How to Serve U.S. Interests by Saving Kurdistan's Economy

by Michael Knights

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Brief Analysis

Unless Washington intervenes with cost-effective, forceful measures, Iraqi Kurdistan could be the first Middle Eastern economy to implode under the pressure of coronavirus and low oil prices.

For the second time in six years, the Kurdistan Region of Iraq, the most pro-American part of the country, is in danger of economically collapsing due to a deadly combination of low oil prices, pandemic, incomplete economic reforms, and a lack of sovereign reserves. In the latter half of 2014, the halving of oil prices from $110 per barrel to $60 brought the KRI to its knees, forcing a partial withholding of civil servant salaries for four years until the region's finances and global prices had sufficiently recovered.

Now prices have again halved, from around $60 to under $30, while the coronavirus has flattened the KRI's previously fast-growing non-oil income from customs, fees, and taxes. Worse, the economic collapse could be irreversible this time if the KRI government fails to make the right decisions quickly, and if the international community fails to provide support soon. The United States has a critical role to play on both fronts.

HOW THE KRI ECONOMY WORKS—AND COLLAPSES

As a semiautonomous regional government within Iraq, the KRI draws on two sources of funding. The first is its own income, principally from oil exports, including around 320,000 barrels per day jointly operated by the region and international oil companies, plus around 170,000 bpd operated by the KRI itself. The second stream is its annual revenue-sharing arrangement with the Iraqi federal government, which varies annually in exact implementation and is dependent on Baghdad's own financial health .

In late 2019, the KRI economy was functioning fairly well under a Brent crude price of around $64 per barrel. Its operating costs and debt servicing obligations totaled around $1.2 billion per month, but these were more than met with a combination of income from independent oil sales (about $700 million), transfers from Baghdad ($328 million), and non-oil income ($261 million). This year, under a new arrangement embraced by both Baghdad and the KRI, the Kurds expected to receive a larger income (up to $1.44 billion under the higher oil prices of late 2019) even after transferring 250,000 bpd of their production to Baghdad.

Yet the current crises have erased this promising picture. Despite a lower monthly operating budget of around $950 million, the KRI is only generating around $648 million in revenue between federal transfers ($328 million), independent sales ($270 million), and non-oil income ($50 million). The resultant $300 million monthly deficit is spurring KRI leaders to consider curtailing payments to international investors (which total around $270 million each month) as an alternative to the broad-based salary reductions used to balance the budget in 2015-2019.

SAVING KURDISTAN TODAY WITHOUT KILLING IT TOMORROW

At a moment of crisis, it is tempting for a government to look at international investors as a soft target, since their assets are stranded and they lack the local political clout of the domestic population. Yet investor confidence in Kurdistan is already very low due to a series of previous crises: the 2014 Islamic State uprising, the 2014-2015 payment shortfall, and the ill-fated 2017 independence referendum. Even before the current emergency, the KRI was beginning to miss payments to its investors in late 2019 due to the stranding of its financial reserves in Lebanon's troubled Bankmed—a major red flag since many investors are required by law to announce non-payment, and all of them can suffer huge share price reductions and withdrawal of financing.

Last year, the internationally operated oil sector provided Kurdistan with half its monthly revenues (around $500 million), or $6 billion per year, making it the region's only world-class industry. On February 19, U.S. energy secretary Dan Brouillette told KRI prime minister Masrour Barzani that the industry is "a miracle," noting, "The Kurds are a land-locked people, in the middle of a continent, yet today they export more oil than Libya." He attributed this progress to Barzani's "good work" and "leadership," but the miracle is in danger of self-destructing just a few short weeks later.

In response, the KRI should duplicate the approach taken after the 2014 crash, which was to press ahead with economic reforms while at the same time reassuring investors that it is a reliable partner. The prior Kurdish administration faced a similarly hard choice: asking the people to shoulder budget cuts at a time when they were fighting the Islamic State. Yet this is exactly what the KRI did, and the people reacted magnificently. As a result, when the next crisis came—over the 2017 referendum and subsequent fallout—investors were still in place and willing to boost the region's oil exports, even as 220,000 bpd were lost due to the federal government's takeover in Kirkuk. By managing the 2014-2015 crisis correctly, KRI leaders had laid the groundwork to survive the next one and emerge stronger.

U.S. POLICY PRIORITIES IN KURDISTAN

The KRI is probably the most vulnerable economy in the Middle East—it lacks access to any of Iraq's $60 billion in sovereign reserves, it is saddled with debts that may exceed $10 billion (or around 70 percent of Kurdistan's annual GDP), and it is unable to negotiate sovereign loans or aid packages. It is also one of America's strongest friends in the region, born under the umbrella of U.S. air patrols and written into the Iraqi constitution with strong U.S. support. Accordingly, Washington should take the following cost-effective steps to ensure the KRI's economic survival:

- **Ensure Baghdad shares revenue in 2020.** When oil prices hover around $30, the KRI cannot cover its costs with independent sales, in part due to an additional $11 per barrel discount it must absorb for pipeline fees and trader discounts. Meanwhile, the central government has yet to pass its 2020 budget because it is awaiting the appointment of a new prime minister, due by April 16. To spare the Kurds a potential double blow, U.S. officials should strongly encourage Baghdad to keep providing the KRI's current $328 million monthly share per the 2019 budget (which is being reused this year on a pro-rata basis until the new budget is approved). Once the budget passes, Washington should use its own leverage and that of international financial institutions to ensure that the Kurds are not unfairly penalized—specifically, they need at least $700 million per month from Baghdad to supplement their diminished oil and non-oil incomes. U.S. officials should also make sure that the KRI receives its fair share of any economic or coronavirus aid packages granted to Iraq by the World Bank or other institutions.
- **Ensure the KRI pays investors.** The U.S. Energy Department has worked assiduously to support the KRI with advocacy and equity financing for oil and gas infrastructure projects, but this relationship will come crashing down if the Kurds stop paying investors. The department should immediately tell KRI officials that their current plan—to defer four missing months of payments for at least nine more months—will shatter remaining investor confidence. Instead, the KRI leadership needs to teleconference with investors immediately to negotiate a consensual payment deferral deal, as opposed to an enforced industry loan to the KRI. Speed is essential; if just one investor collapses, others will take fright.
- **Help Kurdish gas replace imported diesel.** The Energy Department is well-placed to support the KRI's plans for extending its natural gas distribution system to those power stations still running on expensive imported diesel. This step alone would save the Kurds tens of millions of dollars each month and increase electricity availability by 750 megawatts at little cost. The same pipe could also export gas to Turkey in the future.
- **Buy Kurdish oil.** The U.S. Strategic Petroleum Reserve is buying oil at the current low prices, and while most of these purchases come from American producers, there is leeway to buy some abroad. For example, Washington could purchase some Kurdish crude as a form of soft loan at this critical moment.
- **Support the Peshmerga.** The United States currently provides $17 million per month to the KRI security forces, who are battling both the Islamic State and the coronavirus. Yet this aid is down from $23 million last year and is due to end altogether in April. Instead, Washington should sustain the aid for as long as needed and increase it back to its 2019 level.
- **Help recover Bankmed assets.** The KRI appears to have up to $1 billion in assets frozen in this Lebanese bank—a sum that could by itself transform the region's near-term economic outlook. As a major investor and financial services player, the United States may be able to speed up the recovery process.
- **Reassure Barzani, drive reforms.** The KRI prime minister is committed to economic reforms, but the previous government arguably undercut this effort from the outset by relaxing salary reductions at the end of its term, which put around $200 million in monthly costs back onto the new government. Barzani's effective handling of the coronavirus underlines his strong potential as an economic reformer, and the need to cut salaries and allowances is his first test. The U.S. government should embrace such efforts warmly, and press other Kurdish actors in Sulaymaniyah, Erbil, and Dahuk to publicly back all austerity measures ordered by Barzani rather than exploiting the situation for short-sighted political benefit.

All of this help would have an important ancillary benefit: increasing U.S. leverage at a moment when the KRI leadership is unwilling to support federal prime minister-elect Adnan al-Zurfi. Kurdish commitment to bolster Zurfi would help Iraq immeasurably—and help Kurdistan survive, since the new premier will be crucial in passing the next budget. If this rapprochement fails and revenue sharing falls short, there will be little else Washington can do to help the KRI economy.

Michael Knights, a senior fellow with The Washington Institute, has worked at the interface of U.S., Iraqi, and KRI strategic relations since 2003. ❖

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