Formulating and Implementing Monetary Policy

FOLLOW UP REPORT 3

USAID | Iraq Economic Governance II

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I. 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. A second follow up visit took place in Amman, Jordan, November 22 to December 2, 2004 and a third follow up in Baghdad March 22 – 31 and in Amman April 1-5, 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 and Amman Dr. Coats met with CBI Governor Sinan Shabibi, Deputy Governors Hadji Faleh, 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 Loans and Agreements Department, and CBI staff and with Deputy Minister of Finance Abd al-Azez al-Hakim .

This third **Follow Up** reviews progress toward implementing the earlier recommendations and work program since December 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.

II. 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 objective (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.

More recently, the CBI added an overnight dollar deposit facility (yielding 2 percent) to enable it to replenish its supply of dollar cash sold in the daily auctions and to provide an outlet for dollars deposited with the state banks, which are not able to invest them abroad because of the risk of attachment by creditors.

To formulate and implement monetary policy within this framework, the CBI needs information about economic and financial developments. The main Report recommended steps to **improve the quality and timeliness of relevant data** and recommended that the CBI's Governing Board require regular progress reports.

These data need to be analyzed and the analysis needs to be presented to the policy makers in a useful and timely manner. The report outlined a process similar to what is used in most central banks by which **staff prepare Briefs** for the Board's monetary policy reviews. These Briefs, in a structured way, analyze economic developments relevant for monetary policy and formulate policy recommendations and/or analyze policy options for the consideration of the Board. The main Report outlined management's role in promoting the usefulness of these Briefs to the Board.

Central bank boards generally express their monetary policy decisions in a **Policy Directive** that delegates the day-to-day implementation of policy to management or to a **Monetary Policy Committee**. The main Report outlined the process for doing so and for communicating policy to the public.

B. Progress Report

This Report documents the progress between December 2004 and March 2005 in implementing the work plan set out in the Advisor's July 2004 Report and subsequent Follow Up Reports.

Until the last two working days of March[2], the exchange rate has been kept at 1460 in the daily auctions since May 2004 and the foreign exchange reserves of the CBI have continued to grow fairly rapidly (doubling over that period). More importantly for CBI income, the composition of its reserves has improved. Its dollar cash in vaults in Baghdad has declined from over 6 trillion dinars equivalent (4 billion USD) to about 500 million USD while interest earning investments at the Federal Reserve Bank of New York have increased from zero to over 11 trillion dinars equivalent (7.5 billion USD), yielding an income of about 2 million dollars per week. **Reporting on the auctions should be improved, settlement changed to two day value, and a wider spread (or commission) introduced for cash.**

Two Overnight Deposit Facilities became active in March, one in dinar at 4 percent and the other in dollars at 2 percent. In the first two weeks balances rose to IQD 791.9 billion and USD 164.8 million (241 billion Iraqi dinar equivalent) respectively.

The Lender of Last Resort Facility (LLRF) has been adopted as part of the Banking Facilities regulation, but the CBI needs urgently to 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 new reserve requirement regulation has not been fully implemented because many banks have not been making the required deposit reports. The Board has approved penalties for non-compliance with reporting. **A much stronger compliance effort by the Supervision Department is needed and the Board should enforce the new formal penalties for non-compliance. Banks not in full compliance with their reserve requirements should be denied access to the Overnight Deposit Facilities. The CBI should consider remunerating required (but not excess) reserves at the Policy rate (or at least at the Overnight Deposit rate).**

The timeliness of important data suffers more generally because of slow bank reporting. The CBI compiles data on money stock (Base money, M1 and M2), interest rates (bank deposit and lending, and t-bills), balance of payments, and exchange rates as well as creating a sectoral balance sheet for the IMF. While refinements in these data continue to be discussed and made, timeliness is currently the most serious problem. The balance sheet and monetary data are available with a one and a half to two month lag. The key sources of delay derive from slow reporting from the many branches of Rasheed Bank and from the Basrah, Irbil, and Mosul branches of the CBI. Unreliable telecommunications and lack of automation are major factors in these delays as is the lack of a clear enforcement

[2] March 29 and 30 the exchange rate depreciated to 1465 and 1470 respectively.

policy by the CBI. **The enforcement of compliance to laws and regulations by the Supervision Department needs to be strengthened with priority.**

The IMF has recently clarified its data reporting requirements and BearingPoint is providing assistance to the CBI in satisfying those requirements. The interface between the monthly supervisory bank (call) reports to Banking Supervision Department and the reserve requirement, and the weekly "Dewald" reports is being clarified and documented in a Memorandum of Understanding (MOU) between the Loans and Agreement, Statistics and Research, and Banking Supervision Departments. (See Attached Memorandum of Understanding). **Relevant department heads should review and approve the MOU.**

A weekly report to the Governor on **Key Financial Indicators** provides a useful summary of key financial sector and monetary developments. More weekly data will be added. Data for 2003 should be added as well. This report is available on the CBI's web site.

Following the first **Policy Briefs** prepared in June, Briefs have been prepared each month. Briefs are reviewed and commented on by the Senior Monetary Policy Advisor and mentors who have been established for most of the Briefing teams at the Board of Governors of the Federal Reserve System and BearingPoint. Briefing teams some times encounter resistance from data providers not accustomed to sharing information. CBI management may need to formally establish their need for such information. Little progress has been made to date in developing the systematic and effective use of the Policy Briefs by the Board in its monetary policy deliberations. **While the quality of most Briefs has improved over time, more feed back from the Board to the Brief teams is needed.**

The CBI and the MOF have revised last year's agreement to restructure the CBI's claims on the government. The terms have been improved but will still make the CBI insolvent. **The agreement should be formally implemented immediately to give clarity to the CBI's actual balance sheet position. The MOF should issue additional securities to cover the resulting insolvency once the CBI's balance sheet is revised and audited to show actual asset valuations. As needed for monetary policy the CBI should ask the MOF to swap the new restructured bonds for the equivalent (75 percent) value of normal t-bills with maturities that match the bonds being replaced. This normal bill can then be sold to the market as needed.**

III. 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 and December 24, 2004. This body of work documents progress to date in implementing recommendations and updates and refines the work program going forward.

IV. The Monetary Policy Regime

The CBI continues to target an exchange rate of about 1460. While selling all of the dollars the market has demanded at that rate, the foreign exchange reserves of the CBI have continued to grow rapidly, with an average annual rate of growth of over 100 percent over the last six months. Over the same period, base money also grew at almost the same rate, about the same as over the first half of last year. Inflation, however, accelerated from approximately zero the first half of 2004 to an annual rate of 64 percent the second half. Over the six-month period ending February 2005, the average annual rate of inflation increased further to over 90 percent after a 2.5 percent drop in February compared to January. Preliminary data indicates that an even larger drop will be recorded in March.

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.

V. Monetary Policy Instruments

The viability of continued reliance on an exchange rate target, with market-determined money supply, will be strengthened by the further development of the CBI's Banking Facilities, the government securities market, and an interbank money market. These badly needed developments should help stabilize bank liquidity and the market's determination of interest rates and facilitate the development of an interbank market.

The primary instrument of policy, the foreign exchange auction, works well but needs improvement. The new reserve requirement and Banking Facilities regulations have been approved but are not yet fully operational.

A. Dollar Auctions

The daily auction of dollars to the market has functioned quite well for over the last year and a half. It has enabled the central bank to successfully target the exchange rate and allowed the market to adjust its holdings of dinars to desired levels at that exchange rate.

Information provided to the public on the auctions should be improved. Information on individual bank bids and awards should not be made public, however, it now appears on the CBI web site. On the other hand, information on the street rates should be added to the daily public report on each auction as should other information known by the CBI that might be relevant to understanding the auction results. For example, the auction on March 22 resulted in the largest sale of dollars ever in one day. The accompanying note should have reported the street rate, which was rather significantly depreciated, indicating excess demand for dollars. It should also have noted that much or all of this high demand was thought to reflect the accumulation of orders over the week-end and holiday on the 21st. The auction on March 23, which reflected a substantial fall in the amount needed to keep the rate at 1460, was also accompanied by a significant narrowing of the spread between the street rate and the CBI's target rate. Such information would have better explained the results to the market and reassured it of the ability of the CBI to maintain the targeted rate.

In a more recent example, the rate depreciated in the auctions of March 29 and 30 reflecting movements in street rates. The CBI believes that banks mistook the CBI's limit on sales to them for their own account in relation to their capital as a shortage of dollars that the central bank had available for sale. The CBI has taken steps to explain its actions and to reassure the market that it is prepared to offer additional dollars if needed to stabilize the rate. **The CBI should adopt the draft foreign exchange exposure limit regulation as a more appropriate way to limit banks' foreign exchange exposure risk.**

Sales of dollars in the auction have disproportionately taken the form of cash. The CBI's earlier large holdings of dollars in its vaults have been used up and had to be replenished. Dollar purchases in the auction are taken in cash in part because border trade is largely paid in cash and in part because individuals wishing to invest abroad prefer to do so in cash to avoid a paper trail, to avoid the expense of transfer through banks, or simply because they do not trust the local banks. It may also be suspected that some amounts of the dollar sales are going to finance insurgent activities. These motivations for cash will not go away quickly but the move to deposit transfers rather than cash can be encouraged and accelerated in several ways:

a) Dealing in cash is more costly to the CBI and to the country. This higher cost should be reflected in the exchange rate spread (or a higher commission) when using cash).

b) In addition, auctions are settled same day rather than with one or two day value (the international norm). Normal Spot (two day value) settlement would allow and encourage banks to better manage the domestic funding side of these transactions and thus make dealing in deposit balances rather than cash more attractive.

c) Finally, the CBI has acted to request information from banks about their customers for dollars. This may make it more difficult to acquire dollars in the auctions for insurgency financing.

Recommendation: The CBI should pass on the higher cost of using cash (both dollars and dinars) to banks and their customers and should settle dollar auctions on a two day basis.

B. Reserve Requirement

The new Reserve Requirement Regulations replaced the old ones as of December, 2004. They are based on weekly deposit reports from banks covering four Thursdays beginning with October 28th. Banks are required to submit these reports on the last business day of each month to form the bases of the reserve requirement for the next month. However, as many as half of the banks did not submit these reports for several months. By the end of March, all but three banks had reported through February. Rafidain Bank submitted the required data for December 2004, and January and February 2005 only in early March 2005. Rasheed Bank has reported more or less on time from the beginning. No banking data from banks in the Kurdish region was received at all. The most serious problem for the requirement has been the lack of enforcement of the reporting requirement (see the December Update for details).

In addition, the requirement as been amended in two respects from the regulation as proposed and as posted on the CBI's web site. The reserve requirement against foreign currency deposits, which were to be met in dinars, has been amended and may now be met in dollars. This agreement may be informal and temporary but this is not clear. Starting May 1, the requirement will also be levied against government deposits based on deposits of April for the month of May**.** Only the state banks hold government deposits. As they have considerable excess liquidity the addition of government deposits to the reserve base is intended to lock up this liquidity.

The required reserve ratio is at a very high level. If the addition of government deposits reduces excess reserves too much, the CBI can and should reduce the ratio modestly. In any event, requiring banks to hold such a large part of their assets in required reserves deprives them of a significant amount of income if their required reserves are not remunerated. The CBI should strongly consider remunerating required (but not excess) reserves at the Policy rate (or at a minimum at the Overnight Deposit rate).

The amendments to the reserve requirement as originally proposed complicate the definition of excess reserves. There are now four separate reserves requirements: one on dinar deposits that must be met with vault cash (in dinars); one on dinar deposits that must be met with dinar balances with the CBI (other than in an interest earning Deposit Facility); one on foreign currency deposits that must be met with vault cash (in dollars) and one on foreign currency deposits that may be met with dollar deposits with the CBI (other than in an interest earning Deposit Facility). On a comprehensive basis, excess reserves are the dinar equivalent of deposits at the CBI and dinar vault cash that are not invested in an interest earning Deposit Facility and are not required by the reserve requirement regulation. If banks do not manage their liquidity well and or if it is difficult shifting excess reserves from vault cash or dollars into dinars, there is a case for tracking the four different categories of excess reserves separately (or purpose tracking the dollar and dinar components separately). The choice of approaches is an empirical matter and depends on which approach results in the most stable and hence predictable level of desired excess reserves. Desired excess reserves are the level banks will voluntarily hold against unexpected clearings for which reserves are needed.

Representatives from the four units of the CBI involved with the receipt and processing of the reserve requirement data have agreed on a Memorandum of Understanding regarding the role of each unit in the receipt, processing, use and verification of the relevant data (attached). The heads of the three departments involved should review and sign the agreement.

Enforcement of bank reporting requirements should be pursued with urgency. To facilitate enforcement the CBI Board just adopted the penalties proposed by the Banking Supervision Department. Several other measures should be taken urgently. Rules should be put in place as soon as possible for how to compute the reserve requirement provisionally when some or all of the deposit data is missing (see the attached MOU for more details). A systematic program should be undertaken with each bank to verify the accuracy of its reporting. This should include reconciling the existing voluntary “Dewald” report with the new reserve requirement report. As these two reports may come from different sections of a bank, though the two are substantially the same in principle, the reconciliation should include a joint meeting at each bank between the providers of each of the two reports and with the participation of the division of the Statistics and Research Department that now receives the Dewald reports and the Banking Supervision Department, which is responsible for the collection, verification, and enforcement of reporting. The person responsible for bank compliance with the requirement in each bank should be identified and should participate in the “reconciliation” meetings. At the conclusion of this review for each bank, the Dewald report should be discontinued.

Failure to resolve these reporting problems carries several risks along with delaying the compilation and publication of important monetary data. Without a clearly defined reserve requirement, there is risk that banks may abuse the Overnight Deposit Facilities. **Banks that are not in full compliance with all aspects of their reserve requirement should be deprived of access to the Overnight Facilities.**

Work plan

1. Banking Supervision Department should prepare to enforce and monitor new bank reports, including establishment of penalties for non-compliance;
Status: BearingPoint is providing assistance in developing a proactive compliance program. Penalties have been adopted by the Board.

2. The Agreements and Loan Department should prepare to monitor monthly and intra monthly compliance with the new requirements;
Status: A&L has indicated that it is ready to perform this function.

3. The Research and Statistics Department should begin publishing weekly money supply data in the Key Financial Indicators Report.
Status: Expected soon

4. The Research and Statistics Department, Agreements and Loans Department, and the Banking Supervision Department should develop and sign a Memorandum of Understanding with regard to the compilation, use, verification, and enforcement of bank reporting required by the reserve requirement.
Status: Completed and attached

5. The Research and Statistics Department and the Banking Supervision Department should meet jointly with the reserve requirement compliance officer of each bank in the company of the unit in the bank providing the Dewald report and the unit providing the reserve requirement report to review the accuracy of the new reserve requirement report.

C. Standing Facilities

The CBI delayed implementing the Overnight Deposit Facility because of its concern over the interest cost of the facility. More recently it has renegotiated the restructuring of its claims on the government with the MOF on somewhat more favorable terms and banks have been informed that they may now use the deposit facility. They began to do so March 14. In the first four days of operation, Overnight Deposits averaged 653 billion dinars. In the second week of operation they averaged 768 billion dinars. This compares with “excess” reserve deposits in the CBI (i.e., excluding vault cash) in November, the most recent month for which data is available and the last month under the old reserve requirement) of 920 billion dinars (31 percent of the deposit component of M2).

Now that the Overnight Deposit Facility is in active use, the full enforcement of the reserve requirement becomes even more important. **It is recommended that use of the Deposit Facility be denied to any bank not in full compliance with its reserve requirement.**

Given the general excess liquidity in banks, the Credit Facilities have not been needed yet. However, it is possible that one or more banks will need to borrow during or after May when government deposits are added back to the reservable deposit liabilities for purposes of the reserve requirement.

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. At least one bank (with existing overdraft credits from the CBI and in violation of its reserve requirement) is thought to be insolvent already and should be intervened by the CBI. It is bad policy and not allowed by the terms of the LLRF for central banks to lend to insolvent banks, but the CBI is not yet prepared to carry out the needed intervention though it has the necessary legal powers under the central bank and banking laws. The potential for sale of this bank in the near term could provide a satisfactory resolution. The CBI should require the purchasing bank to repay the problem bank’s overdraft from the CBI and to bring it into compliance with all prudential regulations as a condition of sale.

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.

D. FX Deposit Facility

On March 14th the CBI also introduced an interest bearing dollar deposit facility. The primary motivation for this facility is to acquire dollar cash from the banks that wish to retain dollar assets and (in the case of the state banks) are not able to hold dollar assets abroad (because of attachment risk). The new facility is available to all banks at 2 percent per annum for overnight deposits. By the end of the second week (March 24) six banks had deposited USD 164.8 million, of which USD 110 million was from Rafidain and Rasheed.

Recommendation: The regulations governing this new facility should be added to the web site.

E. Open Market Operations

There has been no progress in this area (see the Advisor's September 15, 2004 Report). Under the new agreement with MOF for restructuring its claims on the government, the CBI will receive new government securities with which open market operations (OMO) can be conducted when indicated by monetary policy considerations (see the next section for details). 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 actual securities sold should be new bills provided by the MOF in exchange for the comparable value of those used by the MOF to restructure existing claims on the government). These securities would have the same features as those now auctioned by the MOF but with longer maturities (maturing July 1, 2005, January 1, 2006, and July 1, 2006). These weekly auctions in the amounts proposed in the preceding paragraph, should be auctioned to the highest bidders in the same way the MOF's t-bills are now auctioned. The rules of the auction should be the same as for the regular t-bill auctions by the MOF except there should be no limit on the amounts bid by the state owned banks. In addition, the CBI might consider an initial one time sale at the fixed rate of 5 percent, the rate paid to the CBI by the MOF on its restructured bonds. Assuming that this is done soon, while interest rates on t-bills are still below 5 percent, the CBI might offer to sell at par up to 200 billion of the three above maturities.

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.

VI. CBI claims on MOF

A. New Agreement

A major factor deterring the CBI from opening its Overnight Deposit Facility was concern for where the income would come from to pay the interest on it. This concern was rooted in an agreement with the MOF in June 2004 to restructure the CBI's claims on the MOF that would have reduced the CBI's assets in present value terms by over 1.9 trillion dinars. This agreement was recently renegotiated as follows:[3]

Overdraft facilities

The stock of overdraft facility claims at end February 2005 amounted to ID 1.8 trillion. The overdraft facility claims will be repaid from the government's share of CBI profit with a 2 percent interest rate over 15 years in annual installments. If CBI profits are insufficient to cover these payments then the term will be extended until the overdraft debt is entirely repaid, with interest paid on the unpaid amount that accrues.

Treasury bills

The stock of T-bill claims at end February 2005 amounted to ID 3.2 trillion. This will be repaid over 15 years, in 30 semi-annual installments, with a 5 percent interest rate on 75 percent of the face value (haircut). For this purpose existing securities will be replace with new bonds maturing every six months over the next 15 years. For the first installment, which was due on January 1st, 2005, the MOF will pay the CBI 75 percent of the face value, in cash, with an interest rate of 2 percent on the reduced amount (from July 2004). The remaining 29 bonds with staggered maturities (29½ years, 29 years, 28½ years....1/2 year) matures will pay 5 percent interest on the haircut amount. At maturity, 75 percent of the bonds' face value, plus interest due, will be paid by the MOF.

The loss in present value terms of the new agreement is 1,406 billion dinar with a discount rate of 6 percent (the current policy rate), or 1,172 billion dinar with a 5 percent discount rate (the rate paid on the bonds). These estimates assume that the CBI generates

[3] The following description of the terms of the new agreement were largely formulated by Hervé Ferhani, IMF, and elaborated on by Hassan Al_Haidary, CBI.

sufficient net income over the next 15 years to “write off” the overdrafts as agreed above and to absorb the 25 percent haircut on the t-bills. The present value of debt service on the overdrafts and t-bills that would then result from the above agreement (i.e. the payments to the CBI with respect to these claims) is computed on these assumptions. The calculations ignore the additional interest cost that the CBI would bear (and thus the modestly larger loss) if it sold “special” government securities to the public.

The aim is to develop a secondary market for these bonds. For this purpose each of these 29 individual bonds can be subdivided into smaller denominations that can be sold to the public at full face value (pre haircut) and with the five percent interest paid on the full amount. Mr. Hassan Al Haidary explained the operation as follows:

> “The securities will be sold to banks at 100 percent face value. The face value of the securities will be placed in an account with CBI. On maturity the bank that purchased the securities will receive the face value of the securities plus interest. Simultaneously, CBI shall debit the account of MOF in its books with 75% of face value plus interest due on that part and also debit the profit and loss account of CBI with 25% of face value (haircut) plus interest on that part too…. Banks may purchase and discount securities at any time through CBI office hours. Discount shall be with margin on interest rate (i.e. 5%) for actual days.”

B. Recommendations

Open Market Operations

The arrangements for selling these “special” government securities should make them relatively attractive to the market. However, as proposed they are relatively complex and the exact legal nature of the securities banks would hold if they bought them is unclear. Furthermore, the stipulation (or assumption?) that they would be sold at par would render them unmarketable if interest rates rose above 5 percent. In current market conditions in which t-bills are being auctioned at 3 percent, they should sell quickly (given the proposed repurchase facility at the CBI).

Even with the CBI’s promise to pay holders the 25 percent haircut (and interest) amounts, these bonds are not readily usable for open market operations. During discussions with the IMF in Amman Deputy Finance Minister Azez indicated the Ministry’s willingness to replace (swap) the new restructured bonds with new “clean” t-bills with the same features as those now being auctioned by the MOF (but with longer maturities). The CBI should request that the next three “new bonds” (maturing July 1 05, January 1, 06, and July 1 06) should be swapped for normal t-bills of equivalent value (cost to the MOF) in May (after seeing the results of the revisions to the reserve requirement to add government deposits). New bonds with a face value of 107.833 billion ID mature on each of these dates and would be replaced with normal “clean” bills of the same maturities of 80.875 billion ID (plus the present value of the 5 percent interest on each of the three 80.875 billion amounts on each of those three dates). An alternative is to wait until July, letting the MOF pay off to the CBI the bond maturing on July 1 and to replace (swap) the two bonds maturing in 2006.

Use existing banking facilities

The CBI suggested that the liquidity of "special" government securities sold to the market would be guaranteed by the provision of a discount facility. However, all of the arguments that supported replacing the old discount facility with the new Banking Facilities now in place would to apply to a new discount facility. The CBI should not introduce a new discount facility, but should rely on the new Banking Facilities to provide some liquidity protection. This would also encourage, rather than undermine, the development of an interbank market.

Recapitalize the CBI

The realization of haircuts only at the time of the maturity of each security does not in any way mitigate the immediate loss in the present value of such securities as a result of the prospective haircuts. The below market interest rate on overdrafts (at least in relation to the "policy rate") also produces a loss in present value terms. The independence of the CBI and the integrity of its balance sheet and income statements require that the MOF recapitalize it for these losses.

Recapitalization bonds could also be spread out evenly over 15 years and pay 5 percent but should not be subject to further haircuts. They would produce addition actual payments from the MOF to the CBI as they matured. In the interest of security market development, they should have the same features as the government might introduce in bonds sold to the market in primary auctions. It might also be desirable for the agreement to provide for the MOF to swap them for bills of equivalent value as their maturity reached one year.

The CBI indicated that it will undergo an audit by the Supreme Audit Council in order to verify that its balance sheet and capital are valued and recorded in accordance with international accounting standards. If this audit confirms that it has negative capital as a result of the recapitalization agreement (or for any other reason), it will ask the MOF to recapitalize it. This seems an appropriate and prudent approach.

The MOF might reasonably be concerned that current insolvency reflects, to some extent at least, external liabilities that the CBI will not have to repay once the external debt issues have all been resolved. On the other hand, the CBI has some external assets that are frozen and might not have been included in this balance sheet. Given these uncertainties, it would be reasonable for the MOF recapitalization of the CBI to contain a contingency that would require the CBI to return any recapitalization bonds that later proved to be excessive once all external debt write off have been made and freezes lifted.

Amend central bank law

To a considerable extent, the convoluted arrangements that have been described above derive from the lack of explicit provisions in the central bank law for the remittance of CBI profits to the MOF. At a suitable time, perhaps in two or three years, the law should be amended to make explicit and customary provision for the payment of CBI excess profits to the MOF. In addition, the law should be amended at that time to strengthen the provisions requiring the MOF to cover any CBI losses that would reduce its capital below stipulated minimum levels in relation to its monetary liabilities.

VII. Government Securities Market

Ninety one day t-bill auctions have been held almost every other week since mid July 2004 when the first auction was held. The MOF has not published its auction plans and schedule as advised and has not auctioned enough to fully refinance the redemptions of earlier securities held outside the central bank (all of the old ones have now matured) and of the new bills that have already matured. Of the 1,426 billion dinars to be refinanced over time, the currently outstanding stock of t-bills is only 950 billion leaving additional un-invested liquidity in the market of 476 billion. **The amount of auctions should be increased to fully refinance already matured securities.**

None-the-less, the auctions have been modestly successful. The April 3 auction had 6 bidders and 5 winning bidders with a coverage ratio (amounts bid to amount offered) of 201 percent. Interest rates on the auctions have varied between 6.8 percent on the first auction to 1.1 percent on November 7, 2004. The rate has been 3.0 percent for the last four auctions.

There is no secondary trading in the traditional sense, though it is permitted. It is recommended that the CBI (Loans and Agreement Department) develop a Money Market Conditions Report every other week just prior to each government securities auction for use by the MOF and CBI management. 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 Loan and Agreements 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 L&A Department indicated that it will prepare such a report with some of the data provided by the Statistics Department.

The MOF should also consider replacing its 91-day bills with 84-day bills if it wishes to continue with fortnightly auctions. Ninety-one day bills mature between two fortnightly auctions and thus leave banks with cash for seven days until the next auction. Issuing 84-day bills would eliminate this problem. Existing fortnightly auctions of 84 day bills will finance debt of 900 billion IQD on a continuous basis.

The 2005 budget also calls for no net new borrowing, which will make the further development of this market a bit more challenging for the MOF. The development of secondary trading is particularly important to banks and to the CBI for the implementation of monetary policy.

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 publish quarterly issue plans designed to achieve the orderly refinancing of existing debt and the creation of a smooth maturity structure (which should include a shift to 84 day bills).
Status: The CBI has discussed this recommendation with the MOF but it is not implemented.

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.

VIII. 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 money stock (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 is currently the most serious problem. The balance sheet and monetary data are available with a one and a half to two month lag. The key sources of delay derive from slow reporting from the many branches of Rasheed and from the Basra, Irbil, and Mosul branches of the CBI and no reporting at all from Suleymaniyah. Unreliable telecommunications and lack of automation are major factors in these delays as is the lack of a clear enforcement policy by the CBI.

The IMF has recently clarified its data reporting requirements and BearingPoint is providing assistance to the CBI in satisfying those requirements. The interface between the monthly supervisory bank (call) reports to Banking Supervision Department and the reserve requirement, and the weekly "Dewald" reports is being clarified and documented in an MOU between the Loans and Agreement, Statistics and Research, and Banking Supervision Departments (attached).

Data Reports

Two very useful weekly reports are prepared with only modest delays, which vary from a few days (from the target of Wednesday with respect to the previous Thursday) to several weeks.

Key Financial Indicators—KFI--(posting to the Internet needs to be made timelier and additional weekly data added)

Weekly Foreign Exchange Reserve Report (available internally only)

The daily FX auction report should restore information on the morning street exchange rates to the table now published. In addition, the CBI should consider establishing a new **Weekly Exchange Market Report.** This report would add to existing daily exchange rate (street and auction) and FX auction data some market surveillance information on daily exchange rate and FX auction developments.

Accounting Issues

A number of accounting issues continue to hamper the above data. Both the timelines and accuracy of the IMF version of the CBI balance sheet will be improved with the implementing the new accounting (banking) system of the CBI. Its implementation was postponed beyond December 2004 due to several problems appearing during the parallel testing of the system.

This system will initially operate only on the Headquarters computer and data. It will operate in the other branches independently at a later stage. The full system—the Headquarters and four branches—will be connected and integrated as a final stage. The IT Department.has given no fixed dates for the implementation of these stages.

The problem of negative US dollar vault cash (for example) was resolved by eliminating the artificial and separate auction account (established for historical reasons to give a clean start until other accounts were sorted out) and reporting total vault cash (which most readers of these data might have mistakenly thought they were seeing).

In August, the CBI revalued its balance sheet to reflect current exchange rates rather then the rate of February 2003. As the CBI's foreign liabilities greatly exceed its foreign assets (until the conclusion of the external debt restructuring agreements and the write off of a substantial part of these foreign liabilities), this revaluation introduced a very significant one time loss. From August until November the IMF balance sheet reflected this in the "revaluation account". In December an adjustment was made to the capital account, which produced the negative balance we now see (until the external debt is written down). Miss Hayfa'a will add a note on this to the balance sheet in the future.

B. Data Analysis

Work on improving the monetary policy briefs continues. In some instances Briefing team members have encountered reluctance from others to share data needed for the briefs. There is no tradition here of information sharing. One purpose of the Briefs is to develop expertise in understanding the behavior of relevant data in part by building relationships with others within the CBI, the MOF or other government agencies that provide these data. **CBI management may need to formally establish the authority and need for Briefing team members to receive relevant information.**

Considerable discussion of the **Government Expenditure and Financing Brief** is converging on a set of tables that should be very useful and relatively normal (revenue and expenditures in one table and financing in another). The main difference with standard practice is to present dollar receipts and disbursements separately from local currency receipts and disbursements. This is useful now because of the unique and dominate role played by dollar Oil revenues and the off shore stabilization account (UN protected DFI account at the FRBNY).

The **Real Income Brief** is the least developed as there is very little data to work with. The CBI is the user, not the producer of data in this area (as with the CPI data). The **Exchange Rate and Foreign Exchange Market Brief** has plenty of good data but a very poor and inadequate analysis of the market.

All other background Briefs (**BOP, Credit and Banking, Monetary Aggregates, Interest Rates and Domestic Financial Markets**) are making slow progress but need considerable help.

The least developed and most important of the briefs is the **Monetary Policy Options Brief**. Dr. Hashim Al-Ali of BearingPoint is expected to work with the Macro Forecasting Division to develop its general capacities and to work with them to develop the Policy Options Briefs. Bill Dewald, who returns to Baghdad shortly, may be expected to play an active role advising in this area as well.

A **Liquidity Forecasting** unit has been established in the Statistics and Research Department in the Macro Forecasting Division of Dr. Mariem. The unit's task is to monitor and forecast excess reserves. As a first step, members of the unit should establish relationships with the other Briefing teams and other units of the CBI that provide relevant data. They should become very familiar with the history of how and why key items in the balance sheet behaved as they have. Over time, as the availability and quality of weekly and daily data builds up, they can begin to forecast the behavior of more and more of these items.

The Liquidity Forecasting Unit will need a lot of help and the CBI should ask the IMF and others for training in this area.

Work plan

1. All data collected and maintained by the CBI should be clearly and fully documented as to its source and content (see IMF Data Documentation Standards). **Status**: Steady progress is being made. CBI and other government representatives will participate in an IMF workshop on GDDS in May, 2005.

2. The Statistics and Research Department should establish target schedules for releasing new data and should develop programs to make the release timelier.
Status: Under discussion.

3. The Statistics and Research Department should develop a request for an improved electronic time series database and training in its use.
Status: BearingPoint will deliver an IT expert to the CBI to help develop a system wide database.

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 newly established Policy Rate.[4] 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).

In order to evaluate financial and economic developments and to take appropriate policy actions in light of them, the Board needs an analytical framework in which to interpret and discuss these developments among directors, with staff and with the public. The Advisor set out a very simple framework in his July Report for this purpose. This is a framework also used by the IMF (more or less). In order for the staff to share with the Board its knowledge and expertise with regard to relevant financial and economic developments, staff began in June to prepare Briefs for the Board on developments and prospects (forecasts) in nine areas. The information and analysis of each of these Briefs feeds into and informs the Policy Options Brief, which is the key document summarizing the staff's understanding of developments and its recommendations to the Board for monetary policy.

The quality of the Briefs is steadily improving with experience and as data to be analyzed improves. BearingPoint advisors and mentors from the Board of Governors of the Federal Reserve System have been recruited to revise and comment on these Briefs.

A schedule for these Briefs has been established in which more detailed Briefs will be prepared twice a year. These would be tied to the semi-annual Statistical Bulletin cycle. These Bulletins are prepared for the first and second halves of each year and are released in mid-February (for the preceding six months through end December) and in mid-August (for the preceding six months through end June). Thus Detailed Briefs, based on these semi-annual Bulletins, would be issued in mid February and mid August. The Detailed Briefs for February could also be linked with the preparation of the Annual Report. The Detailed February Brief would also develop the baseline forecast for the year.

These individual Briefs feed their analysis and forecasts into the Policy Options Brief. The content and form of the Policy Options Brief should reflect the tastes of Board members. Feedback from Board members is essential if this Brief is to play its 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.

Dr. Hashim Al-Ali of BearingPoint will work with the CBI to further develop and deepen the above process. In particular, he will work closely with the Statistics and

[4] 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.

Research Department, particularly the Forecasting Division of Dr. Marien, to define and develop its central role in the process.

Work plan

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

2. The Statistics and Research Department should develop an MOU, with assistance from Dr. Hashim Al-Ali, defining the work and role of the (Macro) Forecast Unit in supporting the monetary policy formulation process.
Status: Unknown.

X APPENDICES

Memorandum of Understanding
On
Enforcement of the Bank Reserve Requirement

The new reserve requirement[5] makes mandatory the weekly money supply reports banks submitted voluntarily since early 2004. While the reporting categories are approximately the same as in the "Dewald" report, some refinements are likely. This memorandum of understanding between the Supervision Department, Loans and Agreements Department and two units of the Statistics and Research Department documents the division of responsibilities among these units for collection of the deposit and vault cash data required to calculate the reserve requirement and for monitoring and enforcing compliance with the requirement.

I. Roles of Each Department

A. Supervision Department

- Gathers the reports submitted by each bank, which should be copied at the same time to L&S and Statistics Departments;
- Reviews documents for errors of presentation or significant changes in trends;
- Sends any comments or issues on each report including its certification of the monthly requirement to Loans and Agreements, Accounting Department and Research and Statistics Department by the 5th working day of the month following the report for the calculation period;
- Interacts with banks to correct reporting or documentation deficiencies. In particular, verifies with banks the proper classification of exclusions (interbank deposits and cash items in the process of collection);
- Issues letters recommending penalties or sanctions for late reporting and other deficiencies or regulatory infractions;
- Confirms reasonableness of reports through coordination with Research and Statistics Departments;
- Performs on-site review of bank documentation process; and
- Prepares and executes intervention policies for banks failing to satisfy the balance requirements for two or more consecutive months.

B. Loans and Agreements Department

- Receives reports from banks and certification of requirement from Supervision Department;

[5] http://www.cbiraq.org/Reserve%20Requirements_EN.pdf

- Monitors records of the daily balance of banks' accounts with the CBI provided by the Current Accounts Department and calculates the provisional average throughout the month;
- Before the end of the Reserve Maintenance Period, discusses with banks their reserve situation if their average reserve balances are significantly below required levels over the first half of the Maintenance Period; and
- Issues notification to the Current Accounts Department, CBI Senior Management, and the Supervision Department in the event of failure to maintain required reserves, in order for Accounts to impose the penalty and for Supervision to under take appropriate intervention when required.

C. Research and Statistics Department

- Reports required reserves based on the records of the Banking Supervision Department and actual reserves based on the records of the Accounts Department;
- Validates reported deposit data against end month [R&S] [Supervision] Department reports for corresponding data;
- Compiles and publishes monthly money stock data based on end month bank call reports; and
- Explores the introduction of a monthly average money stock series based on the new reserve requirement report.

D. Accounting Department

- Maintains accounting records on bank deposits with CBI;
- Reports balances to Loans and Agreements on a daily basis;
- Maintains in notation format the reserve requirement based on the new reserve requirement; and
- Accounts for penalty on reserve account balances when notified of a requirement violation by L&A Department, and the imposition of the penalty by Banking Supervision Department.

II. Current Compliance and Transitional Issues

A. Existing Bank reports

Banks currently provide three reports to the CBI containing deposit data:

a) old monthly reserve requirement report to Supervision Department was discontinued at the end of December 2004;

b) end month bank call reports and balance sheets to Supervision Department;

c) weekly "Dewald" money supply report to Dr. Mariam's division in Statistics and Research Department; and

d) new reserve requirement report to L&A Department (with copy to Supervision and S&R Departments).

The existing end month bank call reports should be amended to harmonize deposit categories (and hence total deposit component of the money stock) with those of the new reserve requirement. For the period December 2004 through March 2005, the data provided by the weekly Dewald report should be validated against those of the new weekly reserve requirement report and any anomalies should be analyzed with the goal of verifying the correctness of data in the new reserve requirement reports. At the end of this process, but as soon as possible, the Dewald report will be discontinued.

Beginning December 2004 required reserves for all purposes and in all reports shall be as determined by the new reserve requirement regulation.

B. Incomplete and late data

At the beginning of a Reserve Maintenance Period, missing or late data will be replaced by the most recently available (adjusted) until the proper data are available. An adjustment will be applied that adjusts the most recently available data by the average weekly growth rate over the most recent six-month period for which data is available. For example, if the total deposit component of the money stock has grown at 0.05 percent per week for the past six months, the adjustment factor is 0.05 per week. If one branch of a bank has not reported by the filing deadline of the last business day of the Reserve Calculation Period, the bank will substitute provisional data for that (those) branch(es) by multiplying the most recently available data by 0.05 for each week that is missing. If the most recently available data is for Thursday February 3 for the report due February 28, the missing data for February 10 and 17 will be provisionally calculated as the February 3 amounts times 0.05 for February 10 and that amount time 0.05 (Y*0.05*0.05) for February 17. Substitutions must be clearly noted and documented. Actually, corrected data will be provided as soon as it is reasonable available.

Banks in the Kurdish areas will begin reporting through their branch of the CBI and fully integrated into the banking system and reserve requirement scheme as quickly as possible.

C. Compliance policy and strategy

Financial penalties established in Section 6 of the regulation should be carried out by the Accounting Department (or supervision) as prescribed by the regulation.

Penalties for late or inadequate reporting have now been formally adopted and will be enforced starting with the April deposit report for the May requirement. The Supervision Department will provide monthly reports to CBI management and to L&A and S&R departments on the status of banks’ compliance with reporting requirements and measures being taken to obtain full compliance. The report will include any issues with regard to the quality of data reported (e.g., cash items in the process of collection, and interbank deposits).

The Supervision Department will prepare plans for supervisory intervention for prolonged non-compliance as required by Section 6.2 of the regulation. This will be done in connection with developing rules for Lender of Last Resort financing, which should be provided when appropriate rather than waving the reserve requirement.

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