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HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

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**Nicholas Cannon**  
**Assistant Private Secretary to the**  
**Prime Minister**  
**10 Downing Street**  
**LONDON**  
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*Dear Nicholas.*

Following the Prime Minister's meeting on Thursday 7 March, I attach a Treasury note on financing Iraqi re-construction.

I am copying this letter to Jim Drummond and Desmond Bowen (CO), David Prout (ODPM), Peter Watkins (MOD), Dominick Chilcott and Kara Owen (FCO) and Anna Bewes (DIFD).

*Mark*

**MARK BOWMAN**  
Principle Private Secretary

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## FINANCING IRAQI RECONSTRUCTION

### Summary

Iraqi reconstruction costs could be as much as \$45 billion over the first 3 years, in addition to military costs. WMD use or humanitarian disasters would add to this. But Iraqi oil may not be able to pay more than a fraction of these costs.

If the UN is involved and endorses the transitional Iraqi regime, our proposal would be for the financing gap to be filled through a burden-sharing arrangement involving:

- other bilateral donors, with non-combatants recognising combatants' military costs in the distribution of costs;
- the International Financial Institutions (IFIs) such as the IMF and World Bank, and also the EU Budget;
- creditors, who could recognise Iraq's current arrears via a debt moratorium, followed up by a formal Paris Club deal; and
- Iraq itself, via 'oil for food' (OFF) money, and borrowing against future oil revenues.

But if the UN does not endorse the transitional arrangements for governing Iraq, many of these approaches would be much more difficult. Our proposal would still be to share the burden as widely as possible, but:

- bilateral donors could be fewer and less generous. DfID's understanding is that, without the UN, it can provide no more than basic humanitarian relief;
- the IFIs would find it difficult to engage until they had a government to negotiate with;
- creditors would still be encouraged to acquiesce in continued arrears, but a formal Paris Club deal could not be negotiated without an IMF programme in place; and
- Iraq itself could contribute but only from current oil revenues, and probably only if the UN agreed.

This would put pressure on the US and allies to pay much more than in the UN case. But with other spending pressures, the outcome would almost certainly be a lot less money for Iraq, and with the added difficulty of getting IFI technical help without UN involvement, this could affect the chances of success of the whole post-conflict project.

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#### The cost of rebuilding Iraq

1. Rebuilding Iraq and feeding its people will be an expensive and difficult task. It is a large and populous country that has slumped into near-ruin through war and sanctions. No-one knows exactly how much reconstruction and relief will cost – and will not until a full IFI needs assessment has been done - but based on experience in other post-conflict situations:

- it could be as much as \$15 billion per year for the first few years – thus perhaps **\$45 billion in the first three years**;
- **WMD use or humanitarian disasters would raise this bill even more**;
- this is additional to the costs of fighting, security and peacekeeping. US campaign costs alone could top \$90 billion;
- **there are risks to Iraq's ability to contribute to this from oil revenues**, including sabotage of facilities, and a possible post-conflict slump in prices. In any case, it will take time to increase production from its current low levels, even if facilities remain intact, given years of under-investment;
- **Iraq's debts and potential compensation claims are staggering**. Even if reduced from c. \$300 billion to \$100 billion, they would still be over 300% of GDP and servicing them would take a quarter of all oil revenues over 20 years.

#### What is the best way to pay for this?

2. In previous cases (e.g. Afghanistan, Bosnia), even with smaller bills to pay, the approach has been to **spread the burden as widely as possible**. This has involved drawing in contributions from other countries (especially non-combatants), from International Financial Institutions (IFIs) like the IMF and World Bank, and from the post-conflict country itself, if it can afford it (as Iraq potentially can, given its oil wealth).

3. However, the likelihood of achieving this is dependent on a number of factors, by far the most significant of which is the issue of political legitimacy – i.e. UN involvement in the transitional government.

#### The optimum financing plan: with UN involvement

4. In this context, 'UN involvement' means that any transitional arrangement for governing Iraq should be endorsed by the UN. This is different from the issue of UN endorsement for war. But it is related: the UN is much more likely to

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endorse a transitional government if it also endorsed the war that caused a change of government.

5. This could open up the possibility of a four-fold financing plan, involving:
- maximising Iraq's own contribution, from both current and future oil revenues;
  - preventing Iraq's revenues being side-tracked into paying unsustainable debts and compensation claims;
  - maximising contributions from the IMF, World Bank, other IFIs and the EU Budget; and
  - looking for disproportionate generosity from non-combatant countries. At present, it looks like a number of very rich countries will not be fighting.

## Iraq's contribution

### *From current oil revenues ...*

6. Iraq's current and future revenues are almost all from oil exports. At the moment, revenues from legal oil exports are paid to the UN, into its 'oil for food' (OFF) account. Most of this is used to pay for Iraqi contracts to import food and humanitarian goods, and to maintain civilian infrastructure. 60% of Iraq's population depends on this for food, and the sums involved are large: c. \$10 billion per year.

7. An obvious way to pay for immediate humanitarian needs in Iraq is to continue this system – both by using the c. \$4 billion unspent in the UN account, and by re-starting oil exports to pay for ongoing needs. This clearly depends on Iraqi oil production facilities surviving the conflict relatively intact.

8. Later on, when OFF is eventually wound-up, oil revenues could be an important source of funding for ongoing relief and reconstruction activities. But it must not be assumed that they can pay for everything. In the most benign circumstances, with rapidly increasing production and high oil prices, they could make a very significant contribution. But there are many potential problems and even a UN-authorized administration would probably not be able to make decisions on the expansion of Iraq's oil production – meaning an upper bound for revenues for some time to come.

### *... and from future oil revenues*

9. Iraq might also be able to contribute by tapping future oil revenues, for example by borrowing from the private sector using future oil revenues as collateral, or by selling some future oil revenues ('securitising').

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10. But Iraq has already used this idea, by accumulating massive and probably unsustainable debts, effectively secured against future revenues. Investors might be reluctant to lend Iraq more until these have been resolved. Secondly, massive investment would be needed to increase future Iraqi oil production and revenues. Finally, there would be major political difficulties in any interim Government effectively being seen to 'mortgage' Iraq's future.

## Protecting Iraq from its creditors

11. Iraq is at present not servicing any of its vast external debts, which may exceed \$90 billion (perhaps three times the size of Iraq's economy). Nor has it faced up to most of the \$310 billion compensation claims it faces, more of which could be in store from the Iran-Iraq war of 1980-88. If Iraq had to start paying these bills – or even a portion of them – its ability to pay for its own relief and reconstruction would be severely compromised.

12. This suggests the need for a debt moratorium in the first few months, before the IMF and the Paris Club can be engaged, and when the Paris Club does get involved, it should look to formalise this breathing space via a restructuring deal. To deliver debt sustainability would require a significant reduction in the NPV of the debt, and this could be problematic for big creditors such as Russia, France and Germany. In addition, a pragmatic approach will need to be taken to the issue of compensation claims (most of which have not yet been considered by the UN), with a need for the UN to bear debt sustainability in mind, working closely with the IMF and Paris Club.

## Involving the IFIs

13. The IFIs – the World Bank, the IMF and regional development banks like the Islamic Development Bank – have the potential to provide significant help in Iraqi reconstruction. Their primary role would, of course, be providing resources, with the burden shared fairly across their shareholders. The IMF's role would be to lend to meet external financing gaps, which would be likely in the early years. The Bank's overall resources would allow full engagement, mainly in the form of lending, including possibly through the IFC. But if Iraq's income per head fell below \$875, short-term help from IDA could be possible.

14. The IFIs could also play other vital roles like advising on economic policy (IMF), assessing reconstruction needs (World Bank) and co-ordinating bilateral donors (World Bank), as they have after previous conflicts.

## Contributions from other countries and the EU

15. The financing burden would also be lightened if more countries provided bilateral aid. When the world unites behind a cause (e.g. the Gulf War of 1991), a lot of countries will do so, and some will pay more than their fair share to make

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up for not having been involved in the fighting (e.g. Japan and Saudi Arabia in 1991). For instance, Germany and the EU gave more to help with Afghan reconstruction than did the US and UK (major combatants).

16. But it is important to understand the differences in this case. Even with UN involvement, it is hard to see countries like France and Germany agreeing to pay disproportionate amounts of aid to Iraq, given the strong views among likely non-combatants about the wisdom of military action.

17. The EU could potentially make a sizeable financial contribution from its annual external budget of around €5bn. In practice, the scope for financial assistance will be severely limited both by the need for Member States' and the European Parliament's agreement and by lack of available resources within the spending ceilings of the EU's Financial Perspectives, once other calls on this funding are met. UN cover would be key to securing Member States' and Parliament's agreement to any contribution beyond a modest humanitarian aid contribution. Even then, the scale of available funds is limited:

- the 2003 budget includes only €21m humanitarian aid allocated or earmarked for Iraq. Subject to other priorities, this could potentially be boosted by up to €217m from an Emergency Aid Reserve (EAR) plus the €22m unallocated margin for external spending, and by up to €188m from a Flexibility Instrument; and
- in 2004, the Commission is expected to propose only a small increase (€10m) to the overall humanitarian aid budget. Subject to other priorities, this could potentially be boosted by up to €217m from the EAR, plus (on current Commission plans) an unallocated margin of around €85m and by up to €200m from the Flexibility Instrument (less any amount used in 2003). It may also be possible to earmark a further amount to Iraq from reallocation within the overall external spending ceiling, given that €160m is potentially available (over 2003 levels), as a result of new arrangements for financing EU spending in Turkey, Cyprus and Malta.

18. There will however be numerous other calls on all these amounts as a result of other priorities for EU external spending (including the EU's commitments to its near neighbours and the EU's international poverty reduction effort).

### **The optimum financing plan: without UN involvement**

19. Lack of UN involvement would definitely be a second-best situation, from a financing angle, but we would still try and achieve as much of the first-best plan as possible. Lack of UN cover would have different impacts on different elements of the above financing plan.

20. On some areas, it could prove a total blockage. Without the UN:

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- **future Iraqi oil revenues could not be tapped**, as this would require international investors to be willing to put money into Iraq, which they would not do if they were buying assets (i.e. oil) from someone who, according to the UN, did not own them. Even if they were willing to put money in, the technical position – in the absence of UN involvement – would be that the transitional government (i.e. the US and its allies) would have to repay them. This would not achieve the objective of sharing the burden with others;
- **humanitarian agencies – both official and NGO – would find it very difficult to engage with Iraq**. Some would be restricted to meeting immediate humanitarian needs (this is DfID's current understanding of its legal position) – others might feel unable to operate. This has implications for both resources and for the institutional capacity to manage relief and reconstruction;
- **bilateral donors would be thinner on the ground, and less generous**. Their argument would be that the US and its allies have illegally inflicted damage on Iraq, and that they should pay for it to be cleared up. Recent EU statements suggest that it would not get involved without UN endorsement;
- **IFIs would find it very difficult to get involved**. Our understanding is that they cannot get involved until they have a government to negotiate with. If the UN failed to recognise the transitional arrangement as a government, this could prove very difficult.
- **a formal Paris Club deal would almost be impossible**, as the Paris Club cannot negotiate a debt restructuring or relief deal without the country in question having an IMF programme in place.

21. In other areas, lack of UN involvement merely increases uncertainty, as:

- **the transitional administration might not be able to use OFF revenues**. First, the UN may only hand over the money in its OFF account to a body that it acknowledges as the Government of Iraq. Second, OFF lapses after six months unless renewed by the UN (i.e. this June). Without this, members of the UN will be required (under the sanctions regime) to boycott Iraqi oil, as other Iraqi exports. Third, it is not clear what status the OFF programme has if the Iraqi government changes – i.e. this phase of the programme could end prematurely. However, it would politically be very difficult for the UN to block the use of Iraqi oil to feed Iraqi people for very long; and
- **creditors might press for an early resumption of debt service**. Paris Club creditors often pragmatically acquiesce in chaotic countries

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remaining in arrears. But, in this case, if stability was restored, and if the politics remained sour (as lack of UN involvement would suggest), some creditors might become awkward, especially as current opponents of war are major holders of Iraqi debt – Russia holds around \$16 billion of debt, France \$9 billion and Germany \$7 billion. In an extreme case, creditors might try and seize Iraqi assets if payments do not resume, such as imports bound for Iraq, oil exports in transit or currently frozen financial assets.

22. The political situation that precluded UN involvement could also bring some further costs. It is not impossible that war in Iraq could produce financial and economic turmoil in certain countries in the region, primarily oil-importers like Turkey, Jordan and Lebanon. Normally, the international community would be prepared to provide financial assistance in such circumstances, via the IMF.

23. On the other hand, all of this refers to the period of a transitional Government. The picture would change substantially once a representative Iraqi regime were in place. For instance, the IFIs would be able to engage, and borrowing against future oil revenues could begin.

24. Taken together, this suggests that the optimal financing plan, in the absence of UN involvement, would be to:

- maximise Iraq's own contribution – by trying to use Iraq's current oil revenues (e.g. to continue OFF). Working with the UN would be essential for this – otherwise the US and its allies would risk opening themselves up to 'stealing oil' allegations. Tapping future oil revenues would be out of the question;
- prevent Iraq's revenues being side-tracked into paying unsustainable debts and compensation claims – by trying to remain in arrears without legal challenge; and
- try and ensure that the US and its combatant allies are not the only bilateral donors. The pool would be shallower and narrower without UN involvement. But there could be some possibility of money from Europeans who have supported the US stance (e.g. 'New Europe', Spain, Italy) and Japan.

25. Whatever the success of this, countries like the UK would almost certainly be faced with pressure for much larger bilateral contributions than would have been the case with UN cover. We could be looking at a situation where only a few bilateral donors were expected to meet most of the financing gap. This would be particularly problematic if Iraq's ability to pay had been compromised by sabotage.

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26. The recent case of Afghanistan is a useful illustration of this. A UN-endorsed government was able to attract pledges of \$4.5 billion from the international community, including the World Bank and EU. Non-combatants like Germany (\$362 million) and the EU (\$500 million) gave money - and gave significantly more than combatants like the US (\$296 million) and the UK (\$288 million). If the US and UK had instead had to pay this \$4.5 billion on their own, they would each have had to pay nearly ten times the amount that they actually did.

27. Meeting a high proportion of the likely reconstruction costs would clearly be a very significant commitment for any Government to take on alone, especially given the recent worsening in public finances on both sides of the Atlantic. It would certainly be beyond the means of the UK Government.

28. A substantial UK financial contribution to the reconstruction efforts is unlikely to be affordable within existing spending plans unless the Government chose to divert spending from other domestic programmes. In the first instance DfIDs unallocated departmental provision (£88 million for 2003/04) should provide for immediate requirements. The UK will, however, come under considerable pressure to contribute much more as its share of immediate humanitarian and reconstruction costs, let alone what would be required as part of an "exceptional response". Substantial further support from central funds though is unlikely to be affordable: the costs of military activity in Iraq and elsewhere have already fully committed the 2003/4 Reserve; and the overall deterioration in the fiscal position severely limits the Government's discretion to make additional spending allocations.

29. But there could be implications beyond those about the distribution of financing bills. Given the fiscal constraints in the US and the UK, it is probable **that the total level of resources going into Iraqi reconstruction would be substantially smaller if the UN were not involved.** This - and the probable inability of the IMF and World Bank to engage in such circumstances, reducing the scope for vital technical assistance - could have a serious impact on the whole project. With less money and less help, it could be harder to put Iraq on a path to peace, stability and democracy.

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