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From:
Date: 19 February 2003
Extn:
Room:

CHANCELLOR

cc: Chief Secretary
Gus O'Donnell
Jon Cunliffe
Nick MacPherson
Stephen Pickford
Jonathan Stephens
John Dodds
Michael Ellam

Ed Balls

UPDATE ON IRAQ

Issue: Latest update on Iraqi reconstruction, public spending and policy co-ordination issues

Recommendation:

- (a) That you use the lines provided in your bilateral with Jon Snow, and consider sharing some of our papers.
- (b) That if the subject of macro-policy co-ordination comes up at the G7, you could be ready to encourage discussion and share some ideas (attached)

Timing: Immediate (Snow and G7 meetings are both imminent)

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Background:

2. This pack provides up-to-date briefing on Iraq, as background for your meetings with Jon Snow tomorrow and with other G7 Finance Ministers at the weekend.

3. The pack contains:

- a note examining G7 macroeconomic policy co-ordination issues in the event of an Iraq or terrorist-related shock to global confidence ();
- a set of papers on Iraq reconstruction issues including:
 - (a) a 2 page summary of key messages on economic and financing issues; which draws on
 - (b) a new paper on pitfalls and process issues we face in planning Iraqi reconstruction; and
 - (c) a paper (that you have seen before) on international financing issues regarding reconstruction. We think (c) (and probably (b) – perhaps your office can advise?) are in a form that can informally be passed to Mr Snow.
 - (d) a note (from John Dodds) on the implications of a UK-administered sector in post-war Iraq.
- a note on the public expenditure implications of war with Iraq (from)
- A past note – as background – on the potential impact of Iraq on Treasury objectives. This includes some material on the potential impact on world and UK economies.

Snow meeting

4. Iraqi reconstruction may come up in this meeting. Even if Mr Snow does not raise it, you may wish to. Our sense is that

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momentum on the issue is developing very fast, and there is a risk that the financing agenda could be set by policy decisions taken in Foreign and Defence ministries. Sharing ideas with Mr Snow may be a useful way to begin to redress this balance. An additional approach would be to write round Whitehall colleagues sharing your concerns (for instance, about the economic and financing implications of foreign and defence policy decisions). We would be happy to provide a draft for you.

G7 meeting

5. An Iraq discussion is not scheduled. And even if Iraqi reconstruction comes up, the kind of lines that can be used with the US are clearly not appropriate for some partners.

6. However, a related issue may come up: the issue of how G7 policy makers can best prepare to co-ordinate any macroeconomic policy moves that become necessary in the event of an Iraq or terror-related shock to confidence. note provides some thoughts.

7. Given the politics, it would probably not be prudent for the UK to raise these issues at G7. But if someone else were to provide a way in, you could encourage such a discussion, which could be useful – particularly in the Surveillance discussion, when Central Bankers will be present. The main aim would be to alert colleagues to the potential need to act quickly and in a co-operative fashion in such circumstances – something that has been problematic on past occasions.

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Potential pitfalls

- We need to be clear that many decisions about post-war Iraq have a financing or economic angle, even if this is not explicit.
- First, the political context will strongly influence the degree of burden-sharing. Without UN cover, there are likely to be far fewer bilateral donors, and IFIs may be unable to operate.
- Second, there may be significant limits to the economic and financing decisions that can be taken by a transitional 'caretaker' administration in Iraq, even with UN cover. These include issues about the future of Iraq's oil industry, and on economic reform.
- Third, military decisions – like whether coalition partners are allocated a sector to administer – can have worrying implications for the scale and duration of cost commitment.
- We also need to be aware of best practice lessons from previous post-conflict situations. For instance, we have learnt that:
 1. Costs are always unclear in advance. It is premature to commit to actual sums of money for reconstruction until a full needs assessment has been done (usually by the World Bank). This can take time.
 2. The UN is an important ally – but must play to its strengths. Involvement in economic policy, and co-ordination of reconstruction efforts are not among them, as the IMF and World Bank are much better-placed to do this.
 3. The IFIs need to be involved early on, so that they can 'hit the ground running'.
 4. Financing decisions – and input to decisions which have a financing angle – need to be taken by Finance Ministries. Co-ordination among the G7 promotes understanding and coherence in this.

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Iraqi reconstruction: pitfalls and process

Summary

- This note looks at pitfalls we may meet in trying to put Iraq on a path to stability and prosperity whilst fairly sharing the financing burden for this. It also examines the process for pursuing this.
- Iraq's prosperity and stability require someone to: keep the peace; meet humanitarian needs; ensure a functioning Government; achieve macroeconomic stability; maximise oil revenues; achieve physical reconstruction; and to effect economic transition.
- There are various challenges to doing all this in an effective and affordable way, including:
 1. Gaining United Nations cover, i.e. a second Security Council Resolution (UNSCR), without which: we will have to pay more of the bill; IFIs will find it hard to engage; and we will be unable to resolve crucial financing issues (e.g. debt, compensation).
 2. Being realistic about the decisions a transitional Government can take. It could be illegitimate and de-stabilising if decisions about future Iraqi economic policy (e.g. structural reform, oil policy) are made by a caretaker Government made up of foreigners (even if it were UN-backed).
 3. Noting the implications of 'sectors' in Iraq. Some military planners are looking at dividing Iraq into administrative sectors. If the UK takes on one, the cost – in terms of money and administrative burden – could rocket, and our stay lengthen. A separate note from John Dodds in DDI refers.
- And we should learn and apply some generic post-conflict lessons including: ensuring UN involvement does not stretch to running economic policy or co-ordinating reconstruction; not committing resources until a needs-assessment has been done; and trying to prevent Foreign Ministries taking financing decisions (even by default).

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- The momentum of this issue makes it difficult for us to influence decisions, as does the concentration of decision-making in the US White House/NSC and Department of Defence. But the UK is feeding into this at official level via a new Iraq Planning Unit – we are leading an economic sub-group within this. And we are part of a trilateral dialogue with the US (and Australia) on 'day after' economic issues.

Introduction

1. Our note of February 11 (attached) set out two objectives for post-war Iraq: that it should be **prosperous and stable**, and that **the bill for achieving this shared fairly across the international community**. It examined what these objectives might mean for some of the international financing decisions we could soon face.

2. This note follows this up by identifying some of the factors that might make these objectives difficult or expensive to achieve, and maps the decision-making processes.

Achieving successful reconstruction

3. Putting post-war Iraq on a path to economic stability and prosperity would involve success on at least seven fronts.

- peacekeeping;
- humanitarian issues;
- proper functioning of Government;
- macroeconomic stability;
- maximisation of oil revenues;
- physical reconstruction; and
- economic transition (structural reform of statist economy).

4. Table 1 (below) looks at each of these in turn, noting the key needs for success, and the key challenges that we could face.

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Table 1: Objectives, needs and challenges in Iraqi reconstruction

	Objective	Key needs	Key challenges
1	Peacekeeping	<ul style="list-style-type: none">• Large force - to cover a large, fractious country• Diversity of peacekeeping force, with maximum Arab and Muslim component	<ul style="list-style-type: none">• Without a 2nd UNSCR, UK burden would be much larger – and it would be harder for other countries to come on board• Military plans may involve Iraq being divided up into administrative sectors, (inc. a UK one), implying a costly, long-term presence
2	Humanitarian	<ul style="list-style-type: none">• Ensuring population fed• Swiftly addressing refugee issues• Addressing health issues arising from war (e.g. normal and WMD casualties)	<ul style="list-style-type: none">• Oil for food programme (on which majority of population depend) could be disrupted either by lack of 2nd UNSCR/lack of legitimate government, or by oil export disruption• Lack of 2nd UNSCR would reduce potential pool of donors, and possibly prevent World Bank involvement, including donor co-ordination
3	Proper function of Government	<ul style="list-style-type: none">• Public services delivered, and soon improved (low baseline)• Taxes collected, public workers paid	<ul style="list-style-type: none">• Lack of 2nd UNSCR could prevent technical assistance being made available from IFIs (e.g. IMF)• UK being given a 'sector' of Iraq could mean having to provide UK staff for onerous and dangerous tasks

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4	Macroeconomic stability	<ul style="list-style-type: none"> • Prevent hyperinflation and currency collapse • Management of monetary policy, including securing FX assets • Prevent public finances crisis, given huge debt burden and compensation claims 	<ul style="list-style-type: none"> • Demands for resumption of debt service and for compensation (e.g. from Iran) will be much higher if no 2nd UNSCR • Similarly, IMF unlikely to be able to engage without 2nd UNSCR. Resolving debt problems via Paris Club impossible without IMF programme in place
5	Maximisation of oil revenues	<ul style="list-style-type: none"> • Shortest possible cessation of exports • Rapid increase in exports, to ensure maximum Iraqi contribution to costs of reconstruction 	<ul style="list-style-type: none"> • Possible massive damage to Iraqi oil infrastructure by retreating regime • Post-war Iraqi oil policy could influence oil price – e.g. aggressive increase in production – perhaps in concert with leaving OPEC - might help cause a price collapse, thus reducing revenues • There are major legitimacy issues about who can take decisions on Iraqi oil policy. Even with a 2nd UNSCR, a transitional Iraqi Government may not have the legitimacy to issue new contracts. It might have to content itself with working through the state oil company and trying to maximize production • There are likely to be legal issues about the status of Saddam-era contracts with foreign (i.e. French, Russian, Chinese) oil companies

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6	Physical reconstruction	<ul style="list-style-type: none">• Getting Iraqi infrastructure and services up to an acceptable level	<ul style="list-style-type: none">• Defining what an 'acceptable level' is: pre-war? Pre-Gulf War? Pre Iran-Iraq war?• Without 2nd UNSCR, many donors are unlikely to contribute (e.g. IFIs, much of G7, Arab world), and IFIs may not be able to co-ordinate assistance or do a needs-assessment
7	Economic transition	<ul style="list-style-type: none">• Helping Iraq become a fast-growing market economy, via structural reform	<ul style="list-style-type: none">• Legitimacy is the key issue. As with oil, it is not clear that even a UN-endorsed transitional Government has the right to take reform policy decisions. But it may not be possible to delay some decisions (e.g. expensive subsidies)

5. The analysis in this table suggests that there are several key risks and issues that we need to bear in mind in addressing Iraqi reconstruction:

- **UN cover.** Without this, our costs will be much higher (peacekeeping, humanitarian, reconstruction), we will be unlikely to make progress on key macro-stability issues (e.g. debt and compensation) and unable to tap the technical and co-ordination expertise of the IFIs. FCO recognise the role that a 2nd UNSCR could play (so long as it provides cast-iron cover for conflict), for this and other reasons. But they hold the view that even without one, the UN might be persuaded to re-engage in post-conflict Iraq, in some circumstances;
- **legitimacy of transitional Government.** Even with a 2nd UNSCR, there are issues that should arguably be left until they can be decided by a representative Iraqi administration (e.g. economic reform and oil policy).

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However, others may take a different view on this (e.g. 'Hawks' with a strong vision for Iraq very rapidly to become a market economy whose oil reserves are exploited more fully by international oil companies, and which probably has no place in OPEC); and

- **the prospect of a UK sector**, which could greatly increase the duration of the UK stay in Iraq, as well as massively increase the costs and administrative burden. A separate (attached) note from John Dodds (DDI) provides some urgent advice on this issue.

6. In addition to these Iraq-specific points, there are some more general post conflict lessons that we need to bear in mind as we engage with this situation:

- **the UN should be involved – but play to its strengths.** In particular, giving the UN any form of economic responsibility is usually problematic. Much better to let the UN provide legitimacy for involvement of IFIs;
- **we can help to contain costs by:**
 - (a) pushing the case for a full needs assessment before anyone makes a precise financial commitment. The World Bank is usually best-placed to do this; and
 - (b) ensuring that financing decisions are taken by Finance Ministries – preferably while in close contact on the G7 net – and that decisions with financing implications are routinely taken only after consultation with Finance Ministries.

Influencing decisions now

7. From the above analysis, and from our earlier note, it can be seen that many reconstruction decisions have a strong economic or financing angle. Despite this, it may not be easy to influence them. This is because of the way that they are being made (primarily by

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Heads, Foreign Ministries and – perhaps most – by military planners), but also the speed at which decisions may have to be made in coming weeks.

8. Decisions on post-war Iraq are largely being made in the White House/NSC, but also increasingly in the US Department of Defence, in a new unit called the **Office for Reconstruction and Humanitarian Assistance** (OHRA). The head of this unit – Jay Garner (a retired American General) – is being groomed by the US to head up the transitional 'civilian' regime in Baghdad, once military government has run its course, and prior to the establishment of Iraqi democracy. There are also UK secondees in the unit (from MoD).

9. In order for the UK to be able to influence this planning (e.g. via this route and via ministerial channels), a cross-cutting **Iraq Planning Unit** has just been set up in the Foreign Office. Its remit covers economic issues – but we have already set up an HMT-led sub-group to provide direction on these.

10. We are also involved in ongoing discussions with the US and Australia about 'day-after' issues, in a group convened by the US State Department. Our initial contribution was to co-author a note with FCO on the immediate priorities that would need to be addressed in ensuring that Iraq's economy kept on its feet after any war.

11. In parallel, there is clearly much interaction at ministerial level, including through some fairly high-profile bilaterals.

Country Economics and Policy Team, HM Treasury

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