Recent developments

The ISIS insurgency and low oil prices have severely impacted Iraq’s growth, which decelerated in 2014-15, with government non-oil investment declining by two-thirds and rapid contraction of agriculture, manufacturing and construction. Strong oil production sustained economic growth in 2016, while the OPEC agreement to cut production until March 2018 is expected to lead to a contraction in growth in 2017. Non-oil growth has been negative since 2014, but a better security situation and the benefits of an initial reconstruction effort are expected to sustain non-oil growth at 1.5 percent in 2017. The drivers are construction and services on the supply side, and pick-up in government consumption and investments on the demand side. Owing to the pegged exchange rate and subdued aggregate demand, inflation has averaged 0.4 percent in 2016 and is estimated at 2 percent in 2017.

The low oil prices and higher security and humanitarian outlays rapidly deteriorated the fiscal and external balances since 2014 in the Federal Government of Iraq (GOI) and the Kurdistan Regional Government. GOI’s overall fiscal deficit increased to 14 percent of GDP in 2016 mainly because of a 22 percent fall in oil prices in the previous year; in response, GOI is implementing a fiscal consolidation program to reduce the non-oil primary deficit. In 2017, the fiscal deficit is estimated to reach 5.1 percent of GDP owing to a small recovery in oil prices and measures to increase non-oil revenues and to contain salaries and pensions. The GOI is prioritizing its limited investment expenditure for reconstruction in areas liberated from ISIS, and to increase electricity. KRG is also implementing measures to contain expenditure and improve non-oil revenue. KRG fiscal deficit decreased by 80 percent from 2014 to 2016. Spending pressures remain high to assist IDPs and refugees.

The government financed the deficit mainly through domestic short-term bank financing. GOI’s public debt-to-GDP ratio increased from 32 percent in 2014 to 67 percent in 2016. Over the same period, domestic debt increased from 7 to 27 percent of GDP. Public debt is estimated to decline to 64 percent in 2017. The GOI has accumulated large contingent liabilities, by issuing 11 foreign-currency denominated guarantees (US$36 billion) for independent power producers.

GOI’s structural reforms are supported by a large international financing package. In 2016, the World Bank provided US$1.44 billion DPF loans and the IMF provided US$1.2 billion financing under a three-year SBA. In January 2017, the government issued a US$1 billion bond guaranteed by the U.S. government. JICA and France have provided parallel budget support financing. In August 2017, following the successful conclusion of the second review of the IMF program, the government issued a US$1 billion bond maturing in 2023, its first independent issuance since 2006. In the first half of 2017, the government introduced a flat
income tax, successfully stabilized current expenditure, and started reducing arrears to domestic and external creditors. It also adopted a social database based on a proxy-means testing system and reduced gas flaring.

In 2017, the current account deficit is expected to decline by 2.4 percentage points of GDP thanks to fiscal consolidation and higher oil revenues. The strong reserve accumulation during 2010–2013 provided a buffer to smooth the fiscal policy adjustment required to maintain external sustainability. Foreign reserves financed most of the balance of payment deficit, declining from US$77.8 billion at end-2013 (or 10 months of imports) to US$41.4 billion at end-2017 (or 6 months of imports).

Jobs were not providing a pathway out of poverty even before the crisis. Iraq has one of the lowest employment-to-population ratios in the region, even among men, and the 2014 crisis has led to an estimated reduction in employment by 800,000 jobs. The Public Distribution System provides the only safety net for the vast majority of the poor, and is currently stretched to its limits. Many IDPs are left largely uncovered by any public safety net. Although the overall food insecurity rate in the country is low and falling, food insecurity rate among IDPs in 2016 was more than twice that of residents.

### Outlook

Iraq’s economic outlook is expected to improve assuming a more favorable security environment, continued fiscal consolidation and reforms. Overall GDP growth is projected to return positive in 2018 following the end of production cuts agreed by OPEC. Oil production in the medium term is expected to increase only marginally as GOI cannot afford to increase investments in the oil sector. Sustained by agriculture, construction and services, non-oil economic growth is conservative projected to recover to about half its pre-2014 average growth to 4 percent as recurrent violent outbursts and lingering presence of ISIS could delay investment and reforms. The fiscal deficit is expected to improve owing to consolidation in non-oil primary current expenditure, while still protecting social spending at around 22 percent of non-oil expenditure. The external current account is expected to remain negative but to improve owing to higher oil prices. Public debt is expected to peak at 65 percent of GDP in 2018, but reconstruction costs are not in the fiscal framework.

### Risks and challenges

Downside risks include lingering security challenges, which are likely to continue to disrupt reconstruction efforts after the liberation of Mosul, and lower oil prices, which could renew pressures on Iraq’s twin deficits and require further fiscal adjustment or additional external financing. The external debt remains highly vulnerable to a further reduction in oil prices or a real exchange rate depreciation. Risks are also related to the capacity of GOI to provide public services even in regions not affected by violence and start reconstruction. Tensions between Baghdad and Erbil could re-ignite following KRG decision to hold a referendum of independence in September 2017. The escalating political tensions and terrorist attacks ahead of the general and provincial elections in April 2018 add additional risks.