

## **Iraq's Economic Prospects and Challenges<sup>1</sup>**

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**Iraq, a fairly prosperous middle-income country in the 1970s, has seen its economy and society battered by three decades of mismanaged government, wars and insurrections.** The U.S. invasion of March 2003 swiftly deposed the murderous regime of Saddam Hussein but then embroiled U.S. forces in a long-running guerilla war involving Sunni, Sufi and Kurd factions as well as foreign Islamist fighters. Following the military “surge” of 2007, the strength of the insurrection was reduced significantly, permitting the U.S. to withdraw its combat troops by August 2010 while leaving behind a force of 50,000. President Obama has stated that the remaining troops are dedicated to "advising and assisting Iraq's security forces, supporting Iraqi troops in targeted counterterrorism missions, and protecting our civilians" and will be withdrawn by the end of 2011.

**Iraq has abundant human and natural resources.** It has a relatively well-educated population of about 30 million, the world's third-largest oil reserves (an estimated 11% of the world total), substantial natural gas reserves and ample water resources. At present, however, the nation is going through a period of political uncertainty. The parliamentary election last March gave an unexpectedly large vote to the opposition to Prime Minister Nourial al-Maliki and this led to prolonged wrangling over cabinet formation, which remains unresolved. The Economist Intelligence Unit (EIU) anticipates that a “government of national unity” will eventually be formed, involving the four political factions that emerged as strongest in the March elections.

**Improving security and restoring the rule of law are the most important requirements for economic recovery and development in Iraq.** Infrastructure and public services need to be restored to previous levels and the country's valuable natural and human resources need to be developed. In the past few years, development efforts have been severely hampered by fighting, sabotage and security threats. Future economic development will require a more peaceful and orderly society with a greatly strengthened central government – or alternatively an agreed upon federal system in which regional governments play important roles. As things stand, the EIU fears that the drawdown of U.S. forces amid the continued weakness of central authority may allow militia and insurgent groups to reestablish themselves in some areas, although violence seems unlikely to return to 2006-2007 levels.

**Economic growth is likely to strengthen in 2010-2011 after weakening in 2009.** Falling oil prices hurt economic growth last year and difficulties in undertaking infrastructure projects compounded the problem. After running at 9.5% in 2008, GDP growth fell precipitously to an estimated 4.5% in 2009. The EIU expects real GDP to increase by approximately 6% in both 2010 and 2011 as oil production and prices rise. Faster growth is also likely to be driven by rising investments in oil and infrastructure projects. Consumer spending will rise slowly as security improves. Recent economic growth has been faster in the more stable areas administered by the Kurdish Regional Government and improved security should facilitate recovery in some of Iraq's more ethnically and religiously homogenous southern and western provinces. Mixed areas in central and eastern Iraq may continue to experience economic stagnation. Although

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budget allocations have been increased substantially in the 2010 budget, a significant amount will probably be left unspent owing to the delay in forming a new government. This will retard the growth of private consumption, as will the government's pledge to the IMF to hold recurrent spending steady for two years, since one-third of all employees work for the government. Export earnings will track changes in oil production and prices. Oil production stagnated in 2009, as Iraq's decrepit and deteriorating oil infrastructure held back output growth but will increase this year and next. Imports of both consumption and investment goods will grow rapidly.

**Falling oil prices and stagnant production caused Iraq's external position to deteriorate substantially in 2009 and the balance of payments is expected to remain in deficit through 2011.** The current account deficit in 2009 was around 20% of GDP while the overall balance of payments registered a deficit of around 10% of GDP. Current projections are based on conservative oil price assumptions.

**With receipts from oil exports accounting for the great bulk of government revenues, lower oil prices in 2009 had a similar impact on the government's budget.** Even though spending was seriously hampered in the second half of the year by two bomb attacks on the Ministry of Finance, the budget is estimated to have recorded a deficit of over 20% of GDP. Like the balance of payments, the government budget is expected to record large deficits in 2010 and 2011 before returning to surplus in 2012. The World Bank anticipates that these deficits will be equivalent to 12% of GDP in 2010 and less than 10% in 2011. The 2010 budget is 53% higher than the 2009 allocation. Higher spending is planned on reequipping security forces, public sector salaries and investments in the oil, water and electricity sectors.

**The medium-term outlook for economic growth is guardedly favorable.** The two big unknowns in Iraq's economic future are security and oil. According to the World Bank, the oil sector generates two-thirds of GDP and over 98% of both export earnings and government revenue. This makes GDP highly volatile, as demonstrated by the sharp decline in the growth rate that occurred after world oil prices slumped in late 2008. Iraq's massive oil reserves continue to attract international oil companies and oil exploration and production is likely to increase. The government hopes to boost production to an ambitious 12 million barrels per day through contracts with international oil companies. In two recent negotiations, the companies ended up acceding to terms proposed by the government, increasing the value of Iraq's oil production. Meanwhile, exploration in the area administered by the Kurdish Regional Government could accelerate if tensions with the oil ministry eased.

**However, a new Kurdish gas deal recently rekindled tensions with Baghdad.** In late August the Kurdistan Regional Government (KRG) signed a deal with Germany's RWE to develop a gas distribution and transport network within the region. Earlier in the month, the KRG's natural resources minister announced plans to increase Kurdish oil production to 3-4 million barrels per day within four years and to export gas through Turkey. The RWE deal drew criticism from Baghdad, which called it illegal. The EIU comments that while differences of opinion over federal and regional rights to develop Iraq's hydrocarbons have been the major source of conflict between the KRG and the central government for years, the absence of a new government in Baghdad worsens matters. A compromise agreement worked out in May has yet to be ratified, pending the formation of a new cabinet.

**Agriculture, which plays an essential role in Iraq's food security and rural economy, remains the largest employer and biggest contributor to GDP after oil and suffers from lack of investment as well as distorted input and output prices.** Agriculture and energy are the two priority sectors in the next five-year National Development Plan. Iraq's Mid-Term Agricultural Strategic Plan (2009-2015) aims at increased self-sufficiency in food and improved rural livelihoods through rehabilitation of essential infrastructure and improvement in agricultural extension services.

**The government is committed to reforming public financial management and has made notable progress in budget design and implementation.** In September 2004, the IMF approved the first stabilization program for Iraq in three decades, opening the way to a Paris Club agreement to write off 80% of Iraq's debt in three stages over 2004-2008. A new two-year Stand-By Arrangement with the IMF and a Fiscal Sustainability Development Policy Loan (DPL) from the World Bank were approved in February 2010. The DPL supports needed structural reforms in the areas of budget management and prioritization, financial sector reform and improvements in the efficiency of the social protection system.

**The new standby arrangement with the IMF supports the government's economic program.** This program seeks to contain current government spending while catching up on badly needed investment spending. The budget deficit is officially targeted to decline to 19% of GDP in 2010 and 6% in 2011 before returning to surplus in 2012. Monetary and exchange rate policies are to continue aiming at keeping inflation low. The new program is also intended to help the authorities move forward with structural reforms, particularly in the areas of public financial management, including the management of the oil resources, and financial sector development. The arrangement will give the government access to Fund resources if needed, depending on trends in the oil sector and the government's success in executing its capital budget. Realistically, however, it can be anticipated that economic policymaking will continue to be constrained by the weakness of central government control. The government's practical emphasis may be on improving project implementation, for example by encouraging local participation and cutting bureaucratic constraints. Progress may well remain slow and piecemeal, hindered by vested interests and corruption, but better security should at least allow progress with upgrading basic services, such as electricity and water.

**Since 2003, Iraq has taken steps to reintegrate into the international financial system.** An action plan has been adopted to modernize the banking sector and the WB and other partners are supporting this through a project focusing on: institutional & operational restructuring of the two main state-owned commercial banks (Rasheed Bank and Rafidian Bank); strengthening of the regulatory and supervisory functions of the Central Bank of Iraq; and project management, monitoring and evaluation. Reforms aim at fostering more efficient financial intermediation, resource mobilization and risk management, and increasing private participation in banking.

**Monetary policy is seeking to encourage lending and investment.** The Central Bank cut the reserve requirement for Iraqi banks from 20% to 15% effective September 1, following a reduction from 25% last April. Since the banks already hold excessive reserves, partly because of inadequate legal arrangements for lending, the policy change may have little effect on lending.

**Iraq's private business climate remains one of the world's most forbidding.** In the World Bank's *Doing Business in 2010* ratings, Iraq ranked 153<sup>rd</sup> among 183 countries in general ease of doing business. It ranked particularly low in ease of starting a business (175<sup>th</sup>), trading across borders (180<sup>th</sup>) and closing a business (183<sup>rd</sup>, dead last). The need for reform in business regulation is obvious.

**Although data constraints are significant, surveys indicate that poverty and human development indicators worsened in the 1990s and have not improved much in recent years.** The 2007 Household Survey conducted with the support of the World Bank estimated the overall unemployment rate at 11.7%. It was found to be higher among younger adults (20-24 years old): 16.9% for men & 35.7% for women. Public utility service delivery continued to be patchy and unreliable. Only 12.5% of persons whose dwelling is connected to the public network reported that their supply of water was stable. Furthermore, only 22.4% could rely solely on the public network for electricity to their housing unit. The government continues to provide large subsidies for food, fuel and utilities. In November 2009, the Cabinet approved a new National Strategy for Poverty Reduction for the years 2010-2014. This strategy was launched in January 2010 with the aim of reducing poverty from its existing level of 23% to 16% by 2014. Efforts are also underway to reform the Public Distribution System (PDS), Iraq's largest safety net program in terms of reaching the poor, which is characterized by gross inefficiencies and insufficiently targets the neediest social groups.

**Refugees have slowly started returning home as security improves, but displacement remains a concern.** The United Nations High Commissioner for Refugees estimates that more than 4.7 million Iraqis left their homes during the recent conflicts. Of these, 2.7 million are displaced internally while about two million sought refuge in countries such as Syria and Jordan.

**Iraq continues to receive large amounts of foreign financial and technical assistance support.** In addition to the large IMF and World Bank programs mentioned earlier, Iraq is the beneficiary of one of the largest foreign assistance programs undertaken by the U.S. government since the Marshall Plan.

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