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Iraq – Summer 2004 Economic Overview

Overview

Significant progress over the summer towards agreeing IMF programme and on debt processes. 2004 and draft 2005 budgets - as well as outline of "Letter of Intent" agreed with IMF. Medium-term fiscal framework still being developed, with DFID assistance. Oil production below target – but revenues higher than expected due to high price. Electricity situation improving slowly, although reducing demand into the autumn should provide a breathing space for further maintenance. Gaps in food pipeline of potential concern.

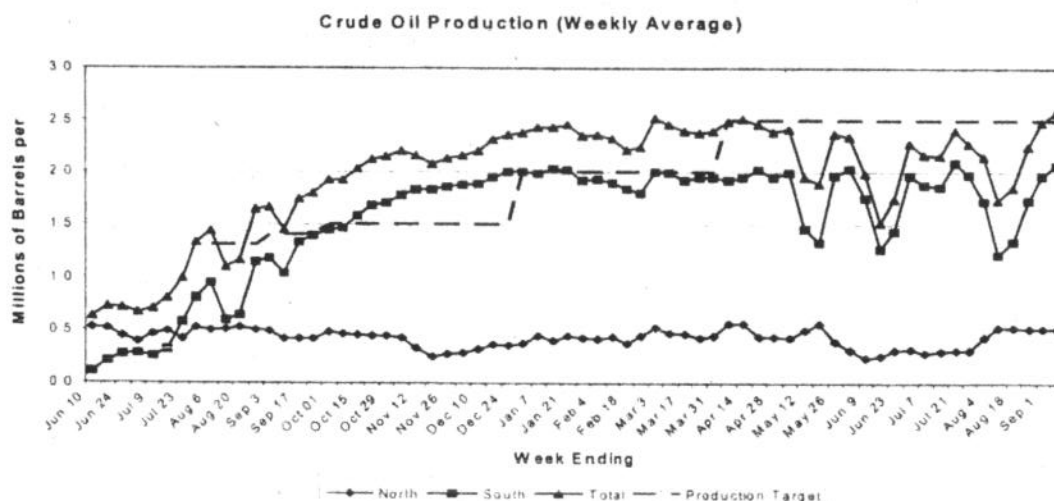
Tokyo conference will give Iraqi's an opportunity to showcase their National Development Strategy, and provide an opportunity to discuss Trust Fund progress and evaluation. DFID Macroeconomic Programme progressing on the ground.

Detail

Oil and Essential Services

Oil production is below target. But high prices should result in a significant (\$6bn) surplus for the Iraqi budget in 2004.

As the chart below shows, the crude oil production target of 2.5 million barrels per day has not been achieved (although 2.6 million barrels were pumped on 31 August). This is mainly due to security, which shows as heightened production volatility (particularly in the South) towards the end of the chart.

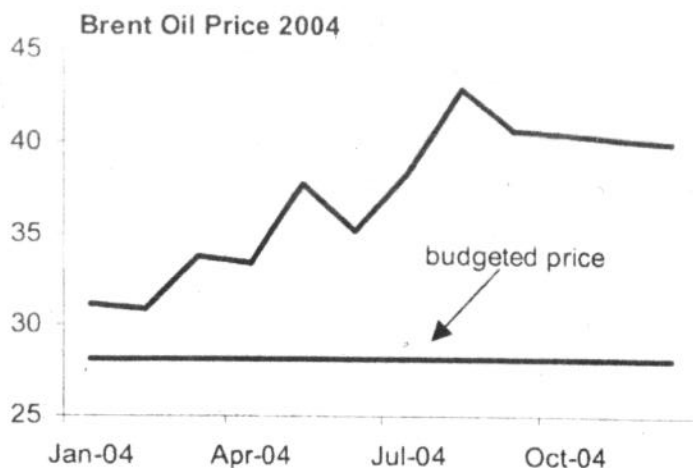


That said, oil prices are well above the budgeted level of \$22 per barrel¹. The chart below shows Brent prices from Jan 04 to Aug 04, and the futures curve for Sep 04 to year-end. Using these prices/ futures, and a discount of \$6.15 per barrel from Brent we estimate that Iraq will have a surplus of around \$6bn to carry forward into the 2005 budget.

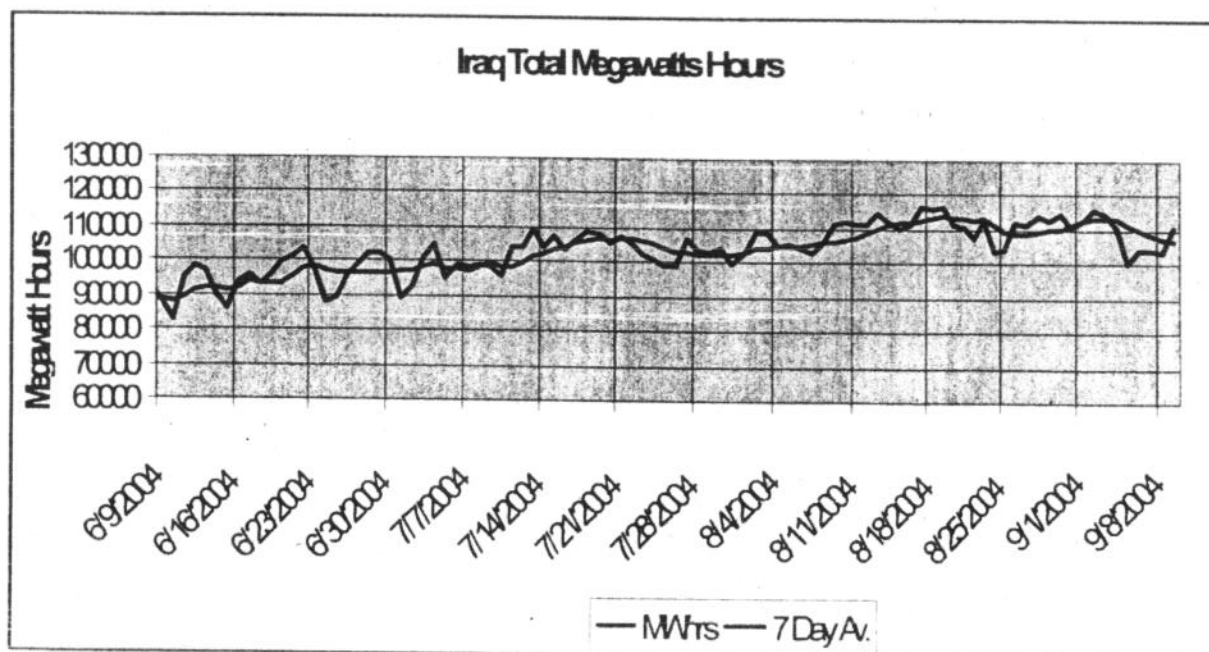
¹ (\$22 per barrel for Iraqi oil and hence around \$28.15 for Brent)

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The picture on **electricity** is also fairly positive. The chart below shows electricity production over the summer. **The overall trend is slowly rising production despite setbacks.** US embassy data suggest that the vast majority of Iraq, including Baghdad and Basra, is now accessing power for between 8 and 16 hours per day. And this should rise into the autumn as the peak summer demand drops off. Perhaps the good news for the long-term is that average plants are still generating only about 42% of their designed capacity. Accessing this capacity will be crucial for continued progress.

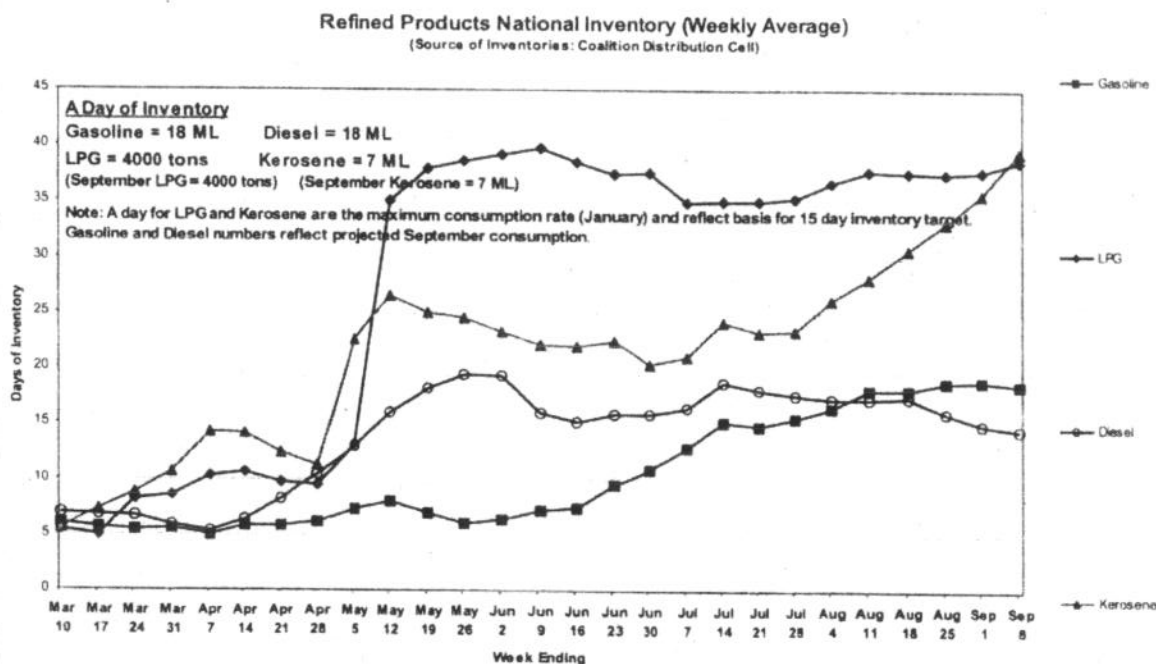


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Perhaps of more concern is the picture on **food**. A large proportion of the Iraqi population are dependent on the food basket. But there are concerns about shortages in the current pipeline for some goods – specifically cooking oil, milk, infant formula, soap and detergent. It is also clear that the Ministry of Trade is no longer working with the World Food Programme to develop the food pipeline. All this said, there have been several times over the past year when false alarms have been raised over the food basket running out. DFID Baghdad and the Embassy are following up.

The fuel situation is improving. Stocks, especially of LPG and kerosene the primary cooking fuels for the poor, have risen significantly since the spring. Reserves of diesel and petrol are still below target, but for diesel there may be scope for substituting Kerosene if necessary.



2005 Budget, IMF programme, Debt and Financial issues

Progress continues with finalising the 2005 budget, agreeing an IMF programme and a Paris Club debt deal.

2005 Budget - No details are yet available to us on the draft 2005 budget figures. In recent discussions with the Baghdad Embassy the Finance Minister said total expenditure would be "less than in 2004, but above the figure in the original 2004 Budget". This gives an envelope of between \$19.5bn and \$22.5bn. However, subsequent figures suggest spending of up to \$26bn. The aim is to finalise the budget by 10th October, as required in the Financial Management Law.

IMF Programme - Discussions with the IMF early in September agreed basic provisional budget numbers for 04 and 05, and also the key terms of a letter of intent – including a reduction in fuel price subsidies. Work remains on developing a medium term fiscal framework and finalising the 2005 budget numbers. Delays in finalising the 2005 budget numbers may not necessarily

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hold up agreement of an IMF programme, as the IMF could reach agreement on an emergency post conflict arrangement (EPCA) based on a provisional assessment of the fiscal numbers for 2005. But, if this happens, 2005 budget approval (in line with the numbers in the EPCA) may be a prior condition for disbursement.

Debt – A roadshow over the summer by Shabibi (Central Bank Governor) and Azez (Deputy Finance Minister) introduced Iraq's two key arguments for debt forgiveness. In brief they were that 1) Costs of instability in Iraq if there were no debt relief would be higher than providing debt relief, and 2) Creditor countries would gain more from exports to a stable, financially secure Iraq than from claiming debt service. The Paris Club had a special session to discuss Iraq in Paris on 9th and 10th, and Iraq will be formally discussed at the Paris Club in October. Iraqi debt is currently trading at around 26 pence in the pound – implying relatively high private sector expectations of Iraqi repayment.

Monetary Policy and Financial Markets

The exchange rate has remained remarkably stable, at ID 1460 to the dollar since mid-June; demand at recent auctions has regularly been above USD 20 mn, and while this still allows a small level of reserve build, the CBI may need to consider a small rate movement later this year;

Treasury bill auctions have been running fortnightly since 18 July; but the dominance of the state-owned banks, and MoF interference, means that there is no genuine price formation, and private banks are largely excluded; the CBI needs to develop open market operations, but this could give rise to clashes with the MoF if the CBI judges interest rates need to rise;

The CBI has authorised the opening of several new Iraqi banks, as well as giving preliminary authorisation to three new foreign banks. No foreign bank has yet started operations in Iraq, although the first authorisations were given six months ago;

CBI FX reserves now excess USD 4 billion, all of which is held physically in its vaults. Commercial banks have a further USD 2-3 billion; we have recommended a way for private banks to transfer excess cash holdings into interest earning accounts outside Iraq;

Inflation in August was up 3.6% month on month - largely reflecting fuel and housing increases - but the price level is still below that for January this year.

The Stock exchange now lists 47 companies.

Donors

Donors The key progress for donors over the summer has been the development of the Iraqi national development strategy. This process was led by the Ministry of Planning, and discussed with the World Bank in Amman in early September. The Strategy will form the cornerstone of the Tokyo Donors' conference in Tokyo on 13th and 14th October, and will be presented in the

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Minister of Planning's keynote speech - "Vision for a Sovereign Iraq". In addition to calls for donor contributions to the Trust Funds, perhaps the key issue will be progress on Trust Fund spending, and ways to monitor and evaluate that spending. Care will need to be taken in ensuring policy documents from different ministries do not conflict.

The US Supplemental is currently undergoing a large reallocation process, shifting \$3.4bn (largely \$919mn from electricity, \$1.9bn from water) into extra spending on the oil sector, job creation, governance programmes, debt reduction (although what exactly this means is not clear), and increasing USAID's budget. TO date the supplemental has committed \$9.8bn, obligated \$7bn, and disbursed \$1.1bn.

DFID Macroeconomic Programme is now progressing on the ground. Despite some initial administrative difficulties both the State Owned Enterprise and Macro-Fiscal teams have been able to start work. : helped facilitate the success of the Paris Macroeconomic discussions, and now the macro-fiscal team (including) is working to help finalise the 2005 budget and develop the medium term fiscal framework. The SOE team have now developed their contacts in the Ministry of Industry and Minerals, and are agreeing a workplan for the next few months. Initial pieces of work will include advising the Ministry on its internal structures, and starting the process of developing asset and employee registers for the Ministry's SOEs.

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