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IRAQ: ECONOMIC CHALLENGES FOR THE NEW GOVERNMENT

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The outcome of the forthcoming general elections is wide open, and Iraq's political scene could change considerably in a short time. But, whatever its shape and color, the government that takes power will have to address serious medium-term economic challenges. In one way or another, these challenges all relate to oil – and it is difficult to see how it could be otherwise, as Iraq is already one of the largest oil producers in the world and the third largest exporter after Saudi Arabia and Russia.

The first challenge is to fully exploit Iraq's oil potential. Accounting for 60 per cent of GDP, oil will continue to be the main driver of the Iraqi economy for a long time. The IMF projects exports to double from 2.4 mbpd in 2013 to 4.8 million barrels per day (mbd) in 2019. The oil sector would thus push GDP growth rates from about 4 percent in 2013 to 6 per cent in 2014 and 8-9 per cent in the medium term. However, this potential can be fully exploited only if the government devotes increasing resources to investment in the oil sector, including for distribution and export infrastructure, and addresses the overall organization of the sector through a hydrocarbon law (which has been in the making for years). The new central government will also need to reach a durable deal

with the Kurdistan Regional Government over oil revenue sharing, ideally in the context of an overall sector framework.

The second challenge is to improve the way the oil money is used. This means reforming fiscal policy to make it support the growth of Iraq, the welfare of its citizen, and help insulate the economy from shocks in the oil market. In this area, the most immediate urgency is addressing the administration's weak capacity to formulate and execute fiscal policy. This objective calls for strengthening budgetary institutions, including the role of the ministry of finance. Reflecting poor fiscal institutions, budgets have become a political exercise rather than a tool for the allocation of public resources. Spending increases in recent budgets – while justified in some cases, for example security – have become extravagantly large, while revenue assumptions are unrealistic. This is obviously a recipe for poor fiscal performance. Indeed, the government balance declined from a surplus of 4 per cent of GDP in 2012 to a deficit of 6 per cent of GDP in 2013, and in the first months of this year, severe liquidity problems have forced the government to delay all but non-essential spending.

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The new government will also need to tackle the high level and skewed composition of public spending. Streamlining the booming current spending (for example, from rising public employment and the expensive in-kind universal subsidy system) would allow devoting more resources to investment in the oil sector and infrastructure, but also to better targeted social spending. More effective public spending will be crucial to make the benefits of oil wealth trickle down to the people, which so far has not really been the case: the UNDP Human Development indicator is still well below most other oil exporters and has not improved much in the last ten years.

A prudent spending policy would also allow accumulating fiscal surpluses and increasing fiscal buffers. Buffers are essential to protect an oil-dependent economy like Iraq from shocks in oil revenues, which could come from a fall in oil prices, a decline in world demand, or a slowdown in Iraqi oil supply. The stall in oil production and exports in 2013 was an example of this vulnerability. Exports (and therefore government revenues) were hurt by a combination of terrorist attacks to the Ceyan pipeline in the north, the suspension of exports from the KRG, and big maintenance operations at the Fao terminal in the south. Adequate buffers would help make fiscal policy an effective countercyclical tool, given that the Iraqi dinar's fixed exchange rate with the U.S. dollar severely constrains monetary policy.

The third challenge is to go beyond oil and promote the growth of a vibrant private sector economy. For an economy like Iraq, prospects of diversification away from oil are realistically limited, not least because non-oil GDP is driven by government spending, which, in turn, depends almost exclusively on oil revenues. But, there is potential for increasing private activity in non-oil sectors such as in services (banking), construction, transport,

religious tourism (particularly around Shia destination in the South), and agriculture (a traditionally important sector in the past). These sectors could also help absorb Iraq's large and young labor force, given the oil industry's relatively low employment creation.

Helping private sector growth requires a shift in the government's focus from an industrial policy approach to creating the environmental conditions that support private sector growth. The potential of the private sector is however strangled by a pervasive presence of the state in the economy, reflecting Iraq's planned economy heritage. Over 170 state-owned enterprises cover sectors from car dealing to sugar production, while state-owned banks monopolize government business and dominate the financial sector. The restructuring of largely loss-making state-owned enterprises would free space for private companies and stop the leakage from the budget. In the financial sector, restructuring the state-owned banks and gradually removing the restrictions barring the private banks from accessing government business would foster the growth of the numerous but small private banks and trigger lending to private enterprises.

A vibrant private sector also needs higher levels of investment, particularly in energy, but also a better business environment, among the worst in the world, which can be improved by cutting down on bureaucracy and regulation and starting to address the pervasive corruption.

These economic challenges are only a small part of the agenda of a new government, and will need years to be addressed. But it is nevertheless vital to start the work as soon as possible –with the help of Iraq's partners, such as the IMF – to revitalize the economy but also to give the Iraqi people confidence in an improvement in their lives.