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FROM:

ME/NA Economic Adviser
Economic Policy Department

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cc: Mr Fry
Mr Arthur
Mr Chaplin
Mr Archer, NENAD
Mr Butler, EcPol
Ms Tanfield, MED
MED
MENARG
Mr Hetherington, MENARG
HMA Amman

Mr Gray, MED

IRAQ: ECONOMIC ISSUES RAISED BY MILITARY ACTION AND REGIME
CHANGE

Summary

1. Military action will have a variety of immediate economic consequences and raise some policy issues, notably protecting Jordan and planning for refugee movements.
2. Regime change will open the way to far-reaching economic changes in the longer term. There is real danger of a policy vacuum later if the West does not prepare in advance: it would be sensible to get the IBRD and IMF working on the issues.
3. If we're not already doing so we ought to be engaging the US on these issues.

Detail

4. I attach a brief assessment, drawing on a variety of earlier minutes, of the economic problems and challenges which successful military action will throw up. The immediate ones are the direct consequence of military action; the longer-term ones would have surfaced in due course anyway, but regime change precipitated by military action will bring them forward.

5. My main conclusions are that:

- if we and the US do not want to take the risk of an economic convulsion in Jordan occasioned by military action we will need to ensure that a properly designed safety net is in place in good time;

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- If we want to minimise the economic hardships of ordinary Iraqis, in GoI territory and in the North, we should work to keep the food and medicine parts of the distribution plan going as long as possible but also plan for emergency relief/creation of a successor mechanism once the fighting is over;
- to increase the chances of a new regime and its friends hitting the ground running on economic issues we should get the IMF and World Bank involved in assessment of Iraq's economy sooner rather than later.

6. I'm not sure to what extent these ideas are in play anyway. Since returning from leave I have seen nothing of substance to suggest that the issues are being fully addressed here or in Washington. We ought to be talking to the US about them.

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REGIONAL ECONOMIC CONSEQUENCES OF MILITARY ACTION AGAINST IRAQ

Short term consequences: overview

1. Military action itself - and the build-up to it - will have potentially important economic consequences not just in the region but further afield. Oil price changes and uncertainty will affect the global economy: there has been recent minuting on the former. Additional military spending will have budgetary implications in the US and other countries involved. What follows covers only the regional consequences.

2. Clearly the effects are likely to be most profound in **GoI-controlled Iraq** itself. There may be some combination of loss of oil revenues; dislocation/suspension of the distribution plans under oil for food; damage to economic infrastructure, economic administration and public services; and new refugee outflows.

3. There are likely to be economic consequences across the region:

- (a) uncertainty and the possible loss of Iraq production will affect **oil prices**. Regional oil exporters will benefit, importers [including Jordan, Lebanon and Israel] lose from a rise in prices. Even if the effects are short-lived they could contribute to financial pressures in vulnerable oil importers, especially Lebanon [] and Jordan;
- (b) the **political, social reaction and business reaction** to military action could of course have economic consequences. Confidence among businessmen and foreign investors is likely to be at least temporarily dented by the extra uncertainty, even if the political and social reaction is modest; foreign investment could be put on hold. With a more serious reaction confidence could plummet, with some capital flight likely. In a handful of cases vulnerable exchange rates could come under pressure: Jordan is the biggest worry, Lebanon of course the most likely to get into trouble.

The reaction in the Gulf could be particularly important to the oil market. Under normal circumstances the Saudi authorities and their Gulf allies would use their spare production capacity to try to head off an excessive rise in oil prices. If they felt inhibited by public opinion from doing this there could be a period of exceptionally high prices.

4. On top of these region-wide effects there will be some more direct, localised effects of military action on neighbours:

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- (a) there could be substantial **refugee flows**. Jordan, Iran and Northern Iraq are perhaps the most likely destinations; the Iranians and Jordanians at least are visibly concerned at the prospect.
- (b) the disruption of oil and other bilateral trade will hit Iraq's immediate neighbours. **Jordan's** economy is particularly vulnerable to dislocation of the trade and oil protocol, whether instigated by the GoI or forced by military action. **Syria** would suffer from any loss of the pipeline oil [sympathy limited. since it's illegal anyway] and from a reduction in recently buoyant bilateral trade, the **Northern Iraq** authorities from any reduction in revenues associated with transit trade.
- (c) **Northern Iraq** will also be affected by any dislocation/suspension of the distribution plans under oil for food.

Short term consequences: priorities and policy issues

5. **Priorities.** The most serious worry - because of its potential political consequences - seems to me to be the overall risk to Jordan. Economic activity and the balance of payments are both quite heavily dependent on oil and trade arrangements with Iraq, and the balance of payments will worsen further with higher oil prices; in addition Jordan could face a humanitarian emergency - and extra pressure on spending - caused by substantial refugee flows; and of course must run a significant risk of a strong popular reaction to military action.

6. Without some sort of safety net the combination of falling confidence, disrupted production, a weakening balance of payments, and new spending on refugees could easily throw the budget well off course and precipitate intense pressure on the fixed exchange rate. A sizeable fall in the exchange rate would push prices up and hit living standards across the board. Poverty and unemployment, both already high, would go up further, exacerbating social and political tensions.

7. Although there may not be the same type of political risk, potential humanitarian problems must also be a priority:

- (b) any dislocation of the distribution plans in GoI-controlled and Kurdish Iraq carries the real risk of food shortages, possibly compounded in GoI territory by deliberate withholding of food for propaganda purposes;
- (c) refugee flows to Iran and Northern Iraq could cause acute local problems.

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7. **Policy issues.** If we and the US do not want to take the risk of an economic convulsion in Jordan we will need to ensure that a properly designed **safety net** is in place in good time - probably before any sizeable military build up becomes apparent. It would have to be funded bilaterally rather than through multilateral institutions like the IMF and World Bank. The precise design is for discussion, but might include such elements as:

- quick-disbursing grants, with triggers agreed in advance, to compensate for the direct cost to Jordan of disruption of the oil and trade protocols [the idea being so far as possible to preserve the status quo];
- assistance with physical arrangements for alternative oil supplies;
- flexible, quick-disbursing arrangements for helping any refugees from Iraq [perhaps as part of a wider package covering other refugee destinations]; and
- an agreed mechanism - eg a quick-disbursing line of credit - for protecting the Jordanian currency.

8. If we want to minimise the economic hardships of ordinary Iraqis, in GoI territory and in the North, we should presumably both

- (a) do everything possible to keep at least the food and medicine parts of the distribution plan going as long as possible; and
- (b) have work in hand for emergency relief/creation of a successor mechanism once the fighting is over - or indeed earlier in Northern Iraq and liberated parts of GoI Iraq.

The longer term: after regime change

9. An enormous task of reconstruction and economic and financial normalisation lies ahead. For all Iraq's oil wealth it will take many years before the country can get back to levels of prosperity seen in the 1980s. The Iraqis will need help through - and Western countries will want to protect their interest during - a tough transitional period.

10. Help will be needed on many fronts. Immediate humanitarian problems may be the first priority. Beyond that there will be a huge job of reforming Iraqi economic policies and institutions: dismantling Baath Party economic control and corruption and replacing it with competent, transparent market-oriented management will probably be akin to

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dismantling Communist Party control in Central and Eastern Europe. A strategy for reconstruction and long-term development will have to be worked out.

11. Whilst the West will want to help, there are important Western interests to be protected. One is the servicing of **external debt**, neglected now for many years by the Iraqis. Normalisation of debt service, no doubt underpinned by rescheduling [forgiveness looks unlikely] will be essential before normal Iraqi access to the IMF and IBRD can be agreed. The other is the continuation of UNCC **compensation payments**, at present facilitated by sanctions arrangements.

12. Gearing up a comprehensive Western posture on these economic issues will take time. Even if some of the key policy issues could be addressed quite quickly, there is a desperate shortage of available information on Iraq's economy which will delay assessment of both the financial position and the requirements for institutional change/technical assistance. Unless serious preparatory work is put in hand many months before regime change occurs there is likely to be a serious and politically embarrassing hiatus.

13. There is one obvious thing that could be done now: to **get the IMF and World Bank involved** in assessment of Iraq's economy sooner rather than later. It might not be appropriate for them to open a dialogue with the present Iraqi authorities, but they could do a lot at arm's length. Neither institution, so far as I know, has done any substantive work for many years; but with the right push from the top they could no doubt put together in a matter of months some serious assessments and policy advice. These would at least mean that an incoming new regime, and its friends abroad, would not be flying completely blind on economic matters, and they would set the scene for intensive policy discussions with both institutions. My own contacts have indicated that the Bank at least would welcome an approach from the UK or other senior Board member.