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Economic Aspects of Stability in Iraq

Economic growth and job creation has a vital part to play in building sustainable peace and stability and reconciling Iraq's divided communities. However, after a post-sanctions 'bounce-back' in economic growth, linkages between growth, jobs and peace have remained weak. The UK has been working with the Government of Iraq (GoI) to support political, security and economic development, but spiraling insecurity, exacerbated by weak political leadership, lack of cohesion and unity in government, and poor capacity of ministries and other authorities have undermined these efforts. Greater security and political solutions are key, but need to be complemented with a focus on priority economic problems.

Context:

1. In 2004 Iraq received an immediate boost to growth arising from the end of sanctions, increased foreign aid and the oil price boom. However, since then economic growth has slowed to an average of 3 per cent per annum, down from 46 per cent in 2004. This has been driven by internal conflict, worsening violence, and displacement of Iraqis (around 4 million since 2003). Public sector investment is limited, progress on oil production has been lower than expected and oil exports are below target (although high oil prices have impacted positively on government revenues), public services are under-strain and living standards continue to decline.
2. There is a limit, however, to the number of jobs that can be created in the near to medium-term, and the effect job-creation will have on reducing the violence. An optimistically large increase in investment between now and 2011 might be expected to create 1.8 million jobs, although expectations remain that overall labour force participation in Iraq, as in its oil exporting Gulf neighbours, will remain relatively low. And whilst more jobs may help to divert some energies away from conflict, it will only be a small contributory factor to reducing the violence, whose root causes are multi-faceted.

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3. Key structural economic problems Iraq faces at present include:
- Low levels of labour force participation and high unemployment – a long-standing feature of Iraq's economy including before 2003;
 - Economy dominated by an inefficient energy sector with poor quality infrastructure and low rates of investment;
 - Missing or very weak economic institutions: limited banking services, no insurance, no company networks;
 - Natural resource curse – which encourages rent-seeking and makes other industries uncompetitive and unattractive;
 - High levels of inefficiency in the public sector leading to waste of public resources and poor quality public services (leaving Iraqis dissatisfied with their government).
4. Decades of under-investment have led to a complete run-down of Iraq's infrastructure. Higher growth and better public services will require a sustained level of investment on public infrastructure. Fortunately Iraq has money to invest. In 2006 Iraq expected to raise US\$28 billion in government revenues from oil exports (it actually raised US\$31.9 billion), but spent less than a quarter of the US\$8.4 billion allocated for investment.
5. Iraq will remain dependent on the capital-intensive oil sector for many decades, which will generate few jobs. But without a lasting political settlement to facilitate significant increases in investment (including FDI), expanding and improving the oil sector will not be possible. **Production levels of crude oil currently stand at 2.1 million barrels per day. This contrasts with the peaks of almost 2.9 million barrels reached in 1989 and 1999.**
6. Economic growth across all sectors requires a stable and secure environment for government, firms and individuals to make investment decisions. **Insecurity is probably the biggest single obstacle to achieving progress on economic and political development.** Spiraling levels of sectarian violence have undermined efforts by the GoI to win

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the confidence of most Iraqis and neighbouring governments. Many are skeptical about the commitment of key political figures, including Prime Minister Maliki, to reconciliation and doubt their ability to tackle sectarian violence, reconcile increasingly polarized communities and to deliver or improve much needed basic services. Combined with a lack of cohesion in government, this has prohibited substantive progress in tackling these economic challenges and prolonged the dire economic and social conditions and poverty in which extremists and armed groups have thrived. In some parts of Iraq basic services are more often served by militias and patronage networks than by the GoI.

Priority Areas for Action:

7. Iraq needs a **broadly representative and inclusive government** acting strongly in the national interest to promote the security and reconciliation required to provide a **stable enough environment in which economic reform, growth and job creation can take hold**. Given Iraq's fragile state and weak capacity it is important to focus on the three main priorities which will do most to boost economic growth:
 - i. Iraq needs to continue to build on existing **macroeconomic stability**. It has remained on-track with its IMF programme and avoided hyperinflation, a balance of payments crisis and unsustainable spending increases. Inflation is high at 37 per cent in March 2007, but has come down from 65 per cent in December 2006, following a successful exchange rate appreciation at the end of the year. Recent progress in reducing fuel subsidies (March 2007), albeit after much delay, and the further reductions planned for June 2007 should, if implemented, bring the domestic fuel price to near market levels.
 - ii. **Improving efficiency and effectiveness of the public sector** will help reduce wastage and improve basic public services (including public infrastructure). Initial focus should be on medium-term expenditure management, subsidy reform, budget management, strengthening public financial management systems, reducing corruption (including eliminating 'ghost

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employees from the public sector payroll) and a resolution of fiscal federalism to clarify the roles and responsibility of central and provincial government.

- iii. **Expanding and improving the efficiency of the oil industry** (the dominance of the oil sector means the non-oil sector remains less of a priority in the short-term). This firstly requires a political agreement on the package of **Hydrocarbons legislation**, which will agree ownership, management and regulation of the oil sector, including the sharing of oil revenues. An improvement in the security situation is also needed to facilitate the **significant increase in investment (including foreign investment) needed to increase oil production in Iraq**. Thirdly, an **integrated energy strategy** for investment and reform in Iraq's electricity, oil and gas sectors would ensure that the development of the hydrocarbon sector delivers **visible improvements in electricity supply needed to drive private sector recovery**. But, until there is high level political settlement on oil and real leadership there will be little traction.

Constraints to this Action:

8. Iraq has the financial resources to significantly improve the lives of ordinary Iraqis (in 2007 Iraq expects to earn \$31 billion from oil exports). However, at present there are several substantial constraints preventing sustainable economic progress from taking hold. Particular problems include Iraq's:
 - a. **Political coalition;**
 - b. **Institutional capacity;**
 - c. **Security; and**
 - d. **International regeneration efforts**
9. **Iraq's fragile political coalition.** Weak Iraqi leadership on the economic agenda means that the GoI is not thinking through and delivering on difficult economic reforms. Much needed legislation such as the hydrocarbons law is stalled in political wrangling, which dilutes the quality of the legislations and fails to reach the necessary political compromises.

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Whilst other key pieces of economic legislation, such as the Investment Law and the Fuel import liberalisation law, have been passed, they need to be effectively implemented. We lack strong interlocutors in the GoI, with authority on the economy and who can be held accountable for implementing difficult policies and reforms.

10. **Institutional capacity.** Weak capacity in the Iraqi government hinders the implementation of political decisions and the delivery of services. DFID provides some capacity building to the Prime Minister Office, the Council of Minister's Secretariat and the Government's Communications Directorate, although this is greatly limited by the security situation which endangers DIFD staff, reduces access to key ministries and results in a high turnover of Iraqi counterparts
11. **Security remains the biggest impediment to more rapid reconstruction progress.** International contractors can very occasionally visit project sites. For example, no international staff have visited DFID's £7m water towers project in over 15 months, and meetings with local officials and contractors can only take place at the Basra Air Station. **Visits into the city centre have been impossible for months.**
12. **International regeneration efforts.** Widening international focus onto the long-term nature of economic development and regeneration in Iraq is key. **The UK Government has pledged a total of £744 million for reconstruction in Iraq** from 2003 onwards (including contributions from DFID, FCO, MoD, the Global Conflict Prevention Pool, and the UK's share of EC funding). This includes the **additional £200mn pledged at the launch of the International Compact for Iraq on 2 May 2007 by the Foreign Secretary** (and which includes the £100mn the Chancellor announced in Basra in December).
13. Whilst the bulk (but not all) of the UK effort (and DFID's activities in particular) have focussed on the medium and long-term creation of an environment in which sustainable economic growth can take hold, the US, the largest and most influential international partner in Iraq has tended to focus its economic development efforts on short-term actions with

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limited Iraqi ownership (since 2003, the US is estimated to have given more than \$400 million of technical assistance alone to Iraq). The US has also made Iraqi budget execution a top priority in Iraq. Iraq must use its own resources more effectively. But a narrow focus on quickly spending a lot more money needs to be balanced by strengthening wider public financial management systems to avoid corruption, wastage and inflation and to deliver better public services.

14. It is important to **bring in other international partners** to support Iraq, both to counterbalance US influence and to bring in wider and more independent expertise. The UK works closely with the US (to encourage short-term activities to link into longer-term plans) and bringing in other players e.g. World Bank and IMF. For example, DFID initiated the first Budget Execution roundtable for donors in Baghdad, which will now become a regular event chaired by Ambassador Tim Carney, US Tsar for Reconstruction.

What more can we do to help?

15. On the economic front, HMG has been prioritising the development of a secure and sustainable Iraqi economy, with significant focus on creating an enabling environment in which economic growth (largely driven by the oil sector) can flourish. Ways in which we should continue to support this are set out below. We should consider ways of improving the more short-term initiatives supported by the international community, which could have a more immediate impact (again see below), although with the difficult security situation and forthcoming drawdown of forces, such initiatives are only going to get harder to mount and sustain.

Enabling Environment:

16. **Securing a second IMF Stand-By Agreement (SBA) in September 2007.** This will be important to helping the Iraqis to maintain **macroeconomic stability**. The successful completion of a second SBA is also an essential condition to secure the final 20% tranche of the Paris Club debt forgiveness deal (to write-off a total of 80% of Iraq's Paris Club debt) and is consistent with our efforts to internationalise support to Iraq.

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17. Following the successful launch of the International Compact for Iraq in April 2007, a **Compact Secretariat** run by the GoI and the UN needs to be put in place as soon as possible to ensure the **Government of Iraq delivers on its commitment to this programme of economic, political and security reforms** and policies. The international community, and particular the neighbours, need to see progress from the GoI, but the leverage of debt relief, donor funding and greater investment create clear incentives for the GoI to deliver.
18. **Supporting an Efficient and expanded oil sector.** Negotiations over a suite of new **hydrocarbons legislation** including a revenue sharing law have been ongoing since the new national government was formed in May 2006. The law is facing two fundamental obstacles: disputes between the KRG and Baghdad over the extent of regional authority in the sector; and concerns over the implications of foreign investment for Iraqi sovereign control over its oil and gas resources. Technical accuracy has often come second to political considerations, creating a deliberately ambiguous law unlikely to deliver the right incentives for a more efficient oil sector or to appeal to large international investors or more importantly resolve political problems. We should allow the process to run its course even if it is protracted, both to **minimise the technical ambiguities in the law**, but also by **forcing all political sides to face up to difficult political disputes**.
19. The Iraqis need **independent expertise to help them address their challenges in the energy sector**. The UK is working to bring in the World Bank to assist Iraqi in developing and implementing an integrated investment and reform strategy. **Expediting the development of a comprehensive energy strategy** would help the GoI and international partners identify and leverage funds towards priority investments in the energy sector, including in power infrastructure.

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Specific Initiatives:

20. **Evidence suggests Quick Impact Projects (QIPs) may be helpful for force protection and immediate stabilisation purposes.** However, they have limited role in promoting long-term economic development and DFID advise that they do not translate into sustainable employment. Nevertheless, Operation Sinbad and the Baghdad Security Plan had some immediate economic benefits, including providing short- term electricity supplies and street lighting.
21. **Operation Sinbad**, in particular, was designed to combat the deteriorating security situation in Basra in early summer 2006 through focussing on Iraqi Security Force training, reconstruction, job creation and the re-development on city areas. It produced promising, but not startling results. However, the operation did succeed in **improving the perceptions of the average Baswari that the situation was improving.**
22. There has been little follow-up on Operation Sinbad. However, **the desirability and feasibility of further such initiatives will need to be considered in the context of existing and anticipated MNF troop drawdown, including the withdrawal of UK troops from Basra Palace to the Basra Air Station.** Once troops have withdrawn to the Basra Air Station (currently anticipated by end August), operations or patrols into Basra City (both militarily and in support of economic development) will attract greater risk due to reduced situational awareness and the relative freedom of movement for anti-coalition forces.
23. The US has also initiated the "**Brinkley Initiative**", whose main objective is to **'restart a critical mass of Iraqi industry in Iraq'**. Run by Paul Brinkley, a political appointee reporting to MNF, it has identified firms in sectors such as construction supplies, ceramics and leather goods whose factories are able to produce high quality goods for export. Operated through the MNF it allows access to areas of Iraq inaccessible by civilians, but there are legitimate concerns over the reach (only a handful of factories are involved) and the financial viability of the programme. Again, as with QIPs, the sustainability of the initiative alongside MNF troops

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drawdown is questionable. Current military planning is that **after handover of provincial control the prime task of UK troops in the south will be mentoring and training Iraqi security forces.** There is an ongoing debate about how far it is realistic that UK troops could be called back into Basra City after handover if the situation there deteriorated, and what sort of force levels would be necessary to meet this requirement.

24. We will continue to explore areas in which the UK could provide further support for economic development and employment generation in Iraq in the short, medium and long-term.

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