



Our Ref: jd098

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29 January 2004

IRAQ: RECONSTRUCTION AND THE POLITICAL PROCESS

At the last Strategy Group Meeting I was commissioned to produce a note for discussion tomorrow. This is attached. It benefits from input from Hilary Synnott, Andy Bearpark and colleagues in FCO and Treasury. I plan to show it to my Secretary of State over the weekend. Please could you arrange distribution to the Strategy Group.

2. Copies of this go to , David Richmond, Andy Bearpark,
Suma Chakrabarti, and the Iraq Team
here.

Jim Drummond

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IRAQ: RECONSTRUCTION AND THE POLITICAL PROCESS

1. The key points in the political process in 2004 are likely to be the selection of a Transitional Assembly in May, the end of occupation on 30 June, and a new Transitional Government struggling to grip the reform agenda over the rest of the year. There is a general lack of reliable statistics to measure progress. Much of the course to the middle of the year is already set. This note assesses the prospects for the economy, employment and service provision and identifies some action points (**in bold**).

Economy

2. Iraq's economy shrank by 31% in 2003, but is expected to rebound by about 33% in 2004. The main drivers will be reconstruction funded by donors and, potentially, oil sector recovery. Per capita GDP in 2004 will be in the range \$620-\$810 (compared to \$500 in 2003 and \$3,600 in the early 1980's).

3. Some of the foundations of a market economy have been laid: liberalisation of all prices except energy and some food items; simplification of taxes; abolition of licensing requirements for trade; abolition of tariffs but a 5% reconstruction levy placed on all imports. There is a new, though far from perfect, budget process and an independent Central Bank with an anti inflation mandate, and a new currency. The policy of no recourse to domestic financing by the Government should keep inflation under control though there will be pressures from foreign inflows and further price liberalisation.

4. Major structural reforms including the State Owned Enterprises (SOEs), the ending of the Public Distribution System for food, and changes to

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fuel and utility prices will be decisions for the Transitional Government. So major distortions will remain and act as a drag on economic activity.

5. This means that most Iraqis will enjoy free food, very cheap fuel and power, and some will still have unproductive jobs in state owned enterprise through the transition. **We should use the next five months to help Iraqi ministries to plan the structural changes required and sensitise Iraqi politicians to the decisions they should make and why.** If they make these reforms, security improves and the IFIs and investors return, the second half of the year could lay the foundations for real economic recovery. Iraq's debts should be rescheduled around the end of 2004, but progress towards debt rescheduling during the year will improve investor confidence.

Employment

6. Unemployment is a potential flashpoint. CJTF7 estimate that 90% of demonstrations are about unemployment or salaries. So far most have been peaceful, but they could get out of control, particularly in the run up to the transition.

7. There is no reliable estimate for unemployment, but the best guesses range from 20-50% of the labour force. The oil sector is very capital intensive. While it provides around 60% of GDP it probably accounts for about 3% of jobs. SOEs employ about 500,000 people. Liberalising imports has brought an increase in trading, but donor reconstruction programmes apart, there is little sign of increased investment and output from Iraqi private and state owned enterprises. Security is a major constraint, and some foreign investors will hold back until the occupation ends.

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8. Structural problems mean it will be difficult to increase employment significantly by the middle of the year, but the donors and the CPA should:

- **Design reconstruction programmes, which maximise local labour input.** The US stipulates this requirement in the latest round of tenders. DFID will aim to do the same for the next round of programmes in the south.
- **Provide finance to small businesses.** The recently approved IFC programme, which the US, UK and Japan will support, is the main vehicle for this.
- **Fund Employment Creation Schemes.** USAID has recently increased its programmes with the aim of creating 100,000 jobs. **They should be targeted on the higher risk places.** DFID will consider the options for the South with CPAS during its mid February mission.
- **Make sure that pension payments are up to date, and give priority to training the Iraqis to police demonstrations effectively.**

9. But the big gains will come later from liberalising the economy. Better security and handing over power to an Iraqi sovereign government will give investors confidence.

Oil Exports and Fuel Supplies

10. Current oil production is about 2.4 million barrels per day, of which 1.6 mbpd is exported. This may rise to 3 mbpd by the end of 2004, but exports (potentially 2.5mbpd) will not rise until the northern pipeline is made secure or additional export routes are agreed. Production levels will only be sustainable

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if further investment in infrastructure is made. **The re-prioritisation of project RIO is to address this.**

11. Cheap fuel encourages over consumption and smuggling. These problems will persist though the transition. **The CPA and the Iraqi Government will have to ensure that supplies are sustained.** This is primarily a logistics operation, which the CPA will have to manage, but the CPA/US may have to provide more money to finance imports.

Services

Electricity

12. Current estimate of power demand is 5,700 MW, but demand is increasing rapidly and will probably exceed 6,000 MW by June 2004. About 4,000 MW are currently being generated, down from a peak of 4,500 MW in October 2003. The current plan is to hit 6,000 MW by June 2004, which requires almost 1,000 MW of new generating capacity, 1,380 MW of rehabilitated existing capacity and 300 MW of imports. Existing contracts will provide 2,300 MW of the required extra capacity. Work is underway to rebuild downed transmission lines and new ones to link the Kurdish region to the national grid.

13. The US plans are ambitious and the south apart there is not much we can do to help them. The likely outcome is that they will not meet their target. So Iraq will go through the summer with substantially more power than in 2003 but insufficient to meet the full demand increasing the risk of public discontent at a sensitive time. The Emergency Infrastructure Programme in the South will help to ensure there is sufficient power to meet demand there.

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But the South is a net export of power and there needs to be a plan to share power equitably, with advance notice and explanation of any load shedding. **This will arouse considerable concern in the South. We must encourage the CPA to plan carefully.**

14. The priority now must be to implement the programmes agreed under the US Supplemental, to encourage Japanese investment in the power sector, in the expectation that little will have been delivered from this by the middle of the year. **We will consider whether any further UK investment is required in the south.** A DFID team visits in mid-February to take this forward.

Water

15. There has been a steady improvement in the quantity and to a lesser extent quality of water supplies since the conflict. Most parts of Iraq, including Baghdad and Basra, should have 24 hour water supply through the summer, if the power supply hold up. But most people will remain dependent on bottled water for drinking. Baghdad's three main sewage treatment plants should be operating at full capacity by October 2004 improving the quality of water in the Tigris.

Education and Health

16. Iraq's schools and hospitals are functioning. There have been significant improvements in the supply of medicines and new textbooks for schools since the conflict. There are refurbishment programmes for health and education facilities, which are gradually bringing improvements. But there remain serious problems and under funding. We should not expect step changes between now and June. Both will be addressed through the Trust

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Funds. **We must help the UN and World Bank to reengage quickly and the Japanese to disburse their funds for health and education.**

17. There are important judgements still to be made over the next two months about how much the Coalition and other donors will dictate the reconstruction agenda after 30 June, and therefore how much the Iraqis will be forced to do for themselves. DFID experience elsewhere suggests that too heavy a donor presence breeds dependence, but withdrawing too fast could risk a decline in services and popular discontent. **We should give priority to improving Iraqi economic policy making and make decisions on the structure to succeed CPAS urgently.** We should be prepared for 3 or 4 months of government inaction in the hot months after 30 June, which may produce rising levels of discontent.

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