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From the Principal Private Secretary

24 February 2003

*Dear Mark,***IRAQ: RECONSTRUCTION**

I attach a paper prepared by the No.10 Policy Directorate. The Prime Minister would like to feed this into the US Administration as soon as possible. Could I therefore have any comments from you and copy recipients by close of play tomorrow.

I am copying this to Simon McDonald (FCO), Erica Zimmer (DTI), Anna Bewes (DFID) and (CO).

Yours Sincerely,

pp JEREMY HEYWOOD

Mark Bowman
HM Treasury

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FINANCING THE RECONSTRUCTION OF IRAQ

Summary

1. There are various estimates circulating about the cost of reconstruction and nation building in Iraq. Depending on the assumptions made, it is believed that between \$30 billion and \$105 billion will be required for the task. These figures exclude the direct costs of a conflict and also that of peacekeeping afterwards.
2. The UK Government's resources are under pressure. Expanding trade and fiscal deficits limits the extent to which the Exchequer can respond to Iraqi rebuilding needs.
3. US finances are severely strained. The Budget reforms proposed by President Bush to Congress are considered by many commentators to be close to the limits of what is fiscally possible. It is not clear that Congress will allow all the tax cuts he wishes. In such an environment, The Administration might find it very difficult to raise additional money for the purposes of nation building.
4. In the present environment aid from the EU is expected to be minuscule. I understand that around ten million euro out of a two hundred million euro

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reserve can be rapidly mobilised. Individual amounts from other countries are also likely to be small in the context of the task at hand.

5. The Arab world's finances are not in as healthy a state as they were in 1990. The terms and conditions associated with any financial help that they might make available would need to be examined with care.
6. It may take many months and, in the worst case, two or more years for oil production to be first restored and then output raised to a level closer to what is believed to be the long-run potential of the Iraqi oil fields.
7. The markets can meet the financing gap as well as the expected reconstruction costs. Iraq's future oil production may be used as security to raise money for rebuilding. In the first instance, this would be done by way of bank credit lines but a better large-scale systematic approach would be to issue oil-backed bonds. The security markets are easily able to provide the funds required.
8. However, the markets would require to know who stood behind the debts? If they were to be issued in the name of an Anglo-American occupying force then the liabilities would clearly have to be booked as those of the United States and Great Britain. In view of the financial constraints already pointed out, this is not a tenable solution. It might also invite litigation from other claimants who would question the right of such an administration to pledge future Iraqi oil production in this manner.
9. In the absence of any international cover, oil sales, even if used exclusively for the purposes of aiding the Iraqi people, are likely to be wilfully

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misinterpreted by our opponents as 'theft'. This means increased resistance to any US/UK occupation as well as inciting out of theatre terrorist activity.

10. The holder of a UN mandate would have little difficulty tapping the markets on behalf of the Iraqi people. They would find it straightforward to obtain aid from multilateral agencies such as the IMF and the World Bank. Friendly Arab governments would also find it easier to endorse and explain our actions to their citizens helping reduce any local discontent.

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Conclusion

Legitimacy, preferably established before but certainly in place after any conflict would allow both the financial markets and the multilateral lending organisations to bridge what appears to be a very large financing gap.

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COSTS OF RECONSTRUCTION

Regional Economic Profile

COUNTRY	POPULATION (M)	GDP US\$ BILLIONS
IRAQ	22.3	15*
IRAN	68.2	82
TURKEY	67.6	148
SAUDI ARABIA	21	176
ISRAEL	6.2	110
KUWAIT	2.1	42.3

Source: International Institute of Strategic Studies 2002-2003

* This estimate appears to us to be on the low side but may reflect oil revenue leakage.

Reconstruction costs may be estimated by reference to a 1991 report to the United Nations on restoring Iraq's infrastructure back to its pre-war condition. It was then suggested that it would take \$22 billion in 1991 prices to achieve this end. Expressing this in 2002 prices and taking into account further deterioration in Iraq's economy as well as assuming a short war suggests that US \$28-\$30 billion would be a reasonable estimate of reconstruction costs today.

Calculations by the World Bank, based on the known costs of rebuilding in Lebanon, East Timor and Bosnia suggests that around \$1000 a person would be needed. This implies a total requirement of around \$24 billion.

An alternative, econometrically-based, approach is to note that oil sensitive economies have a capital output ratio that is different from that of more developed nations or other developing countries. This reflects the capital

intensity of oil production. If Iraq were to attain a per capita GDP equal say to Egypt or Iran, and furthermore if one half of the capital stock required to be replaced, this would imply rebuilding needs of about \$1200 per capita or a total of \$28 billion.

A more ambitious proposal would be to have a 'Marshall Plan' for Iraq. The goal here would be to engage in a comprehensive rebuilding programme. This would establish the basis for a sustainable rise in living standards thus producing a showcase for democratic Arab development; along the lines of what the Americans achieved in Germany and Japan following the Second World War. One calculation suggests that, using the original Marshall Plan as a template, the required amount of assistance today would come to about \$2000 per person spread over four years. This suggests that a total of between US\$50 and \$60 billion would be needed.

If one also takes into account the regime's outstanding liabilities to other countries, including the possibility of extensive litigation for damages (this is to be considered later in the document) then the total amount readily balloons to over \$100 billion.

The state of UK public finances

The Treasury projects a public sector net borrowing requirement for the financial year 2003-4 of £24 billion. In view of the fiscal pressures it would be unwise to assume that the UK is in a position to engage in any of the financial heavy lifting associated with Iraq.

US finances in trouble

In the coming year the United States' federal deficit is expected to be around 4.5% of GDP. Furthermore, if the fiscal stimulus package that the President has proposed is materially enacted then there is the danger that 2004 could see this figure balloon to nearly 5.5% of US GDP.

In 2002, according to the information collected by Consensus Forecasts, the US ran a current account deficit of \$498 billion. This figure is 50 per cent greater than the United States defence budget. It is also growing at an alarming rate.

A contentious budget, a large and growing fiscal deficit matched by the huge current account problem, together with a falling dollar, makes it difficult for the United States to take on large additional funding responsibilities.

Other aid

The war, though not the reconstruction costs, of the first Persian Gulf conflict were picked up by the Allies. However, if a similar war were to be undertaken today, with neither UN sanction nor broad international support, then material help is unlikely.

The EU aid budget for humanitarian relief is about 200m euros in size. However, it is mostly committed and only about 10m euros can be readily mobilised. To this might be added small amounts from individual countries given for humanitarian purposes.

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The United Nations could also be tapped for additional relief money but the sums are likely to be small, especially as the organisation is financially stretched.

Other claims on Iraq

At the end of the first quarter of 2002 there were an estimated \$78 billion of business claims against Iraq (source: Wall Street Journal). Of this, only \$3.6 billion is believed to have been settled. The claims against Iraq made after the 1991 war total over \$300 billion. The quality of these figures is difficult to establish and there are a number of them, especially the damage claims, that are sure to be reduced in the context of legitimate negotiation. Some of the business claims refer to deals signed with Russia, China and France. These countries have between them negotiated \$40 billion worth of development contracts that together, it is claimed, would increase Iraq's output by an additional five million barrels a day. It should be noted that the companies involved have done little work so far and it is suspected that the contracts have been set on excessively favourable terms, probably for non-commercial reasons. A legitimate Iraqi entity would almost certainly seek to renegotiate these deals.

At the present time, Iraq produces a little under 1.8 million barrels a day of crude oil. It is thought that even if wellheads are captured intact, the deterioration that has occurred in the country's oil's infrastructure means that it would take between 9 and 18 months to raise output to over 3 million barrels a day. This level of output would generate a revenue of around \$25 billion a year assuming that oil traded in line with forward market expectations of \$22 per barrel.

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The country's reserves are such that oil company projections indicate that Iraq is capable of pumping as much as 6 to 7 million barrels per day if required.

However, in order to achieve this level of output political as well as financial costs would need to be incurred. Soundings in the oil markets indicate that other OPEC countries would be most unlikely to countenance an increase in Iraq's quota to much above the 3 million barrels per day level. It should be noted that Iran's present quota is 3.2 million barrels per day and it is difficult to conceive of that country agreeing to an allowance for Iraq that exceeded its own allotment. To achieve full output, Iraq would have to withdraw from OPEC and that would have a profoundly destabilising impact not just on a number of the surrounding nations but much further afield. Russia for example is likely to be very alarmed at such a development.

Assuming that the forward market is right about future oil prices and working upon the assumption that Iraq's quota will match that of Iran then, along with a minor degree of leakage (cheating) output may easily be sustained at three and a half million barrels per day. This is equivalent to annual revenues of around \$28 billion. A significant portion of this money would be available for investment purposes so long as the contracts required to produce the oil were not too onerous (for example the French, Chinese and Russian contracts would need to be carefully re-examined).

The role of markets

It is clear from the foregoing that, once oil output has been properly restored then the funds exist to finance reconstruction. Assuming that the money is spent wisely and not frittered away on domestic subsidies (the Iraqi economy presently

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runs a complex system of subsidies) or used to pay for military expenditure, peacekeeping duties or international damages, then a thorough going Marshall-type programme can be domestically funded.

The problem lies in the financing needed in the first few years in order both to repair the oil infrastructure and to kickstart civil reconstruction. While the money for this is unlikely to be found in national treasuries, the financial markets are readily able to provide it.

In the first instance bank loans followed later by sovereign bond issuance, all secured against future oil revenues, should readily be able to raise the funds estimated to be needed at the beginning of this note.

The importance of legitimacy

Banks and bondholders require security for their loans. It is a moot question how legal it would be for any administration that lacked the blessing of the United Nations to use Iraq's oil wealth to finance reconstruction. The financial markets would almost certainly insist that the liability for repayment rested with the occupying power. Bearing in mind the state of national accounts, this is not a palatable solution. Furthermore it is entirely likely that there would be legal challenges to the validity of any such arrangement.

However an UN-endorsed mandate would be free of these hindrances. An administration cloaked in the mantle of legitimacy provided by the UN would be free to engage with the financial markets in order to secure funding for Iraq's long-term future. Such an administration would also find it easy to tap the

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finance and expertise of multilateral organisations such as the World Bank and the IMF. The countries concerned would not have to strain their national balance sheets in order to provide the money required to re-build Iraq.

Conclusion

If Iraq is to be reconstructed in a manner that turns that nation from being a foe into a staunch ally, then a large-scale Marshall-type reconstruction programme maybe required. The US or the UK cannot readily fund such a programme. It can however be managed by way of a borrowing/bond issuance programme secured against future oil revenues. However, such a scheme demands that the administering agent be seen as wholly legitimate and acting in the long-term interests of the Iraqi people as well as the global community. In this context, UN blessing is of great financial advantage.

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