الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

Republic of Iraq

September , 2021

TRUST . TRANSPARENCY . INDEPENDENCE

ECONOMIC OVERVIEW

Table 1: Key Economic Indicators - Iraq					
Figures as stated	**2017**	**2018**	**2019**	**2020**	**2021F**
Population (mn)	37.1	38.1	39.1	40.1	41.2
Nominal GDP (US$'bn)	192	217	222	172	191
GDP per capita (US$)	5,179	5,690	5,687	4,288	4,632
Real GDP Growth (%)	-3.4	0.8	4.5	-10.9	1.1
Oil GDP growth (%)	N.A.	-1.3	3.8	-12.6	-1.3
Non-oil GDP growth (%)	-3.1	4.7	5.7	-8.0	5.0
Average CPI (%)	0.1	0.4	-0.2	0.6	9.4
Current Account Balance (% of GDP)	-4.7	4.5	0.5	-14.8	0
Fiscal Balance (% of GDP)	-1.5	8.2	0.9	-19.8	-9.2
General Government Debt (% of GDP)	59.1	50	47.7	81.2	69.7
External Debt (% of GDP)	35.9	30.8	30.6	47.9	34.0
Gross official reserves (US$'bn)	49.4	64.7	68.0	54.1	52.5

Source: IMF; Article IV consultation press release February 2021; Regional Economic Outlook statistics April 2021; F: forecast; N.A: not available; per capita GDP from World Bank

Republic of Iraq has a population of 40mn and a nominal GDP of US$172bn. As such, it is a middle income Country with a GDP per capita of US$4,288. Iraq has seen major economic disruptions prior to 2012 and has been in a recovery phase over the last few years. Geographically, it has borders with Turkey, Iran, Kuwait, Saudi Arabia, Jordan and Syria.

After registering strong growth in 2018, the economy tapered off in 2019 as hydrocarbon prices trended lower at US$64/barrel (2018: US$71/barrel), in addition to social and political disturbance. With a sharp decline in hydrocarbon prices precipitated by the onset of Covid-19 in 2020, the economy is expected to have contracted by around 11%, with a rebound expected in 2021, as the effects of the global recession begin to taper off, causing oil prices to soar to its highest since October 2018[1], and OPEC+ cuts to gradually be reversed. We expect average real economic growth of 4.5%, over 2021-2023.

Iraq has the fifth largest oil reserves in the world and a significant amount of gas reserves, but extraction has remained limited due to the after effects of war and damaged infrastructure. Despite focus on improving non-oil GDP, oil related growth has remained the main driver of the economy. Oil revenues still comprise almost 90% of government revenues, 100% of exports and about 55% of GDP. Very high unemployment rate, potentially lays ground for social discontent.

A pegged currency has given the CBI limited monetary policy management tools. The policy rate has remained constant at 4% since 2016. Maintaining the peg is a challenge amid high current account and fiscal deficits. To ease the pressure on the currency and to narrow the external imbalance, CBI announced devaluation of US$ / IQD exchange rate by 22.7% in December 2020. The US$ / IQD parity moved up from 1,190 to 1,460 after the devaluation. Weak domestic demand and lower imports kept consumer prices steady with inflation at 0.6% in 2020; however, the latest round of currency devaluation is expected to translate into inflationary pressures in the current year. In June 2021, the Central Bank of Iraq confirmed no further currency rate changes.

With the external account reliant largely on oil and gas exports, current account had remained in surplus over the past years, and driven by a high trade surplus. Notwithstanding the recovery in oil prices during H2'20, following a sharp dip in the early part of the year, Iraq posted a current account deficit of -14.8% in 2020 driven also by lower export volumes due to the pandemic. Moreover with pressure on revenues, fiscal deficit increased to -19.8% of GDP during 2020 (2019: surplus 0.9% of GDP). The Government deferred the regularization of new entrants and contractual workers to 2021 thus accruing wage arrears, and rescheduled part of the domestic debt. Limited fiscal space has also impacted the cash transfers schemes for vulnerable households. In the approved 2021 budget, various measures were announced to consolidate the fiscal position, including introduction of consumption taxes, better targeting of public distribution system ("PDS") benefits, improved electricity tariff collection and automation of customs. These measures are in line with the Government's white

[1] *Year-to-date September 7, 2021 average of US$67.2/barrel with highest point in July 2021 (US$78.3/barrel) vis-à-vis previous highest point in October 2018 (US$86.1/barrel)*

paper and if implemented could help moderate the fiscal deficit and pressures on the exchange rate. With higher oil prices, the fiscal strain is likely to begin easing off and current account will likely revert to its surplus position in the current year.

The twin deficit in 2020 has caused both government debt and external debt to increase significantly during the year. General government debt increased from 47.7% of GDP in 2019 to 81.2% of GDP during 2020, whereas external debt increased to 47.9% of GDP (2019: 30.6%), with the latter also impacted by a sharp devaluation of 22.7% during the year. In late 2020, an emergency borrowing law was ratified by the legislature and in November 2020 the parliament approved the Government's request of US$10bn debt issuance to cover the public sector workers' wages and contractors' payments. Both government debt and external debt are high, though supported by still high official reserve balance yet lower than prior year at US$54.1bn as at end-2020. Iraq's current fiscal break-even oil price is in the range of US$60/barrel, which might allow the economy reprieve in the post Covid-19 scenario, but calls for continued investment in economic diversification.

In April 2021, Iraq was excluded from the classification of high risk countries by the U.K., which is noted favorably in terms of enhancing the prospects of future investments and facilitating correspondent banking relationships between the two countries. In the previous years, European Union had removed CBI from the sanctions list in September 2018, which followed the International Financial Action Task Force's ("FATF") announcement in July same year to no longer subjecting Iraq to the monitoring and follow-up process taking cognizance of the significant progress having been made by CBI and its AML and Terrorist Financing office towards addressing the deficiencies.

BANKING SECTOR:

Iraqi banking system comprised 74 banks, of which 7 are government owned and 66 are local and foreign private banks. Altogether there are 43 conventional commercial banks, followed by 27 Islamic banks and 3 specialized banks.

Despite the presence of large number of private banks, government banks dominate the sector at more than 80% of assets and deposits in relation to the sector. Share of Islamic banks has remained limited at 7.4% of banking sector assets at 2019, albeit growing gradually.

Table 2: Banking Sector Indicators

Figures as stated	**2017**	**2018**	**2019**	**2020**	**Q1'21**
Number of banks	67	70	72	74	N.A.
Assets (IQD'bn)	111,286	122,995	133,090	138,264	140,828
Total cash credit (IQD'bn)	37,953	38,487	42,053	49,750	49,854
Total Deposits (IQD'bn)	67,049	76,894	82,106	84,924	84,978
Equity (IQD'bn)	14,341	15,001	15,351	16,772	17,121
Liquidity ratios (%)	45	214	194	588	N.A.
NPFs to total financings (%)	14.02	15.68	11.71	10.32	N.A.
Loans to Assets (%)	27.83	25.32	26.61	31.08	N.A.
Capital Adequacy Ratio (%)	181	285	173	N.A.	N.A.
Return on Assets (%)	1.19	0.59	0.82	0.88	N.A.
Equity to Assets (%)	12.89	12.2	11.53	12.13	N.A.
Return on Equity (%)	9.22	4.37	7.1	7.22	N.A.
Islamic Banking Segment ("IB"): Number	24	25	27	30	30
IB assets (%) of total banking sector assets	5.3	7.4	7.4	N.A.	N.A.
IB cash financings to total cash credit (%)	5.7	6.2	5.7	N.A.	N.A.
IB deposits (%) of total banking sector deposits	3.0	3.3	3.4	N.A.	N.A.
IB capital (%) of total banking sector capital	32.3	34.2	35.1	N.A.	N.A.

Source: CBI Financial Stability Reports; CBI statistics; Quarterly early warning indicators; N.A.: not available

Fuelled by mostly deposits increase (11.1% CAGR over 2017-Q1'21), overall assets of Iraqi banks posted similar growth over the period and stood at IQD140.8trn at Q1'21. However, the economy remains under banked, and financial sector inclusion is weak, with lack of public confidence in the banking system. Adverse effects of protests in late 2019, followed by the pandemic have contributed to the recent slowdown in 2020. Cash financings off-take has remained weak, although having grown over the years to IQD 49.8trn at 2020 (2019: IQD42.1trn; Q1'21: IQD49.9trn), while volume of unfunded financing has remained largely consistent for the sector at about IQD25.5trn at 2020 (2019: IQD25.3trn; Q1'21: IQD27.4trn).

CBI's Covid-19 measures were effective until end-2020. Key highlights are as follows:

- CBI lowered the reserve requirement from 15% to 13% and announced moratorium on interest and principal repayments by SMEs on its directed lending initiatives
- Encouraged banks to extend the maturities of all loans as they deem appropriate
- CBI also encouraged the use of electronic payments to contain the transmission of the virus and instructed vendors to eliminate commissions on such payments for six months
- Lowered the interest rates on financings to support the economic and productive sectors including housing, hotel, tourism and restaurant
- In Q1'21, the CBI offered additional support to SMEs under the "one trillion IQD" initiative and reduced the interest rates on loans extended through the scheme

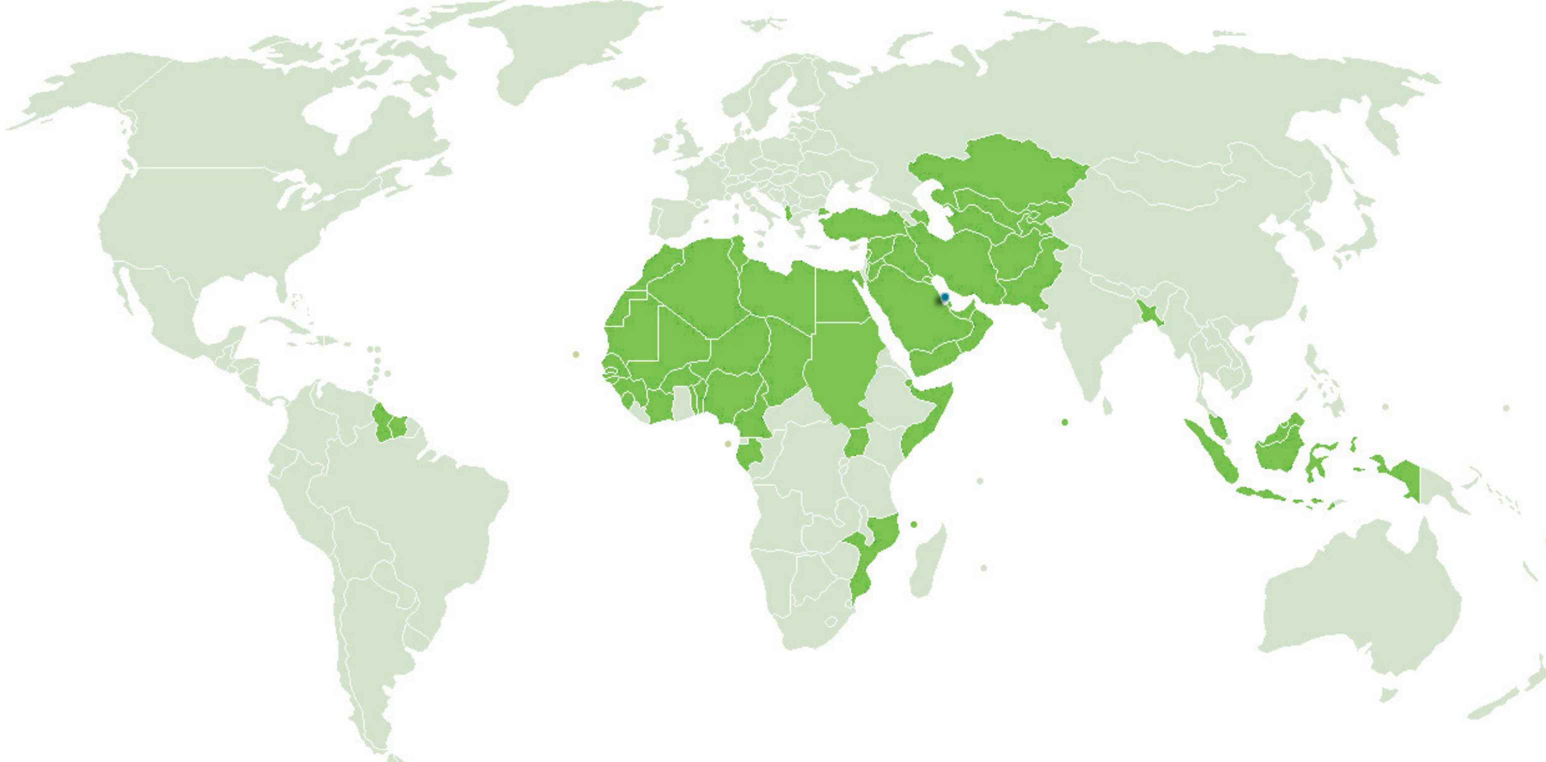
In 2019, CBI had reduced the mandatory reserve ratios on Islamic bank deposits to 5% (from 10%) on absolute (unrestricted), savings (fixed) and (fixed) for IQD and USD accounts, while current deposits and other deposits continued to require 15% reserve ratio. The relaxation provided in lieu of Covid has been withdrawn from January 2021.

In July 2021, CBI also increased the allocation towards housing finance sector to more than IQD1.9trn, including IQD1trn to Real Estate Banks and remaining towards the Housing Fund. This brings the total amounts allocated under the IQD5trn scheme to exceed IQD3.6trn. CBI also canceled the interest on previous loans, both current loans and with repayment period of (20) years, and only an administrative commission is to be charged.

Overall sophistication of Iraqi banking system may be poised for improvement through measures to be taken by the CBI in terms of ESG , credit risk benchmarking, amendments in Islamic Banking law, restructuring of large state-owned banks and reinforcement of AML framework, being on the anvil.

While being stressed, asset quality indicators in terms of NPFs to total financings are noted to have improved on a timeline since 2018. Sector-wise distribution indicates higher NPFs from relatively vulnerable economic activity sectors like construction and hospitality, contributed in large part to the non-performance in 2019.

Generally, the banking sector exhibits high liquidity with investment in capital-light assets. Underutilization of available sources is evident. Excess capital buffers leave room for significant growth for private banks while, state owned banks, are stressed for capital. Profitability metrics are also noted to have improved over the last two years, but remain weak overall.



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