

Iraq

Politics & Economics – The Next Battle

Over the past few years, the primary focus for the Iraqi government – in tandem with its local and foreign partners – has been and remains working to defeat ISIS. They now appear close to achieving this goal, and so reconstruction, dealing with the humanitarian crises and establishing political stability across the country will be their next and probably even greater challenge.

The Cost of Stability

There are more than 3 million Iraqis who have been displaced internally by the current conflict, and while some of these have begun to return to their homes, the vast scale of destruction after so many years of war means that even the most basic services in many towns and cities have to be rebuilt from scratch. Such an environment is a breeding ground for extremism, and so the government will need to act quickly to give its people a real feeling of hope for the future. The cost of this rebuilding will also be substantial, a fact underlined by the country's Prime Minister, who estimated that the bill to reconstruct key infrastructure in just the Anbar and Nineveh provinces could reach US\$ 50 billion, although the final tally will likely be much higher. Thus continued financial, technical and political support from the US, as well as other world powers and institutions, will be vital in ensuring Iraq has a better chance to avoid the mistakes of the past and allow this strategically important country to successfully re-emerge following years of strife.

Political & Economic Hurdles

Iraq's constitution, which was ratified in 2005, defines the country as a democratic federal parliamentary republic, and the current head of the government is Prime Minister Haider Al-Abadi. Since his appointment in 2014, he has attempted to unify Iraq's various ethnic and religious communities in order to enable the government to function and to effectively pursue the war against 'Daesh'. Once the latter is vanquished however, his diplomatic skills will once again be severely tested; the leadership of Iraq's diverse tribal and religious factions will seek not only some reward for their assistance in defeating the militants, but also direct influence in the future direction of the country. Added to this will be the extremely tricky and longer term task of integrating the various anti-ISIS forces, including the 'Popular Mobilisation Front' which currently has over 100,000 men under arms, into a single Iraqi security force. Whether or not al Abadi has the ability and enough 'wasta' to accomplish all this is yet to be seen, it's not even clear yet if he will be given the chance either, with the domestic political scene already beginning to heat up ahead of provincial elections scheduled for September 2017. Parliamentary elections will then also probably follow early next year, but a large part of any leverage he or his successor can wield will depend on the performance of the economy.

Currently, Iraq relies on its oil and gas exports for more than 90% of government revenues, thus the twin shocks of a sharp fall in oil prices and the diversion of limited government resources towards the fight against ISIS has cost the economy dear. With crude now back around US\$50 and some clear progress being made on the military front, an air of cautious optimism is beginning to return. However, there are historically entrenched problems that require urgent attention including; corruption, a bloated bureaucracy, and the lacklustre productivity of state-owned enterprises. All of these factors will continue to weigh on any future recovery economic recovery.

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In July 2016, the IMF approved a three-year US\$5.34 billion loan to assist Iraq undertake a series of reforms, including a reduction in fiscal spending, a streamlining of government services, an increase in private sector participation, and an overhaul of the country's weak banking system. Real progress on these issues has thus far been spotty, primarily due to domestic political roadblocks, but once the war is officially over all the main players will have to confront the dire economic and humanitarian situation the country currently faces, and it's this realization that could provide Al-Abadi's administration with a unique opportunity to follow a more aggressive path towards the implementation of these reforms this year. It's not all bad news though; oil production has risen sharply over the past two years, despite the ongoing conflict, and this helped real GDP growth reach approximately 10.2% last year. However, crude output levels appear to have peaked for now, as important facilities and fields require fresh investment in order to expand their capabilities. Meanwhile, the non-oil related sectors saw a contraction of 5% in 2016, following a 14% contraction in 2015, according to the latest IMF data. This underlies the importance of economic diversification and the implementation of structural reforms such as those discussed earlier.

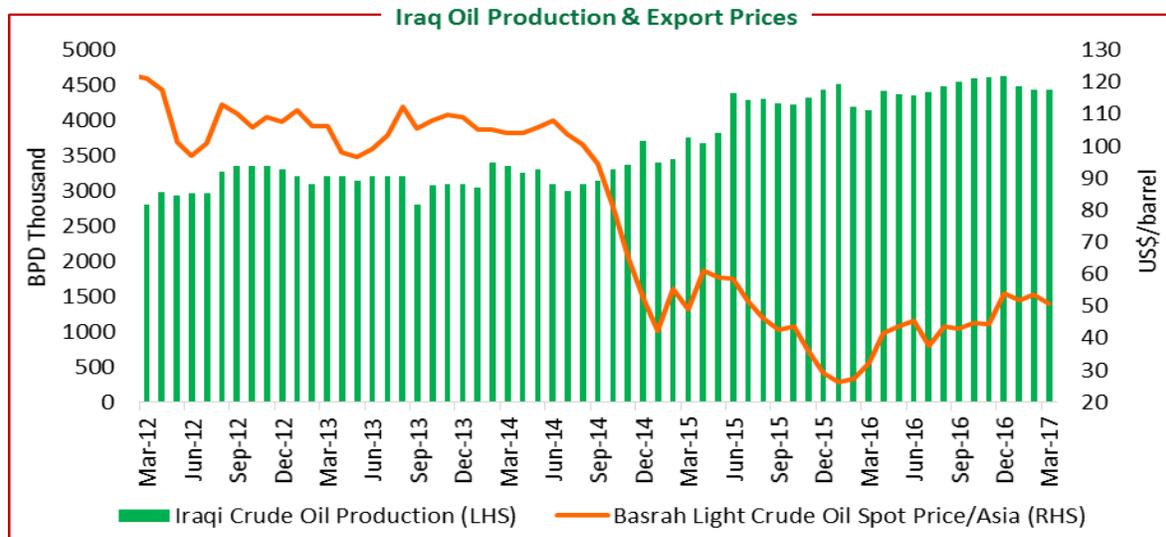
Monetary Pressures

Total public debt as a percentage of GDP rose from 32% in 2014 to more than 60% by the end of last year, while the government deficit was reportedly steady at 12% of GDP in 2016 as security spending remained high. Apart from the IMF, Iraq has also received US\$ 3.4 billion via three long-term loans from the World Bank since 2015, and Japan's Bank for International Cooperation recently approved its first loan (US\$480 mio) to the country in over 30 years. Meanwhile Iraq issued a US\$1 billion five-year international bond in January at a yield of 2.149% in order to diversify some of its funding sources, although it is important to note that this bond received an explicit guarantee from the US Agency for International Development.

In terms of the local currency, the Central Bank currently maintains a peg to the US dollar, a regime which we do not expect to change in the near term, although FX reserves have deteriorated in recent years primarily due to the cost of the conflict (US\$46.5 bio at the end of 2016, compared to US\$80 bio in May 2014).

Conclusion

Even when this current conflict is over Iraq still faces an extremely difficult road ahead, and the successful implementation of reforms will not mean that either the government's heavy reliance on oil related revenues, or 'petrodollar' politics which dominates interprovincial relations with Baghdad, will ease in the near to medium term. However if some sort of stability can be achieved and maintained, this country of over 36 million people which is also home to the world's 5th largest reserves of oil, has significant economic potential. Perhaps a small signal of this cautious optimism was highlighted by last month's decision by FITCH to switch its outlook on the country from negative to stable, although the ratings agency did admit that the risks there remain "among the highest" faced by any sovereign rated by the firm.



Source: NBAD Global Markets estimates; Bloomberg.

Economic Indicators	2014	2015	2016	2017F	2018F
Economic Data					
Real GDP (percentage change)	0.1	2.9	10.2	1.1	0.7
Non-oil real GDP (percentage change)	-5.1	-13.9	-5.0	3.0	2.0
GDP per capita (US\$)	6,672	5,127	4,818	5,200	5,434
GDP (in US\$ billion)	228.7	180.3	173.8	192.4	206.2
Oil production (mbpd)	3.1	3.7	4.5	4.5	4.5
Oil exports (mbpd)	2.6	3.4	3.8	3.8	3.8
Iraq oil export prices (US\$ pb)	96.5	45.9	35.5	42.0	45.7
Consumer price inflation (percentage change; avg)	2.2	1.4	2.0	2.0	2
Reserves excluding gold (US\$ bio; eop)	62.9	54.0	46.5	40.0	--
Public Finance					
Total government debt (in percent of GDP)	32.6	54.9	61.3	61.9	63.1
Total government debt (in US\$ billion)	74.6	97.8	106.6	119.1	130.1
External government debt (in percent of GDP)	25.2	36.7	37.8	38.2	40.3
External government debt (in US\$ billion)	57.6	66.1	65.7	73.5	83.2

Note: In 2016, real GDP growth was supported by a large increase in oil output that benefitted from past oil investments.

Source: NBAD Global Markets estimates; IIF; IMF.

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