, procurement, financial management, and environmental and social safeguards. It also supported sector-specific training for line ministries in key reconstruction sectors.

36. **From May to December 2004, the Bank approved eight additional projects, as anticipated in the First Interim Strategy Note.** A Textbook Provision Project (costing US\$40 million), the first ITF-financed project implemented by Iraq, financed the printing and distribution of 69 million textbooks for all primary and secondary schools for the 2004/2005 school year. It led to the Emergency School Construction and Rehabilitation Project (costing US\$60 million) to rehabilitate or construct 250 schools throughout Iraq. An Emergency Health Rehabilitation Project (costing US\$25 million) is underway, focusing on improving emergency services in twelve hospitals. Three other projects address water supply and sanitation, a critical need in Iraq: the Emergency Baghdad Water Supply and Sanitation Project (costing US\$65 million); the Emergency Water Supply, Sanitation, and Urban Reconstruction Project (costing US\$90 million), which covers nine governorates; and the Emergency Community Infrastructure Rehabilitation Project (costing US\$20 million), which finances labor-intensive water rehabilitation in rural areas. An Emergency Private Sector Development Project (costing US\$55 million) finances part of the telecommunications backbone and related infrastructure needed for a payments and settlements system and will also develop and strengthen the institutional framework for private sector development. A Second Capacity Building Project (costing US\$7 million) is focusing on economic reform; poverty and social safety nets; public sector management; and project preparation and implementation. (See Table 2 for an overview of ITF-financed projects. For additional information on ITF-financed projects, including objectives and benefits, see Annex 5.)

37. **Seven of the ITF-financed projects are being implemented by Iraqi ministries,** a considerable achievement considering that Iraq lacks recent experience with international donor procedures and has not borrowed from the Bank for 25 years.¹¹ The Bank's implementing arrangements seek to both ensure Iraqi ownership and strengthen institutional capacity. Project management teams (PMTs) in recipient ministries comprise dedicated ministry staff paid at regular salary levels. PMTs are thus designed to provide the skills needed for effective project implementation, yet be flexible and easily reintegrated into the ministry's institutional structure. Experience in other conflict-affected environments shows that ring-fenced or stand-alone project implementation units can undermine long-term sustainability and institution building.

38. **Under the ITF, tender documents amounting to US\$110 million have been issued, of which 72 contracts have been awarded or signed, resulting in US\$50 million in commitments.**¹² Actual ITF disbursements are US\$29 million. Five of the projects were approved in December 2004 and are just completing the first or second procurement phase in accordance with World Bank competitive bidding procedures. By the end of 2005, contracts totaling over US\$150 million are expected to be signed and underway. Experience so far indicates that contractors in Iraq often choose not to receive an advance payment, typically 10-20 percent of the contract value, in order to avoid the costs of obtaining an advance payment security. As a result, disbursements will take place only after work is completed. The ITF does not finance quick-disbursing expenditures such as humanitarian aid, election or other political process-related costs, or government budget recurrent costs.

¹¹ Iraq received six IBRD loans between 1950 and 1973. The last loan closed in 1979. Until May 2003, no Bank mission had visited Iraq for over 25 years.

¹² Data as of August 1, 2005.

Table 2: Projects Financed by the World Bank Iraq Trust Fund

Emergency Project	Grant (US\$ m)	Implementing Agency	Grant Signing	Status (as of August 1, 2005)
First Capacity Building	3.6	World Bank	Feb. 15, 2004	Closed. Financed 22 training activities for nearly 600 Iraqi officials.
Emergency Textbook Provision	40	Min. of Education	May 15, 2004	Sixty-nine million textbooks delivered to 19,000 schools (contract value of US\$30 m) for school year 2004/2005. Procured through methods that yielded savings of about 25% (US\$9 m) compared to previous year. Savings were used to print 2005/2006 textbooks.
Emergency School Rehabilitation and Construction	60	Min. of Education	Oct. 14, 2004	Project is ahead of schedule. Rehabilitation of 135 schools in fourteen governorates is underway and will be largely completed over the summer break. New school construction will begin in late 2005.
Emergency Baghdad Water Supply and Sanitation	65	Municipality of Baghdad	Dec. 4, 2004	The municipality has nearly completed the first batch of procurement (US\$6-9 m. in pumps and spare parts). Hiring of consultants is well advanced, including for the preparation and implementation of a Baghdad City Development Plan. The recent removal of the Mayor of Baghdad could affect project implementation.
Emergency Health Rehabilitation	25	Min. of Health	Dec. 4, 2004	Contracts have been signed with local firms to design and supervise rehabilitation of eleven emergency health units. Procurement of equipment and pharmaceuticals for the emergency units is also underway.
Second Capacity Building	7	World Bank	Dec. 6, 2004	To date, the project has financed twenty-two training activities covering pension reform, labor markets, social safety nets, statistical capacity building, microfinance, and fiscal decentralization.
Emergency Private Sector Development	55	Min. of Planning and Min. of Telecom.	Dec. 6, 2004	Procurement of a telecommunications backbone is underway (US\$39 m.); tender documents were issued in July 2005.
Emergency Water, Sanitation, and Urban Reconstruction	90	Min. of Municipalities and Public Works	Dec. 8, 2004	Hiring of consultants is well advanced. Contracts for the first batch of works will be signed in fall 2005.
Emergency Community Infrastructure Rehabilitation	20	Min. of Water Resources	Dec. 18, 2004	The pace of project implementation has increased sharply since May 2005. The ministry's PMT has contracted nine labor-intensive civil works valued at US\$4.5 m. They are expected to create 6,000-8,000 jobs.
TOTAL	365.6			

The International Finance Corporation

39. **International Finance Corporation (IFC) has focused on supporting the financial sector and small and medium enterprises (SMEs) through both investment and technical assistance.** On the investment side, IFC signed an agreement in March 2005 to acquire a minority stake in the Credit Bank of Iraq, in partnership with the National Bank of Kuwait (NBK), among the first three international financial institutions to receive a full domestic banking license from the Central Bank of Iraq. NBK and IFC plan to increase the capital of the Credit Bank of Iraq in stages to put it in a strong position within the domestic financial market. This investment will have a demonstration effect and pave the way for other international banks to invest in and transfer knowledge to the Iraqi market. In addition, IFC set up the Iraq Small Business Financing Facility (ISBFF), which combines investment and technical assistance to support financing of the SME sector by Iraqi banks. Jointly funded by donors and partly funded by IFC, the ISBFF provides financing, including a first-loss component, and technical partners to the nascent local banking sector. The ISBFF made the first commitment of US\$12 million in early June 2005 to the Iraq National Bank (INB), which entered into a joint venture with Jordan's Export and Finance Bank. IFC has also lined up a technical partner, Rabobank of the Netherlands, for a technical assistance twinning program that will assist the INB in developing capacity and training staff. IFC has been instrumental in upgrading INB's financial statements to international standards—a first for the Iraqi financial sector. The technical assistance has been paid for through contributions from Japan and Spain.

40. **IFC has also been active in technical assistance in Iraq through the Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA).** In January 2005, PEP-MENA concluded a five-month bank training program, which provided 250 Iraqi bankers representing nineteen private banks and the state-owned banks with training in various banking disciplines: credit risk management, asset liability management, foreign exchange risk, strategic planning, marketing and retail financial products, international accounting standards, and credit appraisal and financial analysis. A two-day “wrap-up” seminar held with Iraqi senior executive bankers discussed strategic options for the development of the Iraqi banking sector going forward and provided input on future technical assistance needs.

Analytical and Advisory Activities

41. **The Bank is helping to lay the groundwork for Iraq's medium-term program through analytical and advisory activities (AAA) clustered into three areas:** economic reform and transition; poverty, safety nets, and social development; and public sector management. The Bank has prepared short policy notes at the government's request to provide timely advice on key reforms. The policy notes have also served as building blocks for more comprehensive analytical assessments. Recently completed economic and sector work include: a Country Economic Memorandum (see para. 42) and studies on the Public (food) Distribution System; social protection, including labor policy, safety nets, and pensions; public financial management (with the IMF); the financial sector; and an Operations Procurement Review. Details of completed AAA are provided in Annex 6.

42. **A Country Economic Memorandum (CEM), completed in fiscal year (FY) 2005, provided an integrated analytical platform for this Second Interim Strategy Note.** Titled *Rebuilding Iraq: Economic Reform and Transition*, it drew on sectoral studies of Iraq's economy and policy discussions with Iraqi officials from 2003-2005. To create jobs, restore basic services, and protect the vulnerable, the CEM identifies three main policy instruments: (i) reforming incentive systems and supporting institutions to generate faster and more efficient growth in private sector jobs; (ii) establishing strong formal safety nets to protect the poor and vulnerable as prices are freed; and (iii) strengthening accountable and transparent management of public resources, particularly oil.

Implementation

43. **Iraq's security situation has created an unprecedented working environment for the Bank.** Bank staff evacuated Iraq after the deadly August 2003 bombing of the UN Compound in Baghdad, which also housed the Bank's office. Since then, it has not been possible for the Bank's international staff to travel both safely and effectively to Iraq. The Bank has found ways to work under the current circumstances, although these alternatives have limitations and drawbacks:

- (i) *Iraqi staff and consultants in Baghdad* play a key role in liaising on the ground, although they too face difficulty of movement. They include a senior economist, a legal advisor, a procurement specialist, and advisors on health, private sector development, the water sector, and the financial sector.
- (ii) *The Bank's videoconferencing facilities*, which began to be established in January 2004, now number four: at the Ministry of Finance; at the Ministry of Planning and Development Cooperation; at the Central Bank of Iraq; and in the Green Zone.¹³
- (iii) *An Interim Iraq Office in Amman*, established in January 2004, is staffed by Iraqi nationals and international staff recruited to operate in Baghdad and is poised to relocate to Iraq once the security situation permits. As of November 2004, the IFC is co-located at the Interim Office, covering Iraq operations as well as the overall PEP-MENA regional initiative. The Interim Iraq Office has been instrumental in:
 - Facilitating contact with key Iraqi officials;
 - Coordinating with the UN Assistance Mission to Iraq and other international partners working out of Amman and Baghdad;
 - Providing security and logistics support to Iraqi staff and consultants in Baghdad;
 - Supporting World Bank missions and Iraqi delegations that meet in Amman to appraise and negotiate projects and to discuss implementation issues;
 - Supporting capacity-building activities for Iraqi ministries; and
 - Managing the Bank's network of videoconference facilities in Baghdad.

44. **Trained PMTs facilitate implementation and help ensure compliance with fiduciary and safeguard requirements.** The World Bank provides intensive training to PMT staff before and during project approval in all aspects of project management, including procurement, financial management, and environmental and social safeguards. The Bank is providing continuous assistance to PMT staff through daily contact, periodic workshops and supervision missions to Amman, and a full-time local World Bank procurement specialist in Iraq. A World Bank procurement specialist is relocating from Bank headquarters and will be based at the Interim Iraq Office in Amman as of October 2005. In addition, the projects provide funding for specialized firms to support the PMTs in the areas of procurement and financial management.

45. **The Bank has taken measures to mitigate high fiduciary and safeguard risks and to compensate for weaknesses identified in recent audits of Iraq's control systems** (see Box 6). The Bank is using prudent disbursement procedures: direct payment to contractors and suppliers or reimbursement of small amounts paid by the government, both upon appropriate and full

¹³ In addition, UNESCO has used the Bank's videoconferencing infrastructure to establish a videoconferencing facility in the Ministry of Education.

documentation. In some cases, the Bank has contracted firms to assist in supervising the projects through random inspections. In addition, the Bank is in the process of engaging firms as fiduciary monitoring agents to monitor financial management requirements and procurement transactions under each ITF Grant Agreement. The Bank is also contracting a firm to build the capacity of implementing agencies to comply with environmental and social safeguard requirements.

46. **Despite such efforts, there remains a high residual risk.** The high level of insecurity makes it difficult for even Iraqi staff and consultants to move about the country and carry out on-site supervision. PMTs face major difficulties, including attacks on ministries and death threats to staff. Frequent changes of ministers, high turnover of senior ministerial staff, and political changes at the governorate and municipal levels owing to successive political transitions also contribute to increased risk (see Section VII, Risks and Mitigation.)

Box 6: Fiduciary Controls for Projects Financed from the World Bank Iraq Trust Fund

Recent reports and audits have revealed weaknesses in the control systems of Iraqi ministries. As part of the process of preparing operations to be financed from the World Bank Iraq Trust Fund (ITF), the Bank assesses the financial management and procurement capacity of implementing agencies through discussions with main counterparts and review of relevant documents. The Bank introduces mitigating measures to reduce the identified risks. Rules and controls used in operations financed from the ITF include the following:

During project preparation:

- The implementing agency establishes a project management team (PMT) staffed by qualified employees from the ministry or recipient entity and assisted as needed by consultants. The PMT includes a qualified and experienced accountant, financial officer, and procurement specialist.
- The Bank and implementing agency agree on detailed terms of reference for PMT staff and a matrix of roles and responsibilities.
- The Bank and implementing agency define a clear flow of funds and information.
- Low thresholds for prior Bank review of contracts ensure on-the-job training for PMT procurement staff.

During project implementation:

- A project-launch workshop takes place at the start of each project.
- Bank procurement staff in Baghdad and Amman actively support PMTs and review procurement documents.
- The PMT is required to maintain an accounting system for the project and retain project records and supporting documents for review by Bank staff or their delegates and the appointed auditor.
- The PMT is required to maintain a financial monitoring system that includes a contract management module with updated information on procurement and physical progress.
- The PMT is responsible for reviewing the adequacy of payments and for authorizing payments exclusively for eligible expenditures.
- The Bank will disburse through direct payment to contractors and suppliers or through reimbursement. Full documentation is required in both cases.
- The Bank will engage fiduciary monitoring agents to review project expenditures and conduct physical checks.
- External audit will be carried out by an independent auditor who is acceptable to the Bank and has international experience, in accordance with terms of reference acceptable to the Bank.

In addition, the Bank is conducting regular (bi-monthly) workshops with PMT staff to address project-specific procurement and financial management issues and to simultaneously build staff capacity.

Despite these measures, the residual fiduciary risk in Iraq remains high.

Lessons Learned

47. **An independent review of the Bank's ITF portfolio concluded that, in general, the portfolio represents an appropriate response by the Bank under very difficult circumstances.** The review identified specific strengths and shortcomings, yielding important lessons for future operations (see Box 7). In particular, the Bank needs to be more realistic about project completion timeframes; give more attention to developing systems for monitoring key project performance indicators to measure impact; and begin shifting projects from an exclusive focus on immediate reconstruction needs to supporting strategic thinking and planning at the sector level. Given the challenging implementation environment, the Bank should continue to focus on simple projects that fall within its core competencies.

Box 7: Findings from an Assessment of the World Bank Project Portfolio in Iraq

In anticipation of the Second Interim Strategy Note and IDA lending for Iraq, the Bank's Middle East and North Africa Region commissioned a rapid independent review of the current portfolio of eight ongoing projects funded by the Iraq Trust Fund (ITF). Overall, the assessment concluded that the Bank's approach to projects has been appropriate under the circumstances and that nearly all projects in the current portfolio should meet their development objectives, although with delays. The assessment identified strengths and weaknesses and made recommendations, as summarized below.

Strengths include:

- *The Bank responded swiftly* by processing and approving nine projects valued at about US\$366 million in the fourteen months between the Madrid Conference in October 2003 and the end of 2004.
- *The program has been appropriately sequenced:* an initial needs assessment was followed by a capacity building project (especially on dealing with the Bank), which prepared the ground for initial operations.
- *The initial operations are generally very straightforward*—basic investments in infrastructure rehabilitation and provision of essential goods such as textbooks and pharmaceuticals.
- *Embedding implementation capacity within ministries is appropriate*, even if complicated in the short term, and is consistent with the Bank's emphasis on country execution, which is unique among most donors.

Shortcomings include:

- *The original timeframes for project completion lack realism*, given typical experience, even in countries familiar with the Bank and routinely visited.
- *The Bank should have better managed the expectations of donors and counterparts*, since Iraq is effectively a "new" borrower for the Bank, there is no fast-disbursing adjustment lending, and projects take four to seven years to disburse on average in other countries.
- *Projects should give more attention to developing and measuring performance indicators to assess impact*, especially given an environment where learning by doing is important.
- *Projects should be designed to include support for strategic thinking at the sector level.* Six of the eight current projects focus exclusively on immediate reconstruction needs.
- *The Bank should work toward more explicit cooperation and harmonization among donors*, especially since the Bank is a small player in financial terms but a major player in the development agenda.

Recommendations for managing the current portfolio include:

- *Focus on implementation*, since absorbing an additional US\$500 million in IDA lending would be a challenge for any country, much less a new borrower in a fragile and unpredictable environment.
- *Schedule regular (perhaps quarterly) country portfolio performance reviews* to bring managers and staff together to review progress, discuss and resolve issues, and make decisions regarding individual projects.
- *Be more realistic on timing and focus on monitoring and evaluation.*

Recommendations for the Second Interim Strategy Note include:

- *Stay focused* to avoid spreading the Bank's effort too thinly across too many sectors at a time when the Bank does not have a physical presence in the country. An alternative would be a sequenced approach, initially deepening involvement in sectors where the Bank is already engaged or has particular strengths.
- *Concentrate on implementation*, which will be crucial given the upcoming rapid expansion of the program to almost US\$1 billion in less than two years in a country that has not dealt with the Bank for more than 25 years.

V. THE WORLD BANK GROUP ASSISTANCE STRATEGY FOR FISCAL YEARS 2006-2007

48. **This Second Interim Strategy Note, which builds on the Bank's experience to date in Iraq, provides a framework for World Bank lending and additional ITF financing over the next twenty-four months, covering FY 2006-2007.** Given the ongoing conflict and uncertainty in Iraq, the strategy emphasizes flexibility and simplicity. It takes into consideration the Bank's experience in transition countries and in conflict-affected environments.

49. **The Bank's strategy emphasizes Iraqi ownership, crucial for restoring stability and for the success of the reconstruction program.** The strategy is based on Iraq's National Development Strategy and on consultations with Iraqi authorities, beginning with the Interim Iraqi Government in February 2005 and concluding with the Transitional Iraqi Government in July/August 2005. Broader consultations are not possible at this time.

A. Objectives and Results

50. **The Bank's overarching objective is to help Iraq build efficient, inclusive, transparent, and accountable institutions as needed for stability, good governance, and sustainable economic prosperity.** Given Iraq's main challenge as a conflict-affected country excessively dependent on its oil wealth, and given that the Bank's financial resources for Iraq are relatively modest compared to those of other major donors and to Iraq's own budget, the Bank's most important contribution would be to help Iraq develop institutional frameworks, policies, and systems that allow for more effective use of Iraq's own financial resources and of those of other donors. A particular priority will be to build credible institutions of social inclusion, as appropriate in a conflict-affected environment (see Box 4 and Annex 1).

51. **Under the umbrella of institution building, the Bank Group's work program is organized into four pillars** to support government efforts to: (1) restore basic service delivery; (2) enable private sector development; (3) strengthen social safety nets; and (4) improve public sector governance, with particular focus on public resource management. The Bank will emphasize policies and institution building in all four areas, using analytical and advisory activities and resources from the ITF, IDA, and IFC. The Bank's work program aims to provide a continuum of support: policy advice; support for institutional capacity building; and, the security situation permitting, financing for investment operations to address emergency reconstruction. By the conclusion of this Second Interim Strategy, the Bank aims to have, at the minimum, strengthened institutional capacity in all four pillars. Given current uncertainties and knowledge and data gaps, it is premature to have specific program monitoring indicators. Emphasis will be placed, however, on establishing systems for monitoring and evaluation at the project level that are as effective as possible under the existing conditions. The Bank will also assist the Iraqi authorities to establish their own goals and indicators in key sectors as part of strategy and policy formulation.

B. Second Interim Work Program

52. **Analytical and advisory activities (AAA) will be a key vehicle of Bank assistance over the next twenty-four months.** This will help Iraq strengthen its policies, institutions, and governance, as urgently needed to improve the effectiveness of national expenditures and international aid in the medium term. In addition to sector-specific policy notes and diagnostic studies, AAA will continue to be clustered into three themes: (i) economic reform and transition; (ii) poverty, safety nets, and social development; and (iii) public sector management. Advisory activities will aim to lay out options available to Iraqi policymakers and discuss trade-offs under each option.

53. **The Bank will lend up to US\$500 million of IDA and provide additional ITF resources, as circumstances permit** (see Resources to Iraq, para. 77-79). IDA and ITF resources follow similar project-processing procedures and are largely fungible, although ITF resources will be used for activities that lend themselves to grants rather than loans, such as projects to build institutional capacity, alleviate poverty, protect vulnerable groups, or pilot operations. ITF resources can also be used to cofinance IDA operations.

54. **Iraqi authorities have asked the Bank to initiate IDA lending in four key sectors: education; electricity; transport (roads); and water supply and sanitation.** The Bank is already providing support in two of these sectors through the ITF and will build on its experience to deepen its support. Given the difficulty of implementation in Iraq, IDA- and ITF-financed investment projects will focus mainly on straight-forward rehabilitation, and the Bank will expand cautiously into new sectors. Investment projects fall under Pillar 1: Restore Basic Services. Pillars 2, 3, and 4 are mainly supported by AAA. Proposed AAA, ITF-financed operations, IDA-financed operations, and IFC operations are discussed in paras. 57-75 and summarized in Table 3.

Table 3: Proposed Analytical and Advisory Activities (AAA) and Operations

Overarching Objective: Build Efficient, Inclusive, Transparent, and Accountable Iraqi Institutions			
Restore Basic Services	Facilitate Private Sector Development	Establish Social Safety Nets	Strengthen Public-Sector Governance
AAA <ul style="list-style-type: none">• Utility Reform TA• Healthcare Policy TA	AAA <ul style="list-style-type: none">• SOE Reform TA• Financial Sector ESW/TA• Incentive Framework Reform ESW/TA• Agriculture Strategy ESW/TA	AAA <ul style="list-style-type: none">• Poverty Assessment• Social Protection Strategy TA	AAA <ul style="list-style-type: none">• Pub. Sector Mgmt. TA• Oil & Gas Sector ESW/TA• Intergov. Reform TA• Procurement TA• Financial Mgmt. TA• Water Assistance Strategy• Environment Strategy• Gender TA
Iraq Trust Fund <ul style="list-style-type: none">• Capacity Bldg. for Education and Training• Electricity (south of Iraq)	Iraq Trust Fund <ul style="list-style-type: none">• Trade Facilitation	Iraq Trust Fund <ul style="list-style-type: none">• Capacity Bldg. for Safety Nets• Disabilities	Iraq Trust Fund <ul style="list-style-type: none">• Capacity Bldg for Living Standards Measurement Survey• Environment
IDA* <ul style="list-style-type: none">• Education• Electricity• Transport• Water Supply/Sanitation	IDA	IDA	IDA

Notes: * Potential sectors subject to further discussion are: agriculture/irrigation, healthcare, and urban upgrading.
 (1) In some cases, AAA is embedded in investment projects.
 (2) ITF operations depend on the availability of additional ITF resources.
 (3) IDA funds (up to US\$500 million) will be allocated between investment operations in discussion with the Iraqi authorities, taking into consideration opportunities for impact and implementation.

55. **The Bank aims to retain flexibility and seize opportunities where they arise**, also taking into consideration the work of other international partners and the ongoing experience of ITF-financed operations currently under implementation. Depending on the situation in Iraq, the Bank and Iraqi authorities may decide to focus IDA and ITF resources on fewer areas to increase impact. Or, if conditions are appropriate, the Bank and Iraqi authorities could decide to support one or two additional sectors with potential for high impact: agriculture/irrigation, healthcare, and urban upgrading. Criteria agreed upon with the Iraqi authorities for projects include: Iraqi needs and priorities; implementation feasibility; and contribution to overall sectoral strategy.

56. **Projects will be designed to maximize local ownership, local content, and near-term employment** and will be clustered geographically to facilitate implementation, institution building, and impact. Projects will include components for capacity building, contractual and financial management, and technical sustainability. In addition, projects will be complimented by analytical and technical assistance for sector investment programs and related public expenditure management.

Pillar 1: Restore Basic Services

57. **Restoring basic services, especially electricity, is the Iraqi population's top concern**, ranked even higher than national security according to public opinion polls.¹⁴ Daily shortages of electricity create hardship and undermine government credibility; and inadequate water and sanitation is a serious health threat. Overall, poor infrastructure impedes private sector development, and thereby employment and growth; and affects the recovery and expansion of Iraq's oil production, the country's principal source of revenue. Under the Second Interim Strategy, the Bank will focus the bulk of its investment operations on restoring basic infrastructural and social services, building on the experience of ongoing ITF-financed projects in education and water supply and sanitation, and extending support to electricity and transport. Through both investment projects and AAA, the Bank will also support the government in shifting toward greater strategic thinking and planning at the sectoral level (see para. 47 on lessons learned).

58. **The Bank could be a strategic partner in the energy sector, supporting the government in developing a coherent approach to reconstruction and policy and institutional reform.** This is crucial, given the energy sector's broad impact on other parts of the economy. The Bank has organized two electricity sector workshops, bringing together Iraqi authorities and relevant donors to discuss reconstruction and sector issues. Although the Bank has not yet provided financial resources to the electricity sector, the Bank and Iraqi authorities are well advanced in preparing a first emergency electricity rehabilitation project that will finance selected investments and capacity building. The Bank is also working closely with the Japan Bank for International Cooperation to coordinate interventions in the sector. The Bank and Iraqi authorities are considering use of the ITF for selected investments in the south of Iraq, in collaboration with the United Kingdom's Department for International Development. In the oil and gas sector, the Bank, together with the IMF, organized a workshop with Iraqi authorities on petroleum sector issues (see Box 3); and economic and sector work has started on pricing issues. The Bank will continue to provide advice in these areas as part of the overall reform agenda.

59. **The Bank will deepen and expand its support to improve water supply and sanitation**, building on the good experience of the ongoing ITF-financed projects, which are expected to benefit about 3 million people. Additional investments would expand geographic coverage of water services and rehabilitation of sewerage infrastructure and begin the process of policy and institutional reform.

¹⁴ International Republican Institute, April 11-20, 2005

In addition, if requested and if resources are available, an urban upgrading project could expand ongoing urban rehabilitation, including rebuilding city streets, sidewalks, and markets.

60. **The Bank will help the government address transport bottlenecks that impede reconstruction and public access to services and markets.** The Bank has undertaken preparation work in the sector but has not yet provided financial resources. The government has asked the Bank to focus on roads and bridges. The Bank will finance selected high-impact road rehabilitation, involving local contractors and creating substantial local employment, and will assist the government in preparing an overall road rehabilitation program and in piloting maintenance strategies.

61. **The Bank considers education and healthcare as priority areas of support,** recognizing that expenditures on social services are particularly important in conflict-affected environments (see Annex 1). Despite ongoing reconstruction activities, Iraq's healthcare system is in crisis: most healthcare facilities need major rehabilitation; basic medical equipment and supplies are lacking; a new system is needed to procure and distribute pharmaceuticals; and many Iraqi health professionals have fled the country. Through AAA, the Bank will support health policy reform.

62. **The Bank will support the government in addressing access, equity, and quality in the education system through IDA and ITF operations.** The Bank's strategy is to support the Ministry of Education in meeting basic needs to sustain the system, such as emergency provision of textbooks; and in addressing the most urgent backlogs that undermine quality and access, such as rehabilitation and construction of schools. The Bank and Iraqi authorities are discussing a proposed IDA-financed school construction project that would build on ongoing ITF-financed operations. At the same time, the Bank is helping to build capacity for project implementation and management, for strategy development, and for longer term reform. This includes capacity for system development and wider strategic issues such as the alignment of education and training with the needs of a changing labor market. A proposed ITF-financed Capacity Building for Education and Training Reform Project will help lay the groundwork for substantial reform of the education and training system.

Pillar 2: Facilitate Private Sector Development

63. **Iraq faces the dual challenge of making the transition from a state-dominated to a market-based economy and from an oil-dependent to a diversified economy.** Once security is restored, reconstruction-related activities, services, and agriculture will be main sources of employment. However, reconstruction and associated public sector jobs will be inadequate to provide a sustainable means of job creation. The World Bank, IFC, and Multilateral Investment Guarantee Agency (MIGA) will work collaboratively to support Iraq's transition to a diversified, job-creating, market-driven economy.

64. **The World Bank Group will provide support through AAA to develop and strengthen the financial sector, a cornerstone for private sector development.** Iraqi authorities place high priority on public bank restructuring, which is critical for the normal functioning of the Iraqi economy. The Bank stands ready to assist with in-depth assessments of the state-owned banks to develop restructuring strategies and to provide continued support as needed for the development of the payments and settlement system. In addition, the Bank will undertake analytical work in housing and housing finance. The IFC will continue to look for investments to support the financial sector; and, through PEP-MENA, will provide technical assistance to support the financial sector and SMEs, including a toolkit for SME service providers. Completing these tasks will provide the basis for a dialogue on the larger vision for the financial sector, including the formulation and implementation of a financial-sector strategy and institutional capacity building in collaboration with the World Bank Institute and other partners.

65. **The World Bank Group will also provide technical assistance for key areas of private sector development.** For example, the World Bank and IFC will work together to support SOE reform. The World Bank Group is following up on a number of requests in this area and will coordinate with other key donors. In the longer term, PEP-MENA could play a role in improving the business enabling environment and in promoting public private partnerships or privatization of SOEs. If ITF resources are available, the Bank will also consider a trade facilitation project to lay the groundwork for an expanded trade facilitation program by initiating an assessment of Iraq's trade corridors and conducting a pilot operation at one border crossing.

66. **Iraq is not now a member of MIGA, but the Iraqi authorities have expressed an interest in becoming a member of the Agency.** If it does, MIGA would be able to help Iraqi authorities to develop their capabilities to work with potential foreign investors to identify opportunities during this reconstruction period. MIGA could provide training in investment facilitation, as well as access to MIGA-sponsored information services and tools for investors, including IPAnet; FDI Xchange; PrivatizationLink; and the IPAworks; and the FDI Promotion Center, a portal created by MIGA for investment promotion practitioners, much of which will be available in Arabic in FY 2006. MIGA would also carefully examine the conditions for providing political risk insurance. Given the high risks, the approach used in Afghanistan, where a special donor-assisted facility was established, might be a suitable model.

67. **Agriculture can make a major contribution to employment and growth,** especially considering its backward and forward linkages. Although agricultural production has dropped steadily over the last fifteen years, it still accounts for about 8 percent of GDP and absorbs about 20 percent of the labor force, supporting a rural population of about 8 million. The sector requires significant restructuring and investment to increase productivity and competitiveness. Iraqi authorities have taken initial steps towards freeing prices of fertilizers, insecticides, wheat, barley, and rice. However, given current social and political fragility, the Iraqi Transitional Government is likely to take a cautious approach to further agricultural reform. The Bank has begun a dialogue with the Ministry of Agriculture to explore possible future support, including through rural strategy formulation and policy analysis.

Pillar 3: Improve Social Safety Nets

68. **There is an urgent need for short-term interventions to assist the vulnerable and alleviate conditions stemming from unemployment;** and there is a medium-term need for well-designed social-protection policies to help ease the transition from a highly centralized state-run system to a more market-oriented system. Under even the best of circumstances, Iraq's economic transformation will involve short-term increases in unemployment as labor moves to more productive areas. The existing safety nets cannot address these structural shifts: direct public assistance, including cash transfers, training, and rehabilitation services, is almost exclusively targeted to the chronically vulnerable and is currently very small (about US\$300 million in 2005). The public pension system currently covers about 1.1 million people, mostly public sector workers (excluding the military)—only about 15 percent of the work force. Reforming the social-protection system is a priority to improve its future targeting, efficiency, and sustainability.

69. **The Bank will support the government in developing and implementing a strategic approach to reducing poverty and protecting the vulnerable** through a combination of technical assistance, capacity building, and pilot operations. Through the ITF, the Bank proposes to support a comprehensive household survey and related capacity building to help the government collect data on poverty, understand the characteristics and causes of poverty, predict the impact of economic policies on poverty, and design a poverty-reduction and safety-net strategy (see also para. 75).

Potentially, the Bank could also help pilot and evaluate new safety net programs, such as job creation and adjustment interventions to help former military and militia members reintegrate into society and contribute to a new economy. The Bank is also in an advanced dialogue with the Iraqi authorities regarding services for the disabled, a growing vulnerable group. Subject to the availability of ITF resources, a project could help improve services to rehabilitate the disabled, facilitating their reentry into productive life to prevent them from falling deeper into poverty.

Pillar 4: Strengthen Governance and Public Management

70. **Strengthening public sector governance, including public resource management, will be at the forefront of the reform agenda for years to come.** It is the key to both political stability and sustainable economic growth. At the apex is the challenge of building a legitimate state, ensuring the physical security of Iraqi citizens, and protecting their basic rights and freedoms. Another fundamental challenge is to determine the size and scope of government and the appropriate division of responsibilities between ministries and different levels of government. A third challenge is to build the capacity of public administration to deliver key public services and to provide an environment where private sector growth can flourish. Although many of these tasks are inherently political in nature, they raise several technical questions: how should financial and human resources be organized and optimally deployed? What functions should be devolved to the provincial and municipal level? How can Iraq best ensure integrity within its public sector? To help answer these questions, the Bank will illuminate promising practices in other settings and conduct a range of analytical work, including assistance in putting in place the basic building blocks of effective administration and provision of “just-in-time” policy notes and technical assistance on a demand-driven basis.

Box 8: Governance Issues in Iraq

A common symptom of poor governance is corruption. In 2003, Iraq ranked 111 on Transparency International’s Corruption Perception Index, the lowest of any country in the MENA Region. In 2004, Iraq fell to 129 out of 145 countries. Investigations into the Oil-for-Food Program have revealed major and systemic irregularities. Audits in 2004 and 2005 have also revealed irregularities in accounting practices and inadequate financial and procurement controls (see Box 2).

A number of initiatives were taken in early 2004 to combat corruption: (i) **establishing an independent Inspector General office within individual Iraqi ministries** to perform a variety of functions involving both internal audit and control and the investigation of corruption-related cases; (ii) **establishing a Commission on Public Integrity**; and (iii) **revitalizing a Supreme Board of Audit**. However, these institutions will require significant strengthening to perform as intended. For example, the independent Inspector General offices exist primarily on paper, and the effectiveness of the Commission on Public Integrity is hampered by a lack of independence.

International experience suggests that anticorruption efforts need to operate in a number of dimensions. Four are particularly important: (i) strengthening the legal and regulatory framework; (ii) developing strong accountability institutions; (iii) supporting prevention within individual agencies and line departments; and (iv) enhancing public opinion and awareness. In addition, efforts to combat corruption should be grounded in a rigorous, empirically based analysis of the scope and magnitude of the problem.

The Bank will place a strong emphasis on helping Iraq improve governance and transparency through support for public finance reform and procurement reform.

**Table 4: Bank-IMF Coordination
to Strengthen Public Financial Management**

Government Activity to be Supported	Lead Agency
1. Establish a budget classification and chart of accounts	IMF
2. Review implementing regulations for the Financial Management Law	IMF and WB
3. Establish a debt management unit	WB
4. Establish a cash management unit and introduce a TSA	IMF
5. Improve accounting in the oil sector (DFI)	IMF
6. Strengthen internal control and internal audit	WB
7. Strengthen external audit (Supreme Board of Audit)	WB
8. Strengthen payroll and human-resource systems	WB

71. **The Bank will give strong support to public finance reform in close coordination with the IMF and other key donors.** Iraqi officials have noted the importance of consolidating budget preparation and monitoring within the Ministry of Finance to develop the budget as the principal policy-making instrument of the government. A new financial management law enacted in June 2004 has not yet been implemented. A joint Bank-IMF team, which met with Iraqi officials in Amman in February 2005, undertook a comprehensive diagnostic assessment of the existing public financial management system and recommended high-priority actions. The Bank and IMF have agreed with the Iraqi authorities to work in close coordination to help strengthen public financial management (see Table 4). Through ESW and the ITF-financed Second Capacity Building Project, the Bank will provide support to the Iraqi authorities in five areas: (i) reviewing implementing regulations for the Financial Management Law (jointly with the IMF); (ii) helping to establish a debt management unit; (iii) helping to strengthen internal audit and internal control; (iv) helping to strengthen external audit (Supreme Board of Audit); and (v) helping to strengthen payroll and human resource systems. Strengthening public procurement is a sixth priority area of public finance reform that will be supported by the Bank, closely related to the areas listed above.¹⁵ Procurement reform was not included in the Bank-IMF report, but was the subject of a separate review (see para. 81).

72. **The Bank will use economic and sector work and the ITF-financed Second Capacity Building Project to support payroll and human resource management,** which is essential for providing an accurate picture of the size and scope of the civil service and avoiding theft and pilferage of government resources. Downstream, the government will need to implement additional reforms, including developing human-resource legislation and regulations to enhance meritocracy and protect workers from harassment; and strengthening the management of the civil service by establishing new institutions tasked with human-resource policy and enforcement.

73. **Effective local government will be crucial for effective service delivery and for building state legitimacy,** regardless of the type of national and subnational governments established under the new Iraqi constitution. In December 2004, the Bank and the IMF organized a high-level workshop on intergovernmental fiscal relations. The Bank has offered to provide continued assistance to facilitate technical discussions on fiscal federalism and intergovernmental transfer

¹⁵ Improving the efficiency of procurement transactions and processes is an important purpose of the systems of budget execution, internal control, internal audit, and external audit. According to recent audits commissioned by the IAMB (see Box 2), procurement is a major source of failure of internal control systems in Iraq.

mechanisms. This support would focus on a variety of mechanisms, including interactive courses that set out the principles for arriving at well-designed intergovernmental arrangements as well as lessons learned from the experience of other countries under similar circumstances. Such courses could enable Iraqi participants to design a federal system with political and fiscal autonomy for subnational governments, while still promoting macro-stabilization, sharing the benefits of the exploitation of mineral resources, and maintaining the social safety net.

74. The Bank will support Iraq's efforts to improve management of natural resources and the environment. With its great Tigris and Euphrates rivers, Iraq has ample water resources and substantial opportunities to develop economic activities based on water, mainly through irrigating adjacent agricultural lands. In the coming years, the Iraqi authorities will have to make major decisions on how to refurbish existing investments and whether and where new infrastructure should be built. With the cooperation of the World Bank/Netherlands water partnership, the Bank and Iraqi authorities are preparing a sectoral country assistance strategy for water to evaluate options and priorities in water development. This work is currently underway and the report is scheduled to be delivered in mid-2006. The Bank is also working to build the capacity of the new Ministry of Environment through support for an environmental strategy, and, if resources are available, through an ITF-financed environment project. The Bank will also assist Iraq in developing a Shatt-El-Arab Rehabilitation and Environment Management Project, a regional operation that could be cofinanced by the Global Environmental Facility.

75. The Bank will support improved systems for collecting and utilizing reliable data, crucial for making informed policy decisions, increasing the effectiveness of public expenditures, and assessing progress towards the country's reconstruction and development objectives. The Bank will support Iraq's statistical agency, COSIT, in designing and implementing a Living Standards Measurement Survey (LSMS), the first full income and expenditure survey since 1993. The LSMS will enable Iraq to establish a poverty line, undertake a poverty assessment, construct a household basket for the consumer price index, and feed into the national accounts. The Bank will help build capacity for regular household surveys that will enable the government to monitor the progress toward desired outcomes.

76. The Bank will seek to mainstream gender issues across its operational and analytical work. Lack of sex-disaggregated data, however, is a serious constraint that limits understanding of gender issues. The Bank will help mainstream gender in statistics, monitoring, and evaluation to disaggregate data by sex, which is essential for identifying and addressing gender issues (see Box 9).

Box 9: Mainstreaming Gender in Statistics

The Bank's gender strategy for Iraq focuses on advancing women's economic rights and opportunities through three pillars: (i) women's access to public resources; (ii) women's access to labor markets; and (iii) women's access to asset-creating opportunities.

Sex-disaggregated data and systems of monitoring and evaluation are essential for identifying and addressing gender issues. In May 2005, the World Bank sponsored a workshop in Amman on Gender in Economic Policy, Social Safety Nets, Labor Markets, Statistics, and Monitoring and Evaluation of Projects. Participants were provided with the latest information on topics of immediate interest, such as gender issues in conflict-affected environments, the gender impact of economic policy (including subsidies and public expenditure), statistical data gathering and analyses, and establishing relevant gender indicators to monitor projects. Continuous capacity building in these areas will help ensure that gender issues can be identified and addressed.

C. Resources to Iraq

77. **The First Interim Strategy Note envisioned a lending envelope of US\$500 million from IDA¹⁶ and US\$500 million from IBRD over FY 2004-2005,** once “threshold issues” are resolved, namely the legal status of Iraq’s government, payment of arrears to IBRD, and adequate security for staff to safely visit the country.¹⁷ In addition, the First Interim Strategy Note delineated that Iraq’s creditworthiness for IBRD lending would be predicated on an optimistic scenario of improvements in political stability and security, rapid economic recovery, and generous debt relief.

78. **At this time, with the exception of security, the “threshold issues” have been resolved.** Following unanimous adoption by the UN Security Council of Resolution 1546 on June 8, 2004, and the transfer of authority by the Coalition Provisional Authority to the Interim Iraqi Government on June 28, 2004, the Bank took the view that it can work with the Interim Iraqi Government as the legitimate (*de jure*) representative of Iraq.¹⁸ Iraq cleared its arrears to IBRD (about US\$108 million) on December 16, 2004. Security, however, remains precarious and will affect the Bank’s work in Iraq.

79. **Iraq has made progress in several areas important for IBRD creditworthiness** (see Annex 7). In this context, the Second Interim Strategy Note provides the framework for up to US\$500 million from IDA and additional resources from the ITF.¹⁹ To provide a continuum of resources, up to US\$500 million of IBRD lending could supplement the IDA and ITF envelope, assuming critical progress regarding IBRD creditworthiness.

D. Implementation Arrangements

80. **The Second Interim Strategy will build on the implementation arrangements used for the ITF:**

- (i) Implementation will be carried out by Iraqi ministries through dedicated and trained PMTs. PMTs will continue to comprise civil servants employed at the implementing ministry.
- (ii) The Bank will continue to regularly meet PMT members outside of Iraq to provide technical support and discuss the status of implementation. The Bank will also continue to make frequent use of its videoconferencing facilities in Baghdad. International Bank staff will travel back to Iraq as security conditions permit.
- (iii) Supervision, including random verification, will be conducted to the extent possible by Bank-employed firms reporting directly to the Bank.

¹⁶ IDA Deputies endorsed Iraq’s exceptional access to up to US\$500 million of IDA resources during FY04 and FY05 at the IDA13 Mid-Term Review on November 5-6, 2003, provided that the “threshold conditions” were met. In the course of the IDA14 replenishment negotiations, the IDA donors endorsed a continuation of Iraq’s exceptional access to up to US\$500 million of IDA resources for the IDA14 period.

¹⁷ The First Interim Strategy Note envisioned a further US\$2.0-4.0 billion from IBRD over fiscal years 2006-2008, for a total lending envelope of US\$3.0-5.0 billion over five fiscal years, as expressed at the Madrid Donor Conference in October 2003.

¹⁸ See “Legal Note on Recent Developments in Iraq” (SecM2004-0351, July 9, 2004) by the Senior Vice President and General Counsel.

¹⁹ There are firm pledges or signed commitments to the ITF for an additional US\$55 million (as of August 2005).

- (iv) The Bank will increase its employment of Iraqi staff and consultants based in Baghdad and other areas.
- (v) The Bank's Interim Iraq Office in Amman will continue to be the focal point until it can relocate to Baghdad.
- (vi) The Bank will apply emergency project procedures under OP 8.50 and simplified project design.

81. **The Bank is focusing on procurement at the project level while laying the groundwork for a dialogue on public procurement reform.** A Preliminary Iraq Procurement Assessment in 2003 provided the framework for designing the procurement arrangements for ITF-financed projects in 2004. The Bank also provided the government with a Master Implementation Manual on procurement and financial management, available in Arabic and English, to be used for World Bank-financed projects. In 2005 the Bank carried out an Operational Procurement Review to reassess the status of the procurement system, identify generic procurement issues to be addressed to facilitate project implementation, draw lessons for procurement arrangements for future IDA-financed projects, and lay the groundwork for a dialogue with the government on future public procurement reform. One of the key recommendations is to clarify the legal framework for public procurement and enact needed legal and regulatory instruments. The Bank will continue to support the government in its efforts to build capacity and reform the public procurement system. A full Country Procurement Assessment Review will be undertaken at a later date when circumstances in Iraq permit.

82. **Similarly, the Bank is addressing financial management at the project level, which will inform a broader dialogue on financial management reform.** The Bank is in the process of preparing a Financial Management Accountability Report and will prepare a full Country Financial Accountability Assessment when circumstances in Iraq permit. To mitigate environmental and social risks, the Bank is revising the Environment and Social Screening and Assessment Framework for Iraq, with emphasis on capacity building and establishing national environmental and social guidelines.

83. **There are enormous uncertainties that make it impossible to predict all potential hurdles to implementing the second interim work program.** In addition, although the Bank has increased its knowledge base substantially over the last twenty months, there remain gaps in the Bank's information, given the difficulties in traveling to the country since the Bank and UN evacuation in August 2003, and in traveling within the country during the months prior to that time. At a minimum, the Bank will strive during this second interim period to lay the framework for a more comprehensive program, as conditions permit, while attempting to address emergency needs.

84. **The Bank is well positioned to scale up its programs or scale down, as the changing situation demands.** If security and political stability improve, the Bank will ramp up its assistance and deepen policy dialogues. If the security situation further deteriorates, the Bank will scale down its financial assistance as necessary, while maintaining dialogue to the extent possible.

E. Donor Coordination

85. **There is room to improve overall donor coordination, despite early efforts to establish mechanisms to coordinate the flow of aid.** A December 2003 regulation by the Coalition Provisional Authority established an Iraqi Strategic Review Board (ISRB) chaired by the Minister of Planning and Development Cooperation as a focal point within Iraq for donor coordination and with the authority to approve proposed donor-funded projects. However, most bilateral aid has not utilized

the ISRB. The UNDP is providing support to the Ministry of Planning and Development Cooperation to implement a Donor Assistance Database that will track international aid flow. Donor coordination has so far been unconnected to Iraq's budget process and donor funds, and disbursements are not reflected in the overall budget.

86. **The IRFFI has assisted donor coordination to some extent**, because most external partners providing financing to Iraq are represented on the IRFFI Donor Committee, which meets about twice a year. The Ministry of Planning and Development Cooperation has been the interlocutor with IRFFI, ensuring consistency with Iraq's ISRB.

87. **In July 2005, the Transitional Iraqi Government presented plans for an Iraqi-led donor coordination mechanism.**²⁰ Recognizing the need to move toward a consultative group-type process, the government's plans involves the establishment of an Iraq Reconstruction Forum (IRFO), chaired by the Iraqi government and supported by the World Bank and United Nations, to be held in conjunction with the biannual IRFFI Donor Committee Meetings.²¹ In addition, a Baghdad Coordinating Group, which held its first meeting on August 20, 2005, will enable heads of aid agencies and the Iraqi government to interact on a regular basis. Line ministers will chair sector working groups. The ISRB will continue to approve specific projects. Overall, Iraq's proposal to lead and improve donor coordination represents a positive step.

88. **Ideally, a consolidated budget process linked to an Iraqi national development strategy should be the main vehicle for setting priorities and to discipline donors around guiding principles.** The World Bank will support Iraq's efforts to move toward a strategic and coherent financing framework underpinned by accountable and transparent public finance management as the centerpiece for international donor meetings. The Bank will also support selected sector working groups to elaborate coherent sector strategies as a framework for coordinated donor support at the sectoral level.

Partnerships

89. **The IRFFI has helped ensure close coordination between the UN and the Bank.** The Facility Coordination Committee, comprising the managers of the UN Iraq Trust Fund and the World Bank Iraq Trust Fund, are in regular contact, including periodic face-to-face meetings in New York or Washington to discuss overall trust fund coordination. The UN and World Bank offices in Amman are in constant contact, facilitating collaboration at the technical level.

90. **The Bank and the IMF are working closely together.** The IMF is taking the lead in coordinating technical assistance efforts in its areas of responsibility, including fiscal policy, tax policy and administration, central bank organization, and the macroeconomic statistics framework. Areas of common Bank-IMF responsibilities include public expenditure management, accounting procedures and financial reporting, external debt management, bank regulation and supervision, and the payments system. The Bank will be taking the lead in structural policy areas, including poverty, monitoring, food policy, energy subsidies, SOEs, restructuring of commercial banks, social safety net, and trade policy.

²⁰ See Part VIII of the National Development Strategy, 2005-2007, presented to donors at the IRFFI Donor Meeting held on the Dead Sea on July 18-19, 2005.

²¹ The IRFO meeting will replace the "Expanded Donor Meeting" that has taken place the day before each of the IRFFI Donor Committee Meetings.

91. **The Bank will continue to collaborate with bilateral agencies.** The Bank regularly exchanges information with US agencies and contractors working in Iraq to ensure that Bank-financed projects are consistent with and strategic in relation to the large amounts of US-funded reconstruction. The Bank and the US are also collaborating in providing policy advice, including support for public enterprise and bank restructuring, investment climate, and pension reform. The Bank is conducting joint missions with the Japan Bank for International Cooperation (JBIC) for rehabilitation of electricity and water supply and sanitation, with the aim of closely coordinating investments and facilitating JBIC lending through use of Bank implementation mechanisms, such as PMTs in ministries. The Bank is working closely with the UK Department for International Development in both investment projects (such as electricity in the south of Iraq) and policy advice and capacity building, especially governance, public finance, and price and subsidy reform. Finally, the Bank and Australia intend to work together to provide support—mainly policy advice and capacity building—to the Ministry of Agriculture.

VI. RISKS AND MITIGATION

92. **As was the case for the First Interim Strategy, this Second Interim Strategy is subject to substantial risks.** The situation in Iraq is still evolving. This strategy emphasizes flexibility and presents a range of potential interventions that may narrow or expand depending on conditions in Iraq. In the event security improves, the Bank is well positioned to scale-up its assistance. Within twenty-four months, the Bank will either present to the Executive Directors a third Interim Strategy Note (in accordance with OP 2.30) or a Country Assistance Strategy.

93. **Ongoing conflict continues to pose the principal risk to implementing the Second Interim Strategy and to overall reconstruction and economic recovery.** The Bank mitigates the security risk by avoiding travel to Iraq at this time, engaging Iraqi consultants, establishing a small office for Iraqi activities in Amman, and using videoconferencing facilities. The measures taken to mitigate the security risks, however, create the separate risk of not being able to supervise first-hand the progress of ongoing projects (see para. 94). If security or instability deteriorates to the point where it would be difficult to sustain a dialogue with the Iraqi Transitional Government, employ local consultants, and start-up activities in Iraq, it would be necessary to scale back the proposed work program. In such a situation, the Bank would focus on policy advice and building Iraqi capacity, through videoconferences and training outside of Iraq, to lay the groundwork for a future more comprehensive Bank program of support. If security improves so that Bank staff can travel safely to Iraq, the Bank will establish a physical presence in Baghdad and scale up its assistance.

94. **Ensuring adherence to core fiduciary and safeguard requirements will remain challenging under the circumstances.** The inability to travel to Iraq at this time precludes the Bank's normal program and fiduciary and safeguard oversight processes. The Bank is striving to mitigate fiduciary and safeguard risks and possible delays resulting from fiduciary and safeguard concerns by focusing on capacity building and contracting appropriately qualified and independent local oversight capacity. Nevertheless, risks that funds may not be used effectively or in a manner conforming to Bank procedures are likely to remain high even in comparison to other conflict-affected situations.

95. **Iraq's ongoing political transition could be a source of instability.** At the minimum, it will result in a turnover of ministers and key staff, and could slow project implementation. The political transition is an important opportunity for Iraq to establish a democratic pluralistic society, but the transition will be complicated and building legitimacy will be challenging, especially in a country with no history of democracy. Studies show that fragility of political institutions is an important source of conflict risk.

96. **Iraq's natural resource endowment offers the potential for sustainable economic prosperity but also the potential for adverse effects.** Historically, resource-abundant countries have been prone to poor governance, economic decline, and conflict. Improving Iraq's governance of oil is therefore crucial for reducing the risk of further conflict. The Bank will work with other donors to help Iraq increase the transparency of natural resource revenues.

97. **Insufficient country ownership or inadequate pacing or sequencing of reforms could contribute to social and political instability.** Iraq's fragility dictates that careful consideration be given to the social and poverty impact of all proposed reforms. Reforms that would potentially increase unemployment or poverty in the short term need to be structured to minimize the adverse impact on the poor and accompanied by measures to protect vulnerable groups. Failure to do so could undermine efforts to improve security and stability. The strategy includes policy advice and

analytical work that aims to ensure that reforms are appropriately sequenced and accompanied by safety net measures.

98. **Institutional weaknesses will likely hamper the absorption of international assistance and the reform process.** Although Iraq has been endowed with strong human resources, the country's current institutional capacity is not yet well known in all sectors. However, the current weak financial management practices and lack of internal auditing activity is a known institutional weakness (see Box 2). The Second Interim Strategy Note emphasizes the need to build institutional capacity.

99. **Careful coordination among international partners will be crucial for avoiding duplication and confusion.** The establishment of an Iraqi-led coordination mechanism should help in this regard. The Bank will also strive to help Iraq develop a county-owned national reconstruction and development strategy and to move in the direction of sector-wide approaches.

Annex 1: Lessons Learned from Post-Conflict Reconstruction

The World Bank has extensive experience in supporting reconstruction and development in conflict-affected environments, yielding lessons for Iraq.

- **Excessive dependency on primary commodity exports, unequally distributed income, economic decline, and dominance of one ethnic or religious group¹ are all characteristics that render countries prone to conflict.** If such underlying characteristics persist, a history of conflict can lead to further violent conflict.
- **Natural resource endowments are often associated with conflict, poor governance, and economic decline, because revenues are often used inefficiently or corruptly.** Exposure to price shocks also contributes to increased conflict risk. A strategy of economic diversification is important for sustainable economic development and for reducing medium- and long-term conflict risk. In the short term, governments should give priority to transparent governance of natural resource revenues and to establishing inclusive and credible institutions of scrutiny.
- **The evidence is that democracy per se does not reduce the risk of renewed conflict.** Changes in political arrangements, such as elections, appear to actually increase the risk of conflict. Greater attention needs to be paid to economic policies and institutions, which are often not given sufficient attention by the government itself. Rapid policy and institutional reform should be started immediately after peace has been established and continue for at least a decade, with a special focus on building credible institutions of social inclusion.
- **Post-conflict recovery is not an automatic process of bouncing back; even in successful recoveries, the process is slow.** The pace of recovery is highly dependent, however, on national policy choices and the scale and nature of international support.
- **International aid is extremely effective in raising growth in post-conflict situations, but this effect is greatest during the middle of the first post-conflict decade.** Long lags between commitment and disbursement should be considered “normal” in post-conflict situations. (See also Box 4.)
- **Economic growth reduces the risk of further conflict.** The first post-conflict decade is a good period for growth, but growth is not uniform during the decade. The pace of growth tends to quicken after being modest in the first three post-conflict years, with a growth spurt concentrated in the middle four or five years of the decade.
- **Growth is more sensitive to policy reform during the first post-conflict decade than in normal situations.** Rapid policy and institutional reform should be started immediately after peace has been established, and capacity-building aid will probably be needed for this. Reform efforts should focus on two or three policies that are politically as easy as possible and yield rapid payoffs. The rationale for this approach is to build a constituency for reform in contexts in which the demand for reform is largely latent.
- **The early post-conflict period may politically be a relatively easy time for reform,** because people expect change and old vested interest may have been weakened. However, the greater political scope for reform may be constrained by the limited technical capacity to design and implement policies, although this is amendable through donor assistance.

¹ Where one ethnic or religious group is numerically dominant, so that majority rule could lead to the permanent exclusion of other groups.

- **Inclusive social expenditures are relatively more important in post-conflict situations** than macroeconomic and structural reforms, according to studies on the determinants of growth in post-conflict environments. This suggests that relative to the normal strategies, social policy should be given somewhat more weight, and trade-offs that improve social policies at the expense of a small deterioration in macroeconomic balances may augment growth. High expenditures on social inclusion signal that the government does not intend to run a patronage system for its core support base.

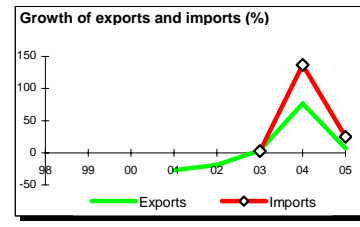
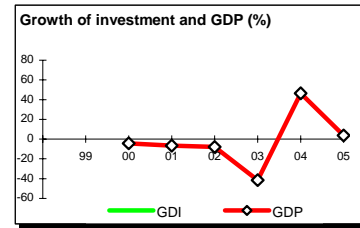
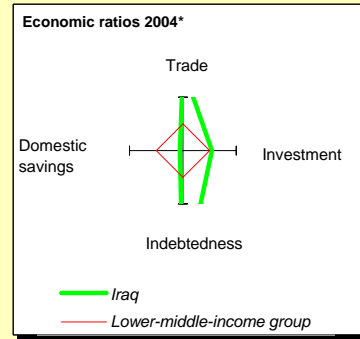
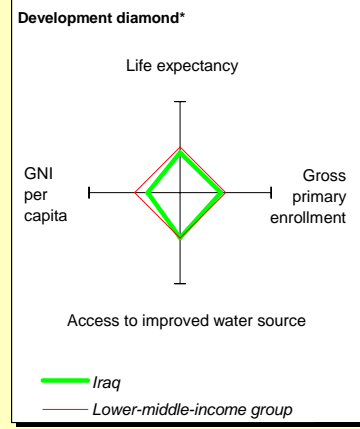
Source: Breaking the Conflict Trap: Civil War and Development Policy. World Bank Policy Research Report. 2003.

Annex 2: Iraq at a Glance

08/23/2005

POVERTY AND SOCIAL	Iraq	M. East & North Africa	Lower-middle-income			
2005						
Population, mid-year (millions)	27.9	312	2,704			
GNI per capita (US\$)	1,051	2,210	1,490			
GNI (US\$ billion)	29.3	744	3,900			
Average annual growth, 1999-05						
Population (%)	2.8	1.9	0.9			
Labor force (%)	..	2.9	1.2			
Most recent estimate (latest year available, 1999-05)						
Poverty (% of population below national poverty line)	..	..	..
Urban population (% of total population)	67	58	49			
Life expectancy at birth (years)	61	69	69			
Infant mortality (per 1,000 live births)	102	43	33			
Child malnutrition (% of children under 5)	12	..	11			
Access to an improved water source (% of population)	81	88	81			
Literacy (% of population age 15+)	65	69	13			
Gross primary enrollment (% of school-age population)	99	95	111			
Male	109	98	111			
Female	89	90	110			
KEY ECONOMIC RATIOS AND LONG-TERM TRENDS						
	2000	2001	2002	2003	2004	2005
GDP (US\$ billion)	25.9	18.9	20.5	13.6	25.5	29.3
Gross domestic investment/GDP	26.6	37.1
Exports of goods and services/GDP	63.8	63.5	52.8	80.0	69.6	64.8
Gross domestic savings/GDP	3.0	0.4
Gross national savings/GDP	-10.4	6.9
Current account balance/GDP	-37.0	-30.2
Total External Public Debt/GDP	992	306	..
Total debt service/exports (actual amounts paid)	0	1	..
Present value of debt/GDP	992	306	..
Present value of debt/exports	1,240	440	..
(real average annual growth)	2000	2001	2002	2003	2004	2005
GDP	-4.3	-6.6	-7.8	-41.4	46.5	3.7
GDP per capita	0.2	2.0	-5.4	-44.2	43.7	0.9
Exports of goods and services	..	-27.3	-19.1	3.8	76.4	6.9

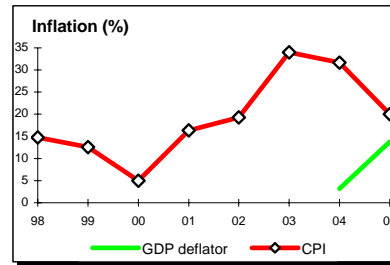
STRUCTURE OF THE ECONOMY (% of GDP)	2000	2001	2002	2003	2004	2005
Oil sector	83.9	76.1	68.0	68.0	67.5	63.0
Non-oil sector	16.1	23.9	33.4	34.4	32.5	37.0
Agriculture	11.1	..	9.8	..
Manufacturing	1.7	..	1.5	..
Services	20.6	..	21.2	..
Private consumption	40.2	38.1
General government consumption	56.8	61.5
Imports of goods and services	53.4	79.8	93.3	101.5
(average annual growth)						
Agriculture
Industry
Manufacturing
Services
Private consumption	8.9
General government consumption	24.4
Gross domestic investment	60.2
Imports of goods and services	2.5	136.8	25.0



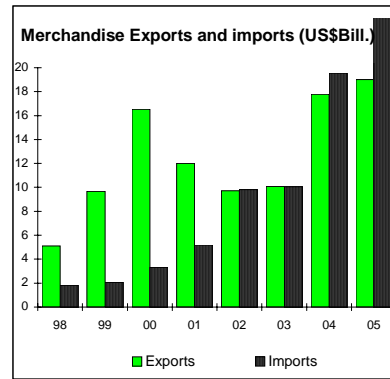
Notes: 2004 data are preliminary estimates, 2005 data are projections; (..) not available.
 (*) The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

PRICES AND GOVERNMENT FINANCE

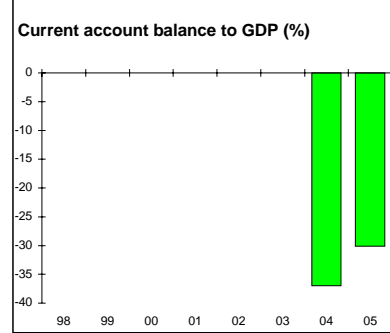
	2000	2001	2002	2003	2004	2005
Domestic prices						
<i>(% change)</i>						
Consumer prices	5.0	16.4	19.3	34.0	31.7	20.0
Implicit GDP deflator	3.2	13.8
Government finance⁴						
<i>(% of GDP, grants)</i>						
Current revenue	80.5	87.7
Current expenditure	99.0	83.6
Capital expenditure	22.3	31.8
Overall surplus/deficit	-40.8	-27.7


FOREIGN TRADE

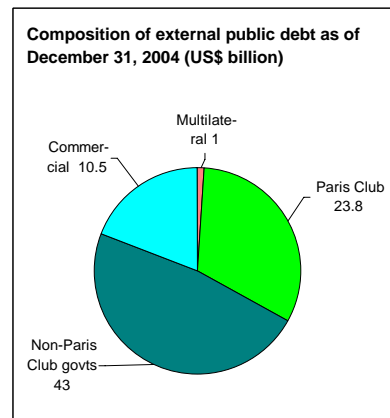
	2000	2001	2002	2003	2004	2005
<i>(US\$ million)</i>						
Total exports (fob)	16,527	12,009	9,711	10,082	17,782	19,016
Crude oil	16,476	11,941	9,653	8,459	17,329	18,410
Petroleum products	..	..	..	..	..	..
Manufactured products	..	..	..	..	..	..
Total imports (cif)	3,320	5,180	9,817	10,063	19,569	24,143
Government imports	..	..	9,434	7,114	13,761	15,199
UN Oil For Food Program	..	..	..	..	3,488	1,884
Post OFFP govt. consumption	..	..	..	..	3,843	5,181
Refined oil products	..	..	0	138	2,648	2,088
Capital goods	..	..	..	..	3,781	6,045
Private sector imports	..	..	384	2,820	5,809	8,944
Consumer goods	..	..	288	1,128	..	..
Capital goods	..	..	96	1,692	..	..
Crude petroleum price (\$/bbl) ¹	24.7	19.9	20.5	26.0	31.6	36.0
Proven Oil Reserves (billion barrels)	113	115	115	115	115	115


BALANCE OF PAYMENTS

	2000	2001	2002	2003	2004	2005
<i>(US\$ million)</i>						
Exports of goods and services ³	16,527	12,009	9,711	10,082	17,782	19,016
Imports of goods and services	9,817	10,063	23,826	29,775
Resource balance	-106	19	-6,044	-10,759
Net income	-5,381	-3,878
Net current transfers	1,979	5,790
Current account balance	-9,447	-8,847
Financing items (net)	-1,573	-1,700
Changes in net reserves	-6,768	-1,700
Memo:						
Reserves including gold (US\$ million)	1,134	7,902	9,602
Conversion rate (NID/US\$)	1,930	1,929	1,957	1,957	1,454	1,500


EXTERNAL LIABILITIES

	2000	2001	2002	2003	2004	2005
<i>(US\$ million)</i>						
External debt²						
Total debt outstanding and disbursed	125,000	78,190	..
Multilateral Organizations	635	890	..
IBRD	101	0	..
IMF	80	436	..
Paris Club Creditors	38,900	23,800	..
o/w Japan	7,249	..	..
France	5,580	..	..
Germany	5,482	..	..
USA	4,010	0	..
Italy	3,920	..	..
Russia	3,598	..	..
Non-Paris Club governments	67,365	43,000	..
o/w Gulf Cooperation Council	48,190	..	..
Commercial creditors	15,000	10,500	..
Of which commercial banks	2,500	1,750	..
UNCC Compensations ⁵	18,992	33,099	..



Notes: 1. Iraqi oil prices carry a discount which reflects the quality of Iraqi blends and frequent security-related supply interruptions.

2. Estimates based on partial data from the creditors. These have not been reconciled and may be incomplete. Data for 2004 assume full application of the first stage of debt reduction, including comparable treatment of non-Paris Club debt.

3. Data for services only available on a net basis, and is added to imports; exports data shown here are for merchandise exports only.

4. Fiscal accounts are consolidation of government budgets, aid flows, and spending by the Development Fund of Iraq (DFI).

5. UNCC - UN Compensation Commission (www.uncc.ch). 2005 amounts awarded are outstanding as of July 28, 2005.

Annex 3: Iraq vis-à-vis the Millennium Development Goals

Economic dislocation has led to major deterioration in Iraq's human development indicators, many of which were superior to Middle East and North Africa region (MENA) averages just two decades ago. No official review of Millennium Development Goals (MDGs) has been issued in Iraq, but the country's ability to attain most of its MDGs appears highly uncertain at this time.

Goal 1: Eradicate extreme poverty and hunger. Data on poverty are not fully reliable, but estimates based on recent surveys suggest that the incidence of absolute poverty might be over 10 percent, with a further 12-15 percent of the population close to the international absolute poverty line of US\$1 in income per day. Up to 60 percent of the population depends on the food ration.

Goal 2: Achieve universal primary education. By 1980, Iraq had achieved nearly universal primary school enrollment. Gross enrollment in primary school (age 7-13) remains high at 98 percent; however, secondary school gross enrollment dropped from 47 percent to 36 percent. The attendance rate remains high at 93 percent but is lower for girls in rural areas (86 percent). By mid-2003, some 12,000 schools were in need of repair; so far, some 3,000 schools have been rehabilitated, with another 1,500 underway.

Goal 3: Promote gender equality and empower women. In 1985, Iraq's ratio of girls to boys in primary and secondary education was comparable to the MENA average of 72 percent. However, while the region's ratio improved steadily to reach 95 percent in 2000, Iraq's ratio increased only to 76 percent (in 1999). The ratio of young (ages 15-24) literate females to males is 50.1 percent, compared with 60 percent in Yemen and 100.3 percent in Jordan. The gender distortion is worse in rural areas.

Goal 4: Reduce child mortality. During the 1980s, several critical health indicators had improved substantially; since 1990, however, health indicators deteriorated sharply. Under-five mortality has increased to 115 per 1,000 in 2003 (compared to 33 in Jordan and 107 in Yemen) and is twice as high in the south and center of the country as it is in the north. Infant mortality has increased by 2002 to 102 per 1,000 live births, compared to 105 in sub-Saharan Africa. It is believed that the majority of infant deaths are due to diarrhea as a result of poor water and sewage quality and overcrowding. The incidence of the most important vaccine-preventable disease, measles, has declined since vaccine coverage improved in the 1990s, but in the north the disease is still the third most common cause of death of children under five.

Goal 5: Improve maternal health. Maternal mortality is extremely high at about 300 per 100,000 live births (compared to 41 in Jordan and 350 in Yemen). The share of women delivering without trained assistance in 2000 was about 28 percent and close to 40 percent in rural areas; more recent data are not available.

Goal 6: Combat HIV/AIDS, malaria and other diseases. Typhoid, cholera, and malaria are endemic. In the center and south of the country, the situation remains critical, with 20 percent of the population at risk from lack of access to safe water and sanitation. The reported incidence of tuberculosis (at 132 per 100,000 people) is markedly higher than in neighboring countries. Iraq is categorized as highly vulnerable to HIV/AIDS, but no reliable supporting data are available. The registered number of cases of HIV/AIDS is low (about 250); however, risk factors are present for increased rates of transmission.

Goal 7: Ensure environmental sustainability. There is widespread destruction and deterioration of key ecosystems and habitats, including waterways, forests, and marshlands. Access to improved drinking water sources has declined over the past two decades. It stands at 81 percent, below the regional average of 88 percent. Emissions from a rapidly growing and often obsolete vehicle fleet and open burning of solid waste cause major air pollution. Attacks on oil infrastructure lead to oil fires and serious air pollution over vast areas. Untreated hazardous and municipal waste accumulated from recent fighting, and no appropriate sanitary landfills exist.

Annex 4: International Assistance to Iraq

Pledges of over US\$100 million at the Madrid Donor Conference (US\$ million)

	Pledged in Madrid (2004-2007)	of which Loan	of which Grant	of which Grant Assistance Deposited in IRFFI*
United States	18,649		18,649	10
Japan	4,914	3,500	1,414	491
Kuwait	500		500	10
Saudi Arabia	500	500		
United Kingdom	452		452	127
Italy	236		236	16
European Community	236		236	227
Spain	220		220	20
United Arab Emirates	215		215	
Canada	187		187	60
Qatar	100		100	7.5
World Bank	3,000	3,000		
IMF	2,500	2,500		
Total	31,709	9,500	22,209	968.5

* As of June 30, 2005. In addition to these eleven donors, fifteen additional donors deposited US\$43.5 million, bringing total IRFFI deposits to US\$1,012 million. As of August 1, 2005, nearly US\$300 million of new pledges to IRFFI have been made, although not yet deposited.

Annex 5: Status of Projects Financed from the World Bank Iraq Trust Fund

Ongoing Projects

EMERGENCY TEXTBOOK PROVISION

Approval Date: May 2004

Closing Date: December 2005

Grant Amount: US\$40 million

Disbursed: US\$22 million

Objective: The project (now nearly completed) provided urgently needed textbooks for the 2004/2005 school year to improve conditions of learning in primary and secondary schools. The grant financed the printing and distribution of approximately 69 million textbooks (over 600 titles) for six million students in all governorates.

Implementation Status: The project objective was achieved: all textbooks procured under the grant for the school year 2004/2005 were delivered to schools; and, for the first time in many years, almost 75 percent of textbooks were delivered within the first three months of the school year. Local printing companies were used to the maximum extent possible. Competitive bidding procedures led to cost savings of US\$9 million, which are being used to procure additional textbooks for 2005/2006. Disbursements lag behind implementation due to lengthy quality control procedures implemented by the Ministry of Education.

EMERGENCY SCHOOL RECONSTRUCTION AND REHABILITATION

Approval Date: October 2004

Closing Date: June 2007

Grant Amount: US\$60 million

Disbursed: US\$0.1 million

Objective: The project will alleviate urgent school building hazards and school overcrowding by constructing or rehabilitating 260 primary and secondary schools throughout all governorates of Iraq. The project benefits over 100,000 families with children attending primary and secondary schools and will create thousands of jobs through use of Iraqi construction companies.

Implementation Status: The project is ahead of schedule: rehabilitation of 135 schools is underway and will be completed in early fall 2005, and an additional nine schools will be completed by the end of the year. Procurement for the construction of new schools will take place in the second half of 2005.

EMERGENCY HEALTH

Approval Date: December 2004

Closing Date: December 2006

Grant Amount: US\$25 million

Disbursed: US\$0.09 million

Objective: The project responds to an urgent need to improve emergency services in twelve hospitals throughout Iraq, selected to ensure that each governorate has at least one well-equipped emergency unit and taking into account the work of other donors in the six remaining governorates. The grant finances rehabilitation of emergency facilities, basic medical and laboratory equipment, and essential emergency drugs to be used at the rehabilitated facilities. About fifteen million Iraqis live within the areas serviced by the twelve emergency health facilities.

Implementation Status: Although the project has experienced implementation delays due mainly to changes in government, the PMT in the Ministry of Health has signed contracts with local firms for design and supervision of the rehabilitation of eleven emergency health units. Rehabilitation works will start during the second half of 2005 and will take about eight months to complete. The Bank has reauthorized the tender of emergency pharmaceuticals due to non-responsiveness of the first bids.

EMERGENCY COMMUNITY INFRASTRUCTURE

Approval Date: December 2004

Closing Date: June 2007

Grant Amount: US\$20 million

Disbursed: US\$0.0 million

Objective: The project will generate near-term employment while improving rural water infrastructure through a flexible program of labor-intensive civil works. In all, the project will finance an estimated twenty to twenty-four subprojects to rehabilitate rural water supply and sanitation as well as irrigation and drainage, creating more than 15,000 jobs.

Implementation Status: After a slow start, there has been a sharp increase in project activity since May 2005. The PMT in the Ministry of Water Resources has contracted nine labor-intensive civil works valued at US\$4.5 million, which will create an estimated 6,000 to 8,000 jobs over the next few months.

EMERGENCY WATER, SANITATION, AND URBAN RECONSTRUCTION

Approval Date: December 2004

Closing Date: August 2007

Grant Amount: US\$90 million

Disbursed: US\$0.10 million

Objective: The project will help restore basic water supply and sanitation services and urban services in the poorest areas of the country, choosing subprojects that will have high impact. The project finances water supply and sanitation rehabilitation in nine cities and rehabilitation of urban infrastructure in the poorest areas of three cities, benefiting over 2 million inhabitants. It will also help reduce waterborne diseases, create substantial short-term employment, and strengthen Iraq's capacity to manage large-scale reconstruction.

Implementation Status: The PMT in the Ministry of Municipalities and Public Works has recruited local and international consultants to prepare tender documents and to subsequently supervise construction works. Construction will begin in late 2005 and early 2006. Under the project, the ministry has also launched a nationwide water and wastewater survey to prepare a water sector strategy; and it is preparing a comprehensive water sector investment program to present to the donor community for future financing.

EMERGENCY BAGHDAD WATER SUPPLY AND SANITATION

Approval Date: December 2004

Closing Date: August 2007

Grant Amount: US\$65 million

Disbursed: US\$0.08 million

Objective: The project aims to help restore basic water supply and sanitation services for Baghdad by reconstructing and rehabilitating existing treatment facilities and networks and by providing capacity-building support. It will benefit about one million residents of Baghdad—about 17 percent of the city's population. It funds rehabilitation of four water pumping stations and water treatment plants, and replaces the water supply network in Za'afarania district and the sewerage collection system in Sadr City. The project includes the development of a Comprehensive City Development Plan to ensure that future expansion of the water supply and sanitation networks are in line with the overall urban development plan.

Implementation Status: The PMT within the Mayoralty of Baghdad has awarded contracts for US\$8.5 million of goods and works and has hired local and international consultants to prepare tender documents and subsequently supervise construction works. The mayoralty has hired a team of advisors to help prepare and implement the Baghdad Comprehensive City Development Plan.

EMERGENCY PRIVATE SECTOR DEVELOPMENT

Approval Date: December 2004

Closing Date: December 2008

Grant Amount: US\$55 million

Disbursed: US\$0.09 million

Objective: The project aims to lay the foundation for investment and private sector development by financing a modern and integrated national digital backbone communications network, interconnecting key parts of the Central Bank of Iraq's payments and settlements system, and developing the capacity of public institutions that support the private sector. The project has national impact, and represents the first phase of a series of interventions within a comprehensive private sector development strategy.

Implementation Status: Procurement is underway for the supply, installation, and commissioning of a national backbone microwave network (\$39 million). The winning contractor will be responsible for operations and maintenance for two years, and will transfer know-how to the Iraqi Telecommunications and Postal Company. In addition, procurement is well advanced for consulting services for other private sector development activities, including for feasibility studies for industrial estates in Irbil and Basra.

SECOND CAPACITY BUILDING PROJECT

Approval Date: December 2004

Closing Date: December 2008

Grant Amount: US\$7 million

Disbursed: US\$1.37 million

Objective: Building on the experience of the first Capacity Building Project, the project aims to build institutional capacity needed to shift to a market-driven economy; improve the efficiency, effectiveness, and quality of public services; and facilitate use of public resources, including donor funds, for urgent reconstruction and development efforts. It will directly benefit over 1,000 officials and help lay the groundwork for crucial institutional strengthening and reform.

Implementation Status: Twenty-four training activities have taken place to date, involving 375 participants from various entities, such as the Ministry of Planning and Development Cooperation, Ministry of Finance, Ministry of Trade, Ministry of Labor, and Central Bank of Iraq.

Closed Projects

FIRST CAPACITY BUILDING PROJECT

Approval Date: February 2004

Closing Date: August 2004

Grant Amount: US\$3.6 million

Disbursed: US\$2.5 million

Objective: The project aimed to build the capacity of Iraqi authorities to enable them to participate effectively in the definition and prioritization of international programs of support and to play a leading role in the reconstruction process. The project sought to do this by: (i) building the capacity in key public administration areas to facilitate use of public resources for urgent reconstruction and development efforts; (ii) helping the authorities strengthen their strategic and technical skills and design integrated policies and programs; and (iii) enhancing policy making within government to ensure the emergence of a private sector able to serve as an engine of growth.

Implementation Status: The project achieved its objectives and closed in August 2004. It built the capacity of Iraqi officials to design and implement projects and start developing sector strategies. During the life of the project, twenty-two activities were completed and 581 Iraqi officials were trained in a variety of subjects/issues.

Annex 6: Status of Analytical and Advisory Services

Completed Activities¹

REBUILDING IRAQ – ECONOMIC REFORM AND TRANSITION

This report focuses on the main cross-cutting issues of Iraq's transition and aims to support the Iraqi government in strengthening its policymaking capacity by laying out the policy options available and discussing tradeoffs under each option. The key themes are reconstruction and job creation; reform of the pricing system; managing oil revenues; and strengthening safety nets. Underpinning this complex agenda are overarching issues in public sector governance.

Status: Delivered to the Government of Iraq, available in Arabic.

CONSIDERING THE FUTURE OF THE IRAQI PUBLIC DISTRIBUTION SYSTEM

The report informs the decisions that the Iraqi government and public need to make in the next few years on the roles of the public and private sectors in food markets. The exercise presents a wide range of reform options and provides analysis of the potential consequences of each option. A background paper on international experience with food subsidies was prepared for this study.

Status: Delivered to the Government of Iraq, available in Arabic.

A STUDY OF FOOD GRAIN MARKET IN IRAQ

The study analyzed the functioning of Iraq's food grain market and the relative roles of the public and private sectors; evaluated data on domestic supply and demand of food grain using estimates of production, imports, government distribution and consumption; and examined available price data to assess the extent of price variations and the extent to which markets are integrated. This is one of the first background papers for the World Bank's work on social protection and options for food security in Iraq.

Status: Delivered to the Government of Iraq in June 2004 and published.

PETROLEUM ISSUES—HIGH-LEVEL SEMINAR AND POLICY STUDIES

The seminar was prepared jointly by the Bank and the IMF and covered oil revenue management, transparency, sector structure, fiscal/legal/contractual framework, mitigation options for oil price volatility, and domestic fuel pricing. Prior to the seminar, the Bank had prepared two background papers: Reforming Energy Prices in Iraq—Discussion Paper (November 2003) and Oil and Gas Sector in Iraq—Background Paper (June 2004). Following the seminar, the Bank prepared for the government several policy notes on fuel pricing.

Status: Completed in January 2005.

IRAQ - ENHANCING SOUND PUBLIC FINANCIAL MANAGEMENT

Jointly prepared by the Bank and the IMF, this is a systematic review of Iraq's public finance management systems and improvements needed to ensure transparency in managing Iraq's public finances, report in the context of IMF-supported stabilization programs, and access funds provided by the World Bank and other donors. The report builds on a previous IMF assessment (2003), reports by US and United Kingdom consultants working in Iraq, and detailed discussions with the Iraqi authorities. A companion paper on payroll system was prepared, which led to the government's request for a detailed assessment of payroll reform options (see next entry).

Status: Delivered to the Government of Iraq.

¹ Activities accomplished during the period of the First Interim Strategy Note (2004-2005). Most individual entries comprise several activities (both analytical work and technical assistance).

REPORT ON PAYROLL REFORM

The report sets the strategic framework for payroll reform and describes interventions in three areas: (i) securing the payroll process; (ii) creating an effective management of staffing; and (iii) transforming management reporting. The report outlines the intervention plan, proposing organization, functional architecture, deployment of payroll systems, and project management arrangements, together with the costing and a tentative timetable. The report was elaborated during two workshops in April and June 2005 with Iraqi officials in charge of human resource management and payroll.

Status: Delivery to Government expected in August 2005.

IRAQ FINANCIAL MANAGEMENT ACCOUNTABILITY REPORT

The report evaluates the current public financial management system in terms of its capacity to comply with the Bank's financial management requirements and acceptable standards in six main areas: budgeting, accounting, financial reporting, internal controls, auditing, and flow of funds. The report will help future project teams address systemic financial management issues, taking into consideration experience with ongoing projects.

OPERATIONS PROCUREMENT REVIEW (OPR)

The review assesses the evolving public procurement system and recent experience with the new procurement regulations established in 2003-2004 and with donor-funded activities, especially the World Bank Iraq Trust Fund (ITF). The review identifies generic procurement issues which need to be addressed to speed up implementation of ongoing projects, draws lessons for procurement arrangements to be included in World Bank- and ITF-financed projects, and offers recommendations for improving the Iraqi public procurement system.

Status: Delivered to the Government of Iraq, available in Arabic.

MASTER IMPLEMENTATION MANUAL FOR BANK-FINANCED PROJECTS

The Manual will help Iraqi project management teams to design and implement comprehensive and reliable procurement and financial management arrangements that meet the Bank requirements and Iraq's financial regulations. The arrangements should allow generation of reports to track project procurement and financial records, reporting all expenditures by project component, by type of expenditure, and by source of funding.

Status: Completed in June 2005, available in Arabic.

FISCAL FEDERALISM--HIGH-LEVEL SEMINAR AND POLICY STUDIES

The objectives of the seminar, jointly conducted by the Bank and the IMF, were to introduce the Iraqis to a comprehensive perspective on intergovernmental fiscal issues based on international experience, and to assist the participants in considering feasible options for reform in Iraq. A Technical Paper was prepared jointly by the Bank and the IMF based on the findings of the seminar and is available on the IMF external website.

Status: Completed in December 2004, report published in 2005.

SOCIAL PROTECTION IN TRANSITION: LABOR POLICY, SAFETY NETS AND PENSIONS

This policy note describes the main social protection mechanisms existing in Iraq and relates them to relevant international experiences; and identifies issues and priority areas for policy development in three areas of social protection: labor market policy, social safety nets, and pensions. To prepare this note, two workshops on social protection policy were held:

- *June/July 2004, Amman:* The workshop focused on building capacity of policymakers through international experience, including targeting modalities of social safety nets, the core elements of active labor market programs, and principles of sound pension design.
 - *A second social protection workshop (January 2005)* provided an opportunity to discuss the issues discussed in the note, reinforce social protection principles, and develop potential strategies and interventions within a working group of policymakers.
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Both workshops were attended by senior policymakers from key ministries concerned with social protection, and by interested donors. The proceedings were simultaneously translated in Arabic and English.

Status: Delivered to the Government of Iraq

PENSIONS IN IRAQ: ISSUES, GUIDELINES FOR REFORM, AND FISCAL IMPLICATIONS

This report analyzes distortions in the Iraqi pension system stemming from structural problems and recent emergency measures. Combined, these issues make the pension system financially unsustainable. The report presents a framework for reform, and assesses the fiscal implications of alternative policy interventions. The report's recommendations were formulated via an extensive capacity-building program which involved pension specialists from all key Iraqi ministries.

Status: Delivered to the Government of Iraq, available in Arabic.

NOTES ON FINANCIAL SECTOR REFORM AND HOUSING FINANCE

The process of reinvigorating the financial sector in Iraq is contingent upon the revival of its payment system and the resumption of banking operations. The immediate need is to restructure Iraq's public banks, which are currently the core component of its financial system. Several policy notes produced by the World Bank evaluate the sector's legal and regulatory aspects (new central bank and commercial laws, and creation of an effective operating structure for banking supervision) as well as developing the country's non-cash payment system, including clearing and settlement and developing electronic settlement facilities. In addition, the Bank provided a just-in-time note on housing finance.

Status: Delivered to the Government of Iraq.

INVESTMENT CLIMATE AND STATE OWNED ENTERPRISE REFORM

Two policy papers—Building a Sustainable Investment Climate in Iraq and State-Owned Enterprise Reform in Iraq—synthesize the findings of capacity-building workshops held in February and May 2004, with lessons from regional and international best practices in developing a competitive investment climate regime and restructuring state-owned enterprises. These workshops, and associated discussions between both the Iraqi experts and the Bank team, have resulted in the emergence of an Iraqi-owned strategy together with a set of detailed priority actions. The workshops and discussions were highly interactive and included study tours, general debates, case studies, and best-practice presentations from experts familiar with the region.

Status: Delivered to the Government of Iraq and published.

LEVERAGING WORLD TRADE ORGANIZATION (WTO) ACCESSION TO DESIGN STRATEGY OF ECONOMIC REFORMS

The note discusses using WTO membership to design a strategy of structural reforms in Iraq. It draws on the experience of recent entrants to the European Union in designing an institutional setting for the development and implementation of the strategy.

Status: Delivered to the Government of Iraq and published.

REGIONAL CAPACITY BUILDING WORKSHOP IN GENDER AND ECONOMIC POLICY, MAY 2005

The workshop aimed to improve capacity in gender and statistics, gender monitoring, and evaluation and gender-responsive economic policy, through training, networking, and knowledge-sharing among gender focal points in ministries, NGOs, experts, and Bank staff. The workshop enhanced participants' comprehension of gender issues and their impact on economic development, effectiveness, and efficiency. Arabic training material and toolkits were developed.

WOMEN'S ECONOMIC PARTICIPATION IN IRAQ

At the request of the former Minister of State for Women's Affairs, the Bank prepared a note on women's labor force participation. It analyzed various labor laws and regulations and proposed international best-practice models for gender-egalitarian labor regulations. It presented constitutional models and specific wordings that would establish a strong umbrella for women's economic rights (e.g. South Africa). This analysis is to help gender advocates in the writing of the

constitution.

Status: Delivered to the Government of Iraq in March 2005.

IRAQ HOUSEHOLD SOCIO-ECONOMIC SURVEY

The Iraq Household Socio-Economic Survey will address a crucial gap in information on living conditions in Iraq; it will provide household expenditure data for the first time since 1993, making it possible to establish a poverty line for Iraq and to analyze the causes and correlates of poverty. It will also provide key information for National Accounts statistics and for the Consumer Price Index. Capacity-building activities for the survey include:

- *An initiating workshop* (March 2005) brought together Iraqi statistical units from Baghdad and the northern governorates and donors to define the issues to be addressed through the survey;
- *A workshop on living standards measurement surveys and sampling methodologies* (April 2005, Baghdad), attended by sixty-three officials;
- *A general data dissemination system workshop* (jointly with the IMF, May 2005, Amman) helped the Iraqi statistical agents to assess their existing systems, to promote improved dissemination and effectiveness using the general data dissemination framework, and to harmonize the statistical systems of the northern governorates with the rest of Iraq.

Status: The workshops have been delivered; preparation of the survey is underway.

Ongoing and Planned Activities

PROJECT DEFINITION	DELIVERY TO CLIENT
ESW	
Oil and Gas Sector Review	September 2005
Iraq Incentive Framework	December 2005
Iraq Public Sector Management	February 2006
Country Water Assistance Strategy	March 2006
Agriculture Sector Review / Strategy	March 2006
Poverty Assessment	FY07
Social Protection Strategy	TBD
Environment Strategy	TBD
TA	
Reform of State-Owned Enterprises	December 2005
Iraq Food Reform and Poverty	February 2006
Trade Policy and Facilitation	March 2006
Iraq - Gender Stocktaking	March 2006
Financial Sector Reform	June 2006
Health Policy and Planning	June 2006
Intergovernmental Reform	Ongoing
Procurement	Ongoing
Financial Management	Ongoing
Utility Reform	Ongoing

Annex 7: IBRD Creditworthiness

Creditworthiness for IBRD lending is assessed by evaluating the borrower's ability and willingness to repay the IBRD on time and in full. Given the long maturity of IBRD loans, repayments risks are assessed over a medium term horizon, taking into account a broad range of factors affecting future financial capacity and political willingness to honor obligations to the IBRD. These factors cover political risks (including security risks), external debt burden and liquidity risks, fiscal policy and public debt burden, balance of payment risks, economic structure and growth prospects, monetary and exchange rate policy, financial sector risks and corporate sector debt. The importance of each factor for any particular country may vary over time depending on its level of development.

For Iraq, at this stage, the overarching risk factors are clustered around the areas of political and security concerns, external debt relief, the establishment of a track record of sound economic policies and of good governance, and the prospects for implementing structural reforms that would enhance strongly the growth outlook and reduce vulnerabilities to external shocks and balance of payments risks. Since the adoption of the First Interim Strategy by the Board, progress has been made in most of these areas. The political transition has moved forward despite exceptionally adverse security conditions; an agreement for emergency assistance with the IMF has been signed; considerable work has been done to articulate a National Development Strategy; and an extraordinary debt agreement with Paris Club creditors has been negotiated. Yet, political and security risks remain exceptionally high; Iraq's policy performance under the EPCA has so far been mixed; governance issues are pervasive; the agenda of structural reforms is daunting and face thorny sequencing and implementation challenges; the debt issue is far from being fully resolved; and the recovery in the oil sector, and the economy as a whole, has been limited, weakening the prospects for a significantly stronger external position.

- **The January 30th democratic elections for the 275-member Transitional National Assembly (TNA) represent a landmark political achievement of the post-Saddam era.** Although the Sunni electorate largely abstained, turnout in most Kurdish and Shia-dominated areas ranged from 60 to 80 percent, and elections met recognized international standards despite widespread violence and an elevated terrorist threat. However, no single party holds a majority in the TNA and alliances built for electoral convenience may lack stability. Indeed, protracted negotiations were necessary to appoint the president (Jalal Talabani, the leader of the Patriotic Union of Kurdistan) and the two vice presidents (the Shia leader, Adel Abdel Mahdi and the Sunni Arab leader, Ghazi al-Yawar). Even longer negotiations were necessary to agree on the composition of the government. Questions arise around the capacity of the fragmented assembly to draft a new constitution which will need to address thorny issues such as the role of Islam in politics and society, the scope of federalism and the status of Kirkuk.

- **Improving security conditions is the overarching priority of the new government but the situation is very precarious, and the outlook remains highly uncertain.** The armed insurgency has shown no signs of abating. Reconstruction, donor assistance and economic recovery are severely complicated by sabotage and the deterioration of security conditions throughout Iraq. The risks of a protracted internal conflict and the potential for Iraq to fragment remain significant. The new assertiveness of the Shia majority could

exacerbate tensions with the Kurds and Sunnis, while sizable segments of the Sunni minority could remain engaged in armed resistance.

- **The authorities have made commendable efforts to implement the 12-month EPCA agreed with the IMF in early October 2004 in a very challenging environment.** Yet track record under the EPCA has been mixed. Some quantitative indicators have been met (currency issued, net reserves, external arrears on new borrowings) but others appear to have been missed by significant margins (lending to the government by the Central Bank, the government primary fiscal deficit). Statistical weaknesses inhibit adequate surveillance. All structural benchmarks are likely to be delayed. Key policy decisions are pending, notably the increase of domestic prices of oil-refined products. Oil production and exports have not fully recovered to their pre-war levels, although high oil prices have allowed oil revenues to exceed projected levels. Major issues plague the development of the highly promising oil and gas sector and addressing them will require massive international expertise and investment that may prove very difficult under the current security situation. Major weaknesses in the administration of the Development Fund for Iraq, including possible misappropriation of oil revenues, have also been reported.

- **The exceptional debt treatment granted to Iraq by Paris Club creditors in November 2004**—a phased reduction of 80 percent (in NPV terms) of the \$39 billion owed to them—is a **very significant step towards resolving the problem of the unsustainable debt burden.** The first phase, equivalent to a 30 percent reduction of the outstanding debt, took place at end-December 2004 through a cancellation of late interest. But Paris Club debt relief will only take effect fully if agreement is reached on an upper credit IMF arrangement to succeed the EPCA and on completion of such a successor arrangement. Debt relief from other (official and private) creditors, who hold two-thirds of Iraq's total debt, has made some progress, but the largest of such creditors may wait full completion of the political transition as they may not wish to strike deals with interim authorities.