



Iraq: Two steps forward, one step back

HARSH ECONOMIC, INFRASTRUCTURE AND SECURITY REALITIES MAKE PROGRESS TOWARDS STABILITY FRAGILE. SEMIH OZKAN EXPLAINS

Iraq is marching towards a more sustainable economic position; however, progress looks much like the Ottoman janissaries' marches – two steps forward, one step back. The ever-increasing security and humanitarian crises have derailed the National Development Plan (2013-2017) and pushed 2015-2017 budgets into the red. Moreover, low oil prices have deepened the impact. Al-Abadi's government is undertaking efforts to fight this double whammy, but at the cost of infrastructure projects and reforms, both of which are needed to help the country realise its potential faster.

The cost of the crisis

The security and humanitarian crises, including, but not limited to, ISIS, have led to substantial costs to the country. The cost of the crisis is estimated at

\$90m per day¹, and increasing. For instance, Iraq has purchased 36 F-16 warplanes² (four of these arrived in Iraq in July this year). Iraq's defence ministry expects the warplanes to reinforce the military capability in its battle against ISIS. These are direct costs. At the same time, there have been devastating opportunity costs given to interruptions to projects across the country, most notably seen in those related to oil and connected sectors. This is significant, as Iraq earns more than 90% of its revenue from oil sales.³ Delays to projects will impact overall development and welfare prospects of the country. Iraq must maintain and further develop its technical and administrative ability to produce and sell oil in order to continue rebuilding the country. However, with the ongoing crises, Iraq has stepped back and appears

unlikely to meet production and export targets of 3.8mbpd and 3.3mbpd, respectively⁴ in 2015.

Deteriorating economics

The 2015 budget – based on a break-even oil price of \$100 per barrel (established by the International Monetary Fund – IMF) is already in deficit (forecast at c. 12% of GDP). FX reserves are being drained at an alarming rate, falling to \$59bn in 2015 from \$74bn in 2014.⁵ To help the country maintain a healthier balance of payments and to stop the deteriorating fiscal deficit, the IMF has fast-tracked the release of a \$1.24bn loan. There are strings attached, however.

The IMF requires more reforms to be undertaken; Iraq will need to revise electricity tariffs, make fiscal adjustments and seek out more financing sources. Steps are already

IMAGE SOURCE

being taken towards these, with the announcement of a \$6bn international bond to be issued by the Iraqi government. Citibank, Deutsche Bank and JPMorgan were appointed to structure the bond, according to a Bloomberg report. The bond is expected to not only help the budget, but also to restore some confidence in the long-term prospect of the country. Earlier this month, Iraq also received its first credit rating of B- from Fitch.⁶ Although the report cited insecurity, government ineffectiveness and weak institutions for the highly speculative rating, it will still help Iraq strengthen its ability to tap the market.

Doing business in Iraq: companies must focus on the fundamentals

Amid the turmoil, international companies are increasingly concerned. The situation has led to

a more challenging, and costly, business environment. Treasurers have a lot more responsibility now to steer the business in Iraq, while adjusting almost immediately to new realities. A solid long-term strategy, and very good banking and commercial partners, will help treasurers manage this delicate task.

Remain committed to the long-term strategy

The ongoing crisis has likely raised concerns in boardrooms globally regarding capital allocation and continued company presence in Iraq. While this is a right concern, companies need to look beyond current events and focus on Iraq's strong base of both natural and human resources. Iraq still has the fifth-largest proven oil reserves (c. 144 billion barrels²) and has the potential to become a major oil producer and exporter in the world.

Iraq requires significant investment across nearly every major sector to meet the country's primary needs. The National Investment Plan outlines incentives, rules and regulations for foreign direct investment into Iraq, while the National Development Plan prioritises sectors that require the most urgent investments. There is progress in almost every sector, but the challenge is not the crises per se, but the lack of a long-term strategy.

Find a good banking partner

Problems related to banking transactions are no rarity in Iraq and hence, a solid banking partner is critical to doing business there. There are more than 50

banks⁸ in Iraq and many suffer from decayed banking infrastructure, inadequate human resources, disrupted electricity and highly unsafe working environments due to ongoing insurgencies. Needless to say, one should temper expectations of any straight-through processing.

The banking system is dominated by two state banks, Rafidain Bank and Rasheed Bank, both of which require immediate recapitalisation in order to function effectively. However, it appears that the government has put this matter aside for some time. The country accesses international markets through the Trade Bank of Iraq (TBI) and the Central Bank of Iraq (CBI). These institutions are the lifeblood of the economy. Their roles are clear: the TBI primarily manages non-oil trade, while the CBI handles oil trade, among other traditional central bank roles and responsibilities. Foreign banks have limited operations in the country and typically operate through local partner banks, and there are instances in which a same local bank serves a number of international banks.

Companies' onshore banking requirements are limited to petty cash transactions and state-related payments. Other transactions are typically managed through offshore accounts in locations such as the United Arab Emirates. Cash is king in Iraq, and payments in US dollars are preferred to those transacted in Iraqi dinar. Cheques account for a small portion of payments and are not preferred due to potential delays in clearing. There are

a number of clearing systems in Iraq, including Real-time Gross Settlement (RTGS), Automated Clearing House, Checks Enablement Project and Securities Registration System, all of which are prone to disruptions, however. The RTGS is currently the most active system with the participants; yet achieving a straight-through process is still on a case-by-case basis. No FX-related restrictions (subject to the provision of supporting documents) and no tax or other charges are applicable. In trade finance, all the TBI's transactions are generally 100% cash collateralised or guaranteed by Iraq's ministry of finance. For companies, this means transactions issued by the TBI are practically risk-free, yet companies still find it difficult, rightfully so, to

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assume direct risk of the TBI. As a result, companies pay c. \$2,500 to \$10,000 for every \$1m sales to mitigate bank and country risks.⁹ This is not only due to Iraq's country risk, but also due to the challenges of dealing directly with the TBI.

Companies must choose a partner bank that can persist and persevere with the needed ownership and follow up on clients' transactions from beginning to end.

Find a good local partner

Iraq ranks 170th out of 175 in Transparency International's corruption index and 156th out of 189 on the World Bank's Ease of Doing Business

ranking. It is important for companies to find a good local partner, one that can help navigate Iraq's legal, political and business environments.

Iraq's budget is already in deficit, which means lesser allocation for the works tendered. According to the International Energy Agency, international oil companies await c. \$27bn of recovery and remuneration fees from Iraq. In contrast, the current budget allocates c. \$12bn towards this header. Companies in non-oil sectors are also seeing a similar pattern. So companies can benefit from their local partners' endeavours to secure as much of the limited allocation as possible. Additionally, treasurers are better off in structuring trade finance transactions

in cooperation with their partner banks in order to avoid significant credit risk.

Pan-Iraq strategies, formulated by companies in early 2013, are being shelved due to heightened security concerns. At this time, companies must focus on their core businesses. Iraq is making progress, but there is still much work to be done. 📌



Semih Ozkan is an ACT student (CertITM) and a transaction banking professional in an international bank

1. According to the Brookings Doha Center, the initial estimate of the cost for 2015 is c. \$27bn. The humanitarian spending to support the displaced people alone is c. \$6bn in 2015.
2. www.meed.com/sectors/transport/aviation-and-airports/first-f-

16-deliveries-arrive-in-iraq/3212013.article
3. www.resourcegovernance.org/countries/middle-east-and-north-africa/iraq/overview
4. www.imf.org/external/pubs/ft/scr/2015/cr15236.pdf
5. According to the Institute

of International Finance and https://en.wikipedia.org/wiki/List_of_countries_by_foreign_exchange_reserves
6. www.fitchratings.com/site/fitch-home/pressrelease?id=989164
7. <http://graphics.wsj.com/lists/opeec-meeting>

8. www.cbi.iq/index.php?pid=IraqFinancialInst
9. An indicative calculation based on the actual experience where the international banks apply on an annualised basis from 0.25% to 1.00% on the cash collateralised transactions, ie confirmed letter of credit.