

Iraq's vulnerability exposed by IS and oil price decline

The political situation in Iraq has deteriorated significantly over the past year. The civil war in Syria has spilled over into Iraq with full force with the Islamic State (IS)'s invasion and occupation of Iraq's Sunni-dominated regions. The Iraqi government has now halted IS advances thanks to international military support. A new and more inclusive government, and improved relations with Kurdistan, give hope of political stability in the coming years. One likely long-term scenario is a nearly independent Kurdistan and a Sunni area in the western part of the country that remains unstable.

The economy and growth will be weak in the short term as a result of the poor security situation. The country's public and external finances are manageable thanks to a relatively favourable starting position and continuing high oil exports. A temporary low oil price increases the vulnerability of both the public finances and the balance of payments. The banking sector is underdeveloped and is dominated by state-owned banks while the difficult business environment impedes the growth of a private business sector. The long-term economic outlook is dependent on a political stabilisation, but is given a boost by rising oil production and increasing investments in the long term.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- International support for rebuilding the country.
- New government and improved relations with Kurdistan.
- Rising oil production and exports.

Weaknesses

- Very poor security situation due to IS invasion.
- Oil dependence making economy vulnerable and exposed to fluctuations.
- Weak business environment with unreliable judiciary, widespread corruption and bureaucratic obstacles.

EKN'S POLICY

Restrictive policy for provision of guarantees

Iraq is categorised in country risk category 7 out of 7 – an assessment made in collaboration with the OECD. All buyer categories except for pure sovereign risks are subject to a restrictive assessment policy. Transactions with other public bodies can be guaranteed provided that Iraq's ministry of finance or central bank is the borrower or guarantor. For bank risks, as when EKN guarantees letters of credit, the Trade Bank of Iraq is preferred, but other banks are acceptable. For corporate risks, risk sharing with the guarantee holder and full transparency of the buyer's financial status are required. EKN normally charges higher premiums for corporate risks when the credit period exceeds one year.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- Political stabilisation and improved security situation.
- Economic diversification which reduces oil dependence in the long term.

The policy may be made more restrictive in the event of

- Turbulence and combat spreading to Baghdad and the oil-rich southern provinces.
- Prolonged low oil prices.

EKN'S EXPOSURE AND EXPERIENCE

Limited exposure and positive experience

EKN has issued guarantees destined for Iraq since 2009. Export transactions at a value of SEK 1.5 billion have been guaranteed since then. The main sectors have been telecom, transport and construction equipment. EKN's payment experience has been positive since 2009. EKN also has old political claims on Iraq from the 1980s.

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IS advance halted

The security situation in Iraq deteriorated after the US troop withdrawal in 2011. Former Prime Minister al-Maliki succeeded in dividing the political opposition and outmanoeuvred his Kurdish and Sunni opponents. The federal government strengthened its power at the expense of Kurdistan and the Arabic provinces. A Sunni uprising with increasing acts of violence started as a response to al-Maliki's authoritarian policies. The civil war in Syria simultaneously spilled over onto Iraqi territory and fomented the sectarian conflicts.

The political situation was further exacerbated in 2014 with the invasion and occupations in western and northern Iraq by the Sunni extremist group IS. The ease with which IS marched into Iraq has created serious concerns about the country's ability to unify under a central government, even under a federal system of government. However, it is unlikely that the oil-rich southern provinces and Kurdistan in northern Iraq will be threatened by IS, especially now that there is international military support. A likely long-term scenario is a nearly, or completely, independent Kurdistan and a Sunni area in the western and northern part of the country that remains unstable.

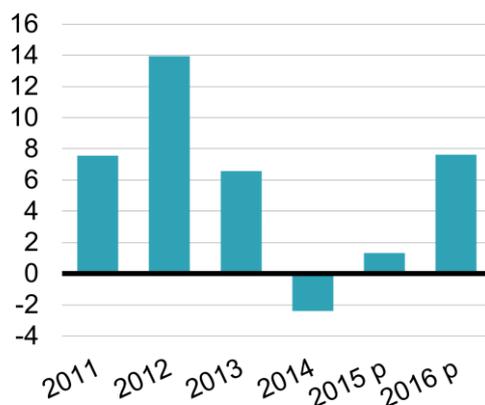
The new government under Prime Minister al-Abadi seems to be more inclusive in terms of other religious and ethnic groups, which is a pre-condition for stabilising Iraq, defeating IS and preventing Iraq from being broken up. The power struggle between the government in Baghdad and Kurdistan has subsided, at least for the time being. Under threat from IS, both sides seem inclined to try to reach compromises on several issues, especially concerning Kurdistan's oil reserves. A new oil distribution agreement was entered into in December 2014 and it seems, at least so far, as if it will hold up.

ECONOMY

IS and oil price burdening economy

The Iraqi economy is based on the oil sector, which accounts for 50% of GDP. With oil production exceeding 3 million barrels a day and rising oil export revenues, the economy grew until 2013. The deteriorating security situation has hindered the rest of the economy

GDP GROWTH (% PER YEAR)



Growth on the rise in the coming years. Data: IMF

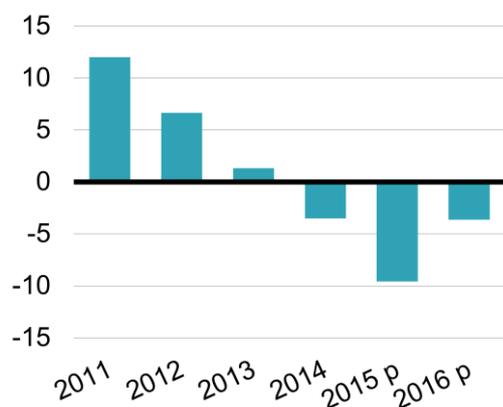
besides the oil sector since then, resulting in lower growth. The economy shrank in 2014 due to the IS invasion and a falling oil price. Oil production, which is mainly in southern Iraq, has continued to rise. Iraq is the second-largest oil producer in the OPEC, and both oil production and exports are expected to further increase in the coming years. IMF forecasts rising growth starting this year. Growth is driven by the oil sector as well as government consumption and investments. Economic growth is linked to political developments, and the conditions for this growth can rapidly deteriorate in a negative scenario.

Apart from the security situation, the country's oil dependence is its main economic risk factor. A long-term oil price decline would have major consequences for the economy. 95% of the Iraqi national budget is funded by oil revenues and an oil price around USD 100 per barrel is required to balance the budget. The current low oil prices, along with the high costs of the war against IS, led to a major budget deficit. The government is being forced to finance this deficit by using its oil funds, increasing borrowing in the banking sector and postponing investments. A loan from the International Monetary Fund (IMF) may also be on the agenda shortly. This would enable the government to cope with a low oil price in the short and medium term. The long-term economic outlook is dependent on political stabilisation, but is given a boost by rising oil production and increasing investments in the country in the long term.

BALANCE OF PAYMENTS AND DEBT ISSUES

Long-term oil price decline the main risk

CURRENT ACCOUNT BALANCE (% OF GDP)



A low oil price leading to deficits. Data: IMF

The balance of payments is relatively strong in consideration of the oil exports and the current account surpluses they generated until 2013. These surpluses have accumulated satisfactory international reserves equal to nine months of imports. Oil accounts for almost all of the country's exports, and as a result, the oil price decline is leading to a temporary current account deficit and lower reserves in the coming years. The international reserves fell from USD 78 billion in 2013 to USD 66 billion in 2014, and are expected to fall to below USD 60 billion this year. However, the reserves remain at an acceptable level, several times larger than the short-term external debt.

Iraq's external debt mainly consists of old loans from the Saddam era which were renegotiated under the auspices of the Paris Club. This debt is being paid at a low interest rate and the country's debt service ratio is very low as a result. Debt service is vulnerable to an oil price decline, but in consideration of Iraq's sizeable reserves, the oil price will have to be low for a long period of time before it puts the country's capacity to pay its external debt in jeopardy. Current forecasts indicates an oil price recovery in a couple of years, albeit to a lower level than the over USD 100 per barrel from before the oil price decline. This makes the balance of payments risk manageable in the short and medium term.

CURRENCY POLICY

Stable exchange rate

The Iraqi dinar is pegged to the US dollar. The exchange rate against the dollar has been maintained at the same level since 2009. The central bank has sufficient international reserves to maintain this fixed exchange rate. There are speculations of a slightly more flexible exchange rate, but changes are unlikely in the short term. The currency arrangement has served Iraq's dollar-denominated economy well and has helped to keep inflation down.

The central bank uses capital controls to hold back imports and ration the supply of foreign currency. These measures restrict the supply of foreign currency in the Iraqi economy and have led to the creation of a parallel currency market where the dinar is traded at a slightly lower value. The authorities have taken certain initiatives to liberalise the currency market and the difference between the official and parallel exchange rate has decreased. Temporary delays on international payments may occur due to the long-winded administration of the central bank.

FINANCIAL SECTOR

Government dominance in underdeveloped banking sector

Iraq's banking system consists of seven state-owned, 32 private and 15 foreign owned banks. The state-owned banks dominate the sector. The government and state-owned companies may only lend from and deposit money with the state-owned banks, and taxes and other payments to the government may only be made through the state-owned banks. Given that state-owned banks have an implicit guarantee from the government, individuals also prefer to use them. Most of the foreign banks operating in Iraq are from Lebanon, the Gulf states and Turkey. Standard Chartered Bank from the UK and Citigroup from the US have established themselves in the country in recent years. Meanwhile, British HSBC, the majority owner of a local bank, is said to be close to leaving the country, having cited the difficulties of operating in a sector dominated by state-owned entities.

The Iraqi banking sector is one of the most underdeveloped in the Middle East. The majority of Iraqis don't have a bank account and the ratio of lending to GDP is one of the lowest in the world. Domestic lending to the private sector is very low, even in comparison to other Middle Eastern countries. Improvements in areas such as credit registers, the legal framework for collateral, the legal system as well as accounting and auditing are required to enable the banks to identify creditworthy clients.

Iraqi banking regulations provide a functioning framework for exercising banking supervision, but several weaknesses remain. The central bank is often unable to perform its duties without political meddling with respect to the state-owned banks. There is a high level of government support for these banks though. Transparency and quality of the financial information of Iraqi banks is often unreliable or unavailable. The requirement to publish audited financial statements on time is not always complied with. When assessing the credit rating of banks, EKN gives priority to the availability of complete audited financial statements.

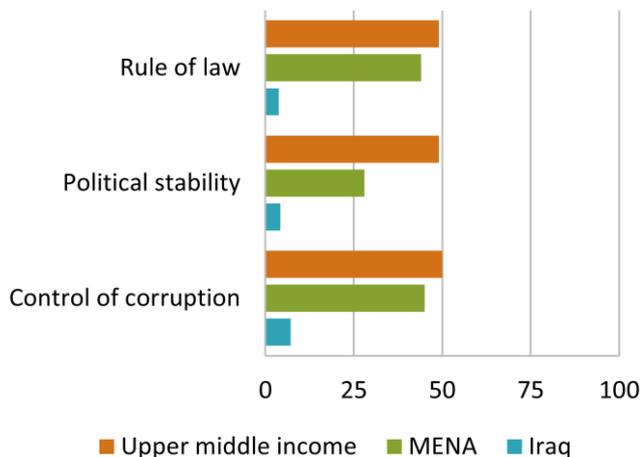
BUSINESS ENVIRONMENT

Substantial challenges

The Iraqi market offers great opportunities at the same time as substantial challenges. Exporters and investors should be prepared for extensive security costs and a public administration that is difficult to navigate and bureaucratic. Corruption, customs delays, unpredictable dispute resolution, power outages and poor access to financing are common concerns. Payment delays from certain Iraqi government agencies are not uncommon. Exporters and investors active in Kurdistan face similar challenges, including corruption and

bureaucratic obstacles. However, the generally more stable security situation makes Kurdistan's business environment more favourable than the rest of Iraq.

BUSINESS ENVIRONMENT
Ranking from 0 (worst) to 100 (best)



Iraq is in the lower quartile of the World Bank's Doing Business rankings due to undeveloped institutions and regulatory systems as well as unavailable credit information. The economy suffers from bottlenecks in infrastructure and an inefficient legal system. The country is ranked among the most corrupt countries in the world by Transparency International and worst in the MENA region.

Iraq ranks at the bottom in rule of law, political stability and corruption.
 Source: World Bank

EKN'S EXPOSURE

Telecom, transport and construction machinery

EKN started to issue guarantees destined for Iraq in 2009 when the political situation in Iraq stabilised to a sufficient extent. Since then, 26 export transactions with a cumulative value of SEK 1.5 billion have been guaranteed. The main sectors have been telecom, transport and construction equipment. At the end of March 2015, there was SEK 55 million in guarantees and SEK 944 million in offers.

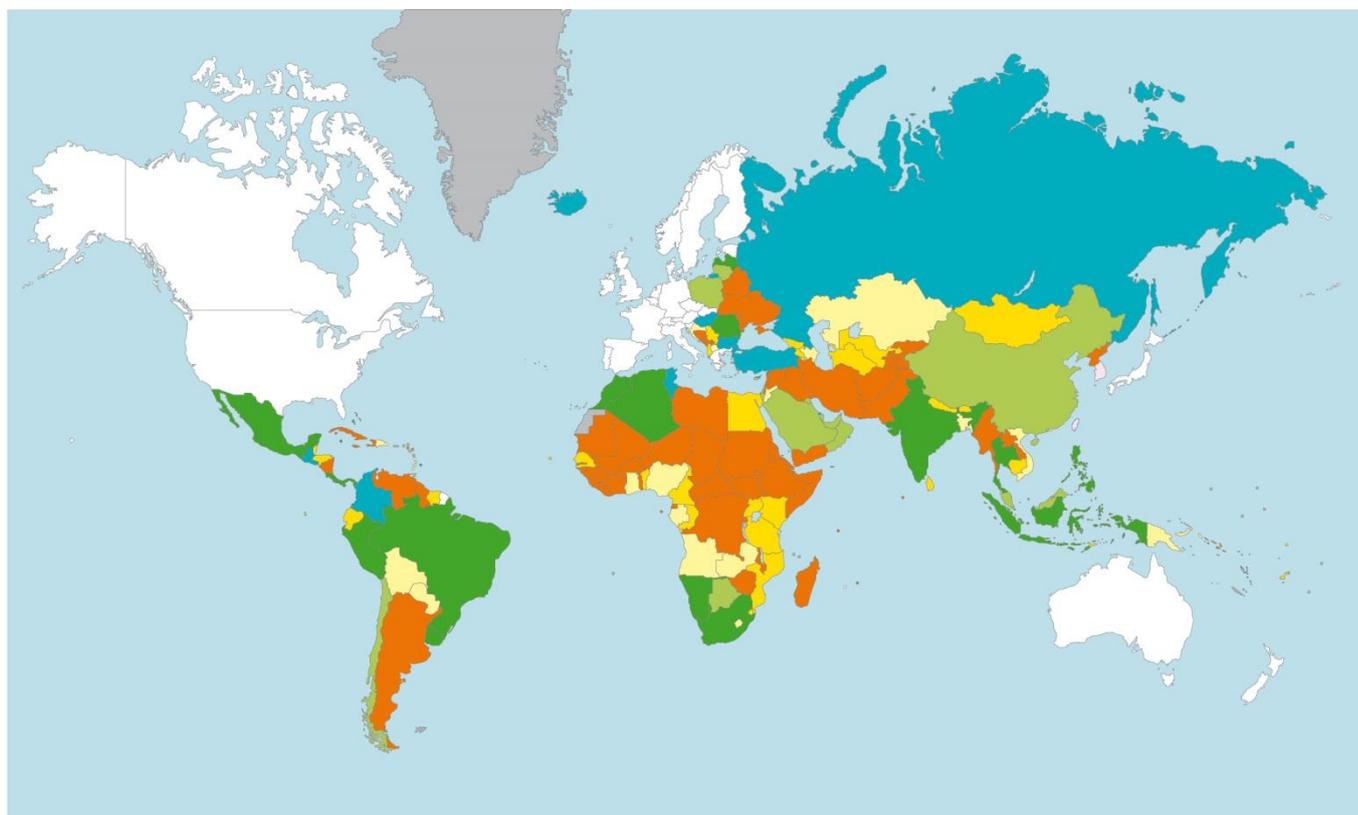
EKN has old political claims on Iraq from the 1980s. An agreement was entered into between Iraq and its creditors in 2004 under the auspices of the Paris Club concerning the management of the debt. The repayments are scheduled until 2038 and nearly SEK 600 million is still payable to EKN.

PAYMENT EXPERIENCE

Positive experience in recent years

It is possible to do business in Iraq in spite of a difficult business environment. EKN's experiences have been positive since we began providing guarantees in 2009. A few payment delays have occurred, but there have not been any indemnifications. EKN has experience of sovereign, bank and corporate risks. Several transactions have been paid for with letters of credit issued by the Trade Bank of Iraq.

<p>COUNTRY DATA</p> <p>Area: 438,446 km² (0.97 times Sweden)</p> <p>Population: 32.6 million (2014)</p> <p>GDP: USD 221 billion in 2014 (Sweden USD 570 billion in 2014)</p> <p>GDP/capita: USD 6,165 in 2014 (Sweden USD 58,491 in 2014)</p>	<p>CREDIT RATING</p> <p>Moody's: -</p> <p>S&P: -</p> <p>Fitch: -</p>
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The country risk categories range from 0 to 7.
The lower the number the better the credit rating the country has.



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EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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