# BearingPoint

**Technical Assistance Report**

**to**

## The Central Bank of Iraq

# Formulating and Implementing Monetary Policy

# Follow Up Report 4

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**December 8, 2005**

[1] BearingPoint's Senior Monetary Policy Advisor to the Central Bank of Iraq.

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## PREFACE

In May and June 2004 Dr. Coats was the Coalition Provisional Authority's (CPA's) Senior Monetary Policy Advisor to the Central Bank of Iraq. At the request of the Central Bank of Iraq (CBI), Dr. Coats returned to Baghdad from August 28 to September 9, 2004, to follow up on the advice and work plan in his Report to the CBI of July 19, 2004. Subsequent follow up visits took place in Amman, Jordan, and Baghdad November 22 to December 2, 2004, March 22 to April 5, 2005 and August 15 – 18, 2005. Between visits, Dr. Coats has continued working with the CBI staff by email. This work is financed by USAID/BearingPoint.

During this visit to Baghdad from November 17 to December 8, 2005 Dr. Coats met with Deputy Prime Minister Ahmad Chalabi, Finance Minister Ali Allawi,[2] CBI Governor Sinan Shabibi, Deputy Governors Faleh D. Salman, and Ahmad Al-Juboori, Dr. Mudher Kasim, Director General of the Statistics and Research Department, Ahmed Ibraihi, Senior Advisor, Hassan Al Haidary, Director General of the Agreements and Loans (A&L) Department, and CBI staff, and Adnan Al-Kinany, Director General of the debt management department of the MOF and his staff. Dr. Coats also participated in the regular monthly meeting of the CBI A&L Department with representatives of banks to discuss market conditions and liquidity management issues.

This forth **Follow Up** report reviews progress toward implementing the earlier recommendations and work program since August and updates that program. The Advisor will continue his work with the CBI to implement and further refine the work programs in these areas by email correspondence and periodic visits.

Dr. Coats is retired from the International Monetary Fund and is currently a Director of the Cayman Islands Monetary Authority. He would like to thank all of his counterparts at the CBI and his colleagues at BearingPoint, especially Kat Woolford, and Kevin Taecker in the U.S. Embassy for their assistance.

[2] Meetings with the Deputy PM and MOF concerned the resolution of banks owned by the state.

## EXECUTIVE SUMMARY

### A. Scope of work

The Advisor's main Report, dated July 19, 2004, outlined a **policy framework** in which the Board of the Central Bank of Iraq (CBI) can discuss and adopt its monetary policy, which has the goal of price stability. The policy framework provides a common language in which Directors can discuss policy options and in which the staff can communicate to Directors its knowledge and analysis of economic developments that are relevant for monetary policy. The CBI's monetary policy targets (but does not fix) the exchange rate and allows the market's demand for money at that exchange rate to determine its supply.

The policy regime operates with a set of instruments designed to stabilize the exchange rate, market liquidity, and interest rates. These instruments are: the daily foreign exchange auctions, bank deposit and lending facilities at the CBI, and a reserve requirement for deposits at the CBI and banks' vault cash. In using these instruments to achieve its inflation (price stability) objective, the CBI must establish an exchange rate target (or target range), interest rates on its banking facilities (in relation to its Policy Rate), and the reserve requirement ratio.

### B. Progress Report

The exchange rate has been kept at between 1460 and 1475 most of 2005 and the growth in net foreign assets of the CBI and money supply have dropped to almost zero for the year. The CBI's USD interest earning investments at the Federal Reserve Bank of New York have increased from zero to over 12 trillion dinars equivalent (8.3 billion USD), yielding an income of about 4.5 million dollars per week.

The reserve requirement regulation has been amended with effect from January, 2006 to eliminate the minimum vault cash requirement and to limit the amount of vault cash that can be used to meet the reserve requirement to 20 percent of the total requirement. Banks now report on time but a number of banks do not comply with the requirement. Banks have been put on notice that starting with the January 2006 maintenance period financial penalties will be assessed against banks not in full compliance. Questions remain about the integrity of deposit data reported by banks. **A much stronger effort by the Supervision Department is needed to establish and verify the integrity of deposit data reported by banks. The CBI should consider remunerating required (but not excess) reserves at the Overnight Deposit rate).**

The Lender of Last Resort Facility (LLRF) adopted as part of the Banking Facilities regulation has not been augmented with implementing guidelines. The CBI must immediately develop the procedures for implementing it in practice. At least one privately owned bank with liquidity problems is thought to be insolvent and is thus not eligible for liquidity support from the CBI (though it already has an overdraft loan from the CBI). **The CBI needs urgently to develop and apply the problem bank resolution measures that are permitted in the law.**

The CBI continues to make progress in improving the quality and timeliness of important data (Base money, M1 and M2, Net Foreign Assets). Reporting from CBI branches has improved and remaining problems are being overcome. The introduction of new accounting software in the headquarters in Baghdad created some new problems that have now been overcome. Going forward, these data will be available with only a small lag. The sectorizations needed for the IMF monetary survey have been developed to the extent possible with the existing chart of accounts and the Monetary Survey is now being compiled and published on the website.

Improvements in the weekly **Key Financial Indicators** report have been proposed for the approval of the Governor. This report is available on the CBI's web site., www.cbiraq.org.

Following the first **Policy Briefs** prepared in June, Briefs have been prepared each month. The advisor was not able to advise on the Briefs during this visit but will continue to do so by email. The advisor met with members of the CBI Board and senior management to review the analytical framework for determining monetary policy and stressed the importance of the systematic use of Briefs and Board member feed back to the Briefing teams. **While the quality of most Briefs has improved over time, more feed back from the Board to the Brief teams is needed and the dates of monetary policy meetings of the Board should be set a year in advance.**

The CBI and the MOF have concluded an agreement on the repayment of the CBI's claims on the MOF arising from earlier purchases of old government securities and overdraft credits. The amount of the claim plus interest was set at 5,343 billion ID as of 12/31/2005 and will be repaid in US dollars at the rate of $150 million US dollars per month starting on January 1, 2006. Interest will accrue on the outstanding balance at the rate of 5%. Other things equal this agreement will raise the CBI's net foreign assets above its domestic currency liabilities (base money). This would allow the CBI to fix its exchange rate and adopt currency board rules (with a change in the central bank law). If it does not intend to adopt a currency board regime, it should consider asking the MOF to replace the remaining claims with government securities yielding 5 percent per annum with maturities matching the agreed repayment schedule (the dinar equivalent of 150 US dollars maturing February 1, 2006, and comparable amounts each month thereafter).

## II. INTRODUCTION

The Central Bank of Iraq (CBI) is mandated in the Law on the Central Bank to maintain price stability. To do so it must adopt a monetary policy regime consistent with price stability and develop the capacity to implement that regime successfully. Successful implementation of the regime requires collecting and analyzing relevant economic data (inflation rate, interest rates, exchange rate, money supply, GDP, BOP, Donor funding, etc.), presenting that data and analysis to the CBI Board with policy options, developing appropriate policy instruments, and developing a liquid government securities market.

This follow up should be read together with the Advisor's Report of July 19, 2004, and his subsequent Follow up Reports of September 15, 2004, December 24, 2004 and April 4, 2005. This body of work documents progress to date in implementing recommendations and updates and refines the work program going forward.

## III. The Monetary Policy Regime

The CBI continues to target an exchange rate of about 1465-1475. Since February, which saw a peak in Net Foreign Assets (NFA), maintaining these exchange rates resulted in almost a 20 percent annual rate of decline in foreign reserves through August. As a result Base Money declined at a similar annual rate over the same period (14.3 percent). By end October, NFA had recovered to close to the February peak. The annualized inflation rate over the same six-month period was 18.7 percent compared with 26 percent over the same six month period in 2004. Inflation has entered its seasonally high half of the year, but seems likely to increase more modestly than it has in the past two years over the comparable period.

With well functioning financial markets, the money stock and prices would adjust to that exchange rate and bring about a balance of international payments and compatible domestic interest rates. While these tendencies are present, financial markets are far from well developed in Iraq at this time. The CBI needs to monitor the continued viability of its balance of payments at the current exchange rate and to take measures to keep liquidity (and thus interest rates) in the banking system at levels appropriate for price stability. Bank liquidity, given the level of deposits the government and the public choose to hold, is influenced by the government's domestic borrowing (outstanding stock of t-bills) and the monetary actions of the CBI. These consist of passive instruments, such as the terms of the CBI's Deposit and Lending Facilities and its reserve requirement, and active instruments such as open market operations, the Policy Rate, and changes in the reserve requirement ratio. The instruments developed by the CBI stress the use of passive instruments. This choice reflects the lack of data on which to base a more active policy and the objective of financial market development.

## IV. Monetary Policy Instruments

During this visit the advisor focused primarily on pending amendments to the reserve requirement, reserve data reporting, and the requirement's enforcement and on the Monetary Policy and Banking Facilities interest rates. Other earlier recommendations were also briefly reviewed.

### A. Dollar Auctions

None of the recommendations made in the April 2005 report in this area have been implemented yet. They deserve further consideration by the CBI. In particular, the information provided on the CBI web site could be improved and the cost of settling FX auction transactions in cash rather than deposits should be passed on to though choosing to settle in cash.

Some concern was expressed that if the CBI charges a commission for those who settle their dollar auction purchases in cash (both the payment of dinars and withdraw of dollars), the market will perceive a depreciation in the dinar of that amount. It is true that such a commission will raise the cost of settling a dollar exchange in cash. That is the intention and purpose of the commission (to provide a price incentive for transactions to settle in deposits). However, the rate for those settling in deposits will not be affected, and the rates paid in the market may well be better than the auction rates plus commissions.

An example will illustrate this point. A one percent commission for dollar cash and one half percent for dinar cash at current exchange rates is about 15 dinars per dollar and 7 dinars per equivalent amount of dinars. The purchase of one million dollars in the auction settled in cash in both directions would cost 1,492.05 million dinars (15,000 dollars) if settled in both dollar and dinar cash or 1,470 million dinars if settled in deposits. A bank customer buying dollars and accepting cash, may well be physically transporting those dollars to Dubai at a cost 1 percent per dollar (or 10,000 dollars in travel, expenses and insurance). Under current (no commission) arrangements, this customer must pay 1,484.7 million dinars (a rate of 1484.7 per dollar) in order to receive credit of 1 million dollars in his account in Dubai. Under the proposed arrangement (with commissions), this customer's bank would receive dollars by a deposit transfer, which it would credit to the customer's account in Dubai and would settle the dinar payment by a debit to its current account at the CBI. Thus it would pay no commissions to the CBI. The bank could sell these dollars to its customer at anything between 1470 and 1484.7 and improve its profit and reduce the cost to its customer compared to the current all cash, no commission arrangement. Thus charging the commission for cash settlements could have significant benefits for the system.

### B. Reserve Requirement

The new Reserve Requirement regulations introduced as of December 2004 will be further amended as of January 2006. The new amendments clarify the intended meaning of last year's regulation and introduce two modest changes. The clarifications are to confirm more clearly that: a) dollar current account deposits with the CBI may only be applied to the reserve requirement up to the requirement ratio times reservable foreign currency deposits, and b) that with respect to the use of vault cash, only Iraq dinar vault cash may be used to satisfy the reserve requirement. The new features are: a) to require banks to report every Thursday rather than only four Thursdays for each Calculation Period (thus Calculation Periods may consist of four or five Thursday's depending on the month), and b) to replace the separate minimum vault cash requirement (of 20 percent of the total required amount), with a limit (a maximum of 20 percent of the required amount) on the amount of vault cash that may be applied to meeting the requirement.

New excel data entry forms have been prepared to enable banks to report electronically. Each bank's Monthly Reserve Calculation Period Report will be electronically entered into a central statistical database, which will retain the reported deposit and vault cash data for every week. Until banks report electronically, CBI staff will enter paper reports from banks into the excel report (see below for a further discussion of the central database and data verification issues). This database, which will also maintain monthly average current account balances at the CBI in both dinars and dollars as well as weekly data on currency issued (outside of CBI), will produce the monthly summary compliance report (an example is attached), and a new weekly and monthly average money supply series.

Following the imposition of fines for late reporting, basically all banks now report on time (the last business day of each month). For example, for November 2005 all banks but one had reported by November 30. The late bank reported on December 1. Questions remain, however, about the integrity of these data. Investigating data integrity questions and working with banks to overcome data integrity problems is the responsibility of the Off Site Division of the Banking Supervision Department. The department does not have a tradition of visiting banks with respect to the reports they submit. **Procedures for checking data consistency and plausibility and of working with banks to clarify data classification and other integrity issues need to be developed and applied urgently.**

The Compliance Report prepared by the CBI (the "Warren Report") continues to be late because of continuing difficulties in determining banks' daily current account balances with the CBI. A poorly managed conversion to a new accounting system resulted in potentially lost CBI data on bank's current account balances in early September. These problems have been resolved going forward. However, until now several CBI branches had difficulties in correctly reporting bank current account balances deposited with them. CBI headquarters staff continues working with the staff of these branches to overcome these problems and timely compliance reports are expected before the end of December.

The Advisor recommended changes in the Compliance Report to reflect the upcoming January amendments to the regulation and to derive excess requires more transparently. In addition to total required reserve for each bank, it reports a) the extent to which the requirement is satisfied by vault cash (the lesser of 20 percent of total required reserves or actual dinar vault cash) and b) the extent to which the requirement is satisfied by dollar current account balances with the CBI (the lesser of the requirement ratio times the dinar equivalent of foreign currency deposits or actual dollar current account balances). That which is not satisfied by dinar vault cash and dollar current account balances must be satisfied by dinar current account balances. Thus the required dinar current account balance is the total required amount less (a + b). The difference between this required amount and the actual (daily average) current account dinar balance each month is the "excess current account balance." "Excess reserves" are defined as the excess current account balance plus that bank's overnight dinar deposit balances. The revised report is attached. All data are averaged over the maintenance period.

The Advisor had previously recommended that Agreements and Loans monitor progress toward compliance throughout the Maintenance Period. This has not been possible until now because data on banks' current account balances with the CBI has not been available during the Maintenance Period to which it applies. While this problem has now been largely overcome, the value of intra period monitoring is questionable and the Advisor now recommends that these intra period monitoring reports be dropped. However, the excel report developed for this purpose may be adopted for use by banks in the management of their reserves and reserve requirement compliance.

The most serious problem for the requirement has been the lack of enforcement of compliance. In November, five banks failed to comply with the requirement. In early November, the CBI levied the fines provided for in the regulation. Following complaints from banks, a two-month additional grace period was given, and fines will be levied on non-complying banks starting in January 2006.

The required reserve ratio is at a very high level. The CBI should strongly consider remunerating required (but not excess) reserves at the Overnight Deposit rate.

**Work plan**

1. Banking Supervision Department should develop and implement a proactive program of bank data verification, including the reserve requirement report.
2. Banking Supervision Department should prepare to enforce compliance with the requirement;

**Status:** BearingPoint is providing assistance in developing a proactive compliance program. Penalties have been adopted by the Board.

## C. Standing Facilities

The Primary Credit Facility rate is 2 percentage points above the Policy Rate or 9 percent. No bank has yet borrowed at this rate. On the other hand, at an overnight deposit rate two percentage points below the Policy rate, or 7 percent, banks have deposited very large amounts. This compares with t-bill rates of 9 to 10 percent in recent months. This rate structure reflects a very high liquidity premium and a perceived lack of liquidity for the 91 day bill. Banks are holding 1,150 trillion ID in t-bills compared to about 1.2 trillion ID in overnight dinar deposits and slightly more in 14-30 day dinar deposits. CBI policy should aim to keep the amount of overnight deposits very low.

It is difficult to judge the appropriate Policy Rate. From a covered interest rate parity perspective it may be about right. Relative to past inflation rates it is negative in real terms and seems low. Given that the growth rates of monetary aggregates have fallen toward zero, the Policy Rate may be too high. None-the-less, the 91 day t-bill rate should be closer to the Policy Rate. If the current Policy Rate is more or less appropriate, the t-bill rates should be lower. Efforts to encourage the development of secondary trading of t-bills will improve its liquidity and tend to increase market demand for (and hence lower interest rates on) the 91 day bills. In addition, the CBI might consider a modest reduction in the Primary Credit Facility rate (say to 1.5 percent above the Policy Rate) and a modestly lower rate on the overnight deposit facility (say to 2.5 percent below the Policy rate). Both of these changes should increase the demand for t-bills and thus modestly lower their rates.

The Lender of Last Resort Facility (LLRF) is already needed but not ready for use. The Banking Supervision Department needs to develop the supervisory and remedial measures that it would require in connection with access to the LLRF.

The CBI has also established overnight, 30 day, and 90 day dollar deposits available to all banks. The initial purpose for offering dollar deposits was to help Rafidain and Rasheed overcome the attachment risk that had frozen all of their overseas deposits. By delivering dollars in their vaults to the CBI, they would be able to earn interest without attachment risk and would save the CBI the cost of flying in that amount of additional dollar cash. It was recommended as a temporary service until the external debt negotiations where completed.

There is no justification for offering these deposits to private sector banks, which are able to place funds abroad without attachment risk. Moreover, the regulations for these dollar deposits permit early withdrawal of funds with an interest rate penalty. Permitting early withdrawal is a questionable feature of the facility. Such a feature encourages banks to speculate on the exchange rate by buying and holding dollars with interest that can be withdrawn at any time to take advantage of any depreciation of the dinar. The advisors recommended that this feature, as well as the availability of this facility to private sector banks should be reconsidered.

**Work plan**

1. The Agreements and Loan Department and the Banking Supervision Department (jointly) should prepare internal guidelines for use of the Lender of Last Resort Facility and plans to deal with banks that fail to meet them;
**Status:** Guidelines are under preparation.

2. The CBI should reconsider offering dollar deposits to private sector banks as well as offering early withdrawal.

## D. Open Market Operations

There has been no progress in this area (see the Advisor’s September 15, 2004 Report). In the future, such operations might be conducted once a week. The amounts of each OMO (whether a purchase or sale of government securities) would be determined by the daily liquidity forecast and the estimates of the demand for excess reserves (the desired level of excess reserves), taking account of the one-month averaging period for the reserve requirement.

At present reliable liquidity forecasts are not available and will not be available for some time. In the interim, the size of OMO might be determined on the basis of the average balances in the Overnight Deposit Facility over the previous week (for sales) and the average borrowing under the CBI Lending Facilities of the previous week (for purchases). Operations of such size (before liquidity forecasts are available) might be expected to replace on average the use of the standing Facilities with the more long-term impact of the OMO.

The Advisor and selected CBI staff participated in a workshop on open market operations and liquidity forecasting in Amman in August, 2005 sponsored by the Bank of England. Staff should prepare the rules for conducting OMO, which would be essentially the same as for the t-bill auctions the CBI now conducts on behalf of the MOF.

**Work plan**

1. In preparation for conducting open market operations, the Agreements and Loans Department should prepare internal procedures and auction rules for open market purchase and sales of government securities. These rules and procedures should be tested with mock auctions**.**

**Status**: No work is being done on this yet.

## V. CBI CLAIMS ON MOF

A new agreement for restructuring and paying off the CBI's claims on the MOF was signed by Minister Allawi and Governor Shabibi on November 29, 2005. The agreement accepts the full value of the claim and provides for its repayment in monthly installments of 150 million US dollars starting in January. It is a very positive development that a relatively full value agreement has now been reached and will be implemented over the next two years. The increase in the CBI's net foreign assets from the repayment of these claims in dollars will raise its net foreign assets about its domestic liabilities (base money) and enable it to adopt a currency board regime (with suitable amendments to the Central Bank Law).

However, if the CBI does not intend to adopt a currency board regime it should consider requesting the MOF to replace the remaining claims with government securities yielding 5 percent per annum with maturities matching the agreed repayment schedule (the dinar equivalent of 150 US dollars maturing February 1, 2006, and comparable amounts each month thereafter). Such government securities on the CBI's books could be used for open market operations and help develop a secondary market for these bonds.

The settlement or restructuring of other claims on the MOF and the possible need to recapitalize the CBI offer additional opportunities for the MOF to place usable government securities on the CBI's books. These opportunities should not be missed.

The resolution of Rafidain and Rasheed will require the infusion of MOF funds into these banks to cover all of their deposit liabilities. These funds should take to form of government securities that build on the stock of t-bills now issued. If secondary trading is sufficiently developed by that time, these banks could sell these government securities to other banks as and when depositors shift their deposits from Rafidain and Rasheed to other banks. However, the CBI may need to buy them in open market transactions to provide Rafidain and Rasheed with cash or deposits that can be paid out to depositors or transferred to other banks. These OMO purchases by the CBI would probably need to be reversed as the withdrawn deposits are re-deposited elsewhere.

## VI. Government Securities Market

Ninetyone day t-bill auctions have been held almost every other week since mid July 2004 when the first auction was held. The MOF now publishes (on the CBI website) its issue schedule a quarter in advance (ID 200 billion 91 day bills every other week) and has stuck to it. The functioning of the auction has gradually improved. In the most recent auction seven banks participated by submitting bids amounting to 122 percent of the amount offered. The cut off yield was 9.0 percent, down modestly from 9.6 percent two weeks earlier.

The MOF agreed to replace the 91-day bills with 84 day bills so that maturing bills would coincide with new auctions to facilitate rolling them over (refinancing). Maturing bills should be repaid in the same morning that newly issued bills must be settled (in the afternoon). They also plan to introduce a 28-day bill and in due course a 182-day bill.

The MOF has not yet auctioned enough to fully refinance the redemptions of earlier securities held outside the central bank when these auctions started in July 2004. Of the 1,426 billion dinars to be refinanced over time, the currently outstanding stock of t-bills is only 1,150 billion. **The amount of auctions should be increased to fully refinance already matured securities.**

There is still very limited secondary trading of t-bills. All such trades to date have been purchases by Rafidain and Rasheed from other banks. Banks should be encouraged to develop standard rules and contracts for trading t-bills and for their use as collateral.

The **Money Market Conditions Report** would normally be no more than one page and should include some tables on t-bills outstanding and maturing, market interest rates and excess reserves. It should include the results of the Agreements and Loans Department’s regular discussions with banks about the market and auctions, and any information on the liquidity (excess reserves) in the market and expected on the day of the auction and day of settlement. The A&L Department indicated that it will prepare such a report with some of the data provided by the Statistics Department.

### Work plan

1. The CBI should undertake regular government securities market surveillance and share its information with the MOF.

**Status**: The A&L Department intends to regularize such consultations with banks.

2. The MOF should replace 91-day bills with 84 day bills and introduce 28-day bills (maybe on alternate Mondays) and increase the aggregate amount auctioned.
**Status**: The MOF agreed to these changes.

3. As the market develops, the MOF should begin to introduce longer maturities (182-day and one year bills).
**Status:** Planned, but not yet implemented.

## VII. THE PROCESS OF POLICY FORMULATION

Good policy decisions require good data (or a regime that doesn't need them), good staff analysis of data, and good procedures for communicating staff analysis to the policy decision makers. This section reports on progress in these areas.

### A. Data Compilation

The CBI compiles data on monetary aggregates (Base money, M1 and M2), interest rates (bank deposit and lending, and t-bills), balance of payments, and exchange rates as well as creating the central bank sectoral balance sheet for the IMF. While refinements in these data continue to be discussed and made, timeliness remains one of the most serious problems. The implementation of new accounting software within the CBI slowed the production of reports initially but now is expected to deliver more accurate reports more quickly. The key sources of delay derived from slow and inadequate reporting from the branches of the CBI. These problems, especially with regard to bank current account balances needed for the reserve requirement have now been largely overcome except with regard to Basra, where the problems are expected to be resolved in the very near future.

The other major problem is limited confidence in the classification of data submitted by banks in both their reserve requirement and end month regulatory reports. The MOU on the collection, verification, and monitoring of the reserve requirement, for example, specifies the responsibility of the Banking Supervision Department. The BSD is responsible for reviewing data reports from banks for errors of presentation or significant changes in trends. It is responsible for interacting with banks to correct reporting or documentation deficiencies and for investigating suspected problems pointed out by the user departments of the CBI (Agreements and Loans, Accounting Department and Research and Statistics Department). BSD is not yet fulfilling these responsibilities and technical assistance is planned to help them develop these capabilities. This should be given high priority.

Data integrity and usability would be significantly enhanced by centralizing checked reports in a central statistical database with clear ownership, access, and update rules. The advisor recommends that a project be undertaken to develop such a database.

Public data should be posted to the CBI website in a timely and convenient manner. The staff does an excellent job in positing FX auction results and t-bill auction result on the same day the auctions occur. Monetary data and the KFI report are not yet posted regularly and are generally very out of date.

**Monetary Survey[3]**

The compilation of a satisfactory monetary survey by the Central Bank of Iraq was a key conditionality set by the IMF under the EPCA program. This condition was satisfied in October 2005. The Accounting and Statistics Departments maintain the central bank and depositary corporation components of the survey, respectively. The survey was backdated to December 2004 and is currently updated to August 2005. It is submitted to the IMF with a two-month lag following the reference period. The preliminary Monetary Survey has been published on the CBI website.

The current system of accounts adopted in Iraq needs to be revised to meet international standards. For example, it is based on cash rather than accrual accounting. Also, the existing financial asset and institutional classifications do not allow for detailed mapping of trial balances to the Other Depository Corporations Sectoral Balance Sheet. The CBI is in the process of setting up a committee that will review proposed changes to the system of accounts for possible future implementation. This is not likely to be in the near future because the commercial banks do not have sufficient IT capacity to cope with significant changes to the existing chart of accounts.

Staff in the Research and Statistics Department were trained on basic verification and analysis techniques. Procedures are in place for the reconciliation of the reserve requirement and Treasury bill holdings. Reconciliation of the commercial bank current accounts at the CBI, and the level of government deposits is still work-in-progress. A significant problem with the verification process is that there is no delegated point of contact at the commercial banks responsible for resolving queries related to the monetary returns. Also, there is significant duplication of effort at the branch level because different divisions are responsible for generating several different sections of separate reports. The CBI will propose that commercial banks produce a single detailed trial balance that will meet all user needs through computer generated reports. A trial balance form has been designed and will be presented to the commercial banks in December 2005. This trial balance has been linked to the IMF monetary survey and the supervision regulatory reports.

**New weekly M2 series**

The advisor recommended the development of new weekly and monthly average M2 series derived from the reserve requirement reports. These data will average the weekly (Thursday) deposit and vault cash data reported by banks under the reserve

[3] This section was prepared by Dominic Mellor (BearingPoint)

requirement regulation. The deposit component of M2 can be compiled from data already reported. By also obtaining Thursday data on currency issued, M2 can be compiled on a weekly basis. These data are currently available on a more timely basis than the end month data.

For the time being the weekly M2 series will differ from the end month M2 series now reported because of the inability to collect weekly post office deposit data.[4] Post offices have been asked to supply their deposit data weekly but have not yet done so.

When banks begin reported their deposits for the reserve requirement electronically, they should be asked to report weekly. They already collect and report weekly deposit data but only send these data to the CBI monthly. Sending these data weekly will not materially add to banks reporting burden and will provide a much more timely weekly series for M2.

**Key Financial Indicators**

The Key Financial Indicator (KFI) Report needs to be amended slightly to allow for consistent reporting of the reserve requirement. This is not possible under the current reporting format because money aggregate data is presented as end of month values, while the reserve requirement components are calculated as averages over the reporting period. Also, as agreed previously, the Iraqi Dinar overnight deposits are to be included in the monetary base. Therefore, the following changes to the KFI report are suggested:

1. The components of bank reserves will be presented as end of month values for (i) ID current account (ii) ID overnight deposits and (iii) ID cash vault. This will ensure consistency with the end of month monetary base as calculated from the net asset position of the CBI and reported to the IMF.

2. An additional section (6) would be included that presents key indicators of the reserve requirement. This would include the required reserve (and the component of which is being met by foreign currency deposits) and excess reserves, calculated as averages over the reporting period.

3. As banks Overnight Iraqi Dinar deposits at the CBI are included in the monetary base, it is suggested that they also be included under excess reserves. This is because they are highly liquid and are therefore likely to have the same effect on short-term interest rates as excess current account dinar balances. The staff will, however, also monitor the narrower definition of excess reserves (the average dinar current account balance over the month less the reserve requirement for the dinar current account balances—i.e., total required reserves, less the amounts

[4] Postal Savings Deposits are about 1.3% of total time and savings deposits of the banking system and less the 0.2% of M2. They have not changed much from month to month over the past two years.

satisfied by vault cash and by dollar current account balances), the so-called excess current account balance.

4. In order to present the most timely data on the monetary supply section will report the monthly average M2, Deposit component of M2, Foreign Currency Deposits, and excess reserves ratio.

5. The dollar deposits at the CBI of the government and banks will be moved to a new section on Foreign Currency Liabilities of the CBI and deducted from the Foreign Currency Assets in order to report Net Foreign Assets of the CBI. The definition of Net Domestic Assets will be adjusted accordingly.

**Work plan**

1. Banking Supervision Department should develop the capacity (with expert assistance) to investigate and verify the integrity of data submitted by banks (e.g., the Reserve Requirement Calculation Period Report).
**Status:** Technical assistance is planned by USAID/BearingPoint.

2. The Statistics department should establish and maintain a central statistical database to serve the needs of all users in the CBI. Software must be selected and purchased, and ownership, maintenance, and access rules developed.
**Status:** Under consideration. Technical assistance is planned by USAID/BearingPoint.

3. A weekly M2 series should be compiled from the Reserve Requirement reports and the post office should be requested to supply weekly data on postal savings deposits.
**Status:** Under development.

4. Implement recommended changes to the KFI report after approval of the Governor.
**Status:** Underway.

5. Establish clear responsibilities and accountability within Statistics Department for keeping monetary and KFI data up to date on the website.

## B. Data Analysis

Work on improving the monetary policy briefs and the liquidity forecasts continues, but the advisor was not able to provide assistance in these areas on this visit. He will continue to do so by email. See work plan from the April 2005 report.

### C. Preparation and Presentation of Policy Options to the Board

The CBI Board's key monetary policy decisions consist of its objectives for the exchange rate, its net domestic assets, and the level of its Monetary Policy Rate.[5] Key intermediate variables for monitoring and assessing the implementation of its policy are the levels and behavior of its foreign exchange reserves, the money supply, and market interest rates. Its ultimate target variables are inflation and the level of economic activity (employment and income).

The Advisor conducted two seminars with members of the CBI Board and senior management concerned with monetary policy. The seminars reviewed the monetary policy framework set out in the Advisors original report and discussed whether the level of the Policy Rate was still appropriate. The Advisor stressed the need for Directors to discuss Policy Briefs with the staff that prepare them, indicating Directors' preferences in data presentation and analysis. Feedback from Directors is essential if these Briefs are to play their intended role in the policy formulation process. The Board should be encouraged to schedule its monetary policy discussions promptly after the monthly completion of the Briefs.

**Work plan**

1. Board feed back should be sought on the form and content of the Briefs.
**Status:** Unknown.

**2.** The Board should schedule its monthly monetary policy discussions one year in advance in relation to the schedule for producing Monetary Policy Briefs.
Status: **Unknown.**

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[5] The reserve requirement ratio is also a policy tool set by the Board. However, the ratio should not be adjusted actively, though as conditions improve it should be gradually reduced to more modest levels. Any reduction in the required ratio must be coordinated with the overall policy objectives and increases in the money stock that might result will need to be neutralized if they would be excessive.