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F  
Sent: Jeremy Heywood  
To: 03 March 2003 15:10  
Subject: Arnab Banerji; David Manning; Jonathan Powell; Andrew Adonis  
RE: FINANCING THE RECONSTRUCTION OF IRAQ/fco

David - over to you

-----Original Message-----

From: Arnab Banerji  
Sent: 03 March 2003 15:03  
To: Jeremy Heywood; David Manning; Jonathan Powell; Andrew Adonis  
Subject: FW: FINANCING THE RECONSTRUCTION OF IRAQ/fco

This version incorporates all the recommendations and views put forward by HMT, DTi and DFID. Most of the FCO's substantive points are included as well. However there is one point of disagreement.

- 1) I believe that (while we are unsure about the precise numbers) the amount of money that will be needed to re-build Iraq is considerable.
- 2) This money is not available in either the US or UK treasuries. The multilateral institutions are in an even worse financial condition.
- 3) The private sector will need to be tapped sooner rather than later for money.
- 4) This can only be done with UN blessing.

I understand that the FCO is keen to only use governmental/multilateral money for any initial rebuilding. The economic state of the US and UK precludes this. This implies a premature withdrawal from Iraq by the Allies leaving behind a messy situation.

If you find the note useful please send it on.

*Jim. Banerji* faxed to

*Advice pre*

*✓ Dry Apologies for the delay. Discussed with  
Tory (who was initially unaware of this work). They  
have incorporated bits into the paper they put  
to the Chancellor last weekend. We did consider  
with the US*

*Is this worth sending? Will it fit strategy (not this)  
with this work in hand following this  
morning's mtg.*

*1/6/3*

*OK. file pre*

*J.D.  
13/3*

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*1/20/3*

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## **FINANCING THE RECONSTRUCTION OF IRAQ**

### **Summary**

1. It is not possible to provide a precise figure for relief/reconstruction costs, given significant uncertainties. However, a number of estimates are in circulation on which a preliminary costing exercise may be based. Depending on the assumptions made, possible relief/reconstruction costs might feasibly range between US \$30 billion and US \$60 billion. These figures exclude potential costs for humanitarian relief and that of peacekeeping after a conflict.
2. Even if oil production continues unabated there is likely to be a need for flows of external finance to Iraq in the early years.
3. In the UK, fiscal pressures restrict the extent to which the Exchequer can respond to Iraqi rebuilding needs.
4. In the US, the Administration has recently announced a sizeable fiscal stimulus package and might find it equally difficult to raise additional money for the purposes of nation building in Iraq.

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5. Provided that there is UN Security Council authorisation, limited funds will be available from multilateral sources like the EU, UN, IMF and World Bank. These organisations are also able to provide essential technical assistance.
6. It is clear that the main burden in the early years will have to be borne by bilateral donors, Western and Arab. For such burden sharing to happen, UN Security Council authorisation is vital.
7. Private capital flows could provide substantial finance for Iraqi reconstruction. For instance, a representative Iraqi government could borrow against future oil revenues to raise money for current spending. However, this would be a non-starter for any non-UN authorised interim administration, as these debts would be seen as the liabilities of the occupying powers and use of oil revenues would be perceived negatively by a suspicious international community.

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### Conclusion

Until a UN – recognised administration is bedded in; it will be difficult if not impossible to fund a rebuilding programme by way of the private sector. Until then, burden sharing for reconstruction can only come from the budgets of States and international organisations. From both a political and legal perspective, UN Security Council authorisation of the internal administration in place after any conflict will be vital to ensure such burden sharing.

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## COSTS OF RECONSTRUCTION

### Regional Economic Profile

COUNTRY	POPULATION (M)	GDP US\$ BILLIONS
IRAQ	22.3	15
IRAN	68.2	82
TURKEY	67.6	148
SAUDI ARABIA	21	176
ISRAEL	6.2	110
KUWAIT	2.1	42.3

Source: International Institute of Strategic Studies 2002-2003

It is not possible to reliably estimate the total costs of relief and reconstruction at this stage given the significant uncertainties, particularly around the impact of conflict. Information currently available only provides the basis for a simple costing exercise and should not be thought of as being in any way definitive. A needs assessment should be conducted at an early stage by the International Financial Institutions (IFIs) to place a reliable figure on financing requirements. The costs of humanitarian relief remain especially uncertain at this stage. They could rise exponentially if Saddam should resort to CBW against his own people. They have therefore been excluded from the figures given below which are based on a paper published by the American Academy of Arts and Sciences. It should be emphasised that their work is far from definitive. With that proviso, rough

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estimates of reconstruction costs – in other words hard currency spending needed to pay for long term investment – can be got at in various ways:

One method would be to use the approach taken by the World Bank in assessing reconstruction needs in Afghanistan; (itself based on rebuilding experience in Lebanon, East Timor and Bosnia). This found that capital stock equivalent to \$1000 per head would be required. In Iraq's case this would mean US \$24 bn., (working off the population estimate given above which is itself somewhat unreliable), would be needed for rebuilding purposes.

An alternative, econometrically-based, approach is to note that oil sensitive economies have a capital output ratio that is different from that of more developed nations or other developing countries. This reflects the capital intensity of oil production. If Iraq were to attain a per capita GDP equal say to Egypt or Iran, and furthermore if one half of the capital stock required to be replaced, this would imply rebuilding needs of about \$1200 per capita or a total of \$28 billion.

Reconstruction costs may also be estimated by reference to a 1991 report to the United Nations on restoring Iraq's infrastructure back to its pre-war condition. It was then suggested that it would take \$22 billion in 1991 prices to achieve this end. Expressing this in 2002 prices and accounting for further deterioration in Iraq's infrastructure suggests that US \$30 billion would be a reasonable estimate of reconstruction costs today.

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A more comprehensive rebuilding programme might be modelled on the Marshall Plan. One calculation suggests that, using the original Plan as a template, the required amount of assistance today would come to about \$2000 per person spread over four years. This suggests that a total of between US\$50 and \$60 billion would be needed.

As this level of investment is clearly beyond what has been given or proposed to other countries in the recent past, (US \$15 bn over 10 years for Afghanistan and US \$5.15 bn over the first five years for the Balkans), a significant share of the money required would have to come from internal Iraqi resources.

These are all rough and ready figures, based on different and heroic assumptions. It does not include the cost of humanitarian and other current spending and it does not allow for the substantial damage that might be caused by a war.

#### UK public finances

The Treasury projects a public sector net borrowing requirement for the financial year 2003-4 of £24 billion. Unfortunately, economic growth appears to be slower than projected and more significantly tax receipts have fallen by more than nominal growth. In view of the fiscal pressures it would be unwise to assume that the UK is in a position to engage in any of the financial heavy lifting associated with Iraq.

#### US Public Finances

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It would be similarly unwise to assume that the US is any better placed to take on large additional financing responsibilities. Taking into account the recently announced fiscal stimulus package, the US deficit is expected to increase from 1.5% of GDP in 2002 to 2.8% in 2003. The US is now expected to run fiscal deficits in each year to 2008.

#### Flows of Finance from Official Sources

If an unsustainable burden is not to fall on the coalition countries it is essential that ways be found of sharing a potentially very large and unpredictable burden with other official donors. However, the scope for multilateral assistance is uncertain and limited.

The EU is likely to contribute to meeting immediate humanitarian and rebuilding requirements. 15m Euro has been allocated to ECHO's Iraq budget this year and this could be increased by a small amount if required. Other sources are the Emergency Aid Reserve (up to 217m Euros available this year), the Rapid Reaction Mechanism (15m Euro likely to be pledged this year) and the Flexibility Instrument (usable in only one year, it will probably be allocated from next year's budget when 200m Euros would become available).

The United Nations is resource constrained. It has already pre-positioned some small additional aid from its own resources but it is unlikely that there will be significant spare funds in the OFF escrow account that can be freed up for humanitarian purposes.

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#### Other claims on Iraq

Other future liens against Iraq's oil revenues, include repaying its external debt (US \$90 bn+) and United Nations Claims Commission (UNCC) reparation claims (total around US \$347 m). Iraq is also in arrears to the IMF (US \$70m) and the World Bank (US \$ 77m) which it would be required to discharge before being able to reschedule its external debt.

Unless significant damage is sustained to oil wells during conflict, oil production is unlikely to be dramatically affected in the short term. However, increasing oil production over the medium – longer term would require significant investment. Whilst there is little doubt that Iraq has great oil potential and export capacity (112 –220 bn barrels of probable reserves), poor maintenance and virtually no new investment for a decade has meant that significant capital would be required even to stabilise current production levels. It is estimated that US \$25-40 billion would be needed to increase sustainable production to 4 m bpd (over 2-3 years) and US \$40-60 bn to increase sustainable production to 6m bpd over a period of up to 10 years.

The country's reserves are such that oil company projections indicate that, within 10 years, Iraq has the potential of pumping as much as 6 to 7 million barrels per day if required. However, in order to achieve this level of output political as well as financial costs would need to be incurred. Soundings in the oil markets indicate that other OPEC countries would be most unlikely to countenance an increase in Iraq's quota to much above the 3.2m bpd level. It should be noted that Iran's present quota is 3.6m bpd, (though it's allotment has been only temporarily increased from 3.2m bpd to compensate for Venezuela). It is

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difficult to conceive of that country agreeing to an allowance for Iraq that exceeded its own allotment.

Even allowing for increases in world oil demand, a quota of 6 to 7m bpd for Iraq by 210 appears unrealistic. To achieve this level of output and in this timescale, Iraq would have to withdraw from OPEC and that would have a profoundly destabilising impact not just on a number of the surrounding nations but much further afield. Russia for example is likely to be very alarmed at such a development. Moreover, given the implication for the oil price, a policy of rapid output expansion is unlikely to maximise Iraq's own oil revenues.

Assuming that the forward market is right about future oil prices and working upon the assumption that Iraq's quota will match that of Iran then, along with a minor degree of leakage (cheating) output may easily be sustained at three and a half million barrels per day. The exported component of this is capable of generating annual revenues of around \$24 billion at \$22 per barrel. A significant portion of this money would be available for investment purposes so long as the contracts required to produce the oil were not too onerous (for example the French, Chinese and Russian contracts would need to be carefully re-examined).

#### The role of markets

This analysis suggests that oil revenues will eventually be able to pay for Iraqi reconstruction, provided that money is spent wisely. This would be greatly helped by dismantling Iraq's system of subsidies and putting in place proper expenditure management and revenue systems.

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However oil revenues on this scale will not be available for years to come, even though major reconstruction needs (including repair of oil infrastructure) will be necessary from day one. One way around this would be to use future oil revenues to finance current reconstruction. One mechanism would be to borrow against future oil revenues, perhaps from banks in the first instance, possibly followed by the issuance of oil-backed bonds.

#### The importance of legitimacy

Banks and bondholders require security for their loans. It is a moot question how legal it would be for any administration that lacked the blessing of the United Nations to use Iraq's oil wealth to finance reconstruction. The financial markets would almost certainly insist that the liability for repayment rested with the occupying power. Bearing in mind the state of national accounts, this is not a palatable solution. Furthermore it is entirely likely that there would be legal challenges to the validity of any such arrangement.

UN cover would be a necessary first step for this approach. It may not be the final word - as the administering body would need to prove that it possessed the appropriate authority before it could borrow against the country's assets - but without it, the idea could not work.

Moreover, without UN cover, it would be extremely difficult, perhaps impossible, to engage the international financial institutions such as the World Bank and the IMF. This would deny Iraq a significant potential pool of grants and loans. It would also make it very difficult for these organisations to provide other traditional forms of post-conflict assistance such as technical assistance

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(e.g. to keep Iraq's economy afloat), donor co-ordination and assessment of needs. Also IMF involvement is usually necessary to unlock solutions to debt problems, via the Paris Club, which would be very important given Iraq's indebtedness.

### Conclusion

If Iraq is to be reconstructed in a manner that turns that nation from being a foe into a staunch ally, then a significant reconstruction programme maybe required although we cannot be certain about total costs. However, while an interim Administration is in place it will have to be bilateral donors who will have to pick up the tab. Potential contributions from international financial institutions and from private capital markets could also prove important, given the constraints on bilateral donors. It is for this reason that it is both desirable and necessary for the interim regime to have a UN mandate, or full UN involvement.

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