

A Primer on Iraq's Finances**Analyst**

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> Summary

- € Economic mismanagement, three major wars since 1980 and a decade of trade sanctions contributed to a prolonged economic decline in Iraq. Prior to the change in regime, more than 60% of Iraqis relied solely on provisions under the UN Oil-for-Food Programme to meet all their household needs. GDP *per capita* is about USD715, comparable to Lesotho ('B+') and Cameroon ('B') among those sovereigns rated by Fitch.
- € The cost of reconstruction for 2004-07 was estimated to be USD36bn by the UN/World Bank Joint Iraq Needs Assessment. In response, international donors pledged USD32bn-USD36bn, depending on IMF and World Bank lending. The Coalition Provisional Authority (CPA) estimates another USD19bn is needed for sectors and issues not included in the UN/World Bank assessment, such as redeveloping the oil industry and enhancing security.
- € Iraq has 11% of global crude oil reserves, second only to Saudi Arabia. Oil exports will be critical to the fiscal and external balances. Based on our oil price and production forecasts, Fitch believes that revenue projections in the 2004 budget are achievable. Expenditure focuses on public sector wages and maintaining basic social subsidies. The medium-term fiscal framework assumes a 50% increase in crude export volumes next year. This may be overly optimistic in our view, since domestic demand for oil is likely to rise as economic activity recovers and it is not clear whether there is sufficient external financing to support the assumed increase in output.
- € Gross external debt is about USD120bn, equivalent to approximately 620% of GDP and 730% of foreign exchange earnings. External assets are limited, and Iraq's net external debt ratios greatly exceed those of all other sovereigns rated by Fitch. In addition, Iraq owes about USD30bn in claims already awarded by the UN Compensation Commission to various parties for losses incurred during the invasion and occupation of Kuwait in 1990-91. Unresolved claims amount to a further USD84bn.
- € For Iraq's ratio of external interest payments/foreign exchange earnings to be comparable to the median of sovereigns rated 'B+' and lower, we estimate gross external debt would need to fall by about 90% to USD14bn. A sizeable debt stock reduction by Paris Club creditors – owed one-third of the debt – is possible under the Evian Approach announced in October 2003. Evian emphasises a fully flexible approach to ensure medium-term debt sustainability. Fitch believes that an extension of the current Paris Club debt moratorium beyond end-2004 is probable, followed by a significant stock reduction, but by less than 90%, as consideration will be given to the effects of higher medium-term oil exports on debt service capacity.

On 1 May 2003, President George W. Bush announced the end of major combat operations in Iraq. Although the war was formally over, remnants of conflict remained and a very tense security situation persists. In addition to the collapse of the former regime, there was widespread looting and many public institutions ceased to function, if not exist. This Special Report focuses on the prospects for rebuilding the Iraqi economy and re-establishing the country's international creditworthiness, drawing together available data on public and external finances, and adding comparisons with other oil exporting countries in the region. The Iraqi economic outlook is also pertinent to Fitch's assessment of regional security risk, which is an important factor in several sovereign ratings.

Economic data on Iraq are scarce and subject to a significant margin of error; there will be revisions for many of the figures in this report. GDP *per capita* is estimated at USD715, which is similar to Lesotho ('B+') and Cameroon ('B') among those sovereigns rated by Fitch. With a population of about 27m, this implies a 2004 GDP estimate of USD19bn. Although the level of output is uncertain, its relative decline over time is not. *Per capita* income was about 30% higher than that of neighbouring Iran ('B+') in the early 1980s, but is now estimated to be 65% lower. Recent economic activity has been driven by the oil sector, which accounts for about three-quarters of GDP. As in any post-conflict country, the short-term economic policy focus is on reconstruction, including infrastructure development and the establishment of reliable public services.

The scale of Iraq's redevelopment needs result not only from its most recent conflict, but also from an extended period of economic mismanagement and neglect. Moreover, three major wars since the early 1980s and a decade of UN-imposed economic sanctions, which severely restricted international trade, have taken their toll.

› **Public Finances**

The Iraqi Governing Council approved the 2004 budget in October 2003. It was prepared by the Ministry of Finance, the Ministry of Planning and the CPA. The budget covers all regions of Iraq, but not all public revenue and expenditure. State-owned enterprises (SOEs), for example, operate largely outside the budget process, and almost none of the external assistance directed at reconstruction will go through the budget. In addition to 2004 targets, the budget also contains a fiscal framework for 2005-06.

Iraq's Governing Structure

The Coalition Provisional Authority: Led by the US and the UK, the CPA was established to administer Iraq in the aftermath of the war. It oversees security and the restoration of public services and institutions, and advises the Governing Council.

The Iraqi Governing Council: The CPA appointed the 25-member Governing Council in July 2003 as an interim representative body.

Under the current timetable, as announced in November 2003, the CPA and the Governing Council will be dissolved by 30 June 2004, at which time the **Transitional National Assembly** will assume sovereignty. Transitional Assembly members are to be elected by local caucuses by 31 May 2004. Direct elections for a **constitutional convention** will be held by 15 March 2005, and the new constitution is to be approved by popular referendum. The constitution will outline the structure of government, and national elections are to be held by 15 December 2005. By end-2005, the Transitional Assembly will be dissolved and the elected government is to be in place.

Led by Grand Ayatollah Ali al-Sistani, a large Iraqi constituency supports earlier direct elections, preferably before sovereignty is transferred. After consulting with various interested parties in Iraq to seek a compromise on the timing of direct elections – and whether they will be held for the Transitional Assembly or the final government – the UN has indicated that they cannot be held by 30 June.

Revenue: Dominated by Oil

With proven oil reserves of 112bn bbl, which is 11% of the world's total and second only to Saudi Arabia, oil exports will be the primary source of government revenue through the medium term. Public finances, therefore, depend crucially on developing Iraq's oil sector. The 2004 budget assumes an export price of USD21/bbl and average exports of 1.6m bbl/day, generating USD12bn, 93% of total government revenue. Even by the standards of major petroleum exporters in the region, Iraq's fiscal revenue will be very concentrated. In neighbouring Iran and Kuwait ('AA-'), oil accounted for about 59% and 72% of fiscal revenue last year. Other revenues in Iraq include a 5% tax on some imports, as well as corporate and personal income taxes at a flat rate of 15%.

Fitch considers the oil revenue projections in the 2004 budget to be reasonable, though our price and production forecasts differ from those of the authorities. We expect oil prices this year to be lower than in 2003 by an average of close to USD2/bbl, with Brent at about USD27/bbl, implying an Iraqi export price higher than assumed in the budget. Regarding production, we are forecasting a 20% increase over the reported December 2003 level of 1.95m bbl/day, to 2.3m bbl/day – equal to a 75% increase over average 2003 production. Assuming domestic consumption doubles, we project exports of about 1.5m bbl/day.

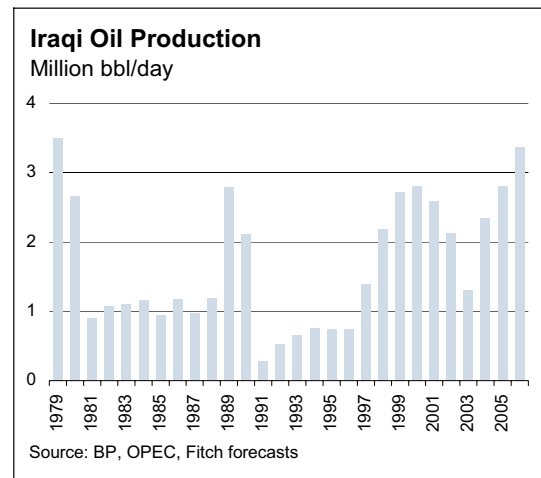
Budget and Fiscal Framework

(NIDbn)	2004	2005	2006
Revenue	19,259	28,775	29,645
Oil	18,000	27,750	28,950
Custom Duties	450	525	0
SOEs	563	142	150
Other	246	358	545
Expenditure	20,145	28,756	29,618
Current	19,027	21,119	21,464
o/w Public Distrib'n System	5,250	7,350	7,350
Wages	3,159	3,153	3,149
Capital	1,118	7,637	8,154
Balance	-886	19	27
Financing:			
Development Fund for Iraq	886	-19	-27

Source: CPA

Medium-term oil revenue projections are more difficult. The fiscal framework assumes prices remain at USD21/bbl and exports increase to 2.4m bbl/day in 2005 and 2.5m bbl/day in 2006. Our export price forecast is USD3-USD4/bbl higher, but Fitch believes that as domestic demand recovers, the production levels of 3m bbl/day or more implied by the export projections in the framework may be overly optimistic, especially in 2005. Production peaked at 3.5m bbl/day in 1979, prior to the decade-long Iran-Iraq war. It is widely believed that there has been very little investment in the oil sector since then. The increase in production in 1997 coincided with the introduction of the UN-administered Oil-for-Food Programme. Iraq was allowed to export crude oil up to a pre-determined maximum value, and the UN deposited 25% of the earnings in a Compensation Fund for Gulf War reparations and the remainder went toward imported humanitarian needs (and some administrative costs). In December 1999 the limits on oil exports were removed, but production and exports fell steadily thereafter, which we interpret as confirmation of the industry's dilapidated state.

Sources of external financing for the redevelopment of the oil sector are as yet unclear. It was not included in the UN/World Bank Joint Needs Assessment for 2004-07, which was published in October 2003 in preparation for the donor's conference in Madrid. The assessment estimates reconstruction costs of USD36bn, and the CPA estimates that another USD19bn is needed for sectors not included in the assessment – oil and enhanced security, among others – bringing the total to USD55bn. Madrid donors pledged USD26.5bn in grants and loans and the IMF and World Bank committed USD5.6bn-USD9.3bn. The US was the largest donor at the conference, pledging USD18.6bn, but only USD1.9bn is directed at the oil sector. The intention of the US-funded oil investment is to restore production to pre-war levels, which we do not believe is consistent with the export projections in the 2005-06 fiscal framework. No financing has been identified for the CPA's additional USD19bn.



The oil sector was also excluded from the new foreign direct investment law (CPA Order 39, September 2003), in which most of the economy was opened to 100% foreign ownership. Under the law, “ownership of the natural resources sector involving primary extraction and initial processing remains prohibited”. Although not unusual in the Gulf region, where foreign ownership of petroleum sector assets is often a sensitive political issue, such restrictions are likely to at least slow the development process in Iraq.

Expenditure: Just the Basics

Two of the largest components of government spending are food subsidies that were previously managed by the Oil-for-Food Programme (now known as the public distribution system) and wages, both of which are denominated in the New Iraqi Dinar (NID). The UN estimates that more than 60% of Iraqis relied solely on monthly provisions

distributed under the programme for all their household needs.¹ This is an enormous social spending burden for the Iraqi government equal to about 20% of GDP, and it will remain for many years. Subsidies in Iran are also high, at about 14% of GDP, mostly for energy.

The public sector wage bill is large, at nearly 10% of GDP this year, and covers 1.05m employees in 25 ministries and a number of other public entities, including the army. Another 500,000 people are employed by SOEs, but, in a change from past practices, their salaries are to be covered by own revenues. In fact, transfers to SOEs amount to an estimated 2% of GDP this year, and are set to decline in absolute terms in the medium-term framework. No other funds are identified for their support or restructuring, leaving them to compete independently.

Financing: The Development Fund

The projected NID886bn deficit for 2004 is to be financed by the Development Fund for Iraq (DFI), which was established in May 2003 under the authority of UN Security Council Resolution 1483. The DFI received a transfer of remaining funds from the UN Oil-for-Food account as it was wound down, as well as vested assets (assets of the previous regime frozen in US bank accounts) and seized assets (funds captured during the change in regime). In addition, the DFI receives all oil export revenues – minus the 5% deposited in the United Nations Compensation Fund (see below). The DFI balance as of mid February was USD8.4bn, most of which is held at the Federal Reserve Bank of New York.

As the primary collector of public revenues, the DFI has a critical role in Iraqi finances. According to Resolution 1483, it is administered by the CPA in co-operation with the Governing Council until an “internationally recognised, representative government” is in place. In the interest of transparency, the DFI is overseen by the International Advisory and Monitoring Board for Iraq, whose members are drawn from the IMF, World Bank, UN and the Arab Fund for Economic and Social Development. Along with the CPA, the Board is currently in the process of selecting external auditors for the DFI.

With the DFI already established, an independent Iraqi government could retain it, either as a revenue agency or as an oil stabilisation fund to offset the effects of oil price changes on public revenues. Once public finances are formally the responsibility

of the sovereign, however, the rationale for keeping the DFI as a separate revenue agency is less compelling, since its practices and resources would, in any event, be managed by the government. Furthermore, Iraq’s basic needs are such that it might not be politically feasible to accumulate oil revenues in a stabilisation fund while acute development objectives are still unmet. Nevertheless, Fitch believes that despite these considerations, to the extent that the DFI contributes to increased transparency as well as local expertise and professionalism in managing the flow of oil funds, its retention in some form would be warranted.

> External Finances

Iraq’s balance of payments will be dominated by oil exports, imports for reconstruction, international aid flows and external debt rescheduling and/or forgiveness. UN-imposed sanctions were lifted in May 2003, facilitating the full resumption of normal international economic relations.

In the short term, the absence of sanctions will not alter the structure of merchandise exports, 95% of which is forecast to be oil. This is a more concentrated export base than in Kuwait (90%) or Iran (80%). We are forecasting average oil production in 2004 to be 75% higher than last year (as noted above), and that output will increase by 20% in 2005 and 2006. Export revenues are projected to rise by 60% this year to USD14.8bn and reach USD20.7bn by 2006.

Trade Balance

(USDbn)	2003e	2004f	2005f	2006f
Exports	9.8	15.6	18.6	21.8
o/w Oil	9.3	14.8	17.7	20.7
Imports	7.2	12.3	16.3	21.3
Trade Balance	2.5	3.3	2.4	0.5

Memo:

Oil Exports (m bbl/day)	0.9	1.5	1.9	2.4
Export Price (USD/bbl)	28.10	26.50	25.50	24.00

Source: IMF, Fitch estimates and forecasts

The above table does not include the imports associated with reconstruction that will be financed externally, largely by the Madrid conference donors, and co-ordinated by the International Reconstruction Fund Facility for Iraq established by the UN and World Bank. We estimate that other imports will increase in 2004 at the same rate as nominal GDP growth (in USD), plus another 25% to account for demand arising from the lifting of sanctions. The resulting own-financed trade balance is positive, but falling, throughout the forecast period.

¹ See the Oil-for-Food Programme performance report to the UN Secretary-General, November 2002.

External Debt: Among the World's Highest

The most recent IMF estimate of Iraq's gross external debt is USD117bn-USD122bn.² Paris Club (official) creditors estimate they are owed USD21bn in principal and another USD21bn in late interest that has accrued on arrears. Japan, Russia, France and Germany account for nearly two-thirds of Paris Club debt, all of which was extended before August 1990. Debt to other official creditors is estimated by the IMF to be USD60bn-USD65bn, and debt to private creditors is estimated at USD15bn.

The IMF figures do not include Iraq's unpaid obligations to the United Nations Compensation Fund (UNCF), which are about USD30bn. The United Nations Compensation Commission (UNCC) was established after the Gulf War to pay parties that suffered losses during the Iraqi invasion and occupation of Kuwait. Most of the 2.6mn claims have been resolved, and USD18m of the USD48m in compensation awarded has been paid. Compensation sought in cases that have not yet been resolved amounts to USD84bn. From December 2000, 25% of Iraqi oil export revenues generated under the Oil-for-Food Programme went to the UNCF, but this was revised down to 5% under Resolution 1483.

Even if the war reparations are set aside, Iraq's estimated gross external debt of USD120bn is equivalent to about 620% of GDP and 730% of foreign currency earnings (CXR), which is exceptionally high. Among sovereigns rated by Fitch, these ratios are exceeded only by those of certain international banking centres, all of which have equally large external assets.

To approximate end-2004 liquid external assets, and thus net external debt, we begin with the DFI balance (USD8.4bn), add the remaining 10 months of forecast oil exports (USD13bn) and subtract the imports (USD10.3bn). As noted above, all export revenues accrue to the DFI, and our assumption is that the Central Bank of Iraq will receive transfers from the Federal Reserve Bank of New York and will then make available to the government the corresponding amount of NID. This yields a liquid asset forecast including the DFI balance and reserves at the central bank of USD11.1bn, and year-end net debt forecasts of 560% of GDP and 660% of CXR. These ratios exceed by a wide margin all those sovereigns rated by Fitch.

The IMF is scheduled to present a debt sustainability analysis to Paris Club creditors in April, at which time a more accurate estimate of Iraq's debt will be

available. Paris Club creditors have indicated that they do not expect repayments to begin in 2004, but it is not clear when they will meet with the Iraqi authorities to reschedule. The case for rescheduling is strong. Iraqi interest service on USD120bn at a 6% rate would amount to USD7.2bn annually, or about 37% of estimated 2004 GDP. Put another way, with the same interest rate, for Iraq's external interest payments relative to CXR to be equivalent to the median for sovereigns rated 'B+' and lower, its debt stock would need to fall by about 90% to USD14bn.

Such a massive debt reduction is conceivable, but improbable in light of medium-term oil export prospects. In December 2003 President Bush appointed James Baker, former US Treasury Secretary and Secretary of State, as special envoy to lead an effort to reduce Iraq's external debt burden. Baker visited Iraq's largest creditors and, according to press reports, secured commitments from almost all countries to reduce the debt stock significantly, though the issue of waiting to deal with a sovereign Iraqi government was raised. In view of what appears to be a relatively favourable reception to the Baker initiative and the international community's interest in promoting a stable and sustainable Iraqi economy, Fitch does not expect the Iraqi authorities to resort to an "odious debt" argument in seeking relief, as has been suggested by some NGOs. Odious debts can be defined as those of a previous regime that were not incurred in the interest of the state or the populace and should be considered obligations of the regime itself, allowing the new state to repudiate them.

From the perspective of Paris Club treatment, post-conflict countries have fared well in recent years. Naples terms (67% debt reduction) and/or Cologne terms (90% debt reduction, or more) have been applied, for example, over the last four years to Bosnia, the Democratic Republic of Congo, Ethiopia, Rwanda and Sierra Leone. In the case of Iraq, a large debt stock reduction could be consistent with the new Evian Approach announced in October 2003. Evian is meant for non-HIPC countries (Heavily Indebted Poor Countries) and it emphasises a flexible approach to ensure medium-term debt sustainability instead of short-term debt relief based on strict formulae. More likely than a 90% write-off, in our view, is an extension of the debt moratorium beyond end-2004 and a smaller debt stock reduction to take account of Iraq's increased oil export revenues in the medium term. Much will depend on the upcoming IMF debt sustainability analysis.

² See IMF Survey Vol. 33 No. 2, 2 February 2004.

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