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Designing Win-Win Economic Policies in Washington and Baghdad

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To pressure Iran without cornering Iraq, U.S. officials should set a program of activities with achievable timeframes, supported by public diplomacy.

On January 3, Iraqi foreign minister Muhammad Ali al-Hakim expressed annoyance at U.S. sanctions on Iran, stating that “the sanctions, the siege, or what is called the embargo, these are unilateral, not international. We are not obliged [to follow] them.” The comments came two weeks after the United States issued a 90-day waiver to allow Iraq to continue importing Iranian natural gas and electricity. This renewal followed the prior 45-day waiver allocated alongside the November 4 reimposition of U.S. sanctions on Iran.

Despite defiant statements, Iraq has signaled its intention to comply with U.S. sanctions and move toward energy independence, while asking Washington for some flexibility with its electricity shortfall problems (especially during summer months). In the next 90 days, the two governments need to agree on a practical program to build confidence and allow for longer waiver periods, akin to the 180-day waivers available to most purchasers of Iranian energy supplies.

IRAQI COMPLIANCE WITH U.S. SANCTIONS

Energy transfers between Iran and Iraq are a potential source of much-needed hard currency for Iran’s security agencies. For example, Washington sanctioned a major Iraqi bank and its well-connected chairman last May for their role in moving millions of dollars from the Islamic Revolutionary Guard Corps to Hezbollah. Iran has also historically used Iraq as a source of U.S. dollars, which is prohibited under sanctions. Washington therefore has three ongoing concerns relating to Iraqi trade with Iran:

Payments for Iranian electricity. Iraq imports between 500 megawatts of electricity from Iran in winter and 1,200 MW in summer, costing approximately $1.2 billion per year. Under the U.S. waiver conditions, Iraq must pay for this in dinars, not U.S. dollars.

Purchases of Iranian gas. The BP 2018 Statistical Review of World Energy reported that Iran’s gas exports to Iraq reached 154 million cubic feet per day (or 13% of the current Iraqi gas supply), allowing Baghdad to generate at least another 1,000 MW of electricity, with plans to increase this to 4,000 MW. Under the waiver, Iraq is required to hold Iran’s revenue from this gas in an escrow account that can only be used to finance bilateral trade.

Other Iranian efforts to secure U.S. dollars. In late 2011, demand for U.S. dollars at currency auctions conducted by the Central Bank of Iraq more than doubled, corresponding to rapid depreciation of the Iranian rial as multilateral sanctions built pressure on Iran’s economy. Although the bank began taking steps in 2015 to ban suspicious buyers in response to U.S. fears that the Islamic State was exploiting auctions, concerns remain that Iran could access the auctions through poorly regulated exchange houses and front companies. Dispensing with the auctions is a distant possibility, but the bank has managed to reduce their profitability by narrowing the gulf between official and actual exchange rates from 6.25% in 2017 to 2% by mid-2018.

FOCUS ON ENERGY INDEPENDENCE

The United States is encouraging Baghdad to reduce its dependence on Iranian gas and electricity by harnessing its own copious and underexploited capacity. Iraq currently wastes around $2.5 billion worth of gas per year via flaring, or 1.55 billion cubic feet per day (ten times the amount imported from Iran). U.S. officials have cautioned Iraq that future waiver extensions will require it to provide a clear plan for achieving energy independence and show tangible steps toward implementation.

Washington would also prefer that Iraq diversify its energy purchases. In July 2018, Saudi Arabia announced its willingness to cooperate on a plan that would supply electricity to Iraq for $21 per megawatt-hour, one-fourth the cost of Iranian imports. Jordan might also be willing to export electricity there, and Turkey has contemplated increasing its cross-border supply to the Mosul area. Moreover, during a recent visit to Iraq, U.S. energy secretary Rick Perry mentioned the potential for temporary imports of liquefied natural gas from the United States and other vendors.

These options could reduce the price of exorbitantly expensive imports from Iran. Iraq buys Iranian gas for $11.23 per thousand cubic feet—compared to the $5.42 that Germany has paid to acquire more-distant gas from Russia, the $6.49 that Kuwait paid for U.S. LNG, or even the $7.82 that Japan paid for LNG, according to BP.

POLICY RECOMMENDATIONS

In the next 90 days, the U.S. government first needs to hold an interagency policy discussion to ensure that the State Department, National Security Council, Treasury Department, intelligence community, and Energy Department are on the same page. Energy experts within these agencies need to clearly lay out which advances are feasible for Iraq in a 90-day timeframe. Likewise, financial and sanctions experts should assess the risks of diverting Iraqi payments to Iran and, relatedly, the capacity of Iraqi financial institutions and their regulators to comply with the waiver conditions. Furthermore, the next waiver extension should be issued with a less arbitrary duration, along with a set of achievable and measurable milestones. These might include:

Iraqi white paper on energy independence. It is reasonable to expect Iraq to draft this paper and get it approved by the cabinet energy committee within the next 90 days. The report should provide a prioritized and sequenced roadmap for increasing gas capture and strengthening the electricity sector by summer 2019 (e.g., the latter effort could include gradually collecting electricity dues with the World Bank's help and reducing power leakage by refurbishing distribution networks).

Memoranda of understanding. Expecting Iraq to sign major deals with energy firms during the first 45-day waiver period may have been unrealistic. Such deals are typically very large in value and require approval from the Iraqi cabinet, which was only partially formed on October 25—a week before the United States began the 45-day clock. It is more realistic to expect Iraq to sign memoranda of understanding and heads of agreement with international companies in the next 90 days. Yet Washington should appreciate that Baghdad has received competing proposals for gas capture and electricity sector management, and thus will likely try to combine them and force providers to work together—a slow process under the best of circumstances. At the same time, the United States is right to expect progress by this summer, when drought and heat may combine to create a new and destabilizing electricity crisis. This suggests the need to set realistic timeframes and prioritize projects that can show immediate effects.

Energy compact among Iraq's neighbors. The United States, Germany, and other parties should work to bring Saudi Arabia, Kuwait, and Jordan together on the sidelines of the January 9 Middle East Strategic Alliance meeting in Oman, with the aim of discussing electricity exports to Iraq.

Monitoring U.S. dollars. U.S. and Iraqi authorities should continue their robust exchange of information related to troubling trends in U.S. dollar demand within Iraq, suspicious cross-border wire transfers, and dubious Iraqi exchange houses. As Iraq and Iran seek to expand bilateral trade from $12 billion to $20 billion, Washington will likely keep a close eye on such activity generally. It also has considerable insight into dollar-denominated transactions that draw on Iraqi reserves held at the U.S. Federal Reserve.

Expose bad actors. The Central Bank of Iraq should identify and ban exchange houses and front companies attempting to access U.S. dollars on Iran's behalf via Iraqi currency auctions. The bank has blacklisted more than 200 exchange houses suspected of engaging in illicit financial activities since 2015, some jointly designated with the United States.

Boost banking sector to counter sanctions evasion. Iraq's cash-based economy makes it a challenge to stifle Iranian sanctions evasion through monitoring of dollar demand and wire transfers alone. To reform its financial sector, Iraq needs prodding and technical assistance in switching public payrolls from cash handouts to bank debits. Beyond efforts to bring additional trade financing activity into the formal sector, U.S. and Iraqi authorities should reach out to banks, financial firms, and commercial actors in key sectors, raising awareness about the legal parameters of U.S. sanctions and the potential consequences of doing business with certain Iranian entities. Washington should also offer technical assistance to increase regulators' capacity to implement counter-illicit finance regulations.

Although the United States is pursuing its own interests through these measures, each aspect of its Iran sanctions policy is good for Iraqis. Their leaders should want to use wasted Iraqi gas instead of buying Iran's expensive imports. They should want to have a more diverse range of electricity providers to secure better value, reliability, and energy independence for the people. And they should want to improve financial controls and promote transparency in the economy, safeguarding its integrity and protecting Iraq's vital connection to the international financial system. The U.S. embassy in Baghdad should use all available channels to ensure that the Iraqi people understand how sanctions can facilitate these benefits.

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