CIG Assessment, 22 May 2009

IRAQ: IMPACT OF THE FALLING OIL PRICE

This paper was discussed by a Current Intelligence Group and approved on 22 May 2009.

Key Judgements

I. The Iraqi government's revenues will be at least halved in 2009 if oil prices remain at current levels, sending its fiscal account into deficit. Iraq's reserves are probably sufficient to see Prime Minister Maliki through to the 2010 election. But they are likely to be close to exhaustion within 18 months unless the oil price recovers.

II. The Ministry of Defence is short of money for many of the Iraqi Security Forces' basic needs [...] Modernisation plans are slowing. The ISF will continue to lack the capability to manage internal security independently or face external threats until oil prices have recovered significantly, and the MoD's budget has been restored.

III. Budgetary problems and political pressure have the potential to derail the integration of the Sons of Iraq. This is unlikely in 2009, but would be likely to increase friction between the Sunni population and the Shia-dominated government and could encourage SoIs to return to insurgency. Widespread mishandling of the SoIs would represent a serious threat to Iraq's stability.

IV. Most senior politicians are not yet ready to compromise on the reform of the oil sector, despite the lower oil price. National hydrocarbons legislation will not be forthcoming in 2009, because there is insufficient time and political energy in an election year. After that, the prospects for a deal are likely to increase.

V. The main constraint on Iraq's ability to improve its infrastructure is not the size of its budget but its limited ability to spend it, a result of corruption, bureaucracy and an antiquated banking system. The current oil price is therefore unlikely to have a significant impact on infrastructure in 2009: most Iraqis are unlikely to notice any difference in their standard of living. The real impact is likely to come later.

VI. If the oil price remains at its current level, there is likely to be a severe crunch in 2010: the government will then need to reconsider its current as well as its capital expenditure, including the possibility of public sector or wage cuts. Improved access to basic services, major reconstruction and the modernisation of the ISF will be further delayed.

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At the request of FCO we look at the effects of falling oil prices on Iraq's economy, and the political and security outlook in the light of its reduced budget for 2009.

An economy dominated by black gold

1. Iraq has the world's third largest proven oil reserves, about two-thirds of which are concentrated in the south around Basra. Lack of diversification is a key vulnerability: Iraq's economy is dominated by the petroleum sector - oil contributes over 90% of government revenues, which benefited significantly from unusually high oil prices in 2008. Prices have declined considerably since then. We judge that oil production and exports are likely to decline slightly over the next two years as US investment falls and international oil companies wait for a proper legal framework for their activities. Ageing infrastructure means that production in Southern oil fields may even decrease; recent improvements to Northern field production are unlikely to compensate for the decline in the South. There is almost no official taxation of private sector activity, which in any case accounts for only around a fifth of Iraq's economy.

2. The impact on government revenues in 2009 will be dramatic if oil prices remain at current levels: most independent forecasts suggest that they will be at least halved, more than reversing 2008's gains. They also predict that the fiscal account will decline from a surplus in 2008 to a deficit of $22bn (26% of GDP) in 2009. The Iraqi Council of Representatives (CoR) has made sharp cuts in its 2009 budget, basing it on an oil price of $50 per barrel and an assumption that Iraq will export 2m barrels per day (bpd). We judge that this is over-optimistic: in January 2009 exports stood at 1.89m bpd at $37 per barrel, falling to 1.7m bpd in February. Although some economic forecasts suggest that prices could recover in 2010 in the light of a global recovery, we judge it remains possible that prices will fall further. Unless the oil price remains above $50 per barrel, Iraq's budget deficit will be bigger than planned.

The government's options

3. Most of the cuts agreed by the CoR affect Iraq's spending on capital projects; current expenditure has been largely protected. We judge that the government will continue to seek to avoid cuts in current spending and will therefore need to consider other options to make up the deficit. There are a number of possibilities: […]

Impact on Iraqi Security Forces

4. […] in February the Finance Ministry temporarily froze recruitment. The MoD is also planning to cut weapons training and the purchase of replacement uniforms and non-essential supplies. Modernisation plans are slowing, though the MoD is trying to reduce the impact of this by signing agreements to purchase cheaper military hardware from a number of countries, including a weapons-for-oil deal with South Korea.

5. We judge that cuts in MoD expenditure will not bring a decline in capability this year. But there will be no significant improvements in 2009 […] We judge that the ISF will continue to lack the capability to manage internal security independently or to face external threats until oil prices have recovered

significantly and the MoD's budget has been restored. Iraq's aspirations for its Air Force and Navy will remain out of reach.

6. The Ministry of Interior (MoI) has less potential to make cuts in capital expenditure to mitigate any shortfall in its budget. We judge that the government will have no choice but to make up any shortfall in salaries, drawing on its reserves if necessary. But improvements to the police's capability will be deferred, delaying the transfer of internal security from the army to the police yet further.

Sons of Iraq

7. We judge that Maliki understands the risk of increasing resentment towards the government from the Sons of Iraq (SoIs) over problems with payment of salaries and slow integration into the security forces. […] While unlikely in 2009, we judge that budgetary problems and political pressure have the potential to derail the integration programme. This would be likely to increase friction between the Sunni population and the Shia dominated government, and could encourage SoIs to return to insurgency. We continue to judge that sustained, widespread mishandling of the SoIs would represent a serious threat to Iraq's stability.

Hydrocarbon legislation

8. The GoI and the Kurdish Regional Government (KRG) have failed since 2005 to agree on hydrocarbons legislation or secure substantial foreign investment in Iraq's oil fields. This has been an important factor in preventing Iraq from increasing oil production and export. Spurred by the low oil price, Kurds and Arabs participated in a symposium that recommended overhauling the oil industry and urgently passing a hydrocarbons law. But senior politicians on both sides are not yet ready to compromise. We judge that national hydrocarbons legislation will not be passed in 2009: there is insufficient time and political energy in an election year. Thereafter, a deal on oil is the most likely area for compromise among the issues dividing Arabs and Kurds.

9. In the meantime, Iraq is likely to sign several development contracts with foreign oil firms, in some cases reviving deals reached before the overthrow of Saddam's regime (in September 2008 the China National Petroleum Corporation was re-awarded a contract to develop the Al Ahdab field). […] But we judge that some deals are likely to be hampered by Iraqi distrust of foreign investment and a lack of capacity in the Oil Ministry. We judge that it will be 18 months before development initiatives show dividends, and even then the rewards are likely to be marginal.

Outlook

10. We judge that the main constraint on Iraq's ability to improve its infrastructure is not the size of its budget but its limited ability to spend it: a result of corruption, bureaucracy and an antiquated banking system. The current oil price is therefore unlikely to have a significant impact on infrastructure in 2009: most Iraqis will not notice any difference in their standard of living, but expectations of improvements in basic services will be disappointed. The real impact of the current budgetary crisis is likely to come later, as improved access to basic services, major reconstruction and the modernisation of the ISF are further delayed. If oil prices remain at current levels, there is likely to be a severe crunch in 2010: the government will then need to reconsider its current as well as its capital expenditure, including the possibility of public sector job or wage cuts.