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**DFID**

Department for  
International  
Development

**Minute**

Reference

**From:** Mark Lowcock &  
Michael Anderson

**Date:** 5 May 2006

**To:** Suma Chakrabarti

**CC:** Private Secretary  
PS/PUSS  
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Directors

Tim Foy

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***Visit to Baghdad: 2-5 May***

**Summary**

1. The Iraqi economy seems to be stagnating, though data is poor. The tough reforms needed to address the fiscal crunch and get growth going should be a high political priority for UK engagement. PM designate Maliki has yet to finalise key Ministerial appointments which will be critical to his ability to deliver more than his predecessor. Iraq's oil windfall from high oil prices (circa \$20bn a year) dwarfs aid inflows, but seems to be being squandered. Oil sector reform will take more than a hydrocarbon law. Extractive Industries Transparency Initiative could help reduce corruption and promote stability – should be a high priority for UK action in Iraq. The proposed international Compact for Iraq will need strong UN and World Bank involvement, with sound preparation in advance of any meeting. A poorly prepared Compact conference could result in public embarrassment for the Iraq reconstruction effort. The DFID programme should continue to move toward more capacity building and strategic assistance to internationalising the effort in Iraq. The Provincial Reconstruction Teams (PRT) proposal still needs to be worked through, with some senior level decisions to be made.

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## **Detail**

2. We saw Barham Saleh, UN SRSG Qazi, the US Government (Speckhard, and Liberi), General Fry, the World Bank, the EU and the HMG teams in Baghdad this week. Our discussions focused on the economy, international assistance (especially the proposed Compact conference) and the DFID programme. The main political focus this week was on Government formation, on which Dominic Asquith, with whom we helpfully coincided, was heavily engaged. We are reporting separately on some other issues.

## **Economic Issues**

3. There are no good assessments of the state of the economy in Iraq. The published data point to a big boost to GDP in 2004, followed by stagnation (or even contraction) in 2005 and very modest growth in 2006 projected to continue next year. Much economic activity is not captured in the data. The US are upbeat about the informal sector, noting that over 20,000 new businesses have been registered in the last 6 months, and pointing to construction booming in many towns and cities. Others, including Iraqis, emphasise that very little new employment is being created (other than in the public sector), unemployment is high and many businesses are closing due to deteriorating security and intimidation. Many middle class professionals have left the country or are planning to do so. Overall, we found more pessimists than optimists on the current state of the economy

4. What is clear is that the new Government faces a daunting economic reform agenda. Barham Saleh's 100 day plan for the new Government contains some of the required elements. But wide political support for reform seems unlikely given the fragile political deals underpinning the emerging government. The fiscal crunch that the Secretary of State highlighted after his March visit remains a real problem (particularly given commitments on public sector pensions made by the Council of Representatives in its dying hours), so unpalatable decisions will be required on subsidy reform if Iraq is to retain its Stand By Arrangement with the IMF. This needs to be a priority in our dialogue with them when the new economic team is in place.

## **Oil**

5. Iraq has enjoyed a massive windfall by dint of the oil price hike since the end of 2003. At the time of setting the 2006 budget, this amounted to a trebling of the oil price over that period; and there have been further substantial rises since. The World Bank are at our request analysing the scale of the windfall, but it must, conservatively, now amount to around \$20 billion a year. Some of this has financed the growth in the budget. But billions – some people say tens of billions – has been lost through large scale corruption and other leakage. Who has got all this money, and what do they plan to do with it? And how is the Government going to regain control?

6. Accounting for 75% of GDP and 95% of Government revenue, oil is fundamental to economic progress. Weak governance, low investment, sabotage and eroding capacity have seen production stagnate over the last 2-3 years despite reconstruction efforts. Reforming the oil and electricity sectors is the first priority to rejuvenate the economy. A new hydrocarbon law will not be sufficient. Private sector investment has

a critical role to play, but it will not solve the problem alone. The priority may be reform of the institutional and governance arrangements. Iraq needs a credible, non-political and technically competent international partner to help it think through these issues. The World Bank is best placed for this.

### **Extractive Industries Transparency Initiative**

7. Transparency measures under EITI could play a critical role in reducing corruption and ensuring long-term stability in Iraq. Given UK comparative advantage on EITI, this should be a priority for HMG action in 2006. The FCO and DFID are making progress on this, but it will need high level support.

### **The proposed international Compact**

8. Work on this is gathering momentum, with Barham Saleh, the State Department, DFID and the FCO all closely engaged. It seems to us that the entry conditions for a successful Compact conference include (a) a credible economic reform programme being presented by the Iraqis, in a way which makes clear they are really committed to it; (b) an internationalisation of the preparations (which may include preparatory technical events) and organisation, with the UN and/or World Bank needing to play prominent roles and (c) realistic ambitions for resource mobilisation from the traditional donors, and a focus on the private sector and the Gulf States. The FCO think that the latter will require eye-catching progress on, for example, militias and or DDR. The Compact will need to contain a political 'deal' but it will also need sound development content if it is to have any real impact.

9. We urged the UN and World Bank to engage more fully on these issues. The Bank are hampered by the continuing failure to confirm the opening of a substantive office in Baghdad (which Mark has raised again this week with Robin Cleveland). The US have appointed Kevin Taecker (UST) as lead negotiator for the Compact. We offered UN SRSG Qazi a seconded member of staff to assist with UN efforts on the Compact.

### **DFID programme**

10. We reviewed the status of the DFID portfolio with Tim Foy and their teams. We also discussed the cross-Whitehall governance and security sector support programmes with other members of the HMG team in Iraq. We are following up a range of detailed issues. But the headline is that, given the constraints, above all security, the impact of the collective effort is impressive. This is a tribute to the professionalism and commitment of the public servants and consultants responsible for it.

11. The forward strategy you and Martin Dinham laid out when you visited in October also still looks right to us, ie:

- a) a strong focus on supporting fuller and more effective engagement by the UN, World Bank and EC;
- b) completing our ongoing infrastructure programmes in the south during the course of 2007; and

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- c) a bilateral focus on capacity building at the centre in the areas of economic reform, public administration and governance.

12. The refocusing of the US effort now from infrastructure to capacity building may have implications for us.

13. There has also been work in both London and Iraq this week on the arrangements for Provincial Reconstruction Team in Basra. There remain a number of important issues to address there, some of which will require decisions at a senior level over the next few days. Work is going forward on that.

14. We are very grateful to the DFID Iraq teams and Embassy staff for the excellent organisation and briefing that went into making our visit rewarding and enjoyable. The volume and quality of the effort produced by a small number of staff working in extremely difficult conditions is impressive.

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