



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

25 February 2003

Jeremy Heywood
Principal Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Jeremy,

Thank you for your letter of 24 February, covering a note on 'financing the reconstruction of Iraq'. I attach some detailed Treasury comments.

The Treasury fully supports the main message of the paper that, in the absence of a UN mandate, the financing costs of reconstructing Iraq will be significantly higher.

As you will be aware, the Treasury is involved in complementary work both here (an economics and finance cross-Whitehall group, working alongside the Iraq Planning Unit, chaired by [redacted] on which No. 10 is represented) and in liaison with the US (and Australia). The latter recently met in Washington, and is following up with joint work on the economic aspects of 'day after' issues. We would be happy to provide you with more information on any of this work.

*I am copying this letter to Simon Malcolm, Erica Zimmerman, Anna Bowen
and 3*

*Yours
Mark*

MARK BOWMAN
Principal Private Secretary

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Drafting comments

General

There are a number of issues on which we feel the paper needs adjustment. These are reflected in the drafting comments below.

First, as currently drafted, the paper could easily be misinterpreted as suggesting that UN cover will solve Iraq's financing problems at a stroke, removing all pressure for US and UK contributions. Our view is merely that UN cover would make life significantly less difficult across a range of financing issues. It is thus a necessary but not a sufficient condition for outcomes like IFI support to Iraq or the establishment of 'oil bonds'.

Second, there may well be merit in the ideas suggested in the paper for using future Iraqi oil revenues for short-term reconstruction (e.g. 'oil bonds'). However, this is a complicated area – both technically and politically – and we should be cautious of promising too much, or settling too firmly on one particular model. In the end, this is an issue of property rights – a Government has to be able to prove it owns something (oil) before it can legitimately borrow against it.

Third, there are issues with some of the statistics in the paper, for instance:

- the range of possible bills for reconstruction is not quite right. DfID will be providing some different estimates, including some drafting. It is also important to emphasise how preliminary estimates of reconstruction cost must remain until the World Bank has done a proper needs assessment, and, for this reason, it would be premature to settle on a figure at this stage;
- the figures on the oil sector reflect a particular viewpoint, which is pessimistic in places (e.g. current Iraqi production capacity) and optimistic in others (e.g. the speed at which Iraq output can reach

potential). DfID have some more accurate numbers on this. DTI may also be helpful on this; and

- the figures for the US macroeconomy are incorrect. It is clearly important to get these right, given the intended audience.

Summary

1. DfID will provide comments
2. Replace text with "In the UK, fiscal pressures restrict the extent to which the Exchequer can respond to Iraqi rebuilding needs." Then delete Para 3, and replace – at the end of para 2 – with a new sentence: "In the US, the Administration has recently announced a sizeable fiscal stimulus package, and might find it equally difficult to raise additional money for the purposes of nation-building in Iraq".
5. Replace with: "Public finances in key Arab countries are currently under strain (e.g. Saudi Arabia), and willingness to provide resources for war or reconstruction is likely to be very different from in 1990, including for political reasons"
6. Redraft, to read: "It may take many months, or even years, to raise Iraqi oil production back to pre-war levels. Raising output to its potential level (much higher than Iraq has ever produced) would take much longer" (Would also be content with more detailed DfID alternative).
7. Our preference would be to shorten radically paras 7 to 10, whose essence could be captured by saying, in two paragraphs:

"Private capital flows could, in certain circumstances, provide helpful additional finance for Iraqi reconstruction. For instance, the Iraqi government could borrow against future oil revenues to raise money for current spending. However, this would be a non-starter



without UN cover, as these debts would be seen as the liabilities of the occupying powers, and use of oil revenues would be perceived negatively by a suspicious international community"

"UN cover would make it possible to explore this option, although there may still be legitimacy questions until the formation of a proper Iraqi government. Equally importantly, financial and technical assistance from international financial institutions (IFIs) like the IMF and the World Bank could prove impossible without a UN-endorsed administration".

Main text

Comments on first sections are provided by DfID

Page 7, first para (section entitled "US finance in trouble")

Replace title with 'US public finances'

Replace whole section with a shortened section, which reads:

"It would be similarly unwise to assume that the US is any better placed to take on large additional financing responsibilities. Taking into account the recently-announced fiscal stimulus package, the US deficit is expected to increase from 1.5% of GDP in 2002 to 2.8% in 2003. The US is now expected to run fiscal deficits in each year to 2008".

Comments on aid section are provided by DfID

Section on 'the role of markets'

Replace section with:

"This analysis suggests that oil revenues will eventually be able to pay for Iraqi reconstruction, provided that money is spent wisely. This would be



greatly helped by dismantling Iraq's system of subsidies, and putting in place proper expenditure management and revenue systems."

"But oil revenues on this scale will not be available for years to come, even though major reconstruction needs (including repair of oil infrastructure) will be necessary from day one. One way around this would be to use future oil revenues to finance current reconstruction. One mechanism would be to borrow against future oil revenues, perhaps from banks in the first instance, followed by issuance of oil-backed bonds."

Section on 'the importance of legitimacy'

First paragraph to remain.

Second paragraph to be replaced with:

"UN cover would be a necessary first step for this approach. It may not be the final word – as the Government would need to prove that it owned the assets before it could borrow against them (which even a UN-authorised interim administration may not be able to do) – but without it, the idea could not work."

New third paragraph, to read:

"Moreover, without UN cover, it would be extremely difficult – perhaps impossible – to engage the IFIs (the World Bank and the IMF). This would deny Iraq a significant potential pool of grants and loans. But it would also make it very difficult for the IFIs to provide other traditional forms of post-conflict assistance, such as technical assistance (e.g. to keep Iraq's economy afloat), donor co-ordination and assessment of needs. IMF involvement is also usually necessary to unlock solutions to debt problems, via the Paris Club, which would be very important given Iraq's indebtedness".

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Conclusion

We agree with DfID's suggestion. We would add: "Potential contributions from private capital markets and from International Financial Institutions could prove important, given the constraints on bilateral donors. However, UN cover is likely to be needed as a first step to unlocking this sort of help".

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