IRAQ OIL REPORT

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Insider's View *Bulletin*: IMF loan conditions spell more spending cuts, put pressure on GoI not to slip on TSC payments

June 1, 2016

Key points:

- Senior International Monetary Fund (IMF)'s official explains conditions of proposed loan agreement worth $5.4 billion
- Timely TSC payments "close to" a requirement
- IMF targets will focus on fiscal discipline for non-oil revenues
- As per the agreement, accumulation of further debt to be frozen
- Drawing down from sovereign reserves to be limited
- More spending cuts
- Senior Iraqi politicians "confident" necessary steps will be taken to secure IMF loan agreement
- Official believes further international loans will follow IMF loan
- KRG allocations contingent on budget law

Potential IOC impact: The prospect of TSC payments being more regularized and timely will improve if and when the IMF loan is realized.

EXECUTIVE SUMMARY: An IMF official explained the fiscal discipline measures enshrined in the proposed loan agreement with the Government of Iraq (GoI). The official also expects that if and when the IMF loan is finalized, there will be fairly rapid movement from other international lenders to provide their own assistance to Iraq. Though the KRG participated in IMF-Iraq meetings, its receiving a share of the loan is predicated on the implementation of the 2016 budget law, something that has not yet occurred in 2016.

This BULLETIN draws from a separate interview than the one covered in the BULLETIN titled, "IMF official discussed terms of Iraq loan deal," from May 26.

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Details: In an exclusive interview, a senior IMF official said that GoI payments to IOCs were "close to" being a prerequisite for receiving IMF loan monies. He said that all arrears outstanding for 90 days or more at the time of the loan "would be paid by the end of the year," and that when the IMF's program begins there must be "zero new accumulation of external arrears."

Conditions like this will be enforced by the IMF through quarterly reviews of five quantitative performance criteria and two indicative targets, said the official.

Iraq's international reserves set to shrink to $40 billion: The loan agreement, yet to obtain the approval of the IMF board and Iraqi cabinet to make it binding, imposes other requirements on the

GoI. The official explained that there is a target for the GoI to achieve a non-oil primary balance, whereby non-oil revenues and expenditures match, not including interest payments on past debt. The IMF will also encourage the Central Bank of Iraq (CBI) to lend to the government by placing a ceiling on net domestic assets, preventing it from accumulating capital. But it will also steer the GoI from exhausting its overseas currency reserves by putting a floor on gross international reserves. The official said that the GoI had burned through $13 billion in international reserves in 2015, bringing their total down to $53 billion. "It will probably do the same by the end of this year," he added, with the caveat that specific numbers were not yet available. Heavy use of savings to make ends meet was acceptable, said The official, because of the fall in oil prices.

Debt freezes, spending cuts: There are several performance criteria included in the loan, including two "indicative" targets. One is a ceiling on arrears to domestic suppliers, a debt that currently totals 7.5 trillion Iraqi dinars. Limited to debts for non-oil investment, the official said arrears would be frozen at this level.

The second indicative target is a floor on social spending, which includes government employee salaries, goods and services for ministries of health and education, aid to IDPs, and subsidies on food and agriculture. The GoI already made significant spending cuts in 2015, reducing the budget by around 30% as compared to 2014, and these budget lines were more or less followed again in 2016.

So to hit IMF targets, 90% of the allocations already in the 2016 federal budget can still be protected because savings are already legislated. But the official said the aim was to continue to reduce spending, and the IMF's fiscal program would require an agreement to cut 2016 budget spending by 13%. He said there would be "big cuts" in non-oil spending, in order to protect social services and programs. "They still have a spending package in the budget that is calibrated to oil prices to $100 plus," said the official. "This is not the situation any more. Nobody sees oil prices coming back to that."

The official added that the IMF's main target is the non-oil primary balance because "oil revenue is too much out of control of authorities," i.e. is too subject to global oil price shifts.

Analysis: *This first target implies that arrears on oil investment could breach the ceiling set by the IMF – its messaging to the GoI, in line with the US', appears focused on maintaining the health of the oil sector at all costs.*

While the IMF is focusing on non-oil revenues and expenditure, this actually represents a small portion of Iraq's spending. The admission that Iraq is essentially unable to control its oil revenues suggests that the IMF's fiscal program probably will not make sweeping changes to Iraq's spending. Iraq's public services are already in tatters, with healthcare and education having been especially badly hit by over a decade of severe instability – spending cuts are unlikely to improve their performance, and may be resented by ordinary Iraqis. It is worth noting that the IMF conditions for receiving loan monies are supported by other potential lenders, including the G7 and World Bank.

Next steps: Before the agreement is presented to the IMF board to be put into action, the GoI must take three steps. First, the revised fiscal program has to be approved by the Iraqi cabinet and presented to parliament (this can be in writing if parliament isn't meeting). Second, the GoI must agree to curb wage exemptions so that tax on civil servants (non-military personnel) can be calculated. Third, the Finance Ministry needs to send revised spending plans to the ministries.

If this is implemented, and the official says senior Iraqi ministers are confident it will be, the IMF loan of $5.4 billion can be approved around the end of June.

Approval of the IMF loan will likely trigger implementation of loans from other international lenders, including the G-7 and potentially JICA, said the official.

Analysis: *Although ministers may be confident of securing consensus on the IMF loan, Baghdad is still politically volatile. While there is every indication the loan will be finalized, it should not yet be taken for granted.*

KRG: Regarding the KRG receiving a share of the allocation, the official said, "We support the budget of the government," meaning the central government. "In the budget there is an oil sharing agreement. When we set the target, we assumed that at some point they (the Iraqi government) will implement the agreement with the KRG. During our mission, the ministry of planning of KRG participated in all of the meetings. The way we set our targets, we have included transfers to KRG. If when we check whether the targets are met, we are going to adjust the targets," said the official.

Analysis: *The implication appears to be that the extent to which the IMF is willing to go to ensure the KRG receives an allocation is hoping that the incentive posed by the available funds may be sufficient to get the KRG and GoI to adhere to the 2016 budget law (which calls for the KRG to turn 550,000 bpd over to SOMO at Ceyhan in exchange for 17% minus sovereign expenses from the monthly budgetary allocation). However, there are multiple reasons to be skeptical that either side is capable of adhering to the deal. The KRG has already committed cargoes as part of forward oil sales with a number of traders under terms that the GoI is unlikely to readily take on. The upshot is the KRG is unlikely to be able to commit 550,000 bpd to SOMO, even if it was inclined to do so. Meanwhile, the GoI has a poor track record – particularly in the low oil price environment – of adhering to the budget law when it comes to ministerial spending, instead operating on what effectively amounts to a "squeakiest wheel" policy. Given this track record, there is limited reason to think that the GoI would treat transfers to the KRG as sacrosanct.*

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