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The economy of Iraq since 2003-a follow-up

A notable characteristic of the Iraqi economy at present is the disparate images that it presents. On the one hand, poverty levels and unemployment remain high--at 23 percent according to Iraq's Ministry of Planning.[1] While security has improved since the nadir of 2005 to 2007, it remains tenuous, as evinced by the frequent bombings in the capital, Baghdad, and in other cities. And, while rising instability elsewhere in the Middle East has induced some of Iraq's refugees in neighboring countries to return to Iraq,[2] Iraqis continue to emigrate, notably to the West. On the other hand, the economy has been experiencing consistent, if unspectacular, growth since 2008: oil production and revenues have been rising. And, foreign businesses, notably oil companies, are anxious to work in Iraq once again.

Understanding the structure of Iraq's economy helps shed light on the dissonance in perspective. Iraq's economy is dominated by the oil sector, which accounts for most of GDP. Any increase in price or exported volume of oil is reflected in

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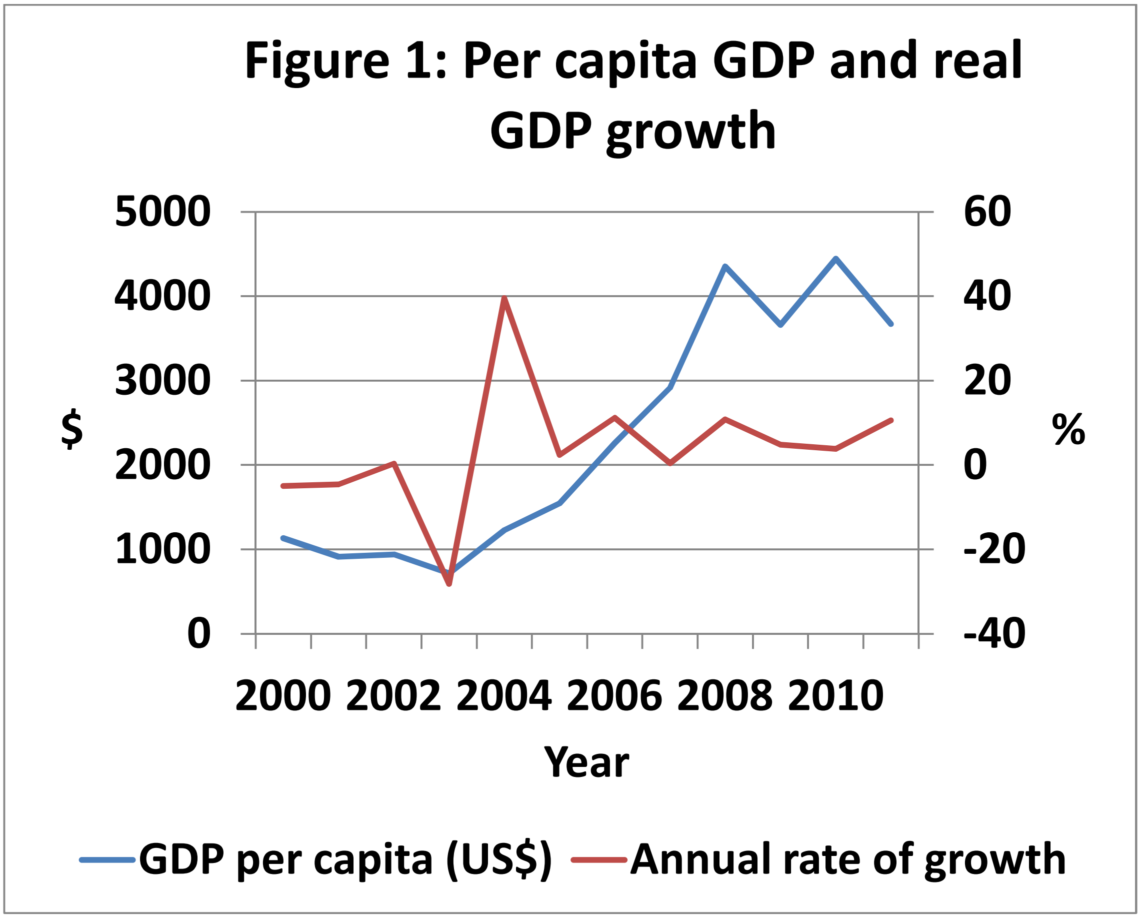
[1] Azzaman, 'Iraq allocates $450 million to reduce unemployment currently at 23%,' July 30th 2012, http://www.azzaman.com/english/?p=241, accessed 08-19-2012.

[2] UN Office for the Coordination of Humanitarian Affairs, IRAQ: Returnees from Syria - a "humanitarian crisis" in the making,' http://www.irinnews.org/Report/95964/IRAQ-Returnees-from-Syria-a-humanitarian-crisis-in-the-making, accessed 08-19-2012.

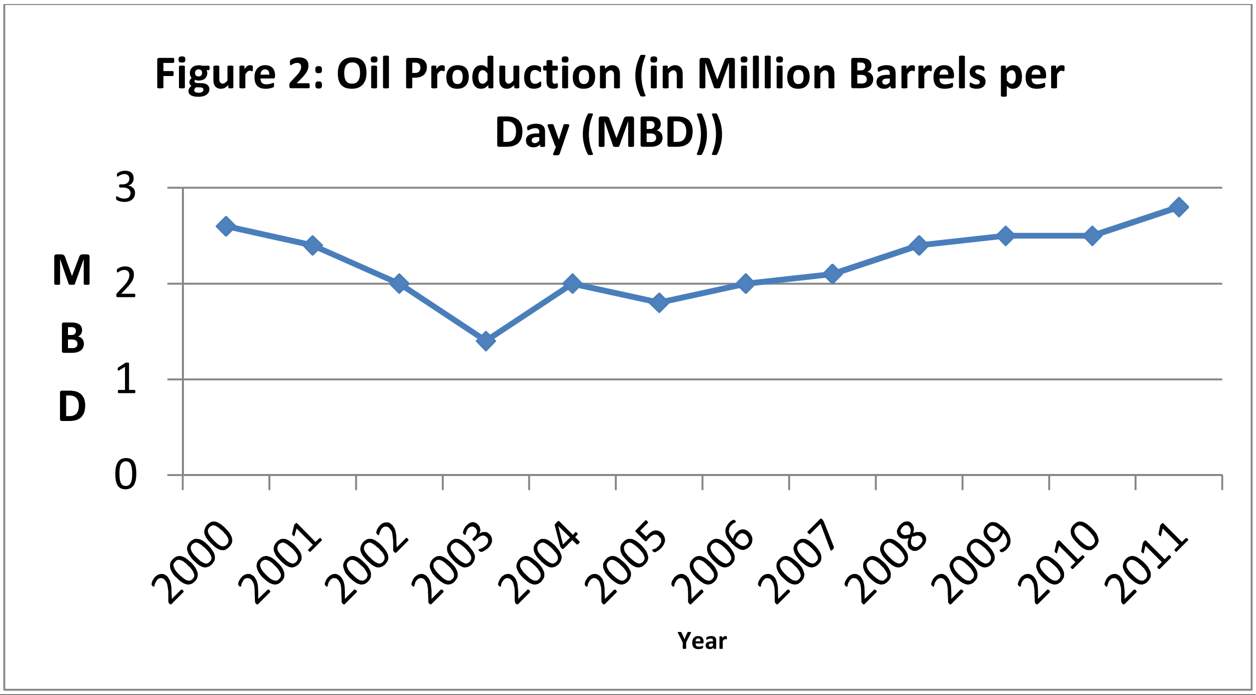
elevated nominal GDP, regardless of whether domestic consumption or investment increases––that is, without reference to whether Iraqis are actually better off. Oil revenues provide funds that can potentially be invested or consumed, but may also accumulate as financial assets. The oil sector itself is unable to generate sufficient employment as oil extraction activities are highly capital-intensive and typically employ a minute fraction of the labor force. Receipts from the sale of oil accrue to governments in oil-exporting nations, either directly or through taxation of profits. Governments, in turn, use oil revenues to finance their spending and investment, which generates demand and employment in non-oil sectors.

Given this nexus, it is understandable that great emphasis has sometimes been placed on the generation and expansion of oil revenues. In the case of Iraq, however, this emphasis has been misplaced, as it is the conversion of oil revenues into spending and investments that has proved problematic. As figure 1 shows, per capita GDP in nominal terms has increased significantly since the 2003 war (left vertical axis). This, however, is not an indication of increased economic activity or improved well-being. Higher oil prices, not increased oil output, have driven most of the rise in nominal GDP, as the price of oil increased three to fourfold between the early 2000s and 2008.



Sources: Business Monitor International (BMI), *Iraq Business Forecast Report (IBFR)*, Q4 2005, p. 2; BMI, *IBFR*, Q4 2006, p. 2; BMI, *IBFR*, Q3 2010, p. 4; and BMI, *IBFR* Q2 2012, p. 2.

The 1990s sanctions-induced decline in the oil sector followed by insurgent attacks on oil pipelines and installations after 2003 prevented increases in production and exports. In fact, as figure 2 shows, oil production recovered roughly to its pre-invasion level only in 2009 and 2010. Two other goods-producing sectors, notably agriculture and manufacturing, have likewise stagnated since the liberalization of imports following Iraq's invasion in 2003. Iraqi agriculture has found it difficult to compete, especially with subsidized cereals produced in the West, while manufacturing has been particularly hard hit by the loss of electrical capacity resulting from sanctions and the US invasion.



Sources: Business Monitor International (BMI), *Iraq Business Forecast Report (IBFR)*, Q4 2005, p. 2; BMI, *IBFR*, Q4 2006, p. 2; BMI, *IBFR*, Q3 2010, p. 4; and BMI, *IBFR* Q2 2012, p. 2.

After recovering from the collapse during the 2003 war, real rates of growth of GDP—-the real output of the economy--have been modest. In fact, the growth rates reported above have to be reduced by a further 2 to 3 percentage points (the annual rate of increase in population) to reflect per capita rates of growth. Given that the Iraqi economy prior to Iraq's invasion was sanctioned and depressed, these rates of growth seem all the more anemic.

The Iraqi government (and before that the CPA) used oil revenues to give a needed boost to private and government consumption. Iraq's fairly large public sector facilitated this. The pay of public sector workers has increased steadily since 2003. Given the liberal import regime that accompanied the lifting of sanctions, this action virtually ensured that real consumption would rise on average (at least for tradable goods). Of course, not everyone has benefitted. Massive dislocation and migration (both internal and external) has meant that some Iraqis have lost access to government jobs. And, the dissolution of the army and de-Ba'thification deprived many people of their public employment (although some were later re-hired). However, in general, there has been a rise in both private and public consumption.

Rebuilding and capital formation have proceeded more slowly. Given the decades of underinvestment during the Iran-Iraq war (1980-88), the destruction of infrastructure in the 1991 Gulf War, and the inability to rebuild under economic sanctions (1990-2003), the ability of the Iraqi economy to absorb investments (especially large-scale) was already limited. This situation, I argue, was exacerbated by the neo-liberal policies that the US pursued in Iraq in 2003 to 2005—-policies that increased unemployment, inflamed insecurity and retarded capital formation.[3] Insecurity both delayed capital formation and increased its costs.[4] The result is that actual investment has lagged considerably behind its targeted level. Thus, in 2007, the Iraqi government, which has traditionally accounted for a substantial part of national investment, was able to spend 80% of its operating budget (much of which went to pay public workers) but only 28% of its (much smaller) investment budget.[5]

The Iraqi government's inability to spend all the allocated expenditures, and resulting fiscal surpluses that Iraq accumulated, became a matter of discussion during the 2008 US presidential elections. Then presidential candidate Obama raised the apparently logical question of why Iraq, which had accrued fiscal surpluses, could not pay for its own reconstruction and security. In fact, the US as the occupying power is responsible for providing security under international law. The US inability to provide adequate security, along with policies that aimed to radically restructure Iraq's economy, promoted insecurity, which explains, in part, why reconstruction has proceeded so slowly. Only since 2008 has capital formation accelerated, facilitated by improved security rather than expanded oil revenues.

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[3] Bassam Yousif, 'Economic Restructuring in Iraq: Intended and Unintended Consequences,' *Journal of Economic Issues*, Vol. 41, No. 1, March 2007, pp. 43-60.

[4] Incredibly, according to the IMF, contractors spent 30 to 50% of the total value of reconstruction contracts directly on security and insurance. See IMF, 'Iraq Staff Report for the Article IV Consultation,' July 8 2005, p. 7.

[5] Government Accountability Office, 'Stabilizing and Rebuilding Iraq: Iraqi Revenues, Expenditures and Surplus,' September 16th 2008, GAO-08-1144T, p. 3.

Contributing to the difficulties associated with physical capital formation has been the migration abroad and the displacement within Iraq of skilled and professional labor. The process began with the sanctions-induced penury during the 1990s, was aided by de-Ba'thification (which idled a large number of managers and professionals), and continues today. Not only does migration deprive Iraq's reconstruction of needed skilled personnel, it effectively represents a deduction of (human) capital from Iraq's productive assets. It also brings into focus the point behind the desired capital formation: to improve living standards and enrich human lives. As a result, it is difficult to discern substantially improved trajectories in human development: enrollment at the primary and secondary levels of education increased between 2000 and 2008, but under-5 mortality rates declined only slightly and life expectancy actually declined.[6]

Given its political economy, the contrasting images of Iraq at present, those of businesses clamoring to return to Iraq in search of profits and others of Iraqis anxious to leave, are neither illogical nor necessarily disharmonious. In the short to medium term, multi-nationals, especially in oil, may continue to be attracted to Iraq by high profits, even as skilled Iraqis

[6] World Bank, World Bank Statistical Database, http://data.worldbank.org, accessed 06-10-2012.

emigrate. And higher oil revenues, while they provide the opportunity to invest, do not automatically translate into investments in productive assets and in people, especially as it becomes more difficult to invest when skilled and professional labor is depleted. The result might be an oil-revenue rich Iraq that Iraqis continue to flee and that remains under-developed.

Further Sources

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