

## Iraq's Economic Prospects and Challenges

**Iraq's strained fiscal situation and sluggish economic development pose risks to continued security and political progress.** While the Iraqi economy averaged 6% economic growth over the past three years, it was driven by large increases in oil export earnings and government spending. Continued high growth projections over the medium term depend on further increases in oil production and private sector activity, neither of which are likely in the near-term. Low oil prices and stagnant oil production will place significant fiscal strains on the Iraqi economy by 2010. The problem will endure if the GOI can not find a way to get international oil companies engaged in the south. A tighter budget could impede Iraq's reconstruction and economic development since the Iraqis would have to cut services, entitlements, subsidies, and security and investment spending.

In the near term, the GOI needs to tap KRG oil contracts and improve the efficiency of government spending to help maintain macroeconomic stability. In the medium term, Iraq needs to implement crucial structural reforms that attract greater foreign investment and unlock Iraq's potential for a more diversified economy grounded in private-sector led growth.

### Current Fiscal Strains:

- The CoR's recent \$4 billion cut (6%) in the 2009 budget was **prudently** concentrated in goods, services, maintenance and non-financial assets spending. In an election year, it was unlikely that the Iraqis would cut salaries, pensions or food subsidies, making cuts in capital expenditures the likely target of any 2009 rescission.
- Iraq has sufficient fiscal reserves to fund the budget's projected deficit this year. The 2009 budget projects a \$16 billion budget deficit; although this could reach as high as \$25 billion if oil prices and production remain at March 2009 levels.
- The Ministry of Finance had approximately \$38 billion in fiscal reserves at the end of 2008. Nonetheless, the Finance Minister announced that he may introduce a rescission ("negative supplemental") in spring 2009 that would reduce government expenditures if oil price and export levels remain low.
- **The fiscal bite of a rescission reducing government spending would occur in the lead up to national elections, with a negative impact on incumbents.**

**Oil Sector Issues:** The oil sector will continue to dominate the Iraqi economy over the next three years.

- In 2008, Iraq produced 2.4 mbpd, a 14% increase over 2007 production. The increase in northern production, however, accounted for all of the production gains.
- The 2009 budget targets oil export levels of 2 mbpd (10% increase over the 2008 average) based on production levels of 2.5 mbpd. **However, we expect crude production to actually fall in 2009 because of natural declines in fields, poor reservoir management, and an absence of new projects.** Export volumes for November, December, January, and February have been 1.89, 1.73, 1.91, and 1.68 mbpd respectively.

- Under the right conditions, international companies are interested in investing in Iraq and are likely to participate in upcoming licensing rounds. At the same time the GOI is undertaking measures to produce short-term improvements. **Yet any steps taken in 2009 to offset decline will not produce significant output increases for two to three years.**

**Fiscal Vulnerabilities and Future Spending Cuts:** In 2010 and 2011, Iraq will likely only have a small amount of fiscal reserves remaining to finance potential budget deficits. **If current export volumes and price hold for 2010, oil export revenue (estimated \$25 billion) will be sufficient to cover only salaries, pensions, and food subsidies. Additional financing, which may be difficult to obtain, will be needed to fund capital investment, military modernization, and other critical needs.**

- Iraq could address the tighter fiscal envelope through a combination of reducing security and capital expenditures and issuing Treasury bills. Such a strategy would help avoid cutting salaries, pensions, SOE employment or food subsidies.
- Maintaining security expenditures at 2008 levels in 2010 and 2011 would cover salaries and goods, services, and maintenances for security forces at 2009 levels, but not allow for any force modernization expenditures.
- The Ministry of Finance plans to expand the Treasury bill market to finance a portion of these deficits, but Iraq's rather undeveloped markets cannot likely sustain more than \$5-7 billion of domestic debt. The current global environment and risk of Iraq's debt may jeopardize any international debt offerings in the next few years.
- Since 2005, Iraq's government payroll has roughly doubled while private sector employment has dropped. Adequate coverage of social payments will be a factor in continued stability.

**Monetary Policy:** Maintaining low inflation rates and relatively stable exchange rates are key policy goals that improve the lives of Iraq's poor and foster a stable environment in Iraq that is conducive to investment and growth. **Any move to use monetary reserves to fund the budget - illegal under the Central Bank Law but politically attractive for some actors - risks stoking inflation, undercutting confidence in the Iraqi Dinar, and threatening the future stability of the economy.**

**International Engagement Anchoring Reform Programs:** Under the International Compact with Iraq (ICI), the GOI agreed to carry out a comprehensive package of economic reforms aimed at strengthening the private sector and achieving economic self-sufficiency by 2012.

**Multilateral and bilateral assistance mechanisms to date have provided a strong foundation for further progress, but Iraq must take responsibility for continuing the reform agenda.**

- Iraq completed its most recent Stand-By Arrangement with the International Monetary Fund in March 2009, which, aided by the Paris Club debt deal, had provided an important anchor for Iraq's economic reform agenda. **A new Fund program would provide an external anchor for unpopular fiscal and monetary policies necessary to maintain macroeconomic stability. The Iraqis have told us that they would like to continue to work with the Fund, but have not committed to pursuing a new program.**

- Iraq has received almost \$75 billion in debt forgiveness from the Paris Club and bilateral creditors. The GOI still has to finalize agreements with several large creditors, primarily from the Gulf. Another significant category of liabilities for Iraq is litigation filed on behalf of U.S. victims of the Saddam regime. Legal immunities for Iraqi assets provided by the UN Security Council expire December 31, 2009. Achieving debt reductions and settling the victims' claims will improve GOI standing in global credit markets.
- With funding from the International Reconstruction Fund Facility for Iraq (IRFFI, international donor mechanism), the World Bank and UN are promoting important private sector, public financial management, and banking sector reforms. The World Bank needs a more senior, larger, and better organized presence in country to ramp up needed technical assistance, oversee new projects as Iraq now has more incentive to borrow, close-out the IRFFI World Bank Iraq Trust Fund, and streamline and coordinate donor activities with the government.
- The bilateral U.S.-Iraq Dialogue on Economic Cooperation and Joint Coordination Committee for Economic Affairs formed under the new Strategic Framework Agreement are also pressing for further capacity building and economic reforms.
- Iraq is currently working on its accession package to the World Trade Organization. WTO membership is unlikely to take place in the near future, but Iraq can improve its economic opportunities through strengthening regional trade ties and boosting international investment.

**Structural Reform Efforts:** Over the medium term, Iraq will need to implement many necessary structural reforms to maintain high growth rates, lower unemployment, reduce budget inefficiencies, and diversify its economy.

- *Hydrocarbons:* Getting international companies to invest in Iraq's oil sector is crucial for expanding output over the medium term. The GOI and the KRG have been at an impasse over oil sector policy since 2006 when work began on a multifaceted Hydrocarbons Law that would also reorganize the oil sector. At issue are fundamental questions of GOI control and KRG autonomy that will require political resolution.
- *Electricity:* Iraq needs to charge tariffs for electricity services to limit rampant demand growth and have enough power available for optimal oil sector utilization and business sector development (an even greater constraint than security, according to WB officials). The Ministry of Electricity is signing multiple contracts to increase production to meet total national demand, but the lack of retail tariffs limits financing options and encourages waste, while degraded transmission and distribution networks limit delivery.
- *Food Subsidy Reform:* Targeting subsidies to the poor will free up budget resources and reduce corruption by enabling the GOI to end the blanket food subsidy program. Iraq imports about 70% of its food and has the world's largest food aid and distribution program (Public Distribution System, PDS), which costs \$3.6 billion per year.
- *Streamlining Regulations:* Foreign direct investment is crucial for job creation and private sector development in Iraq. However, Iraq ranked near the bottom of the World Bank's Doing Business Indicators because of its byzantine regulatory obstacles. The GOI is not taking steps necessary to build competent business assistance institutions and has a poorly designed, ill-coordinated regulatory and business oversight framework.

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- *State-owned Enterprises:* Iraq should restart operations in the limited number of SOEs that show commercial potential and bring in private investment and management to help prepare these companies for eventual privatization. The myriad other SOEs that are completely unequipped but that still pay thousands of workers salaries need to be closed down when the appropriate political moment allows for such measures and when the private sector is capable of absorbing these people into the workforce.
- *Agriculture:* Government imports of foreign produce for the food basket and the price distortions from the PDS subsidies have wrought havoc on Iraq's agriculture sector. Iraq needs to transition to a market driven agricultural sector that will boost employment and production as these subsidies are removed.