

## JIC Assessment, 11 January 2007

### IRAQ: ECONOMIC PROSPECTS

*This paper was discussed and approved by the JIC at their meeting on 10 January 2007.*

#### Key Judgements

- I. Real economic growth in Iraq continues to be positive. But the government has shown little commitment to economic reform and large scale job creation is highly unlikely in the next 2 years.
- II. The government is not short of funds. But it is incapable of investing them effectively. Public investment is hampered by weak central government Ministries and a lack of competent staff across all levels of government. The Kurdish Regional Government has a stronger administrative capacity than the rest of Iraq.
- III. The security situation remains the main obstacle to domestic private sector development and foreign investment. The inability of the security forces to create a safe environment for engineers to carry out repairs inhibits reconstruction. But even under a benign security environment, Iraq would still face severe economic challenges.
- IV. Iraq depends on the oil industry: it is crucial to national economic development. Targets for increased oil production are unrealistic: oil production and exports are likely to remain flat over the next 2 years. As in other major oil producers, unless addressed, lack of diversification is likely to become a vulnerability in the long term.
- V. The electricity infrastructure is unable to meet demand and currently operates at around 60% of capacity. Supply nationwide has been stabilised at 11 hours per day: a number of provinces now receive more electricity than they did under Saddam. But the average daily supply to Baghdad has fallen to only 6 hours: a major source of popular discontent.
- VI. The UN estimates that 2 million Iraqis (7% of the population) have left the country since 2003; a further 1.7 million have been internally displaced. Displacement could reach 2.7 million by the end of 2007. Many displaced Iraqis move in with friends and family: we cannot assess the precise economic impact but the added burden on government resources is likely to be limited.
- VII. Corruption is endemic and will remain so under the current Iraqi government or any likely successor.

## IRAQ: ECONOMIC PROSPECTS

*At the request of the MOD, we consider the prospects for economic development and reconstruction in Iraq over the next two years.*

### Iraq's Macroeconomy

1. Real economic growth in Iraq continues to be positive, averaging 3.9% annually since 2005 (compared to an average of -4.9% between 1990 and 2000). The economy has benefited from favourable external conditions over the past two years: oil prices have been high and donor payments from abroad have been strong<sup>1</sup>. But the government has shown little commitment to economic reform, implementing few economic policy improvements. One exception is the gradual removal of large state fuel subsidies, although this has contributed to high inflation (around 50% in 2006). Inflation is likely to fall in 2007 as these subsidies end, but will remain in double figures. Living conditions for many Iraqis remain very difficult.

2. The government is not short of funds: we assess that around \$12bn has been accumulated since 2003 as a result of unspent budget allocations. Projected government revenue in the 2007 draft budget is \$33.4bn, predominantly from oil sales. Programmed expenditure is \$41bn: an expected budget deficit of \$7.6bn (see annex for budget details). In order to deliver basic services, improve productivity and boost output, some 20% of the government budget has been allocated to investment in reconstruction and public services (\$9.7bn for 2007). But actual public investment in Iraq remains very low, with the majority being financed directly from the US or other foreign donors. Investment from Iraqi sources was only around \$2bn in 2006 (compared to a budget allocation of \$6.3bn). [...]

3. Iraq depends on the oil industry: it is crucial to national economic development. Oil contributes around 75% of GDP and 95% of government revenues. Iraq has the world's third largest proven oil reserves, concentrated (65% or more) in the south around Basrah. Pre-2003 estimates put sustainable production capacity at around 3 million barrels per day (mbd): current production is only some 2.1mbd with exports of around 1.5mbd. Oil Minister Shahristani has pledged to raise production to 4.5mbd by 2010. We judge this target to be unrealistic: oil production and exports are likely to remain flat over the next 2 years as US investment falls and international oil companies wait for an improvement in the security situation. Less than 1% of the Iraqi population are employed in the oil industry: as in other major oil producers, unless addressed, lack of diversification is likely to become a vulnerability in the long term.

### Reconstruction and Development

4. Before 2003, Iraq's infrastructure was in a state of disrepair following years of neglect. The invasion and the continuing insurgency has caused further damage. The electricity infrastructure is unable to meet demand and currently operates at around 60% of capacity. Supply nationwide has been stabilised at 11 hours per day: a number of provinces now receive more electricity than they did under Saddam. But the average daily supply to Baghdad has fallen to only 6 hours: a major source of popular discontent. Iraq also suffers from major fuel shortages. Oil export infrastructure is in a poor condition, and medical resources

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<sup>1</sup> Some \$20bn has been donated in total, predominantly from the US, Japan and the UK. Many Gulf and European countries are yet to disburse pledged aid: over \$10bn remains outstanding.

have deteriorated considerably. Large-scale foreign donor funds have since been invested in reconstruction in an attempt to repair the country's infrastructure. Significant progress has been made since 2003 in the telecommunications and water sectors but reconstruction in the oil sector has been slow: it is more expensive and susceptible to attack.

5. There are many difficulties in translating oil revenues into improved living standards. Growth also depends on private sector development, but there are significant barriers to domestic and foreign private investment. We judge that the main impediments to reconstruction and development in Iraq over the next two years will be:

- **Security.** Violence in Iraq continues to rise. We judge the security situation is the main obstacle to domestic private sector development and foreign investment. The inability of the Iraqi Security Forces and Multinational Forces in Iraq to create a safe environment for engineers to carry out repairs inhibits reconstruction. Attacks on those seeking work, kidnapping and protection rackets limit economic activity and deter investment. Poor security also prevents the delivery of key health and education services, with a long-term impact on the economy. Attacks on oil infrastructure remain low, with only a handful of sabotage incidents each month, but they are proving increasingly effective. In the north oil output has been severely constrained by attacks in Kirkuk: in June Iraq exported only 58% of capacity from its northern fields and has exported little since. The UN estimates that 2 million Iraqis have fled the country since 2003. A further 1.7 million have been internally displaced, leading to a marked reduction in mixed ethnic areas. Displacement could reach 2.7 million by the end of 2007. Many displaced Iraqis move in with friends and family: we cannot assess the precise economic impact but the added burden on government resources is likely to be limited.
- **Institutional Incapacity.** We assess the Iraqi government is incapable of investing available funds effectively. Public investment is hampered by weak central government Ministries, a lack of competent technical and managerial staff across all levels of government and a lack of experience in identifying and executing investment projects. Iraq has suffered from 20 years of severe underinvestment; this is particularly acute in the Ministry of Oil. The Ministry of Finance is cautious about releasing funds allocated for investment in the budget: [...] We judge this situation will persist for at least the next two years. The Kurdish Regional Government has a stronger administrative capacity than the rest of Iraq (largely due to its experience, greater autonomy and the lower level of violence).
- **Corruption.** We judge corruption is endemic and will remain so under the present government or any likely successor. Iraqi officials estimate that \$4bn has been pilfered from state coffers since 2003. Many Iraqis, including Ministers, probably accept corruption as a fact of life: there is no evidence that the government is making progress in tackling it. Bureaucratic anti-corruption measures also hamper effective implementation of investment: some officials are reluctant to sign off projects. The government recognises that addressing these problems would increase efficiency, but efforts so far have been largely cosmetic.
- **Legislative Framework.** The 2007 budget is some three months behind schedule. This constricts investment: no new spending commitments can be made until the budget is passed. [...] Other

legislative problems hamper economic development, most notably the uncertain future management of Iraq's natural resources. A hydrocarbon law is currently being drafted to determine the future structure of the industry and whether central or regional governments should have control of oil and gas fields. This is contentious: oil and gas resources are concentrated in the Shia south and Kurdish north, leaving the Sunni central regions heavily dependent on central government transfers. A law acceptable to all groups is probable but it is unlikely to meet all demands: we assess that it will have limited impact on Iraq's regional economies, though by determining future control of the key national resources it will have a significant impact on the political future of Iraq.

- **Crime and Smuggling.** Thefts of crude oil are largely criminal in nature, committed by militias, insurgents, government officials and security forces seeking profit from black market sales. We judge that the government cannot deliver the improved security and effective management structures necessary to tackle such crime. Smuggling of fuel in and out of Iraq is also rife, sustained by low fuel prices in Iraq compared to neighbouring countries, ineffective security, weak legislation and law enforcement, and pervasive corruption at border points. Most Iraqis buy their fuel on the black market. [...] Reducing domestic fuel subsidies will help, but progress is likely to be slow.

## Employment

6. Less than half of Iraq's working age population in 2004 were employed or looking for work: there is no reason to think this has changed significantly. This is in line with the regional average and historical trend in Iraq where very few women or young men join the workforce. Official unemployment – the share of working age population looking for but unable to find work – is around 18%. The majority of Iraqis seeking work has never been employed (with the important exception of the armed forces). While higher employment may help improve the security situation, we judge that large scale job creation in Iraq is highly unlikely in the next two years. The capital intensive oil industry – the largest sector of the economy – will offer few new employment opportunities. Most available jobs are low paid and offer a poor standard of living. The hand over of security to Iraqi forces offers some opportunities, but job creation will still be minimal (the Iraqi army plans to recruit 37,000 new troops by the end of 2007).

## Outlook

7. We assess that insecurity will remain the greatest constraint on Iraqi economic activity over the next two years. There are regional variations. Demographics and local control of security in the Kurdish north make it the most stable region of Iraq. Prospects for stability are greater in the southern provinces than around Baghdad. But even in a benign security environment, Iraq would still face severe economic challenges. Although the International Compact for Iraq may bring additional foreign investment, institutional capacity is unlikely to improve in the next two years, hindering the effective allocation and use of available funds. Public investment is therefore likely to remain low, with a reduction in Coalition spending and only slow private sector emergence.

Annex: 2007 Budget Breakdown

**2007 Draft Budget Revenues (\$bn)**



**2007 Draft Budget Expenditures By Ministry (\$bn)**

