

CIG Assessment 9 June 2008

IRAQ: BASRA'S ECONOMY

This paper was discussed by a Current Intelligence Group and approved on 9 June 2008.

Key Judgements

- I. The recent Iraqi government security operation in Basra City has largely driven the Jaysh al-Mahdi (JAM) from the streets and brought a degree of stability. While this lasts, there is a window of opportunity to create the conditions for economic growth. However, insecurity, institutional incapacity, corruption, legislation, competing political agendas, crime and smuggling will remain impediments to reconstruction and development for the next twelve months.
- II. [...]
- III. Some nations appear willing to take risks in the uncertain political and security environment. Turkey recently re-opened its Consulate in Basra and Turkish Foreign Minister, Ali Babacan, recently announced Turkey's willingness to play a role in Iraq's economic development. Russia and China have also shown interest in investing in Iraq.
- IV. International oil companies including Shell and BP are in negotiations with the Ministry of Oil for Technical Service Agreements to utilise their expertise, but these companies are unlikely to enter long term investments until a hydrocarbon law has been adopted.
- V. Militia violence and intimidation, which specifically targeted middle class Basrawis, prompted many to leave, leaving a shortage of capable local entrepreneurs, which is likely to persist beyond 2008.

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At the request of DfID we examine Basra City's economy, the impact of criminal activity, obstacles to development and reconstruction, the likely impact of provincial elections and Iranian influence.

1. Last year Iraq exported USD\$33.3bn of crude oil, which accounted for 53% of its GDP (forecast to be \$62.6bn). Basra province produces approximately 72% of Iraq's oil and 80% of Iraq's commerce transits through its main port, Umm Qasr. But years of severe underinvestment under Saddam, followed by five years of ineffective economic management has left Basra in desperate need of reconstruction. Since 2004, Basra has been plagued by high unemployment (about 40% of 18-45 year old males), militia violence and criminal gangs, who have controlled and profited from its plentiful oil fields and illegal use of Umm Qasr port. However, the recent Iraqi government security operation in Basra City - the Charge of the Knights - has largely removed the Jaysh al-Mahdi (JAM) from the streets and brought a degree of stability. While this lasts, we judge that there is a window of opportunity to create the conditions for economic growth.

Opportunities

2. The government in Baghdad is taking a greater interest in Basra City, reversing its previous indifference. Its \$100m reconstruction budget provides opportunities to fund projects, which has the potential to improve the residents' quality of life, provided delivery can be more effective. The Basra Development Commission (BDC) established in 2007, under UK sponsorship has succeeded in generating investor interest in Basra¹. Some other nations appear willing to take risks and invest even in the uncertain political and security environment. **Turkey** is on the verge of opening a Consulate in Basra and Foreign Minister Babacan has publicly declared its willingness to play a role in Iraq's economic development. **Russian** Finance Minister Kudrin has pledged to invest \$4bn in Iraq over the next three to seven years, probably in oil, gas and electricity production. In February Russia agreed to write off 93% of Iraq's outstanding debt (\$11.1bn). We assess this will be linked in part to Russia's access to oil fields and the revival of LUKoil contracts, deemed void after 2003. **China** has also shown interest in investing in Iraq: we expect it to focus on the energy sector.

3. Annual trade between Iraq and **Iran** is some \$2bn, mostly Iranian exports to Iraq. We recently noted that Iran's economic activity in Iraq is skewed towards areas, such as Basra, that the Iranians want to influence politically. [...] But the two countries' oil ministries have yet to commit to plans for Iran to build pipelines between Basra and Iran's Abadan oil refinery. Polling highlights that Iran's approach to investment in Basra generates suspicion amongst Baswaris. We assess that further visible Iranian engagement may stoke negative sentiment but this will have negligible impact on trade; Iranians supply essential goods from fruit to air conditioners that are not imported from anywhere else.

4. The removal of trade barriers imposed by **Kuwait** could increase trade across the Iraq/Kuwait border. Some Kuwaitis are already doing business in Iraq and are interested in investing in or trading in the Basra area. [...]

¹ Ten UK companies have expressed an interest in investing in Basra; none has yet visited Iraq, although several of them are likely to this year.

Continuing obstacles

5. Despite the improved security situation, a number of factors will continue to jeopardise economic progress and concern would-be investors in Basra throughout 2008. Most are not unique to Basra.

- **Mismanagement**, the absence of any systematic approach to spending and lack of experience in identifying and executing investment projects across all levels of government severely hamper reconstruction. Intelligence shows that bureaucracy is already holding up the Iraqi government's reconstruction effort designed to deliver visible rapid results following the Charge of the Knights.

Recent Provincial Treasury figures show a year on year improvement in the distribution of funds, albeit from a very low starting point. Many Baswaris consider development and reconstruction efforts in the city slow, corrupt and shoddy.

Year	\$USDM Budget	<u>Reported Disbursements</u>				% of Budg et
		2006	2007	2008	Total	
2006	215.8	29.4	148	11.3	118.7	87.4%
2007	226.7		61	37.6	98.5	43.5%
2008	307.8				0	
		29.4	209	48.8		

- Competing political agendas mean that reconstruction is subject to **political manoeuvring**. [...] Without a more inclusive approach we judge it will be difficult [...] to make the visible progress needed and the government's current popularity could quickly dissipate.
- Official **corruption** will remain endemic under the present government or any likely successor. [...] Coupled with the difficulties the Iraqi security forces face in enforcing the rule of law, Basra's resources will remain an attractive target for criminals.
- The **uncertain legislative environment** continues to hold investors back. International oil companies [...] are in negotiations with the Ministry of Oil for Technical Service Agreements to utilise their expertise. But we judge that they are unlikely to enter long term investments until a hydrocarbon law has been adopted, setting out the rights and ownership of each party: the current form still leaves uncertainties in some key areas. At present there is little sign that this will be passed any time soon.
- **Security** following the "Charge" remains fragile. Provincial Elections scheduled for October, but more likely to be in December, could see a spike in violence. We lack intelligence on the political parties' strategies but we judge that all Shia parties will compete fiercely for power. We judge that Basra's wealth makes it a particularly attractive prize.
- A lack of customs procedures and poor access control means that Basra's **Umm Qasr Port** has historically been exploited by JAM and Fadilah **militias** and **criminal gangs** to smuggle commodities: primarily white goods, livestock, alcohol and cigarettes. Guards, port officials and labour companies levy unofficial charges on traders. [...] since late March Iraqi Marines have replaced the Fadilah-dominated Facility Protection Service in providing security, and we judge that since the operation, criminal use of the port has been greatly reduced. However, though many JAM members have fled Basra, [...] which could see them seek to return to their pre "Charge" activities.

- Government price controls, which artificially cap the price of petrol and diesel, cause shortages in fuel supply. As a result a **black market for fuel** is rampant - though prices in Basra are somewhat suppressed due to its large refinery, which guarantees a higher level of official supplies than elsewhere in Iraq². [...] The absence of reliable record keeping makes the extent of black market activity in this area difficult to quantify. Maliki has tasked an Investigatory Committee to look into oil theft and smuggling in Basra, but there is little indication that this is having any impact.
 - GDP in Iraq has increased over the last three years by an estimated 40% but the wealth is unevenly spread. Trade in non-oil sectors (retail, produce, transport, construction, manufacturing) is limited. Diversifying Basra's economy would help create more jobs and retain funds in Basra; official oil revenues flow directly to Baghdad. But Basra is suffering a "**brain drain**". Militia violence and intimidation, which specifically targeted middle class Basrawis, prompted many to leave, leaving a shortage of capable local entrepreneurs, which is likely to persist beyond 2008.
6. We continue to judge that insecurity, institutional incapacity, corruption, legislation, competing political agendas, crime and smuggling will remain impediments to reconstruction and development for the next twelve months.

² Official figures for the region put fuel at \$0.37 per litre; the black market nationally at \$0.61 per litre; black market in Basra \$0.41 a litre.