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Using International Financial Aid to Improve Baghdad-KRG Relations

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Brief Analysis

Planned financial aid packages can help prevent economic meltdown in Iraqi Kurdistan and reduce tensions between Baghdad and Erbil.

The Kurdistan Regional Government is making a concerted effort to attract financial aid from the United States and other international players, and the logic for providing such aid is strong. The KRG is the vital launchpad for liberating Mosul, and the Kurds are a pro-Western ally of enduring strategic value. Slowly but surely, they are implementing economic reforms and upping their involvement in the war against the Islamic State.

Yet while the United States and its coalition partners are (rightly) beginning to send emergency financial assistance to the near-bankrupt KRG, such cash infusions -- likely totaling less than half a billion dollars in 2016 -- will only postpone Kurdistan's economic collapse by perhaps a year. Washington's aim should not be to keep the KRG afloat until Mosul is liberated; it should be to provide a much larger infusion of financial assistance that continues to help the Kurds well afterward. The International Monetary Fund and other financial institutions are the key to this approach. Involving them in the assistance effort could not only save Kurdistan, but also foster sustainable political and economic relations between the KRG and the Iraqi federal government.

KURDISTAN'S ECONOMIC FUTURE

The KRG currently employs 1.4 million of the territory's 2 million working-age people, at a cost of $793 million per month; Erbil plans to reduce this figure to $361 million within six months through payroll cuts. Other monthly expenditures include government subsidies on fuels and electricity (around $375 million but declining), wartime costs (around $197 million), and oil export costs (around $70 million). In addition, a mammoth 1.8 million displaced people and refugees (compared to a native population of 5 million) have strained the economy to a degree that is difficult to quantify. Even if economic reforms take hold and war costs are slowly reduced, the KRG will likely still have monthly expenses of around $800-850 million.

In the latter half of 2015, KRG oil sales averaged $629 million per month according to the Ministry of Natural Resources. Depressed oil prices and pipeline disruption will probably keep income at these low levels or even lower (e.g., last month's oil revenue was only $303 million due to pipeline problems). The KRG is already $25 billion in debt and will continue to rack up around $200 million more per month if current oil prices hold. With many civil servants four months behind in salary payments, the potential for strikes, unrest, and accelerated migration is growing. Unless oil prices unexpectedly rally from their present rate of $40 per barrel to at least $60 per barrel, the KRG will continue to fall behind on salaries and debt obligations to domestic creditors and international oil traders.

The current plan to send the KRG tens of millions of dollars in aid will provide some economic relief and keep certain tranches of Peshmerga fighters operational. Yet it may not buy enough time to enact reforms, restore the KRG's credit-worthiness, restart investment in infrastructure, and head off instability.

HOW COULD INTERNATIONAL AID CHANGE THINGS?

Unlike federal Iraq, which holds reserves of $50 billion, the KRG has no reserves and is a sub-sovereign entity, meaning it cannot directly receive large financial aid packages from most international institutions. Yet the package that the IMF will likely offer to Baghdad soon -- perhaps $6-10 billion to be disbursed in 2016-2018 -- has been designed to help all of Iraq's eighteen provinces, including the three provinces that compose the KRG. Similarly, recent World Bank investments in Iraq have had a Kurdistan component, such as the $255 million road improvement plan that is funding federal projects and some smaller KRG projects.

The IMF Staff-Monitored Program currently in place (as a forerunner to a fully funded Stand-By Arrangement) is charged with overseeing Iraq's execution of budget commitments and ensuring that the state makes agreed savings without building up further arrears to domestic and international creditors. This includes monitoring whether the KRG is paid its share of revenue -- which Baghdad would likely interpret to mean 17 percent of net actual revenues per month after the deduction of hefty sovereign expenses (i.e., for defense, parliament, and other federal institutions). Yet in order to claim its share of the federal budget and international aid packages, the KRG would need to resume the transfer of 550,000 barrels of oil per day to the federal oil marketer, as agreed in the budget. The IMF would then want to see that Iraq was making mutually agreed budget cuts, not simply hitting its targets by cutting one portion of the country -- the KRG -- out of the spending plan.

At current oil prices and Iraqi export levels, the KRG could expect to receive perhaps $350 million per month for providing 550,000 bpd, plus another $150-270 million per month from aid packages given to Baghdad by the IMF, other institutions, and states such as Germany and Japan. The Kurds might also be granted some latitude to export any excess oil beyond the committed 550,000 bpd. The net result could turn out to be better for the KRG than full reliance on independent exports for the next two or three years. Better yet, the arrangement would be underwritten by an international monitoring regime -- the first deal of this kind for the Kurds since the UN gave them a 17 percent share of oil-for-food proceeds in the 1990s.

In all likelihood, the main challenge in striking this kind of deal will be gaining Baghdad's assent. For years, the central government sought to keep the KRG from exporting oil independently, but since 2014 it has come to realize that carrying Kurdistan's 1.4 million state employees is a net drain on the federal budget. Baghdad is now crowing over the KRG's economic distress, which is worse than Baghdad's own situation only because the state has been liquidating its reserves at a rate that would fully deplete them within the next year or so if continued. Letting the Kurds back into revenue sharing and giving them a slice of international aid packages is not Baghdad's preference, and the KRG is going through a painful domestic political crisis that will make it difficult for Kurdish leaders to make public concessions to Baghdad. What is needed is an effective mediator.

IMPLICATIONS FOR U.S. POLICY

The United States should seize this opportunity to bring Baghdad and the KRG back together, helping them reach temporary agreement on a common economic policy for oil sales, international aid, and customs issues. With determined U.S. and international mediation, both sides might recognize the midterm benefits of reintegrating their economies, if only temporarily. This could in turn encourage broader long-term cooperation.

The benefits to the KRG are obvious. International mediation could help Kurdistan get its fair share of federal revenues, reserves, and multi-billion-dollar aid packages, while IMF conditionality and monitoring could help KRG officials reform the economy and restore shattered public trust in its revenue and spending figures. In addition, a more benign relationship with Baghdad could eventually net other benefits for Erbil, such as airspace control and backing for sub-sovereign loans.

The benefits to Baghdad are more subtle, but quite compelling. Renewing the effort to resolve its disputes with the KRG could intensify international backing for prompt delivery of IMF and other aid packages. The divisive Kirkuk issue would be put on the back burner once negotiations and international monitoring forced the two parties to stop fighting over the oil-rich area. These and other developments might also encourage the Kurds to request that Turkey withdraw its controversial military base at Bashiqa, a KRG-held area near Mosul. For his part, Iraqi prime minister Haider al-Abadi could lock in Kurdish cooperation for his reform plans. And in the longer term, Baghdad would be assured that Washington will always consult with it on U.S.-Kurdish affairs.

The benefits to the United States are no less compelling: keeping the Mosul offensive on track, lessening tension between two key allies, increasing U.S. leverage in Baghdad and Erbil, and rescuing the Kurds from economic meltdown. As with Mosul Dam, a little extra effort now would be a lot less costly than cleaning up after a disaster.

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