

A divided country?



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- Despite a lack of investment and sabotage by insurgents, Iraq's oil production and exports have hit post-war highs. We expect the upward trend to continue in 2007.
- The approval of a long-awaited hydrocarbon law would help, but it is difficult to predict the timing of the approval by Iraq's deeply divided Parliament.
- President Bush is likely to resist domestic calls for troop withdrawals.

Table 1: Iraq – Key macroeconomic indicators

	2004	2005	2006F	2007F	2008F
Real GDP Growth (%)	46.5	3.7	4	14.4	12.9
GDP – Nominal (US\$ bn)	25.7	34.5	47	60.9	70.5
Inflation (CPI, year-end, %)	31.7	31.6	30	17	10
Current Account Balance (% of GDP)	-34.4	5.2	-1.9	-1.4	-1.7
Fiscal Balance (% of GDP)	-40.6	9.8	-6.1	-2.1	-0.8
International Reserves (mos. of imports)	3.2	3.9	4.4	4.6	4.5
Gross External Debt / GDP (%)	345.5	182.8	102.2	82.9	41.8

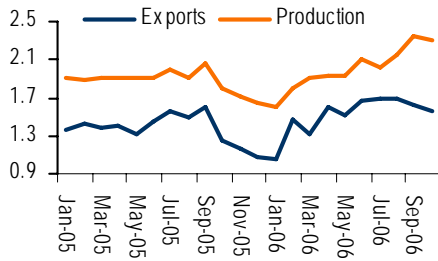
Source: International Monetary Fund

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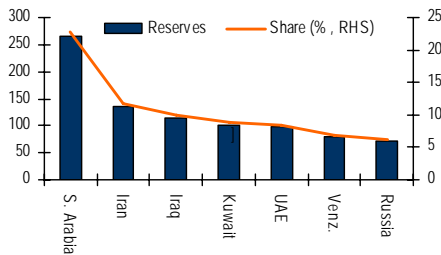
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Chart 1: Oil production and exports (millions of barrels per day)



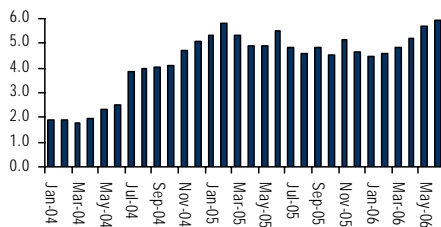
Source: OPEC, Iraq Weekly Status Report

Chart 2: Proven oil reserves and share of world total (billions of barrels, 2005)



Source: BP Statistical Review of World Energy

Chart 3: Gross FX reserves (US\$ bn)



Source: Iraq Weekly Status Report

Can Iraq sustain oil output growth?

The Iraqi economy appears to be recovering, after more than a decade of economic stagnation, sanctions and war.¹ A sustained growth in oil production, which accounts for more than 60% of GDP and nearly 95% of total exports, remains critical to Iraq's macroeconomic performance. Despite a lack of investment and sabotage by insurgents, Iraq's oil production and exports have hit post-war highs (Chart 1). Oil production currently hovers above pre-invasion levels of roughly 2.5mn barrels per day (bpd), up from roughly 1.9mn bpd in 2005 and most of H106, while oil exports have reached 1.8mn bpd. Iraq plans to boost crude oil production to as much as 4.5mn bpd by 2010 and 6.0mn bpd in 2012 with foreign assistance. These targets seem ambitious, considering that Iraq's peak oil output was 3.5mn bpd in 1979.

However, they are not unrealistic, given that the Iraqi oil sector has some of the lowest development and production costs in the world, "ranging from as low as US\$750mn for each additional million barrels per day in Kirkuk, to as high as US\$3bn per million barrels per day for smaller fields in the north-western part of the country."² Iraq is considered a highly attractive oil prospect, with only 21% of discovered fields having been developed.³ The government is allocating significant resources, roughly US\$4bn or 12% of the country's entire budget, to develop the oil infrastructure. While we expect Iraq to sustain oil production at current levels, or to even increase it to 2.7mn bpd, a lack of security and an effective government and the absence of a legal framework governing investments and ownership of the country's oil resources appear set to hamper foreign investment in the sector and prevent Iraq from realizing its full potential in the short run.

A hydrocarbon law in early 2007?

Iraqi government is hoping to push a long-awaited hydrocarbon law through the parliament sometime in early 2007. The legislation, which has already been drafted by parliamentary committees, is aimed at providing a framework for distribution of Iraq's oil wealth and investments by foreign companies in Iraq's oil sector. However, it is difficult to predict the timing of the approval by Iraq's deeply divided parliament. According to Iraq's Oil Minister al-Shahristani, some oil and gas deals could be done prior to the approval of a framework hydrocarbons law. Under the so-called enhanced contracts, Iraq plans to activate less controversial oil and gas projects as soon as possible. The Baghdad government appears to have already begun courting global oil majors.

Minister al-Shahristani, on an official visit to China in October, invited China National Petroleum Corporation (CNPC) to resume the Ahdab oil field, which has an estimated reserve of one billion barrels. The CNPC, which first signed up to explore it in 1997, is expected begin formal discussions with Iraqi officials before end-2006.

¹ It is important to note that estimates of economic growth vary widely. Hence, we use the IMF forecasts for the country.

² Tariq Shafiq (former Vice President of the Iraq National Oil Company), 15 December 2003, "Iraq Oil Development Policy Options: In Search Of Balance," Middle East Economic Survey.

³ The U.S. Department of Energy, Energy Information Administration, June 2006, "Iraq: Country Analysis Brief."

Will the US pull out of Iraq in 2007?

As 2006 draws to a close, Washington is busy assessing the situation in Iraq and reviewing options for the best way forward. The Iraq Study Group, an independent panel led by former Congressman Lee Hamilton and former Secretary of State James Baker, recommends less troops and more diplomacy for Iraq. The Democrats, who control both the House and Senate, are pushing for a phased withdrawal of US troops from Iraq. However, President Bush, who as the commander-in-chief for the next two years has final say, is likely to resist to troop withdrawals for a number of reasons.

First, we think the odds of the Bush administration accepting a defeat of the US and pulling out of Iraq are low. Washington would lose a lot of influence and prestige in the Middle East. Second, one of the primary reasons why the US invaded Iraq was to protect long-term US interests, such as energy security in the region. Early troop withdrawal would not help achieve that. In addition, US withdrawal could increase risks that parts of Iraq could fall under al-Qaeda control. Third, none of the regional US allies want to see premature US troop withdrawal. Our base case scenario sees a phased and gradual withdrawal over the long run. This would be positive, as it would give the country the chance to complete the transition to a loose federation and complete training of Iraqi forces.

What happens if the US were to indeed leave?

The security situation in Iraq is worsening⁴, and the American people appear to have voted for troop withdrawal. **While we do not expect Washington to pull out of Iraq in the foreseeable future, we think it is deliberating on what would happen to Iraq's economy if the US were to withdraw.** First, of the two forms of violence – sectarian and insurgency – the sectarian war between Shiites and Sunnis will probably continue and could even escalate from the currently high level. Second, Iraq may break up into three regions, which could provoke regional powers, such as Turkey, Syria and Iran. Under such a worst case scenario, there probably will not be an agency to service the country's debt.

⁴ The Defense Intelligence Agency reports show that insurgent attacks against US and coalition forces have increased to 180 per month in October from about 70 in January. Similarly, the number of attacks on Iraqi civilians has increased fourfold over that same period of time.

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