

# Iraq Macro View

## The Economic Consequences of Conflict in Iraq

- In the past two weeks there has been a surge in sectarian violence that is threatening to intensify as frustration in Iraq's Sunni community boils over. Separately, as argued in last month's monthly, we believe the risk of a Kurdish-Baghdad military confrontation is rising. The possibility of further escalation and/or a conflict between the KRG and Baghdad threatens a growing and disturbing social, humanitarian and political crisis in Iraq. Not to belittle this fact, the purpose of this note is to assess the possible economic fallout of such a crisis.
- We believe that in both scenarios (an escalation in sectarian fighting and/or a Kurdish-Arab war), the violence would likely be contained within a 'danger zone' in the North and West of the country. Oil infrastructure within this zone would be at risk of sabotage and damage from localised fighting.
- We calculate that only around 10% of Iraq's oil production lies within the danger zone, and consider a realistic downside scenario to be that around half of production in the region is shut-in as a result of the violence.
- The impact on macroeconomic indicators would be significant, but manageable, in our view. We would expect the fiscal deficit to widen 2%-3% of GDP, and the current account balance to deteriorate by a similar order of magnitude. Growth would fall sharply in the immediate term, by around 5% year on year, but this would be a one-off effect, with rising production from the south driving overall economic growth to pre-violence levels in outer years.
- We conclude that while headline risk is likely to remain high in the coming months, the macro and fiscal impact of the violence will be manageable, reducing risks to Iraqi risk assets, particularly the outstanding 2028 bonds.

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## The economic consequences of conflict in Iraq

**Iraq remains a violent and unstable place.** The removal of Saddam Hussein almost exactly 10 years ago turned the political order abruptly on its head: the dominance of the Sunni minority under the Baathist regime has been replaced with a more pluralist system in which the Shia-majority holds the reins of power. The oppressed have come to rule, and the former elite are wary and resentful. This resentment is being exacerbated by the majoritarian tendencies of PM Nouri al-Maliki, who has risked the sectarian balance of power in his fragile unity government over the past two years and, in particular, since the withdrawal of US troops (and influence) from Iraq in December 2011. Since then he has been sidelining Sunni ministers, prosecuted the Sunni Vice President on terrorism charges, and is continuing to renege on promises made to the Sunnis and Kurds in return for their support of his unity government in 2010.

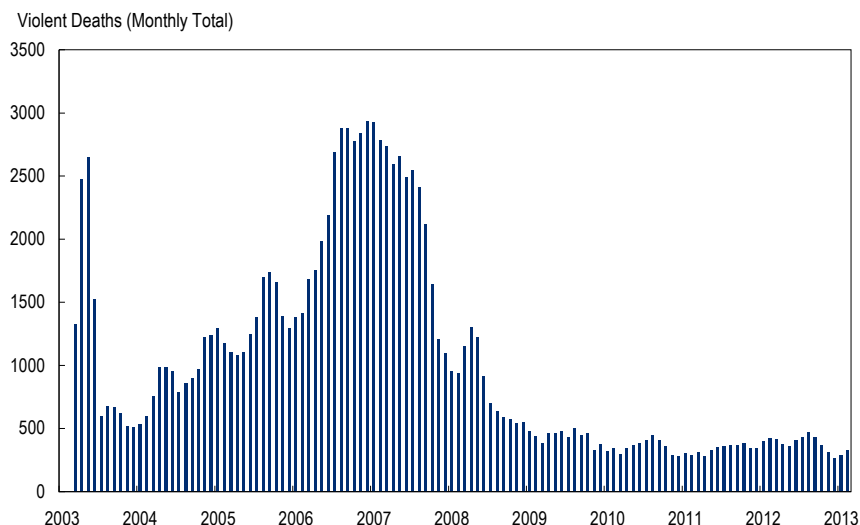
**The outlook is steadily deteriorating.** Since the start of the year, Sunni-led anti-Maliki protests have raged, and the situation took a violent turn on 19 April when security forces tried to clear a protest camp in Hawija, near Kirkuk. Armed protestors clashed with government forces, sparking conflict across Sunni-dominated areas, including the western Anbar province, areas of Salahaddin province and Kirkuk. The trouble has fanned wider sectarian violence, killing dozens in the past three weeks. Fears are rising of renewed sectarian strife similar to the civil war that gripped Iraq in 2006 and 2007.

**Separately, relations between the Kurds and Baghdad continue to deteriorate and are also threatening to slip into military conflict.** In line with our expectations, Turkey and the KRG have moved closer yet to securing an energy deal that will see the semi-autonomous Kurdish region exporting oil independently of Baghdad via Turkish pipelines. Turkey has reportedly informed the Iraqi central government of its intention to go ahead with the pipelines (Bloomberg, April 15), apparently ignoring the recent more conciliatory tone of Baghdad which has been calling for a rapprochement with Ankara (Reuters, April 5). The build-up of military personnel and hardware along the front line in the disputed territories in recent months heightens the threat of escalation, and we see the start of independent KRG exports via Turkey as a potential trigger for military conflict between Baghdad and Erbil.

### The near-term outlook

**In the near term, we do not expect the sectarian violence to escalate to all out civil war as witnessed in 2006/2007.** Then, the violence was the result of fierce competition between Sunni insurgents and Shia militia, but also reflected intra-sectarian fighting, mainly between rival Shia militias. Today, the situation has changed. The main Shia militias (Mehdi army and Badr brigades) have disbanded, either joining the political mainstream or the security forces of the interior ministry. Moreover, the Sunni insurgency, while somewhat revived due to perceived encroachment of political rights by PM al Maliki as well as events in Syria, remains less potent than it was. Finally, US troop withdrawal at the end of 2011 eliminates a major *casus belli*, namely foreign occupation. In short, while the threat of increased violence is real, this will likely pitch Sunni insurgency against the federal government, a somewhat different dynamic to the 2006/2007 violence. As a result, we expect that the violence may intensify but is likely to remain localised to Sunni-majority areas in the north and west of the country.

**Figure 1. Violence is sadly a way of life in Iraq, but is down from the civil war peak**

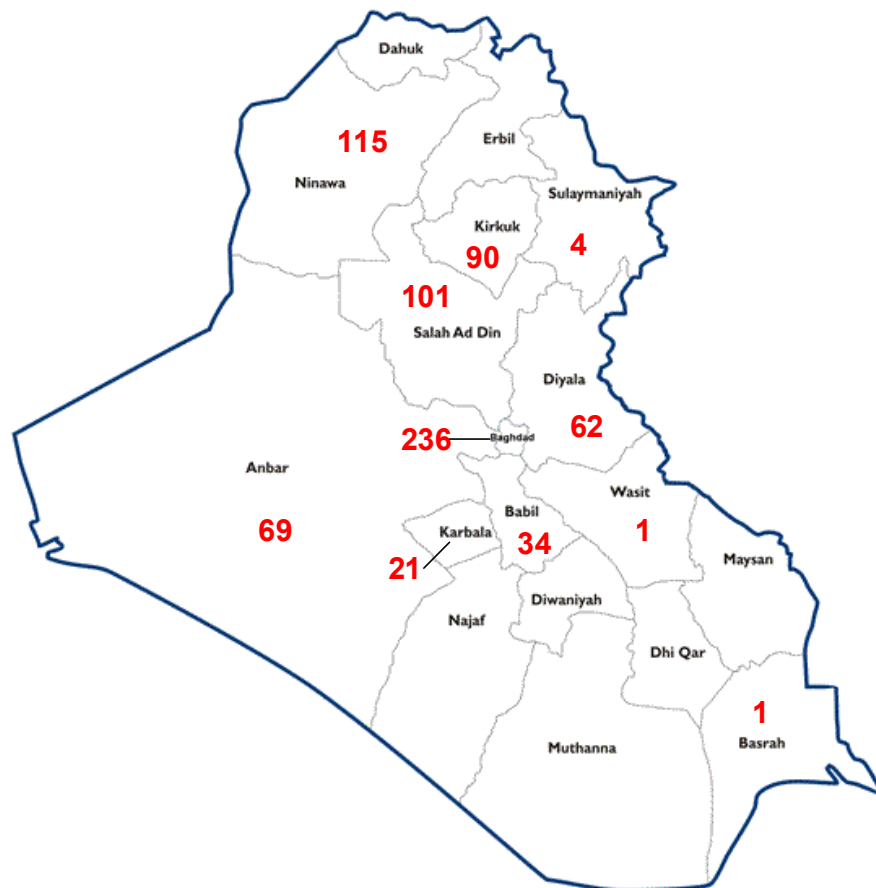


Source: Iraq Body Count, Citi Research

**Figures 1 and 2 make grim reading, but put the recent violence into important historical and geographical perspective.** Figure 1 shows the monthly non-combatant death toll from violence in Iraq as compiled by Iraq Body Count, an on-line project tracking the violence in Iraq through a variety of verifiable sources. The data indicate that the violence in recent months is, unfortunately, unremarkable in Iraq, and remains at levels well below those seen in 2006 and 2007 at the height of the civil war.<sup>1</sup> Figure 2 breaks down the non-combatant death toll by province in Iraq during the first two months of the year. Virtually all of the deaths occurred in Sunni-Majority areas in the north and east of the country, as well as in Baghdad itself.

<sup>1</sup> This does not take into account the apparent rise in combatant fatalities (Sunni insurgents and Iraqi security forces) for which there is no independent data source.

Figure 2. Violent death toll in January/February of this year by province



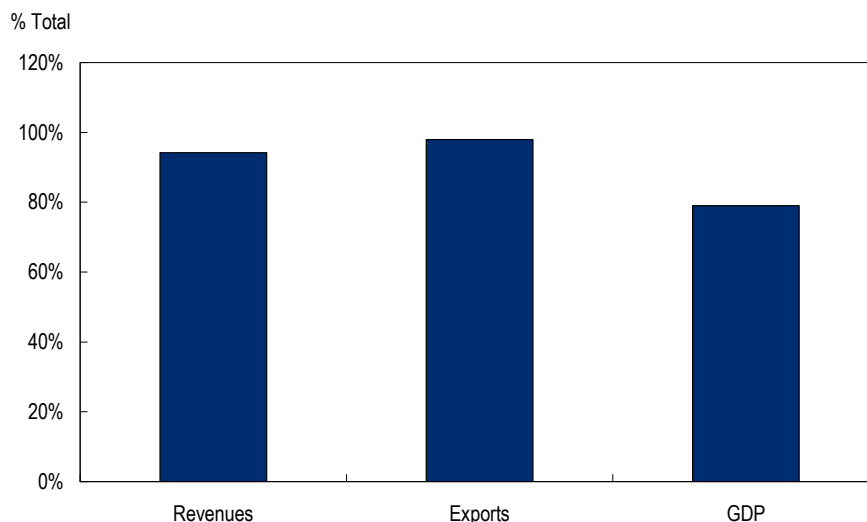
Source: Iraq Body Count, Citi Research

Separately, we believe the near-term risk of war between the KRG and Iraq is rising, and hinges on the question of whether Turkey will provide Erbil with an independent export route for its oil and gas. As we argued in last month's monthly, this is becoming increasingly likely given the improving ties between Ankara and the Kurds (see [Middle East Macro Monthly - What Does Peace in Turkey Mean for Iraq?](#)). That said, we believe that any conflict would remain contained within the disputed areas and the green line that runs between Arab-controlled and Kurdish-controlled territories in Northern Iraq.

### Little oil where the outlook is worst

The main risk to Iraq's economy from a rise in violence comes from the possibility of a significant disruption in current and prospective oil production. Iraq is almost entirely dependent on oil: revenues from oil sales account for 95% of the federal government's earnings, 98% of exports, and almost 80% of economic activity (figure 1). In economic terms, very little else matters.

Figure 3. Iraq's economy is dominated by oil (2012)

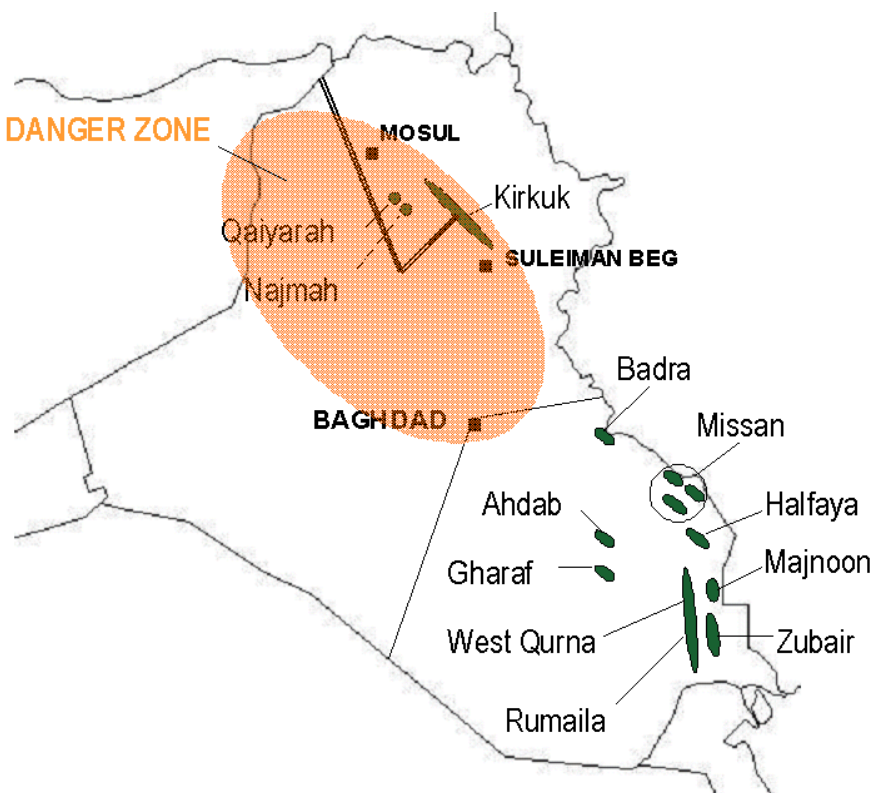


Source: IMF, Haver Analytics, Citi Research

**The violence so far has been centred in and around towns where there is a majority-Sunni presence.** Suleiman Beg, a town south east of Kirkuk in Suleimaniyah province, was in the past week briefly under the control of Sunni insurgents before the Iraqi army recaptured it. Hawijah, where the troubles began, is a few miles south of Kirkuk, and Mosul, the capital of Ninaweh province and a major Sunni stronghold, is up near the Turkish border. Sonangol's operations in Qaiyarah and Najmah oil fields, near Mosul, have been subjected to attacks recently. Baghdad, a mixed-population urban centre, has also experienced an upsurge in violence. As stated earlier, we believe that any escalation in violence will likely remain contained within these geographic limits, marking a 'danger zone' that is exclusively in the north of the country (fig 4).

**With respect to a potential conflict between Kurdistan and Baghdad, again, this is likely to remain contained in the disputed areas (which lie within the 'danger zone' in fig 2, possibly extending into Kurdistan proper, north-east of the zone.** Conflict is unlikely to affect the south, in our view.

Figure 4. The majority of Iraq's productive oil fields are away from the danger zone



Source: Citi Research

Oil infrastructure in the danger zone is at risk of deliberate sabotage and damage from localized fighting. As fig 4 shows, this boils down to the Kirkuk field operations, the Kirkuk-Ceyhan oil pipeline, and the aforementioned Qaiyarah and Najmah oil fields. As the table in figure 5 shows, the Kirkuk field currently averages around 300kbpd in production which is exported via the Kirkuk-Ceyhan pipeline. Qaiyarah and Najmah are still under development and are not, as yet, productive. The Kirkuk Ceyhan oil pipeline has a current maximum capacity for export of around 500kbpd, implying capacity to carry further Kurdish production of around 200kbpd. We do not, however, include Kurdish production in our forecasts given the erratic flow of Kurdish oil resulting from ongoing disputes between Baghdad and Erbil. Thus, the maximum production/export that lies within the danger zone that is at risk is 300kbpd, or around 10% of current Iraqi production (fig 5).

**The vast majority of the oil production is in the South of the country, in Shia-dominated areas, mainly around Basra.** These areas are relatively stable and are unlikely to be affected by the violence in the north, or a Kurdish-Baghdad conflict. Moreover, Iraq's planned future ramp up in production is almost exclusively targeted in the South (fig 5).

Figure 5. Only 10% of Iraq's oil production is in high-risk areas (000s bbl/day)

	Operators	Previous Production	Current Production	Possible production within 12 months	Planned Peak Production
Existing Production					
Rumaila	BP, CNPC	1060	1300	1500	2850
West Qurna-I	ExxonMobil, Shell	244	480	600	2325
<b>Kirkuk</b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
Zubair	ENI, Occidental, KOGAS	180	270	500	1200
Ahdab	CNPC*	0	120	130	130
Halfaya	CNPC, Petronas, Total	0	100	130	535
Missan	CNOOC, TPAO	90	95	95	450
Gharaf	Petronas, Japex	0	35	60	230
Majnoon	Shell, Petronas	0	100	200	1800
West Qurna-II	Lukoil	0	0	150	1800
Badra	Gazprom, KOGAS, Petronas, TPAO	0	0	0	170
Qaiyarah	Sonangol	0	0	0	120
<b>Najmah</b>	<b>Sonangol</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>110</b>
<b>Others</b>			<b>200</b>	<b>200</b>	<b>200</b>
			3000	3865	12220

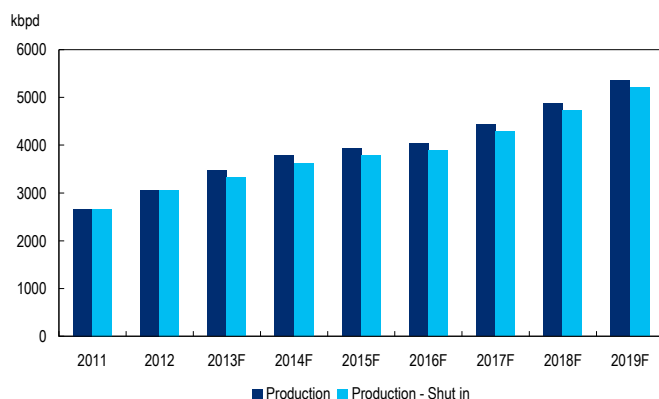
Source: Iraq Oil Report, Iraq Energy Forum, Various Press Reports, Citi Research

## Likely economic impact of the violence

**We see essentially two scenarios of violence, which are not necessarily mutually exclusive.** First, in our view, is the high risk of a rising Sunni insurgency in the north. The second is the more remote, yet still significant risk of a Kurdish-Baghdad military conflict. Either or both of these would have a similar impact on Iraqi oil production, which would pose a threat to the Kirkuk field output via the Kirkuk-Ceyhan pipeline.

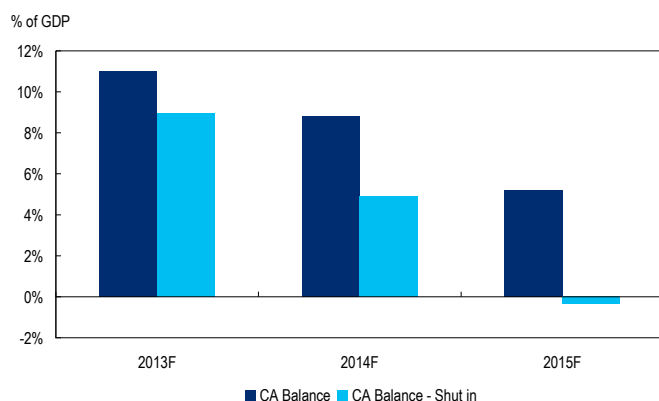
**In our view, it is highly unlikely that either or both scenarios would result in a complete shut-in of Kirkuk oil.** The Pipeline Exclusion Zone, a military protective barrier protecting the Kirkuk-Ceyhan pipeline, will most likely remain in place, although breaches are likely to become more frequent in the event of widespread violence, in our view. The pipeline is currently running at around half its capacity, with exports from Kirkuk at just over 300kbpd in March. This means that a short-term shut down could be made up with an increase of through-put after the fact. More long-term disruptions would, of course, reduce exports, but the likelihood of a total shutdown in the system is highly remote, in our view. A reasonable downside scenario for us would be to assume that exports out of Kirkuk fall by one-half, or around 150kbpd. This translates into a 5% fall in overall oil production (fig 4), and a fall of similar magnitude in fiscal revenues, export earnings and GDP.

**Figure 6. We estimate a 50% shut-in of production from the north will be compensated for by growth in production in the South over time**



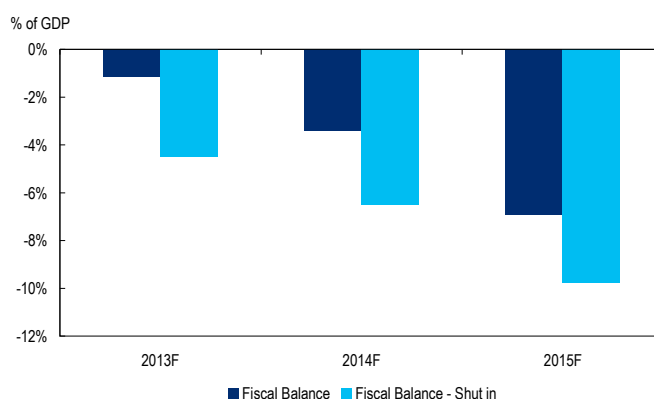
Source: Haver Analytics, Citi Research Estimates

**Figure 8. The current account balance would likely remain positive in near term**



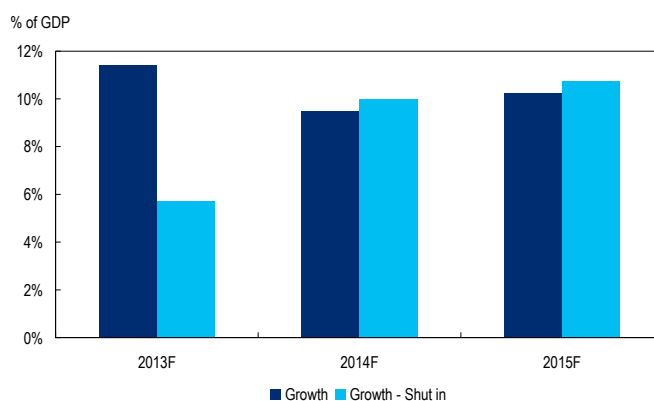
Source: Haver Analytics, Citi Research Estimates

**Figure 7. The fiscal deficit would widen relative to current projections but remain manageable**



Source: Haver Analytics, Citi Research Estimates

**Figure 9. And growth would be temporarily affected**



Source: Haver Analytics, Citi Research Estimates

**The potential impact on key economic indicators would be significant but manageable, in our view.** Assuming an imminent shut-in of half of Kirkuk exports, we would expect the fiscal deficit to widen in 2013 to over 4%, from the 1% deficit we are currently forecasting. We expect the deficit would remain roughly 2% of GDP wider in future relative to current projections, which we consider to be a fairly modest impact.<sup>2</sup> The current account balance would narrow in the near term by around 2% of GDP, but remain significantly positive, only presenting a deficit from 2015 onwards, according to our calculations. Growth would fall sharply, by around 5% of GDP, but this would be a one-off effect, with rising production from the south driving overall economic growth to pre-violence levels in outer years.

<sup>2</sup> This ignores the likelihood of higher federal security expenditures in these scenarios, but we believe that Iraq has enough flexibility on the expenditure side to compensate for these, including a capital expenditure budget that is almost 50% of total spending, and transfers to the KRG of around 15% of spending that would likely be reduced/halted in the event of war. Where the balance goes taking these factors into consideration is highly speculative, so here we focus solely on the net impact of the fall in production.



## The bottom line

**The recent rise in violence in Iraq and the possibility of further escalation and/or a conflict between the KRG and Baghdad threaten a growing and disturbing social, humanitarian and political crisis in Iraq.** Not to belittle this fact, the purpose of this note is to assess the likely economic fallout of this crisis. We believe this would be limited given our view that the south, where 90% of Iraq's oil production is based, would unlikely be materially affected. In our view, this provides support to Iraqi risk assets, particularly the government's outstanding 2028 bonds, despite the negative headline risk.

## Appendix A-1

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