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From:
Date: 11 February 2003
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HMT POLICY ON POST-SADDAM IRAQ

Issue: First thoughts on our policies towards post-Saddam Iraq, focusing on how its needs could be financed (in attached paper)

Recommendation: That you steer on whether we have set out the right direction.

Timing: For your immediate attention – given the political situation.

Background:

We have done some preliminary thinking about what HMT interests would be in any post-Saddam Iraq situation. This is written up for you in the attached paper and summary.

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2. Some of the issues were covered at an informal discussion with US officials in Washington last week, which attended for HMT.

3. We would be grateful for any views you have on the provisional approach set out in the attached paper. However, even if this is the right answer, there is a clear challenge in delivering on it, given the political situation. We are giving some further thought to how this should be raised with G7 and potentially EU partners.

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What should HMT policy be on post-war Iraq?

Summary

- i. Our two main interests in Iraq are in (a) **ensuring its prosperity and stability**, whilst (b) **fairly sharing the burden** for the costs of achieving this. The latter will be the inter-departmental and inter-Government battleground.
- ii. The potential costs of achieving the first objective are hard to predict, potentially massive, and probably comprised of the following elements:
 - peacekeeping costs. FRY needed 40,000 troops, with KFOR's costs to the UK peaking at £325 million in 1999/00. Iraq will probably need more, given ethnic and religious tensions, score-settling and its sheer size. This, and military 'mopping-up' could become a significant burden, if UK troops remain by default (this suggests the constant need to avoid an assumption that troops will stay);
 - humanitarian expenditure. This would be concentrated in the early reconstruction phase. The UN estimates a range of first year costs from \$1.9 billion to \$4 billion plus. But a messy conflict could make it even worse;
 - environmental costs, e.g. from WMD usage or oil fires. UK capacity in this area is limited, so we could get billed by others who actually do the work;
 - general reconstruction. Precedent suggests that annual ongoing costs range between \$50 and \$350 per head per year. This could yield an annual bill (including humanitarian costs) of between \$1.5 billion and \$8 billion; and
 - economic stabilisation, requiring medium-term IMF balance of payments lending.
- iii. There are various potential routes through which such a bill could be paid, including:
 - Iraq itself, which pays for current humanitarian and reconstruction costs through 'oil for food' (OFF), at roughly \$10 billion per year. But this may not be able to make a sufficient contribution, especially if damage is bad and oil stops flowing;
 - debt relief or rescheduling, on Iraq's massive \$80 billion bilateral debt (largest creditors: Russia, France, Japan, Germany). However, since these debts are not being serviced at present, this would merely save Iraq from additional bills. (We must also try and avoid new ECGD business with Iraq, if unstable);
 - multilateral contributions, for instance from the World Bank. The biggest challenge would be justifying grants to a middle income country. EU money would be difficult (given the politics and the budget), but not impossible; and

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- bilateral contributions, which have made up large elements of previous post-conflict reconstruction packages. The difficulties here are that (a) we might get asked to pay a lot, as 'aggressors' and (b) unlike the Gulf War, we are unlikely to find rich Gulf states willing to pay our military bills.
- iv. On top of all this, we would face challenges such as chance that the war could go worse than expected, the lack of support if war or occupation were not UN-endorsed, and the importance of getting the right organisations in the lead. And we would need to push for clear finance ministry and IFI leadership of this process, with contributions only agreed once a proper needs assessment had been done.
- v. Taking all of this into account, an emerging policy position would be to:
 - maximise Iraqi contributions, initially through maintaining OFF;
 - push for debt rescheduling, to ensure that Iraqi contributions are not knocked off course by having to resume crippling debt service. The cost of this would conveniently fall to probable non-combatant countries;
 - maximise MDB contributions, preferably in the form of grants, early on. And push for IMF and World Bank to take the lead in their respective areas;
 - push for bilateral contributions to take into account military contributions, assuming that UK involvement in this was significant. This would, of course, be extremely difficult if the war were not UN-endorsed; and
 - ensure a finance ministry / IFI lead on financing issues, with a clear understanding that no money is committed until needs are properly understood.

Introduction

1. With a regime-changing war in Iraq looking increasingly likely, this note takes a first look at some of the issues that post-Saddam Iraq might raise for HMT, and the optimal policies we might deploy.

What should be our objectives?

2. HMT would have two main interests in post-war Iraq:
 - helping put Iraq on a path to stability and prosperity. Iraq's political and economic stability would have many positive knock-on effects for the region and the world. Iraq is potentially a rich country, which could benefit others via trade; as well as providing greater diversity of energy supplies. And the removal of Iraq's threat could provide a further boost to regional growth. But the task of getting it to this point would cost money; and

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- sharing the burden of financing this as widely and fairly as possible. This should take into account Iraq's ability to pay and recognise the different military contributions of different donors.

3. The main battle here will probably be on the second objective. There will be plenty of pressure for success on the first objective – both within the UK Government and from outside. This could lead to substantial pressure for the UK to make a disproportionate and highly visible contribution to Iraqi reconstruction.

What would be the main elements of the bill?

Peacekeeping

4. Peacekeeping will be a vital element of post-war stabilisation. Iraq is an artificial construct containing heterogeneous racial and religious groups (e.g. Kurds, Sunni and Shia Muslims). There will be pressure for score-settling, after years of oppressive rule – and even within racial groups, there can be bitter rivalry (e.g. Kurds). Surrounding countries, which face similar problems, will want to see these pressures contained (e.g. Saudi Arabia and Turkey). This suggests the need for a very large peacekeeping force. At its peak, the peacekeeping force in FRY numbered 40,000. Iraq's might have to be bigger, given the larger size and population.

5. Peacekeeping costs vary greatly with the size, composition and role of the force. Table 1 (below) sets out the annual UK costs of participation in SFOR (Bosnia), KFOR (Kosovo) and ISAF (Afghanistan).

Table 1: UK annual peacekeeping costs (£ million) in recent operations

	96/97	97/98	98/99	99/00	00/01	01/02	02/03
SFOR	247	386	147	112	120	93	102
KFOR	-	-	-	325	220	141	147
ISAF	-	-	-	-	-	29	18

6. It would be very easy for the default option to be for UK troops to remain in theatre – to mop-up and to keep the peace – just because they happened to be in Iraq. But this would be very expensive, and would need to be the subject of an explicit decision, involving the Treasury. The potential for very large costs from this source, into the medium-term, is significant.

Humanitarian

7. Iraq's humanitarian needs are currently being met by the UN 'oil for food' (OFF) programme, on which 60% of Iraqis are dependent. The latest distribution plan (Phase XIII, December 2002 to June 2003) involves allocating \$4.9 billion to Iraqi domestic needs, the main components of which are set out in table 2 below.

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Table 2: Main OFF allocations, December 2002 to June 2003

	\$ millions
Food	1,275
Agriculture	216
Irrigation	229
Health	143
Special allocation for vulnerable groups	344
Industry	210
Electricity	273
Oil sector	600
Other	1,637
TOTAL	4,927

8. This table indicates that OFF is financing more than just food. It also shows that in the current peacetime equilibrium, just a quarter of the OFF allocation to Iraq is sufficient – in tandem with Iraq's own agricultural production – to ensure that people are fed (the average daily food 'basket' is a relatively respectable 2,200 calories).

9. However, war could change all of this. First, it would stop Iraq's oil from flowing, in the short-term. A messy war could involve a long interruption to oil exports. Second, it would create substantial new needs. Initial UN estimates of needs in the first year are set out in table 3 below. In past conflicts, the UK has contributed roughly 10% of humanitarian spending.

Table 3: UN estimates of humanitarian need, 2003-4, under various war scenarios

	No. requiring food assistance	No. seeking asylum in neighbours	1 st year cost (additional to OFF)
Short war	4.9 million	0.6 million	\$2 billion
Medium war	9.6 million	1.4 million	\$5 billion
Protracted war	c. 20 million	Unknown	\$12 billion

10. There are two further factors to take into account. First, if WMD are deployed in Iraq, needs will be greater and meeting them more complex. Second, the precedent of Afghanistan suggests that humanitarian spending can be required for a lot longer than is initially anticipated on the 'day after'.

Environmental

11. A protracted or messy war could lead to expensive environmental costs, for instance cleaning up WMD-contaminated sites, or putting out burning oil wells. The costs associated with this are likely to be large. UK capabilities are relatively limited in this area, which might lead to demands that we pay for others (1991 Kuwaiti oil fires were largely put out by East Europeans).

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Reconstruction

12. Even before any war, Iraq is in chronic need of reconstruction, due to the damage of past wars and the ongoing impact of sanctions. Reconstruction since the Gulf War has been patchy. For instance, most bridges have been repaired, but power generation capacity in central and southern Iraq meets only 50% of demand. And other infrastructure weaknesses have a strong bearing on the humanitarian situation: for instance, only 46% of rural Iraqis have access to clean water. War would set back Iraqi infrastructure very substantially: for instance, Gulf War bombing destroyed 90% of Iraqi electricity generation capacity

13. World Bank estimates suggest that the amount of international aid provided in post-conflict scenarios in middle income countries has usually been in the range \$100-\$400 per capita per annum (this includes humanitarian expenditure, which tends to be concentrated in the early months). Examples include \$100 (Lebanon), \$233 (East Timor), \$332 (Bosnia) and \$375 (West Bank and Gaza Strip).¹ Iraq's large population (26.5 million) suggests that assistance in this range would be expensive, as shown in table 4.

Table 4: Estimates of total annual reconstruction costs for Iraq

Per capita annual reconstruction cost (\$)	Total annual reconstruction cost for Iraq (\$bn)
50	1.32
100	2.65
200	5.30
300	7.95

14. This, however, excludes reconstruction expenditure on the Iraqi oil sector, which provides most foreign exchange and government revenues. OFF and Iraqi technical skills have kept large quantities of oil flowing in recent years. But investment is urgently needed, even to keep production at its current peak capacity of 2.8mbd (compared with roughly 3.5mbd at its peak). Iraq's own estimate is that it will take \$30 billion to rebuild its petroleum industry. But increasing exports to Iraq's potential of roughly 6mbd would cost a lot more – perhaps \$60 billion over five to ten years (BP's estimate). One option would be for multinational oil companies to provide the bulk of this.

Economic stabilisation

15. Iraq is in chronic need of stabilisation, with high inflation and large budget deficits. The first issue to settle with the Fund is Iraq's arrears (somewhere around \$50 million). But Iraq's debts (somewhere around \$100 billion, none of which is currently being serviced) and the likely damage that war would bring to the oil sector suggest that substantial balance of payments support would be needed for some time to come.

¹ Note that these figures are nominal (i.e. the Lebanon aid would be worth a lot more in 2003 dollars)

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Who would pay?

Iraqi contribution

16. Iraq is in a different league to most recent post-conflict cases, in that it is so big and potentially so rich, with the world's 2nd largest oil reserves and (even in its current state of disrepair) roughly 3% of world production. Oil revenues are currently paying for a substantial humanitarian and reconstruction programme (OFF, details above). The obvious answer is that Iraq should pay for the lion's share of its reconstruction, with a very limited role for donors, except for immediate humanitarian needs.

17. However, there are several reasons why this might not cover all – or even the majority – of the costs of reconstruction:

- oil infrastructure may be damaged in fighting, or deliberately sabotaged by retreating Iraqi forces, as in Kuwait in 1991. There are key vulnerabilities – for instance, half of exports are channelled through one offshore terminal. The worst case scenario is WMD contamination of Iraqi oilfields or infrastructure. This could lead to drastically reduced Iraqi exports;
- the resolution of war with Iraq could remove the war risk premium from oil prices, reducing the oil revenues from a given level of Iraqi production;
- there would be extreme political pressure for Allied 'aggressors' to pick up some of the bill, especially if fighting was not UN-endorsed;
- OFF provides, on a good year, \$10 billion for Iraq. This is enough to keep Iraq ticking over, in a fairly decrepit state. But whether it could also finance an expensive reconstruction programme remains to be seen; and
- post-war Iraq may have to pay bills that Saddam's Iraq currently doesn't. There are two categories. First, compensation. 25% of OFF is given to Kuwait, as compensation for 1990. But Iran has an outstanding claim for \$100 billion compensation for the Iran-Iraq war. Second, debt. Iraq is not currently servicing any of its huge external debt (c. \$82.3 billion, or nearly 300% of GDP). Doing so would greatly reduce the funds available for reconstruction.

Debt relief

18. It is hard to get an accurate picture of the size and ownership of the Iraqi external debt stock, which has not been serviced in years. The EIU's estimates are relatively low: \$53.0 billion, or 166% of GDP. But US estimates are higher, at roughly \$82 billion. The US breakdown of the debt (set out in table 5) paints a very interesting picture. Based on 1990 debt levels, and estimates of accrued interest, this suggests that the total debt level is \$82 billion, of which Russia (\$16 billion), France (\$9 billion) and Germany (\$6.7 billion) are the biggest creditors, along with Japan (\$9 billion). Three of Iraq's biggest

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creditors are thus – perhaps unsurprisingly – three of the countries most opposed to US handling of the crisis.

Table 5: Significant creditors to Iraq (US State Department estimates)

	1990 debt (\$bn)	2002 debt (\$bn)	Percent of 2002 total
Russia	8.0	16.1	19.6
France	4.5	9.1	11.0
Japan	4.8	9.1	11.0
Germany	3.3	6.7	8.1
Italy	3.0	6.0	7.3
US	2.2	4.4	5.4
FRY	2.0	4.0	4.9
Turkey	1.8	3.6	4.4
Romania	1.6	3.2	3.9
UK	1.2	2.4	2.9
Total (inc. others)	40.5	82.3	100.0

19. If these figures are correct, Iraq's debts are thus very significant, making it one of the most heavily-indebted country on earth (however, we must remember that this partly reflects the stagnation in economic performance produced by a decade of sanctions). By comparison, Lebanon's debt is 180% of GDP, much of which is domestic debt. Servicing this would be impossible, especially in the aftermath of a war.

20. In normal circumstances, providing some sort of relief (e.g. rescheduling) from servicing a debt burden of this kind would provide an opportunity for financing the country in question. But Iraq is not servicing any of its external debts, and is inflating away its domestic ones. This means that debt rescheduling or relief does not release funds that are currently tied up – it merely prevents Iraq being faced with a new set of bills. It should thus be seen of a way of removing a barrier to Iraq helping pay for reconstruction.

21. Note that Iraq owes ECGD £620 million in unpaid principal, with probably an equal amount in unpaid, accrued interest. This figure (c. £1250, equals \$2000) is broadly equivalent to the UK figure given above. There is also a need to avoid new ECGD exposure to post-conflict Iraq, until the situation is a lot clearer and more stable.

Multilateral money

22. One obvious way to share a financing burden is to use multilateral resources. The World Bank would be the obvious starting point, but contributions might also be expected from other MDBs (e.g. Asian Development Bank) and from the EU.

23. The problem for the MDBs would be justifying large grants to a country of Iraq's potential wealth. It might be possible for the World Bank to do this for a short period, through IDA or exceptional grants, perhaps by arguing that Iraq has temporarily become a poor country. Other post-conflict countries have benefited from such an approach –

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although none are as rich as Iraq. In the longer-term, assistance could not be concessional. However, this runs into the difficulty that Iraq already has crippling debts – again implying a need for action on Iraq's bilateral debts.

24. IMF money would also probably be needed, for medium-term balance of payments support as Iraq regularised its debt service and repaired its oil industry. But this would not be money available for reconstruction expenditure. However, if Paris Club rules are followed, an IMF programme would be needed in order to kick-start debt rescheduling talks.

25. There is also the difficult initial issue of arrears to the IFIs. In the past, different approaches have been taken to clearing these. In Afghanistan, World Bank arrears have largely been paid by the G7. However, FRY's IMF arrears were paid by an emergency IMF loan.

26. EU money could also play a role, but the difficulties of this should not be underestimated. Resources would come from Category 4 of the EU budget, which deals with external action, and which has a current budget of about €5 billion. A legal instrument would be needed – which MEDA could probably provide (at present, this is roughly a fifth of the budget). Difficulties we would face in getting money for 2004 would include:

- our own priority that resources should go to the poorest countries;
- the need for Budget decisions to be agreed by qualified majority by the European Council and by the European Parliament, which could be hard to do if the French and German positions did not change;
- the degree of pre-commitment within the Budget. All but \$100 million of the 2004 Category 4 budget is pre-committed (excluding Emergency Aid Reserve)

27. Assistance in 2003 would be even more difficult, with a margin of just €23 million unallocated. However, there might still be resources (in 2004) from the €222 million emergency aid reserve. By way of comparison, the EU pledged \$500 million over 5 years to Afghanistan.

Bilateral contributions

28. Previous reconstruction assistance has usually had a large bilateral component. For instance, of \$4.5 billion pledged for Afghan reconstruction, \$288 million came from the UK, \$362 million from Germany and \$296 million from the US.

29. There are two related complicating factors in this case. First, the cost of the fighting is likely to be borne by a far narrower coalition of countries than was the case, say, in Afghanistan and the Gulf War. This will even be the case if a second UN resolution is secured, as evidenced by the attitudes of countries like Germany (a

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combatant in Kosovo) and most of the Middle East. Second, there are likely to be far fewer countries willing to contribute to these military costs than was the case in the Gulf War, when Saudi Arabia, Kuwait and Japan paid \$48 billion of the US's \$61 billion military costs. Taken together, this indicates that potential combatant countries, like the UK, will face very substantial costs - to which others are unlikely to contribute - before reconstruction has even been taken into account.

30. The challenge for the UK will thus be to persuade others that its bilateral contribution to reconstruction should be proportionately less than that from non-combatant countries. A challenge for the Treasury is to ensure that DfID pays its bills on this without a reserve claim. The immediate priority is to communicate the message that DfID should be budgeting for such expenditure from within its contingency reserve. We should also seek a contribution from the FCO global opportunities fund.

Challenges

31. The picture is further complicated by three additional challenges.

32. First - as noted above - all of this becomes much more difficult if the war is protracted or messy. WMD usage would massively complicate the humanitarian and reconstruction tasks, as would the spread of conflict to surrounding countries.

33. Second, further problems would occur if war or occupation were unilateral. This would decrease the potential pool of donors, massively reduce sympathy for a UK reconstruction 'rebate' as a combatant and even potentially - in a worst case - leave open claims for compensation. Additionally, if US plans to administer Iraq unilaterally were enacted, it would be difficult to see how any multilateral donors could be involved.

34. Third, it would be important to get the right organisations in the lead. In the Kosovo crisis, an early political decision was made to put the EU in charge of reconstruction - a task for which it was neither financially nor organisationally equipped. The key will be ensuring each organisation plays to its strengths. The obvious formula is to have the IMF in charge of support on overall economic strategy, with the World Bank co-ordinating reconstruction on the ground (as it did in Afghanistan and East Timor), as well as co-ordinating bilateral donors (e.g. through a Trust Fund). Past crises also show that the earlier the IFIs get involved, the better and swifter the results.

35. A closely related point is the need for finance ministries to play the lead role on behalf of national governments, and avoid the pace, agenda and momentum being set by foreign ministries, or by non-IFIs like the UN. And strong emphasis needs to be placed on resources only being committed when a proper needs assessment has been made (presumably by the World Bank, and presumably some way off yet).

Policy conclusions

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36. The first decision that will be needed will be the desired end-point of reconstruction – what do we want a reconstructed Iraq to look like? This boils down to the question of how prosperous we want to leave Iraq. There will be strong political pressure for it to be noticeably more prosperous and equitable than current Iraq. Early decisions on this will be important, in order to influence other key players.

37. Other decisions relate to ensuring that the burden is fairly shared, avoiding disproportionate UK cost. Our analysis suggests that the best approach could be to:

- **maximise Iraqi contributions.** Initially, this would be done by continuing or resurrecting OFF. But in the longer-term, as sanctions were dismantled, it would probably merely mean donor withdrawal or reduction in generosity; but this could require us to
- **push for debt rescheduling for Iraq.** In post-war Iraq, the UK would be entitled to pursue repayment of Iraq's \$1-\$2 billion bilateral debts, which are currently not being serviced. However, if all creditors did the same and were successful, Iraq's ability to fund its own reconstruction would be severely compromised. This would lead to a fiscal financing gap for Iraq, probably filled largely by bilateral financing. In such a situation, the UK might be under pressure, to make a big contribution, given the politics, which might dwarf the debt payments that Iraq was paying. A simple solution to this would be debt rescheduling, perhaps on terms that reduced the NPV of the debt. The other advantage to rescheduling is that we suspect that most of the debt is owed to probable non-combatant countries (e.g. France, Russia), with debt relief thus providing a neat way of burden sharing. The other strong argument for debt relief is that, without it, multilateral lending is likely to prove very difficult;
- **maximise MDB contributions.** Grants would be needed early on, loans would be preferable later – although this would only be sensible if Iraq's debt problem had first been addressed. We should also push for prominent and early World Bank and IMF co-ordination roles; and
- **push for bilateral contributions to take into account military expenditure.** In other words, the US, UK and other combatants would pay proportionately less of the reconstruction cost than non-combatants. This would probably only work in the event of a 2nd UN resolution. But, even without this, there might be some chance of persuading some of our European allies (others in the group of 8) to contribute, if they had not contributed much to the fighting; and
- in terms of process, **push for IFIs and Finance Ministries to lead, with no money committed until a proper needs-assessment has been done.**

38. However, the position of the US would be crucial to all of this. It would be crucial to have a united position. The only potential difficulties are: (a) that the US owns more Iraqi debt than us (although not much compared with others); (b) if the US feels that it is

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making a disproportionate contribution to peripheral costs (e.g. buying Turkey's support, which could cost several billion dollars).

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