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From: Crook, Andrew
Sent: 06 September 2002 09:52
To: Bowman, Mark, Chancellor's, Action
Cc: , Pickford, Stephen
Subject: What would be the Economic Impact of a War in Iraq?

Importance: High

Mark,

Please find attached the promised note on the oil and economic impacts of a war on Iraq.

Given the sensitivity of the topic, we have kept a limited circulation list to date - although will now share more widely. Stephen Pickford and have agreed the paper.

If the Chancellor is particularly interested in the oil aspect, he should look at para 2 of the summary (page 1) and paras 20-27 of the main paper (pages 6-8).

Happy to answer any further queries.

Andrew Crook

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WHAT WOULD BE THE ECONOMIC IMPACT OF WAR IN IRAQ?

Summary

1. This note examines the global, regional and local economic impact of a US-led war on Iraq. Underlying it are 3 scenarios. The central one involves a swift victory, a large reconstruction task, and increased Middle East instability. The downside is a costlier victory, on all fronts. The upside is for the regime to be toppled from within.

Global Impact

2. Oil markets already think war with Iraq is probable (which, along with OPEC hawkishness, has raised prices to around $27pb). But if war broke out, and markets feared that it might affect neighbours, oil prices could rise by $10pb. If sustained for a year, this could reduce global growth by 0.5pp, and raise inflation by 0.4-0.8pp. Further price spikes could occur during war, e.g. if WMD were used.

3. US investor and consumer confidence could fall significantly if war happened, reducing consumption and investment growth, and thus GDP growth. The Gulf War and September 11 (good precedents) both involved sharp falls in investor confidence and then investment. They also affected consumer confidence, but the fall in consumption growth seen in the Gulf War was not mirrored after September 11, when consumption grew faster, in response to 'patriotic' consumer spending and monetary easing. Confidence outside the US could be affected too. This could be more muted, judging by Eurozone data for 1991 and 2001. But it could also be stronger, if the US saw September 11-style 'patriotic consumption'.

4. Compared with the situation in 2001, there is less room for easing monetary and fiscal policy across the G7. However, defence spending in the US would provide some momentum for growth: the four most recent wars or re-armaments have all seen large rises in defence spending, feeding into more expansionary fiscal positions in the short-term.

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Regional impact

5. The Middle East's oil exporters would benefit from the higher prices in our central scenario, especially those with budgetary problems Their biggest economic fear would be supply disruption, caused by escalation of the war. But several (e.g. Saudi) could also face worrying internal instability, whose containment would be costly. Sseveral of these countries are also owed money by Iraq, which they have an interest in recovering.

6. War would also reduce tourism revenues for countries like Turkey, Egypt and Jordan. The IMF estimates that the Gulf War reduced Turkish tourist receipts by 40%. Post-September 11 losses were also heavy, but not as large (and overestimated, initially).

7. Disruption of trade with Iraq – which any war would bring – would be particularly negative for Jordan and Syria, which conduct both legitimate and sanctions-busting trade with Iraq. Both are implicitly subsidised by cheap oil from Iraq.

8. Countries in the region – especially Iraq's neighbours and those with existing debt problems – could also find themselves facing higher external financing costs, as happened to Afghanistan's neighbour Pakistan in the aftermath of September 11. This could particularly affect Turkey and Jordan. There is a possibility that US allies in the region (including Israel) might need money for reconstruction, if the war spread.

9. Many of these factors suggest that a small group of countries could lose out quite heavily from a war, including Turkey, Jordan and Egypt. These countries are strong US allies, and each has a relatively precarious fiscal position. There could thus be strong pressure for more IMF money for Turkey, raising awkward issues about IMF over-exposure and the undermining of PSI principles, and for more aid for Jordan and Egypt.

10. There will also be increased pressure for the US to generate progress in the Middle East Peace Process, success in which would have major financial costs later on.

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Local impact

11. Recent reconstruction precedents, like the Federal Republic of Yugoslavia (FRY), Afghanistan and East Timor, suggest that the cost of putting a country back on its feet can be high. FRY (quite similar to Iraq, but smaller) appears to have cost nearly $10bn already, not including IMF money. Costs are driven by physical reconstruction, institution-building, stabilisation, transition and peace-keeping.

12. Iraq's starting point suggests that it could be even more expensive:

- its devastation may be greater, given damage from past wars that has not been repaired, and the likely comprehensiveness of any coming assault. Much infrastructure remains in disrepair. Poverty is prevalent – for instance, school enrolment is just 50% and access to clean water 46%. War would also create a refugee problem;

- its economy urgently needs stabilising after years of sanctions, reckless spending and high inflation. And a huge external debt problem will need to be addressed, with major creditors (e.g. Russia, with $8bn) likely to be awkward;

- a large peacekeeping force would be needed to keep a lid on the ethnic and religious tensions that Saddam's dictatorship has hidden for so long; and

- there will be strong pressure for a generous package, given the perception in the region that invading Iraq is of dubious legality and worth.

13. However, in some ways, the challenge is less than in previous cases. For instance, the transition challenge is probably more modest than in FRY, the institution-building task is certainly less than in both Afghanistan and East Timor, and Iraq is much richer (and potentially massively richer) than all three comparator countries.

14. Finally, issues will arise about the distribution of this cost. As usual, there will be a combination of multilateral and bilateral donors

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Iraq could make a bigger contribution than other domestic Governments have been able to, in precedent cases, and the US might expect Iraq to pick up the bill after a short 'bridging' period, especially as – with investment – oil revenues could quickly exceed $20 billion per year.

15. But it is more likely that strong pressure will come to bear on the US and its allies to pay the lion's share, given their role in the war, and the need to try and win hearts and minds on the Arab street.

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Introduction

16. There is growing speculation that the US will mount a military operation in late 2002 or early 2003 to topple the Iraqi Government. This note examines the potential economic consequences – globally, in the Middle East region and for Iraq itself. Background on Iraq can be found in Annex A.

17. Whilst not always explicit, this paper has in mind three scenarios, which are set out in the table below. The paper's main focus is on the central scenario (i.e. most likely).

Table 1: Three Scenarios for War with Iraq

	Regime change in Iraq	**Iraqi reconstruction**	**Regional stability**
Central Scenario	Achieved relatively quickly after a large invasion (similar to 1990). Possible limited use of WMD	Major task, involving addressing new war damage, and building a government for cohesion	Stability in some countries worsened (e.g. Jordan, Egypt). Major pressure for finance for regional allies.
Upside Scenario	Achieved internally, either with US help or as a spontaneous reaction to US threat	Major task, but no new war damage. A legitimate new domestic government and less local resentment of US.	Mild increase in instability in some countries, but probably transitory. Could fall in some
Downside Scenario	Achieved eventually, after a long and bloody US campaign in which Iraq deploys WMD extensively	Huge task, including dealing with local factionalism and WMD clean-up	Major rise in instability (e.g. Saudi too). Islamic terrorism boosted

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Global impact

18. This section explores the potential impact of a US campaign against Iraq on the world economy. Many factors would be at work, but this analysis focuses on three main channels of transmission:

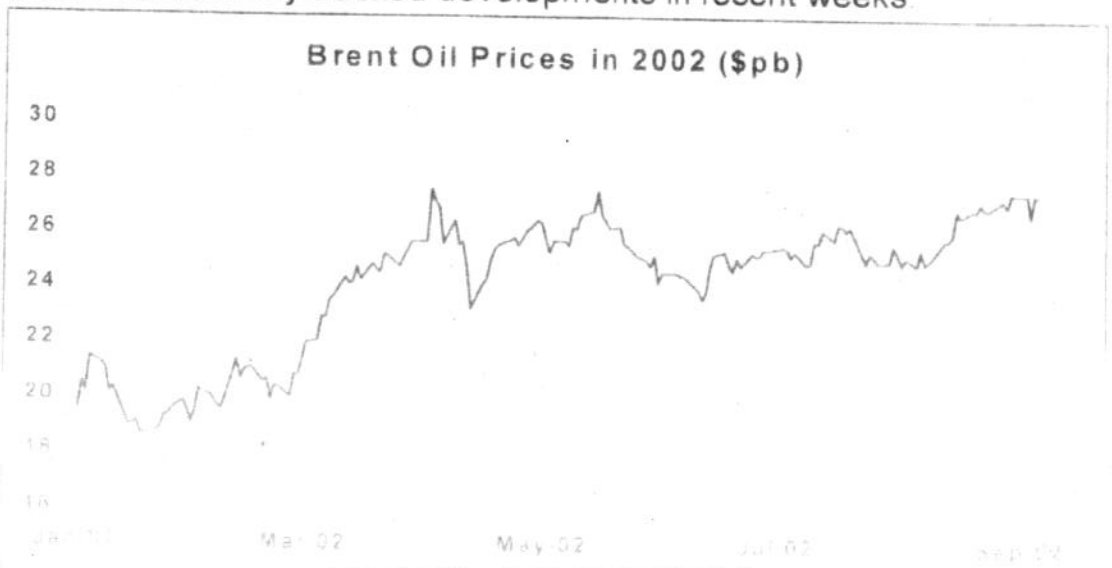
- the oil price;
- business and consumer confidence; and
- government policy, including public spending.

19. The section concludes by looking at international economic interests in Iraq.

Impact on oil markets

How much would prices rise?

20. Oil prices are already high, compared with the long run average of around $19pb. On 5 September, Brent was trading at $27.38, around the highest level for the year. The price includes a $3-4 Middle East risk premium (Iraq and Israel / Palestine), and is also buoyed by OPEC's hawkish stance (latest indications are that production quotas will be left unchanged or raised only marginally at the mid-September meeting). The approach of Northern Hemisphere winter may also be a factor. But Iraq is the key factor at the moment – prices have closely tracked developments in recent weeks.



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21. The current price factors in the probability – but not certainty - of war, with subsequent removal of Iraqi exports from the market for some time (presumably forcibly, as it is Iraq's fiscal lifeline).

22. A conflict with Iraq would almost certainly push oil prices up, with impacts on both growth and inflation. In previous Middle East crises, prices have spiked, and then moderated after the initial panic. The initial reaction to three crises is set out in Table 1. (Note that prices *fell* substantially after September 11, after an initial spike of just $31 (from $28 on September 10).)

Table 1: Oil price spikes in reaction to Middle East crises

Date	Event	Amount of oil removed	Price reaction
1973	OPEC response to Yom Kippur war	4.3 mbd	From $2.50 to $10 *(prices quadrupled)*
1979	Iranian revolution	5.6 mbd	From $13 to $33 *(prices up 150%)*
1990	Iraq invades Kuwait	4.3 mbd	From $20 to $40 *(prices doubled)*

23. However, in this case, invasion of Iraq would *not* be a shock, so we would probably move directly to higher prices – but one which is more moderate and rational than a spike would have been. Estimates of this suggest that, for every 1 mbd taken off the market, the price will rise by:

- $1.50 to $2.00 (DRI/Mc Graw Hill); and
- $3.50 to $4.00 (US Department of Energy).

24. Iraq currently produces around 2.6 mbd of oil, of which 2.25 mbd is exported. Whilst the ready reckoners above suggest a price rise of between $5 and $10 per barrel, due to Iraqi oil being withdrawn from the market, not all of this rise would necessarily come about, as markets are already factoring an Iraq risk premium into the current price (as well as being very used to cessations of Iraqi oil exports). Price rises should be capped by the fact that OPEC would

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be expected to try to stabilise prices in the event of war in Iraq (recent comments suggest that its key members would act in this way). The US Strategic Reserve might also be used in an emergency.

25. However, if a war began (or were about to begin) markets would probably begin to worry about threats to oil supplies in neighbouring countries (especially Kuwait, but also Saudi Arabia), and thus add a hefty risk premium to the price (say $5 per barrel). Taken together, this suggests that prices could quite easily rise (in our central scenario) to around $37 per barrel by the time war broke out. But prices could rise more during a war – probably in the form of sudden, panicky spikes (as in table 1 above) - especially if shock events happened (e.g. deployment of WMD, change in OPEC policy on stabilising prices, threats to the Saudi regime).

26. In our downside scenario, the price could rise further still, as regional stability declined, and especially if supplies were disrupted. In our upside, prices could actually fall, as the Iraq risk premium was removed from prices, with no further risk to supplies.

27. Early August consensus forecasts for oil prices (WTI) are $25.4 for November 2002 and $25.1 for August 2003 (forecasts were made before recent price rises). This does not contradict the above analysis, as: (a) the likely timing of the war (and thus highest prices) would be between these two dates; (b) the forecasts are based on war being likely but not certain; and (c) the consensus oil forecast has steadily risen as tensions have increased (e.g. July consensus for July 2003 was $24.6).

How much would this affect the world economy?

28. In the wake of the 2000 oil price rises, the IMF estimated the impact of oil price rises on the current world economy (which – in the West at least – is a lot less oil-intensive than it used to be). It calculated that a sustained $10 pb rise in the price of oil would:

- knock about 0.5 percentage points off world GDP growth (0.4 percentage points in the OECD);

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- raise the price level by around 0.4 to 0.8 percentage points in the major economies, and perhaps twice that in developing countries; and

- raise the import bill of oil importers by around $100 billion.

29. The OECD has produced similar estimates. The effects are likely to be worse for developing countries.

30. However, these figures are for a year's sustained price rise. In our central scenario, prices could fall very significantly once the war ended – as they did in 1991 – meaning that the effects on world growth and inflation would be more muted.

Impact on confidence

31. A war with Iraq could have a significant impact on investor and consumer confidence, and thus on aggregate demand. The primary effect would likely be in the US, but there would also be wider effects.

32. The best recent precedents are probably the Iraqi invasion of Kuwait in 1990 and subsequent Gulf War of 1991, and the September 11 terrorist attacks of 2001 and subsequent war in Afghanistan. The major difficulty is that, in both cases, the initial negative shock coincided with and compounded an existing downturn, whilst the converse was true for the follow-up war victory (i.e. it coincided with a bounce-back). And (as noted in the section on oil), investors and consumers may already be factoring the risk of war into expectations. Untangling the contribution of war to confidence is thus tricky.

US investment

33. A war with Iraq could cause a re-evaluation of expectations of US and world growth, among both investors and businesses. This would primarily be due to a more negative world security situation, but could have a specific US angle if the war increased global threats to the US (e.g. by provoking more Islamic terrorism).

34. For investors, this could cause a flight to quality (e.g. bonds and precious metals), reducing the funds for corporate investment. For

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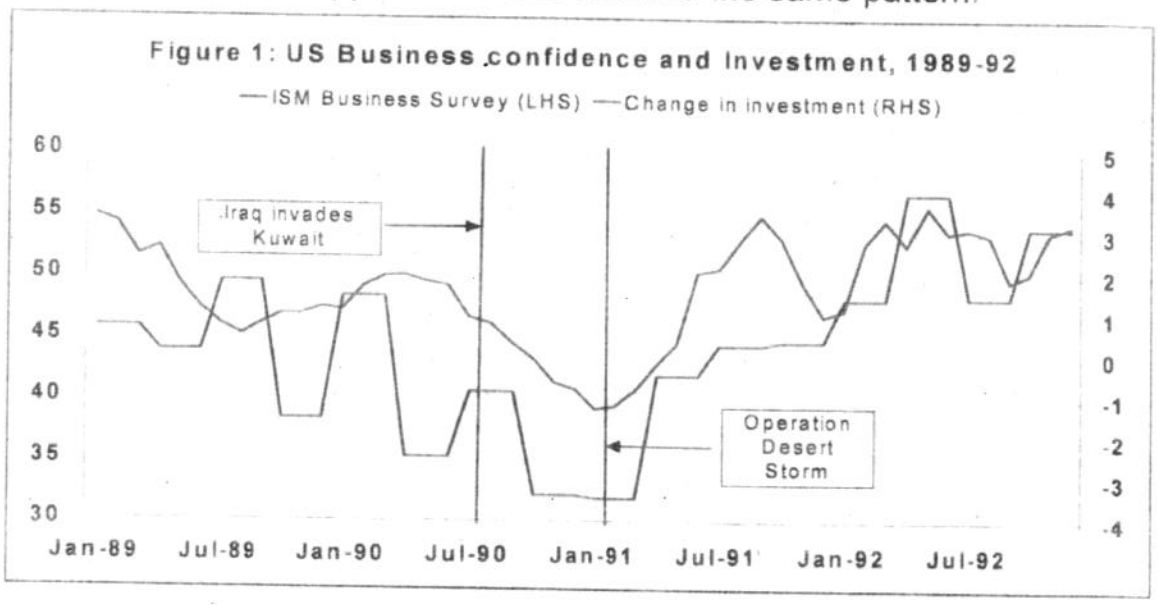
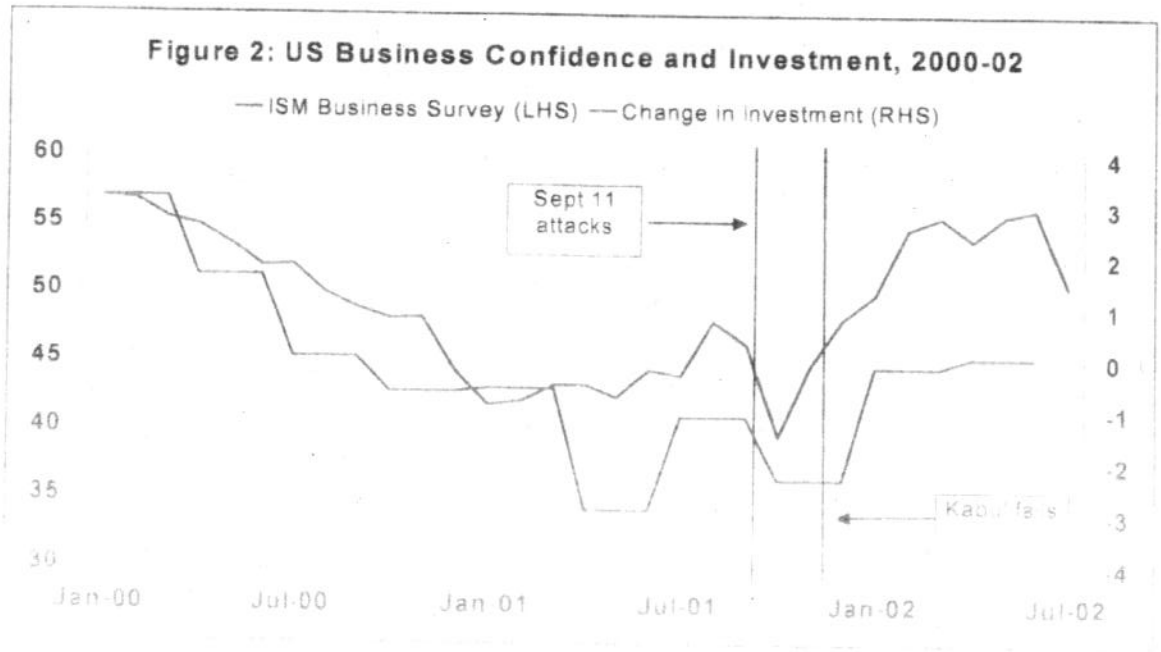
businesses, the consequent increased cost of capital and concerns about future profits could delay or cancel investments.

35. Figures 1 and 2 below show the impact of the Gulf War and September 11 respectively on US business confidence and on total US investment. In each case, confidence fell sharply on the initial shock, with recovery linked to success in prosecuting the resultant war. Investment appears to have followed the same pattern.





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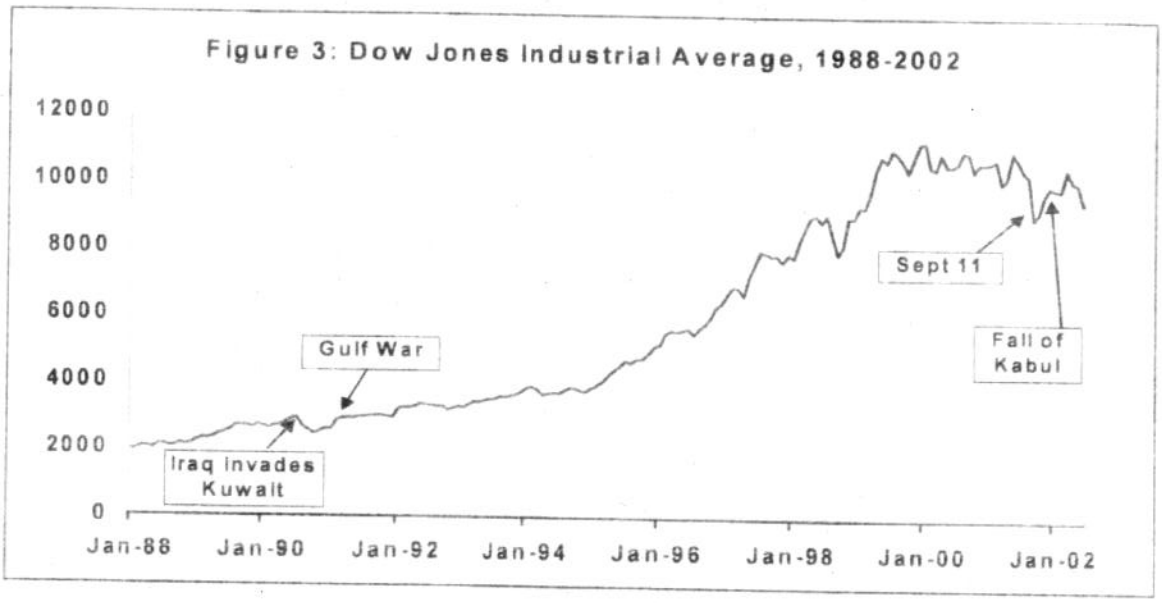
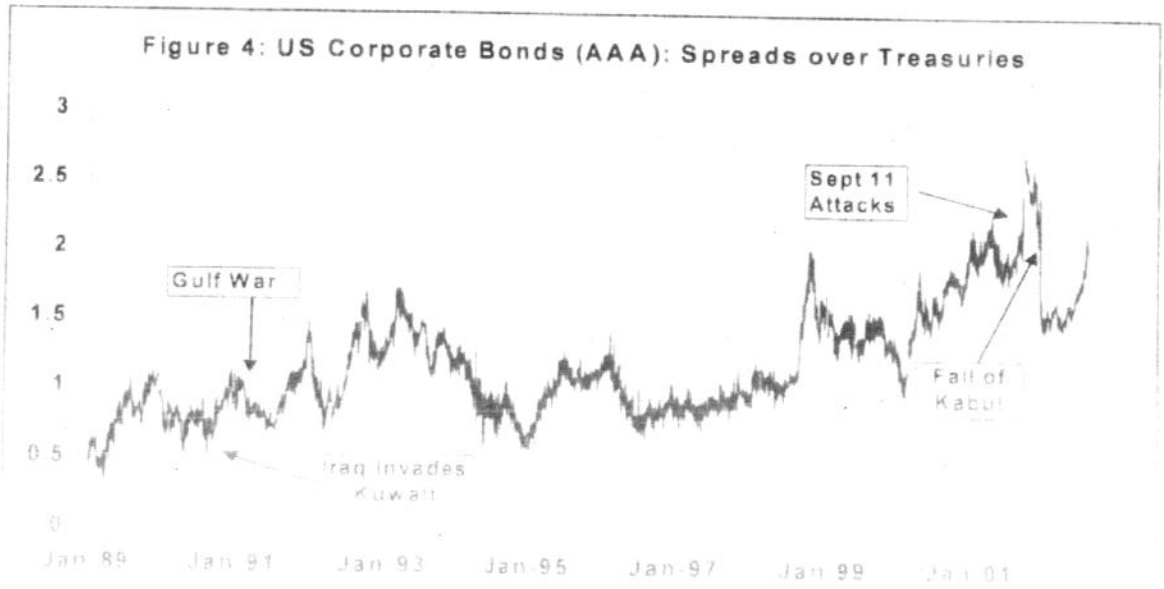
36. Figures 3 and 4 show the impact of the same events on stocks and corporate bonds, giving two measures of investors' changing appetite for investment in US corporates. Both the Gulf War and September 11 had a discernible impact on stocks and bonds (e.g lower stock prices after the initial shock, and a recovery in prices when the situation was resolved). However, other events had a similar impact. For instance, larger stock corrections happened around the time of Russia/LTCM and, of course, in recent months





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US consumption

37. Similar effects could be imagined for consumption (which is, of course, the largest component of aggregate demand). Consumers, facing a worsening in the perceived security situation, might decide to save more and spend less. Figures 5 and 6 present mixed evidence on this, from 1990/1 and 2001.

Figure 5: US Consumer Confidence and Consumption, 1989-92

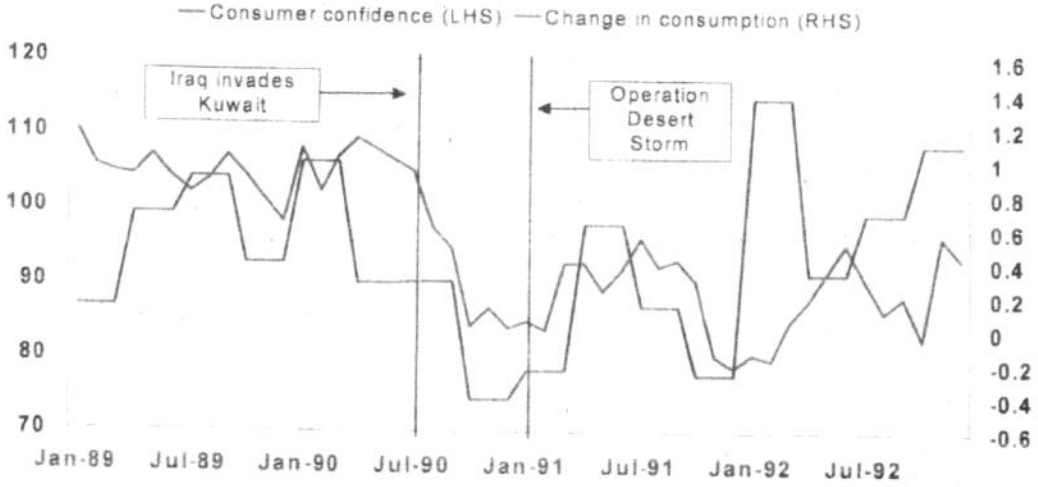
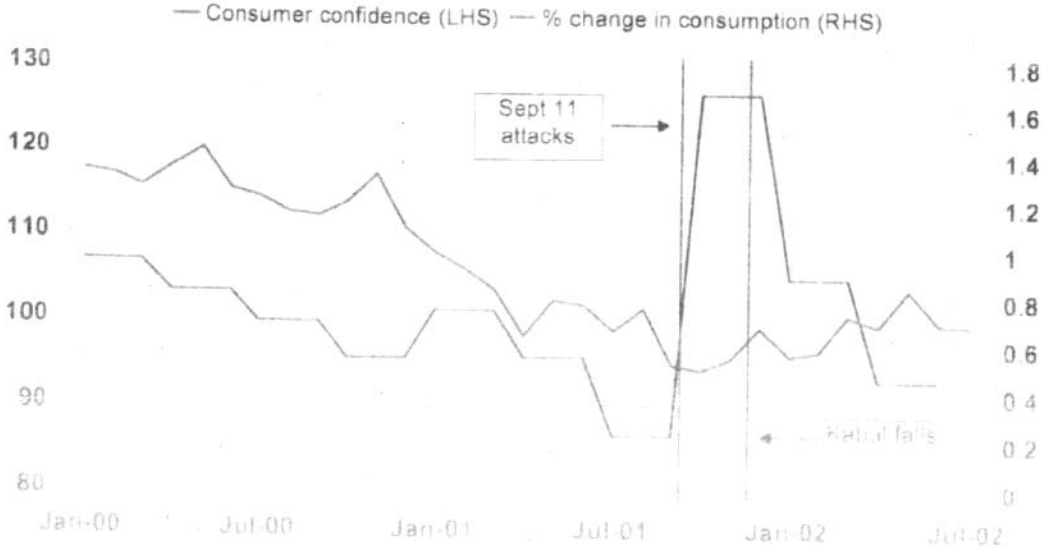


Figure 6: US Consumer Confidence and Consumption, 2000-02



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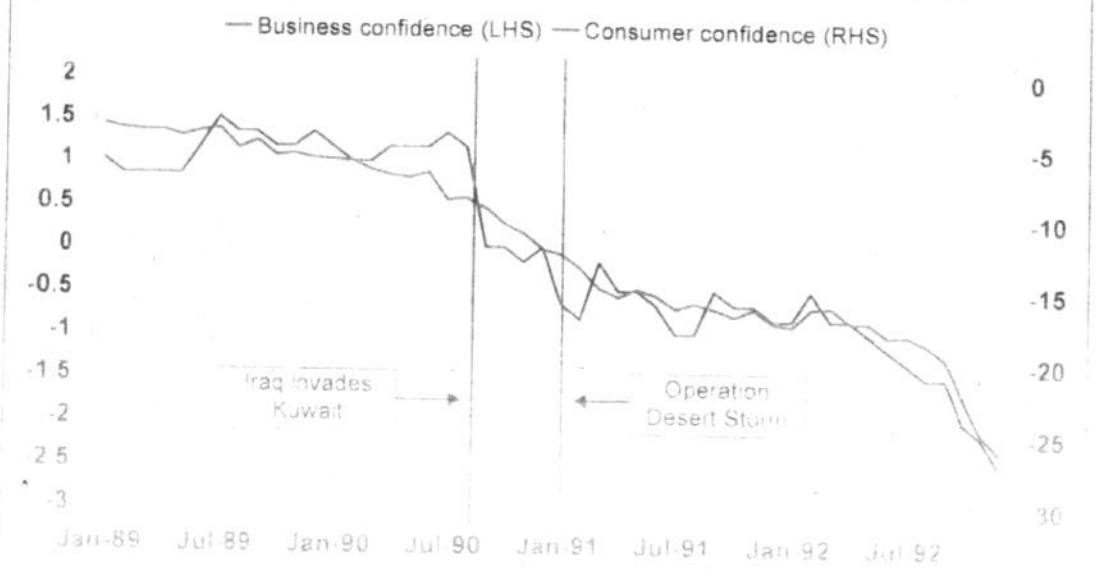
38. Figure 5, which shows the period around the Gulf War, provides some evidence that a negative shock significantly reduces confidence and consumption, and that the resolution of security concerns provides impetus for a bounceback (albeit with a lag). However, the 2001 data tells a different story. Consumer confidence appears to have been relatively flat throughout the autumn of 2001, whilst consumption – whose growth had been declining fairly solidly since early 2000 – suddenly posted a big 1.7% (q-o-q) increase in 2001 Q4. This is probably to a patriotic spending boom, prompt monetary easing undertaken by the Fed and big auto-discounting offers.

Effect on confidence outside the US

39. Precedent suggests that the effects of events like a war in Iraq are more muted outside the US, although still present. This can be seen in figures 7 and 8 below, which show how business and consumer confidence indicators in the Eurozone responded to the events of the Gulf war and September 11. Figure 7 is particularly interesting, as it shows that whilst confidence crumbled (against a falling backdrop) when Kuwait was invaded, there was no pick-up in confidence when the war was won. However, the effect of a war on Iraq on European confidence could be greater, given that there could be a September 11 style patriotic consumption surge in the US.

Figure 7: Eurozone Business and Consumer Confidence, 1989-92



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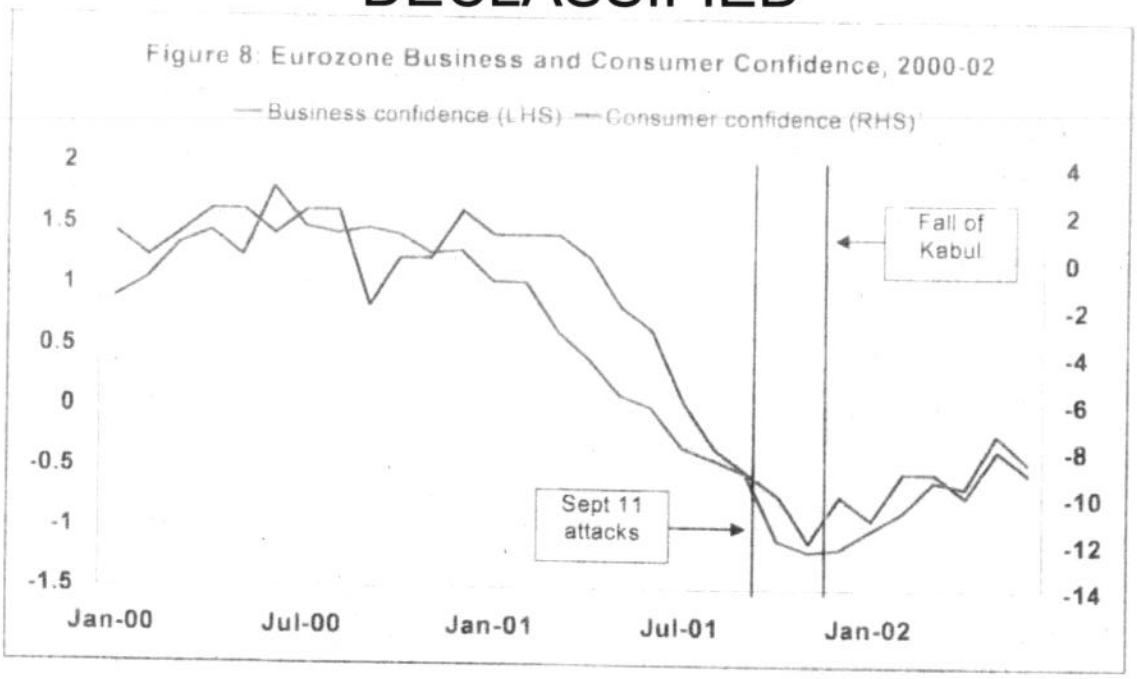

Second-round effects

40. Some of the effects described above could have further repercussions, particularly in the present circumstances. For instance, if a war in Iraq triggered a decline in investor confidence, it could spill over into further stock market corrections, with potential negative impacts on US consumption. Similarly, a decline in investment flows to the US could cause a sharp correction in the dollar. This could have a mildly positive effect on growth, via its impact on net exports (which would anyway benefit from the fact that US consumer demand would probably fall faster than elsewhere).

Policy

Government spending

41. Both of the investment and consumer effects described above would have a negative impact on US (and thus world) GDP growth. Government spending could help to offset this, for instance if higher defence spending led to a significant fiscal easing. The set of precedents for this is slightly larger than the ones used above, also including the Vietnam war and the 'Second Cold War' (the cooling in East/West relations and the renewed arms race that occurred in the

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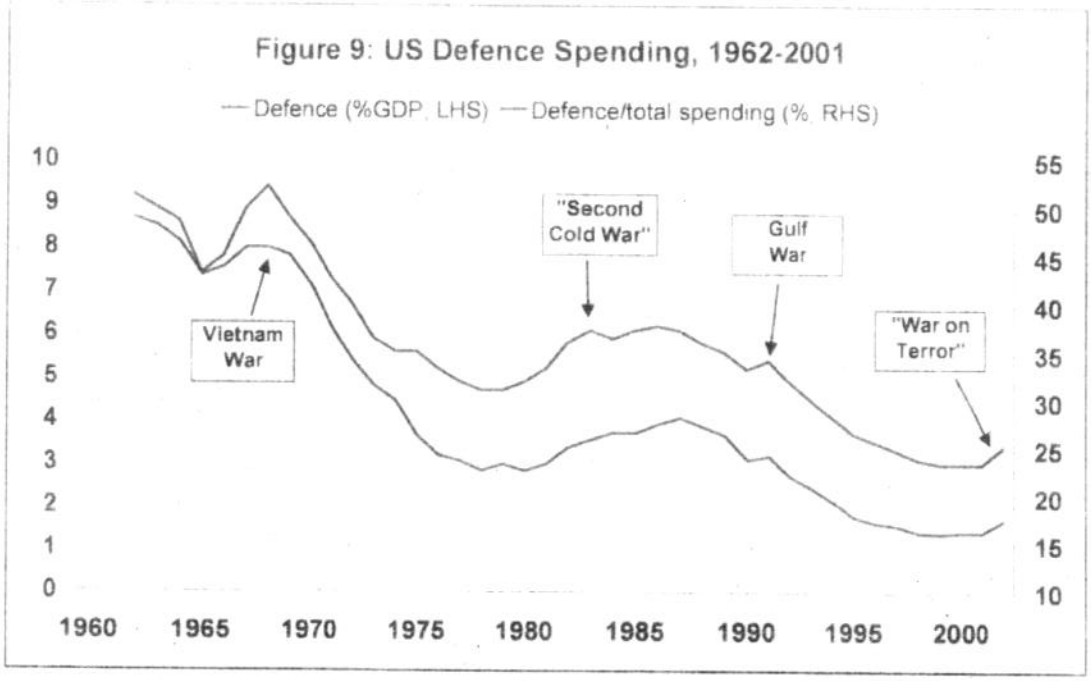
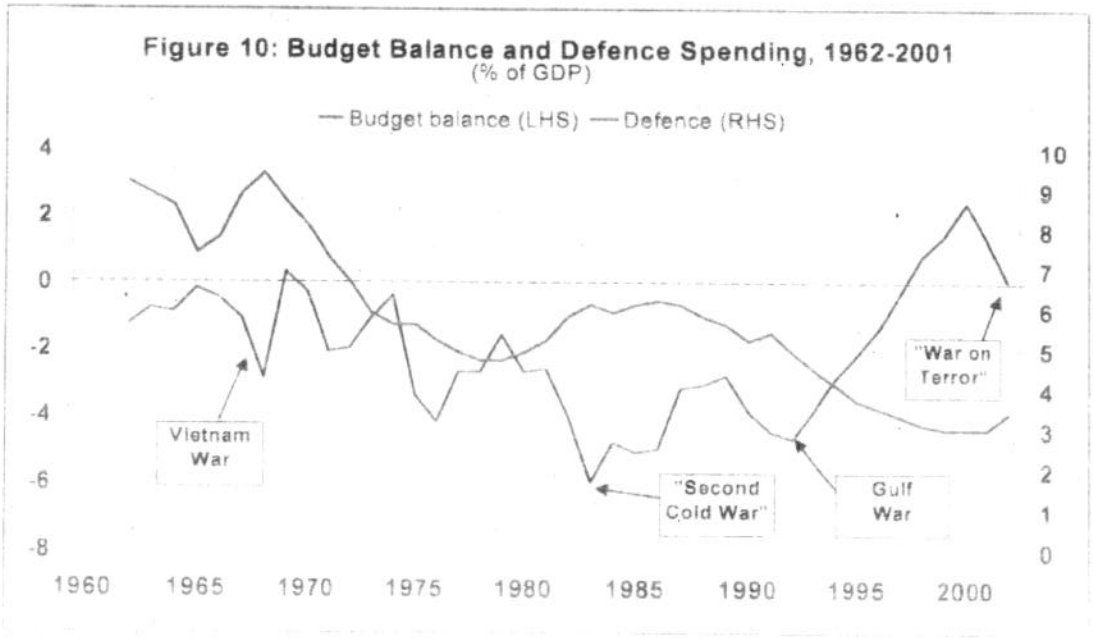
early 1980s). Figures 9 and 10 show the impact that these events had on defence spending and on the budget balance.





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37. The first point to note is how much defence spending has fallen (as a share of US GDP) since the height of the Cold War. During the Vietnam war, defence spending peaked at over 9% of GDP. prior to September 11, it had fallen to just 3%.

43. But against this background, it is also clear (and obvious) that defence spending rises substantially in response to military commitments. Both defence spending and defence as a share of total spending increased substantially in all four cases. In the latter two cases (Gulf War and September 11), this increase seems to have been much less pronounced. However, the US bill for fighting the Gulf War (around $61 billion) was cushioned by Middle East and Asian contributions ($48 billion, from Saudi Arabia, Kuwait and Japan). And whilst, post September 11, defence spending rose less than in previous crises as a proportion of GDP, its increase relative to its previous level was very substantial: FY 2002 saw a rise in defence spending of 14.8%, compared with the 1996-01 average of 2.8%.

44. Figure 10 looks at the links between defence spending and budget balance. Clearly, defence spending is only one influence on the overall fiscal stance. But there does seem to be some correlation between higher defence spending and higher budget deficits. The best example is the early 1980s, when higher defence spending contributed - along with Reagan's tax cuts and economic slowdown - to a loosening of the fiscal stance of over 4% of GDP.

45. Outside the US, public spending would be likely to change little. Changes in defence spending in the Eurozone and Japan would be very unlikely. But if the UK – and/or other Europeans - were involved in the armed conflict, there would be clear fiscal costs.

Monetary and Fiscal Policy

46. As noted above, policy probably played a major role in the mildness of the downturn that accompanied September 11. Aggressive monetary easing across the developed world coincided with a major tax cut in the US.

47. However, there is probably significantly less scope for policy response now than there was a year ago. First, on fiscal policy, the

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US is now in deficit (although, as noted above, a boost to defence spending would be fairly automatic), and Eurozone countries are severely constrained by the Stability and Growth Pact. Second, on monetary policy, nominal interest rates are very low (US rates are at 1.75%, compared with around 6% before September 11), leaving little room for further easing.

Upside and downside scenarios

48. For the downside scenario, the difference from the above would be in the magnitude rather than the direction of the effects. For instance, US investor confidence would probably decline by much more, and defence spending would rise by a lot more than in the scenario above. Disorderly corrections of imbalances would be more likely. And the impact on the wider world would probably be greater.

49. However, in the upside scenario, the direction of many of these effects could be different. A bloodless coup in Iraq could actually boost investor and consumer confidence, and lead to a moderation in US defence spending.

International interests in Iraq

50. A further international effect from a war on Iraq would be disruption of international economic linkages with Iraq, which would have an impact on a number of countries and companies. As far as we know, the key linkages are with three countries (outside the Middle East, whose linkages are addressed below), and comprise:

- debts of around $8bn to Russia (which are currently not being serviced);
- provisional Production Sharing Agreements with France, Russia and China to develop various oil fields with very significant reserves. Contracts were contingent on sanctions being lifted (Iraq wants to go ahead anyway); and
- various 'Oil For Food' contracts, in which Russian firms are prominent.

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Regional Impact

51. This section examines the impact of war on Iraq on the Middle East and North Africa (MENA) region.

Impact of oil market developments: price and supply changes

52. Oil prices have an enormous impact on a large number of countries in the region, and in particular on their budgets. It is very hard to work out ready-reckoners for these impacts, given that price changes can be endogenous (i.e. they can be caused by changes in oil production behaviour). However, tables 2 and 3 below show how fiscal and external balance have been affected by the extreme oil prices seen in the last 4 years.

53. Table 2 shows how significantly oil price changes affect the budget balances of MENA oil exporters. It is not untypical for the fiscal balance to have improved by over 10% of GDP between the oil price slump of 1998 and the spike of 2000.

Table 2: Budget balance (% GDP) and net public debt position, MENA oil exporters

	1997	1998	1999	2000	Public debt/GDP (%) (latest figure)
Algeria	2.4	-3.9	-0.5	9.9	-
Bahrain	-3.8	-4.0	-5.7	9.8	29.3
Egypt	-1.0	-4.2	-5.0	-5.2	96.5
Iran	-2.4	-6.9	-0.6	8.6	25.9
Kuwait	20.0	15.3	-1.3	28.6	-
Libya	-0.4	-4.2	14.6	6.9	-
Oman	4.2	-5.7	1.2	11.8	27.2
Qatar	-9.0	-10.4	-4.3	8.4	58.4
Saudi	-2.9	-10.2	-6.8	3.5	95.0
Syria	12.1	11.9	10.8	13.2	-
UAE	1.5	-6.3	-5.4	4.7	7.3
Yemen	-2.4	-6.8	1.1	7.7	69.1
Brent price	$19.3	$13.1	$18.1	$28.8	

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54 Our central scenario would thus be very good news for oil exporters: it would dramatically improve fiscal balances, which would be particularly helpful for countries like Saudi Arabia, Egypt and Yemen, which are struggling with high debt burdens. However, if our downside scenario began to emerge – with the potential for disruption of oil supplies in Iraq's neighbours – some of these countries could get into difficulties. Saudi Arabia is a prominent example: on average, around 75% of its revenues come from oil. A disruption of oil supplies could cause a major financing crisis.

55. Table 3 shows a similar volatility in current account position in response to turbulent oil prices, although overall external financing positions are generally sound. It also demonstrates how many of them have fixed exchange rate regimes. A prolonged disruption of exports could put these under pressure (again, Iraq's immediate neighbours – like Saudi Arabia and Kuwait - would be most at risk).

Table 3: Current account (% GDP) and external vulnerabilities, MENA oil exporters

	1997	1998	1999	2000	Reserves (months import cover)	External debt/GDP (%)	Exchange rate regime
					(latest figures)		
Algeria	7.2	-1.9	-1.9	16.8	12.2	47.9	Managed
Bahrain	-0.5	-12.5	-4.8	1.7	3.0	26.1	Peg to dollar
Egypt	-3.0	-1.9	-1.8	0.0	10.2	27.8	Band
Iran	1.5	-2.3	6.5	13.1	4.2	10.6	Multiple
Kuwait	28.6	8.7	17.0	39.3	7.5	13.7	Peg to basket
Libya	3.6	-5.1	2.0	12.1	12.7	-	Peg w. band
Oman	-2.6	-23.3	-2.9	13.5	7.1	43.4	Peg to dollar
Qatar	-25.6	-20.7	7.1	22.2	2.7	86.5	Peg to dollar
Saudi	0.2	-10.2	0.3	9.0	10.3	17.3	Peg to dollar
Syria	1.9	-0.3	0.6	5.8	2.3	28.6	Multiple, fixed
UAE	10.7	5.3	10.9	24.9	4.6	33.6	Peg to dollar
Yemen	0.3	-3.6	2.6	13.7	11.0	55.0	Free float
Brent price	$19.3	$13.1	$18.1	$28.8			

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56. Paradoxically, our upside would probably represent a downside for this group of countries – as oil prices would moderate. However, this would not represent nearly so serious a problem as a disruption of oil supplies.

57. In contrast, countries with little or no oil exports – like Turkey, Jordan and Lebanon – would suffer in our central or downside scenarios, with deteriorating current account positions.

Impact on internal stability

58. Both our central and downside scenarios envisage increased instability in countries in the region, whose containment would be costly. For instance, Saudi Arabia could – in our central scenario – face pressure for more rights for its Shia minority. And in our downside, it could face higher risk of Islamic terrorism, fuelled by a messy Western attack on a Muslim country.

Impact on tourism

59. Several countries in the region have large tourism industries, which support growth and are a significant source of export earnings. This is particularly important for countries like Turkey and Jordan, which are not major oil exporters.

60. Evidence suggests that these industries are fairly sensitive to regional developments. For instance, the IMF estimates that the Gulf War reduced Turkish tourism revenues by 40%, compared with their pre-war peak.

61. Experience since September 11 backs this up, to some extent. Tables 4 and 5 show how actual and projected tourism receipts have been affected by the events of September 11, based on IMF figures, estimates and forecasts.

62. In both cases, these are clearly significant impacts. However, two caveats should be noted. First, the IMF's initial assessment of the impact on Turkey was much too pessimistic (which is worrying considering it was a major reason for the generosity of the IMF package of February 2002). Initially, the IMF was projecting a

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collapse in tourism revenues to just $6bn in 2002, rather than the more modest fall to $7.5bn. Second, Jordan's more spectacular (projected) fall in tourism earnings is probably more to do with the ongoing problems in Israel / Palestine than September 11, and also reflects a smaller and less established industry.

Table 4: Estimates and Forecasts of Turkish Tourism Earnings, 2001 and 2002

	2000	2001	2002	2003
2001 estimates ($bn)	7.6	*8.5*	*8.8*	*9.3*
2002 estimates ($bn)	7.6	8.1	*7.5*	*8.1*
% change		-5	-17	-15

Table 5: Estimates and Forecasts of Jordanian Travel Earnings, 2001 and 2002

	2000	2001	2002	2003
2001 estimates ($m)	336	*290*	*335*	*381*
2002 estimates ($m)	336	280	*240*	*227*
% change		-4	-40	-68

Note: Estimates and Forecasts are in italics, historical figures in normal type

63. Despite these qualifications, there is clearly a risk that in the central and downside scenarios, countries like these and Egypt and Syria would suffer a major fall in export and tax earnings from their tourism industries. This is particularly significant for countries with fixed exchange rates (all of these except Turkey).

Impact on Trade

64. Iraq's trading is governed by a restrictive sanctions regime, which allows Iraq to trade oil in order to buy a limited range of food and humanitarian imports (which have to be approved by the UN Security Council's sanctions committee).

65. However, there is also significant smuggling of goods in violation of the sanctions regime (i.e. to allow Iraq to buy what it wants). For instance, the EIU estimates that 300,000 bd of oil are

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smuggled out of Iraq (out of a total of 2.3 mbd of exports). The main routes are through Jordan, Syria and Turkey, although Iranian military forces are prominent in helping Iraq. Efforts have become more blatant in recent months, with the opening of a pipeline to Syria.

66. Smuggled and legitimately traded oil is often sold cheaply to neighbours, particularly Syria (whose 100,000 bpd from Iraq are designated as a 'gift') and to Jordan, which trades cheap Iraqi oil for food and medicine (and is increasingly dependent on trade with Iraq, given the situation in Israel).

67. Other Middle Eastern countries are also increasing trade links with Iraq, mostly under the 'Oil for food' programme. UAE, Bahrain, Oman and Qatar have all recently re-established diplomatic ties with Iraq, in order to deepen commercial ties. A proposed project to build a gas pipeline to Turkey is on hold until sanctions are lifted. Table 6 shows Iraq's (declared) merchandise trade pattern in 2000.

Table 6: Iraq's main trading partners, 2000

	Export destination	Value of exports ($m)	Import origin	Value of imports ($m)
1	USA	5,770	France	393
2	Italy	1,520	Australia	376
3	France	1,197	China	360
4	Spain	1,079	Italy	262
5	Jordan	621	Jordan	155
6	Japan	601	Germany	139
7	China	589	Russia	99
8	Netherlands	466	Indonesia	94
9	Korea	462	Ukraine	75
10	Austria	259	Belgium	65

68. From a regional perspective, the most important fact is the prominence of Jordan, which is Iraq's fifth largest export and import partner, despite its modest economic weight in the world. Exports to Iraq represent 8% of Jordan's total exports, whilst imports from Iraq are 13% of Jordan's total imports (much of which is cheap oil).

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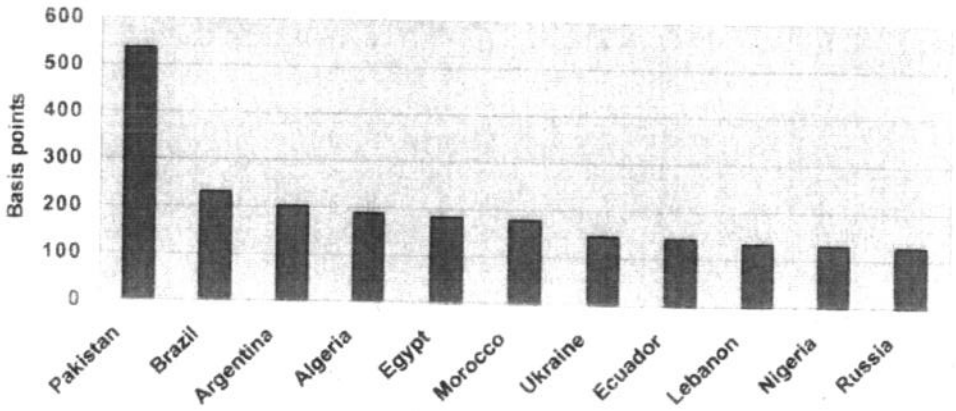
Impact on financing

69. The kind of investor flight to quality described earlier would have an impact on emerging markets, similar to the effect on US corporates (indeed, spreads on emerging market sovereign bonds and corporate bonds tend to move in the same direction). The cost of financing would rise, as risk appetite fell. This would be particularly marked for countries with obvious links to the conflict, such as neighbours and countries basing US forces or supporting the US (the list could include Turkey, Jordan, Kuwait and Egypt).

70. September 11 is an interesting precedent for this: spreads in a number of emerging markets rose, but most markedly in Middle Eastern countries, countries with existing financing difficulties, and particularly in Pakistan (where spreads rose by around 500 basis points). This is illustrated in figure 11 (below).

Figure 11: Countries where spreads rose by more than 100 basis points, September 2001



71. There would be an obvious concern that countries with financing difficulties could be particularly hard hit, including Lebanon and Turkey

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Reconstruction

72. In our central scenario, there would be little need for reconstruction expenditure outside Iraq. But in a downside, needs might be greater. It is relatively easy to imagine Iraq launching attacks, in desperation – and possibly with WMD – on US forces in host countries, or even on these countries themselves. These countries might include Turkey, Jordan and Kuwait. Attacks on Israel (as in 1991) would be even more likely. There would almost certainly be large refugee costs, too (e.g. Kurds fleeing to Turkey). The reconstruction and clean-up bill could be large, and would probably be shared between bilateral donors, the World Bank, other IFIs, and any other new facility set up to deal with reconstruction.

Impact on IFI and bilateral support

73. Analysis of oil, trade, tourism, financing and reconstruction (above) show that a fairly predictable set of countries would be likely to experience fiscal and external financing difficulties in the wake of a war on Iraq, with possible extreme difficulties in a downside scenario. These countries (Turkey, Jordan and Egypt) have been regular borrowers from the Fund, and the first two are currently implementing programmes.

74. Coincidentally, these are also three of the countries most likely to provide the US with support in an operation against Iraq: Turkey and Jordan with a base for operations, Egypt with moral support (or perhaps more muted opposition than other regimes).

75. Taken together, this suggests both that these countries would want some sort of financial return for their support of the US, and that war would provide a legitimate excuse for providing this (e.g. through IFIs). Countries like Jordan and Turkey would probably expect a particularly generous pay-off, if they actually agreed to host US forces (in the teeth of fierce popular and diplomatic opposition). Each of these three cases is discussed in more detail below

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Turkey

76. Since the start of its IMF-backed disinflation programme of December 1999, Turkey has borrowed (net) $21.1 billion from the IMF, or 1648% of quota. It has also borrowed several billion dollars from the World Bank. Exposure to the Fund peaks in 2003 at over 1800% of quota.

77. Turkey is already looking reasonably likely to need another bail-out, even before any US action against Iraq, given domestic political uncertainties – an early election is now scheduled for November 3. If the resulting Government is less willing or able to implement the IMF programme, Turkey's debt could once again move onto an unsustainable path, meaning either bail-out or default.

78. A further request to bail-out Turkey (e.g. as a reward for help with Iraq/compensation for economic losses from the war) would raise several major difficulties for the IMF:

- it would raise Fund exposure to Turkey to even more imprudent levels: even prior to February's augmentation, Turkey took up nearly a fifth of the Fund's lending;
- it would further compromise important Private Sector Involvement principles, such as on access limits; and
- it would involve further politicisation of Fund lending.

79. But the alternative (domestic default) might be equally unpalatable – certainly to Turks, who pride themselves on never having defaulted, but also to the US and others interested in Turkey's stability and friendship. This might thus raise the prospect of alternative ways of financing Turkey, such as bilateral lending, debt forgiveness (e.g. Turkey's substantial military debts to the US), or even bilateral grants. Whatever route was taken, the sum involved would be likely to be substantial (several billion dollars).

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Jordan

80 Jordan has just received a new 2 year SBA programme from the IMF, worth $113 million (50% of quota). This follows on directly from an EFF programme. Jordan's debts to the Fund are projected to peak at $459 million (215% of quota) at the end of 2002.

81 The IMF programme is small in size, for two reasons. First, Jordan is in fairly good shape economically – there was some debate in the board as to whether a disbursing programme was needed at all. Second, the real prize for Jordan was not the programme's resources, but the ticket that a disbursing programme gave them to seek a Paris Club rescheduling of their substantial Paris Club debts (the UK gave enthusiastic support, having turned down Abdullah's appeal for bilateral aid). This will be used – alongside privatization receipts - to help finance the ambitious Plan for Social and Economic Transformation, aimed at improving growth, employment and tackling poverty.

82. Once the IMF programme was in place, Jordan went to the Paris Club and negotiated a generous rescheduling, aimed to ensure Jordan never had to return to the Paris Club. This involved rescheduling $1.2 billion of $2 billion originally due between July 2002 and December 2007.

83. In the event of a war on Iraq, it is highly likely that Jordan will look for more money. There would probably be justification for further IMF lending (economic fallout from the war), although this would raise the issue of how long we would want to help defend Jordan's exchange rate peg. But Jordan would probably also look for further generous contributions – in the form of bilateral grants – to help finance the PSET (whose budget has already been reduced due to lack of foreign support). This would be awkward from the UK's perspective, as we have no budget for grant aid to Middle Income countries.

Egypt

84 Egypt has no Fund programme. But in the aftermath of September 11 it looked – like Jordan – for international support for its

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economic programme (tackling high unemployment and other problems). A donor conference (the 'Consultative Group Meeting') in February pledged $10.3 billion over 3 years. But little of this was new money, and the IFI component ($1.5 billion) was contingent on a 'credible macroeconomic framework' (i.e. modifications to the fixed exchange rate policy). Despite this – and a large current account deficit - Egypt has done little to broker a deal with the Fund, partly as economic conditions have improved somewhat.

85. In the event of a war on Iraq, Egypt's preferred source of support would probably be bilateral aid, rather than Fund money. However, if the war hit Egypt hard, this approach could be combined with an attempt to negotiate generous Fund support.

Middle East Peace Process

86. Financial contributions to US allies may not be enough, on their own, to ensure their support, or to prevent turmoil on the Arab street elsewhere. The most obvious non-financial contribution the US could make would be to broker substantial progress in the Middle East peace process. Indeed, some commentators see this as a pre-requisite for getting any Middle Eastern allies on board for an assault on Iraq.

87. The initial costs of this would, of course, be political. But at some point in the process, if successful, donor money would be expected, to finance issues such as compensation and resettlement of refugees. When this issue was last seriously discussed (in 2000), early estimates were of a bill running into tens of billions of dollars.

Iraqi debts to Gulf countries

88. Iraq still owes a number of Gulf countries huge sums, as a result of lending to finance the Iran/Iraq war of 1980-88. Prior to 1990, Saudi Arabia, Kuwait and (to some extent) the UAE lent Iraq $35 billion, only some of which was ever repaid (and on the remainder of which substantial interest arrears have built up). Further loans were made (and not repaid) in the form of 'war relief crude' (i.e. Kuwaiti and Saudi oil sold on Iraq's behalf). Any post-war Iraqi Government will need to come to an arrangement with creditors on these debts.

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Domestic impact

89. This section looks at the impact of war on Iraq – or, more broadly, the likely costs of putting Iraq on the road to post-war economic recovery. It draws significantly on recent precedents.

90. These precedents – and the current situation of Iraq – suggest that there are several sources of post-war cost, including: reconstruction, institutional establishment or change, economic stabilisation, economic transition and peacekeeping.

91. External funding for these activities, tends to fall into two broad categories: multilateral (e.g. IFIs, UN) and bilateral (including through the Paris Club).

Precedents

92. This section draws on three recent instances of international post conflict assistance: Afghanistan, East Timor and the Federal Republic of Yugoslavia (FRY). They are relevant primarily because each needed reconstruction after the involvement of the international community in resolving deep-seated issues, and because they are so recent. Table 6 lists the various post-war challenges faced in each of these 3 cases.

Table 6: Post-war challenges in FRY, Afghanistan and East Timor

	FRY	Afghanistan	East Timor
Reconstruction	Estimated $3.8 bn of war damage in Serbia alone. 650,000 refugees.	Infrastructure decimated by 20 years of war: e.g. only 23% had safe water, 6% electricity. Huge refugee problem	2/3 of the population displaced, with widespread destruction (e.g. looting)
Institution-building	Institutions existed, but needed to be adapted for market transition	Failed state, requiring most institutions to be built up from scratch	Independence and violence required building from scratch

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Stabilisation	War, sanctions and mismanagement had left output at 50% of 1989 level, unemployment at 30% and inflation 100%	No. Economy too primitive. But huge challenge to kickstart growth, post war and drought (3 years)	More a case of trying to re-start the economy (e.g. payments system, currency). Real GDP had fallen by 1/3.
Transition	Huge task across the board, including how to privatise socially-owned enterprises	Task of creation of a functioning economy, rather than transition.	No. Indonesia (from which East Timor seceded) was a market economy.
Peacekeeping	NATO's K-FOR employed to keep peace in Kosovo. In 2000, 46,000 troops were involved	UN's ISAF, involving 5,000 troops in Kabul initially.	UN-led operation, involving around 8,000 peacekeepers.

93. Table 7 (below) goes on to examine the resources committed by different elements of the international community.

Table 7: External contribution to Post-War costs: FRY, Afghanistan and East Timor

	FRY	Afghanistan	East Timor
IMF	2000: emergency post conflict assistance ($149.5m (25% of quota), partly to pay arrears) 2001: 2 year SBA ($255m, or 43% of quota) 2002: 3 year EFF ($830m, or 139% of quota)	Technical assistance only, at this stage (e.g. statistics capacity, budget, administration)	Technical assistance only, prior to independence. Has just become a member of the IMF.

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World Bank	Initial $30m Trust Fund for emergency projects. Deal done to reschedule arrears of $1.7bn Contribution of $130m out of donor pledges of $1.3bn in June 2001 Separate Transition Support Programme for Kosovo.	Has committed $500m for the period 2002-4. Runs a Trust Fund for Afghanistan, into which some donor money has gone.	Runs Trust Fund for East Timor which had received $142 million by June 2001. A further $26m of WB money given separately.
Bilateral	$500m pledged by donors in December 2000 Further $1.3 bn pledged in June 2001. Additional $2.1 bn for Kosovo in 3 donor conferences	Total donor money amounts to $4.5 billion over 5 years, including $288m from UK, $500m from EU, $362m from Germany, $296m from US.	Donor money had contributed to Trust Fund. 2002 Dili conference provided $360m of new donor money.
Paris Club	Cancellation of $3bn of $4.5bn Paris Club debts, in two stages (conditional on performance)	None	None
UN (does not cover all peacekeeping costs, many	UNMIK has a budget of $413m for 01-02	N/A	UNMISET has a budget of $316m for 2002-03

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of which are covered by donor defence budgets)			

94. This table shows – albeit roughly – that the costs incurred by the international community in the aftermath of a war can be very substantial. Non-IMF contributions to FRY appear to have been somewhere approaching $9 billion, with Afghanistan at about half this level (East Timor – a very small country - has been relatively cheap in comparison).

Iraq's starting point

95. The precedents described above provide a helpful starting point in assessing the cost of addressing the post-war needs of Iraq. FRY – although much smaller (see below) - is a particularly useful precedent. There are some uncanny similarities to Iraq (e.g. long experience of sanctions, Western military intervention, high US premium on regime change, ethnic diversity and friction).

96. But there are reasons to believe that Iraq could be much more expensive (as well as some mitigating factors – mainly its oil wealth). These are drawn out in the description of Iraq's post-war challenges in this section.

Reconstruction

97. Even now, before a new war, Iraq still has much to rebuild, following war with Iran and with the US, and economic sanctions (often violently enforced, e.g. in 1998).

98. Reconstruction has been patchy. On some fronts, achievements look impressive. For instance, the Government claimed to have repaired 104 of 132 damaged bridges by 1992. However, the work has been shoddy and temporary. And on many other fronts, much remains to be done. For instance

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- telephone density is still well below 1990 levels (partly due to sanctions restrictions on telecoms imports);

- the UN estimates that power generation capacity in central and southern Iraq meets only 50% of demand (meaning average 12-hour power cuts daily); and

- Iraq's oil ministry calculates that post-sanctions, $30 billion will be needed to rebuild the petroleum sector. Refining capacity is still only half of its 1990 level.

99. Sanctions have also had an impact on poverty. For instance, school attendance has dropped as child labour has become more essential to family budgets (partly because of the introduction of school fees). UN figures show that enrolment fell from 67% in 1980 to 50% in 1998. Chronic malnutrition affects 16.2% of under-fives (although this is an improvement on earlier in the decade), and only 30% of essential drugs reach hospitals. In rural areas, only 46% of people have access to clean drinking water.

100. War would worsen this situation substantially. The damage would depend on the nature of the war. A limited and clinical campaign could mean minimum additional damage. But the US would probably worry more about minimising its own casualties and maximising the ease of victory than about minimising post-war reconstruction costs. This would probably mean heavy damage to infrastructure. For instance, 90% of Iraq's electricity generation capacity was destroyed in the Gulf War. And war would almost certainly create refugees and internal displacement, especially if a collapse of law and order brought ethnic antagonisms to the surface.

101. Worse still, our downside scenario envisages the possible use of WMD. Cleaning this up (assuming no US retaliation in kind) could add very substantially to the reconstruction costs. And even if Iraq's WMD stockpiles were not used, they will have to be destroyed (the whole point of the invasion). This is expensive work. The Russians calculate that the destruction of their (admittedly much larger) chemical stockpile will cost $15 billion. And – even more worrying – the possibility of a devastating (e.g. nuclear) Israeli response to any WMD attacks on its territory cannot be ruled out.

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102. There is also the strong possibility of the doomed Iraqi regime 'spiking its guns' with regard to its economy, for instance destroying oil infrastructure, much as it did when withdrawing from Kuwait.

Institution building

103. This is an area where less effort will need to be applied than in cases like Afghanistan (failed state) or East Timor (new country). Like FRY, Iraq already has institutions of Government. The challenges, whilst still major, are second-order compared with building a state from scratch. They would include issues like introducing democracy, reform of security services and transition to market-based economic institutions. Any transitional administration would need to be carefully overseen to ensure it eased rather than exacerbated ethnic tensions and secessionist tendencies. And there would be longer-term challenges like bringing current regime figures to justice for war crimes and crimes against humanity (e.g. gassing Kurds in 1988).

Economic stabilisation

104. Iraq's economy will need stabilisation, given fiscal problems, a high debt burden and high inflation (around 70%). Like FRY (but unlike Afghanistan and East Timor), we judge that it would fairly rapidly be ready for IMF financial assistance. However, Iraq is both more populous than FRY and its economy roughly three times the size (thus a larger Fund quota). This means that the resources the Fund might need to provide could be much bigger than the relatively meagre sums provided for FRY. And, as with FRY, arrears to the Fund will also need to be cleared.

105. Balance of payments support would probably only be needed in the short-term, as Iraq's potential oil revenues are huge. But the short-term need could be substantial if the oil sector was badly damaged in the fighting. In general, stabilisation problems (e.g. budget deficits, inflation) are likely to be exacerbated by war.

106. Iraq's debt problems would be more urgent (problems it has circumvented for years by accumulating arrears). A generous Paris Club deal would be an obvious next step after an IMF programme had been put in place. But the Russians could be a major stumbling

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block to this, given the size of Iraq's Russian debts (c. $8 bn, or 15% of Iraq's total external debt). Russia's ability to be awkward in such cases was demonstrated in the FRY negotiations of 2001. And much of the debt is not to Paris Club creditors at all, but to Gulf countries like Saudi Arabia, UAE and Kuwait, which would bring additional complications (especially if these countries had reservations about regime change).

Economic transition

107. Cases like FRY and Bosnia-Herzegovina demonstrate that transition is a second order priority in post-war states: reconstruction, peace-keeping and stabilisation come first. But despite being longer-term, the bill can still be substantial, and the path difficult. FRY was a particularly difficult case, given that it faced all the usual problems of a post-Communist state (e.g. non-functioning financial sector, no tax administration), plus the unique problems of unraveling its socially-owned enterprises.

108. Iraqi transition should be a slightly easier prospect. Despite its socialist credentials, the destruction of the private sector has never been anything like as systematic, enduring or complete as in the former Soviet-bloc. But major problems remain. For instance, the entire financial sector is Government controlled. And Government interference in agricultural pricing has led to the abandonment of large portions of land (300,000 ha, according to the UN). However, Iraq's oil wealth must not be forgotten, along with the fact that many Middle Eastern economies function in a relatively statist equilibrium. Iraq's preferred economic destination might not be the kind of liberal market economy to which central Europe aspired in the early 1990s.

Peacekeeping

109. Unlike all the precedents described above, Iraq will be recovering from an external invasion, not a civil war

In one sense, this should reduce the peacekeeping task. But we should not be complacent about this. Saddam's autocratic rule has kept ethnic and religious tensions well buried, much as Communist rule did in Yugoslavia and colonial rule in Africa. Its removal could lead to their

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rekindling, especially if it encouraged secessionist tendencies from the Kurds, flexing of Shia Muslim muscles and the desire for revenge from long-downtrodden groups. One of Iraq's neighbours' biggest fears is that the country might disintegrate into Kurdish, Shia and Sunni fragments (Turkey is worried, given its Kurdish problems, as is Saudi Arabia, with its Shia minority).

110. For these reasons, as well as major investment in building a stable and representative transitional administration, post-war Iraq will probably need a very sizeable peacekeeping force. This might even need to be as large as – or larger than – the FRY force (over 40,000) given Iraq's size and population (twice that of FRY).

Who would pay?

111. Precedent suggests that the IMF, World Bank and UN would play well-defined roles in post-war Iraq, shouldering certain elements of the bill (e.g. IMF providing forex for stabilisation). Other IFIs would probably play a role (e.g. the Islamic Development Bank). The difficulty would come in dividing up bilateral contributions, both between external donors (e.g. to what extent would the US and other assailants be expected to pay for cleaning up their own war), and between external donors and oil-rich Iraq itself.

112. The US might expect bilateral help merely to act as 'bridging finance', given Iraq's oil wealth (returning to 1990 oil production and export levels could give Iraq oil receipts in excess of $20 billion per year, depending on prevailing prices). But, on balance, we should expect heavy moral pressure on the US and its allies to pay a disproportionate share, and for a good duration, particularly to placate opinion on the 'Arab street'.

COUNTRY ECONOMICS AND POLICY TEAM

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Annex A: Background on Iraq

Geography

113. Iraq is a Middle Eastern country, dominated by the Tigris and Euphrates rivers. It borders 6 countries: Kuwait, Saudi Arabia, Jordan, Syria, Turkey and Iran. The longest of these are with Saudi Arabia, Syria and Iran.

114. Its climate is characterised by hot summers (daily maximum: 43°C) and cool winters (16°C). Central Iraq is a fertile plain, dominated by the rivers. The north (e.g. border with Turkey) is mountainous, the west is desert, and the border with Syria is marshy.

Demography

115. Iraq's population is around 22 million, nearly a third of who live in Baghdad. The population growth rate has recently increased to around 3% per annum. Iraq is 97% Muslim (the remaining 3% being Christian), of which 60% are Shia Muslims (as in Iran). The Kurds are a substantial, dissatisfied but fragmented ethnic group, in the north.

Politics

116. Iraq was formed, following the First World War, from three former Ottoman provinces: Basra, Baghdad and Mosul. From 1921 to 1932 it was administered by the British, on behalf of the League of Nations. Independence in 1932 was followed by over thirty years of instability, with the army prominent in politics. This ended in 1968 with a coup by the Ba'ath party, who still hold power. Saddam Hussein formally took power in 1979, having been a prominent security figure in the regime.

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117. The Ba'ath party espouses Pan-Arab nationalism and socialism. But in reality, Iraq is autocratic and nationalist. A pretence of democracy (e.g. an elected legislature) does not disguise the near total power exercised by Saddam Hussein, who sits at the head of a web of patronage and brutal, competing security services. His support is mainly drawn from the minority Sunni population – his power being reinforced through fear and the distribution of rents from oil wealth. Attempted uprisings and coups have failed.

118. Saddam has orchestrated two unsuccessful military attacks on neighbours: Iran (1980-88) and Kuwait (1990-91). Since its eviction from Kuwait in 19991, Iraq's military ambitions have been contained by economic sanctions, attempts to destroy its WMD programme, and a vigilant US/UK military presence (based in Turkey and Saudi Arabia), enforcing Northern and Southern no-fly zones.

Economy

119. Table 1 below sets out some key indicators for Iraq for 2000.

Table A1: Iraq, Key Economic Indicators, 2000

GDP (US$ bn)	31.8
GDP per head (US$)	1,376
Real GDP growth (%)	4.0
Consumer price inflation (%)	70.0
Current account balance (US$ bn)	3.3
External debt (US$ bn)	53.0

120. There are three main distinguishing features of the current Iraqi economy – the dominance of oil and gas, statism, and the recent disruption caused by war and sanctions.

121. First, oil and gas. At present (partly due to sanctions), oil represents 60% of Iraqi GDP, and 95% of foreign currency earnings. Iraq's proven oil reserves are the 3rd largest in the world (78 billion barrels, or 8% of world reserves), whilst its proven gas reserves are more modest (3285 billion m^3, or 2% of world reserves), the world's 13th largest. Oil production is around 2.5 mbd, but fluctuates wildly for

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political reasons (as a bargaining tool with the UN over oil-for-food). Potential production is much higher.

122. Second, statism. The 1968 Ba'ath coup saw a centralised economic system introduced, with regulation of most areas of the economy (except some agriculture, personal services and trade). Oil is clearly a prominent part in this – with only the Iraq National Oil Company involved in oil and gas (although some PSAs are on the drawing board). Prior to sanctions, a degree of liberalisation was introduced.

123. Third, disruption from war and sanctions. Iraq's wars and their aftermath have imposed huge costs on the economy. Part of this is military spending, which has regularly taken more than 25% of GDP. Resultant budget deficits have been monetised, fuelling inflation (an ongoing problem). Large external debts were taken on to finance the war with Iran, drawing primarily on Gulf countries and Russia.

124. But the invasion of Kuwait and subsequent sanctions have had an even greater effect. GDP collapsed in 1991, and – in nominal dollar terms – is still less than half its 1989 level. Growth has been concentrated in the oil sector, in response to the oil-for-food deal (1995) and the removal of oil export ceilings within this (1999). Severe shortages of basic goods are still common. This is often as much to do with Government neglect and interference as sanctions – for instance, domestic vegetable and cereal production is a third down on 1990. War damage and sanctions together have left some of the country's infrastructure in disrepair. For instance, telephone density is still below 1990 levels, and most civilian aircraft are still hidden in neighbouring states.

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