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Kurdistan's Economic Woes

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The Kurdistan Regional Government (KRG) has legal jurisdiction over three provinces: Erbil, Dohuk, and Sulaymaniyah. Following the collapse of the Iraqi military in the region and the occupation by ISIS forces, the KRG gained de facto jurisdiction over an additional three provinces, Diyala, Nineveh, and Sinjar. The area controlled by the KRG is landlocked: it borders Syria to the west, Iran to the east, and Turkey to the north. It is crossed by the Sirwan and the Tigris rivers and tributaries and has an area of 40,643 square kilometers. The population (including Syrian and other refugees) has been estimated at between six and seven million, while the Kurdish population worldwide exceeds 30 million and may be over 35 million.

On October 15, 2017, the KRG lost the majority of territories outside of the officially recognized autonomous region – including Kirkuk, Sinjar, Makhmour and Qanaqin – after the Iraqi army and pro-Baghdad militias took control following the dispute that emerged after the KRG's independence referendum. All the oil fields and facilities in Kirkuk province are now under Iraqi control.

As a result, the KRG faces a major crisis. Iraq's occupation of the disputed territories in Kirkuk, Nineveh, and Diyala provinces has resulted in it losing nearly half of its oil production and revenues. The KRG economy depends overwhelmingly on oil revenue, and until 15 October, it produced 610,000 barrels a day (b/d) and exported about 560,000 b/d through Turkey. It has now lost some 280,000 b/d production from the Bai Hassan field and the Avana Dome of the Kirkuk field. It also lost output from smaller fields in Nineveh province such as Ain Zalah. The KRG is now left with around 327,000 b/d of production, of which some 280,000 b/d are exported. Around 110,000 b/d of this is the Kirkuk field, Khurmala Dome, in which the Kurdish firm, KAR has been operating since 2007.

A further 110,000 b/d has come from the Tawke licence (Norway's DNO accounts for 75% of production there, London-based, Genel, accounts for 25%). Reduced investment due to unreliable payments and low prices, as well as geological challenges, have limited development in the region in recent years. Output at the Shaikan field (Gulf Keystone Petroleum 80%, Hungary's MOL 20%) is stable at 35,000-37,000 b/d, but output at Taq (Genel 44%, China's Sinopec 36% and the KRG 20%) has collapsed. The only recent success story has been the Atrush field (operated by the Abu Dhabi based Taqa 40%, Canada-based Shamaran 20%, US independent Marathon 15%, KRG 25%), which started operations in July 2017 and is now producing 23,000 b/d.

These losses would be catastrophic at the best of times, but they come at a time when the KRG has an estimated $20 billion debt. In order to survive the period of low oil prices, the government obtained revenues through prepayments with trading houses, such as Singapore-based trading company, Vitol-Trafigura and more recently Russia's Rosneft.

Lost exports were worth about $340 million per month, but in October 2017, the KRG Ministry of Natural Resources said that the government's monthly public-sector salary bill was $785 million, and this was after cuts in salaries. The KRG owes at least $1 billion to Rosneft. The latter's investments in Kurdistan in 2017 may well be motivated more by Moscow's political ambitions than by economic ones. On October 18, 2017, Rosneft announced that it had finalized a contract for five production blocks for which it will pay up to $400 million. This cash will be welcomed in Erbil, but covers only one month's worth of export revenue.

This deal could mean that the KRG will become reliant on Moscow for financial support, in addition to its dependence on Turkey as an export route for its oil. Turkey's reaction to the Kurdish referendum may well have been influenced by its relations with Russia. The only direct sanctions that Turkey imposed on the Iraqi Kurds were halting flights by all Turkish airlines, to Erbil and Sulaymaniyah, telling the representative of Iraqi Kurdish leader Masoud Barzani that he would not be allowed to return to his post in Ankara, banning an Iraqi Kurdish television channel, Rudaw, from Turkish airwaves and ending Turkish military training for the Iraqi Kurdish armed forces (*peshmerg*a) force.

Why did Turkey to refrain from shutting the oil pipeline and the border? One reason is that Russia and Turkey need the pipeline taking Kurdish oil to Turkey. Russia has invested $4 billion in Iraqi Kurdistan's oil and natural gas industries in last year, and has surpassed the United States to become the largest foreign investor. Rosneft plans to ship large quantities of crude from Turkey's Ceyhan terminal to Germany, where it will be refined and sold to Europeans. Any tightening of the valves on the Kirkuk-Ceyhan pipeline would impede that trade.

Turkey is constrained also by its own economic interests: it sold $7.6 billion worth of food, consumer goods, construction materials and other goods to Iraq in 2016, according to the Turkish Statistics Institute and the economy minister has said that nonoil trade with Iraqi Kurdistan was worth $2.5 billion. It is also wary of increased Iranian and Shiʿi influence in Iraq. The Kurds are largely Sunni and their interests in Iraq coincide with Turkey's.

According to the World Bank, the Kurdish economy suffers from a number of structural problems. The first is its reliance on oil. Despite a series of negotiations, a dispute with the central government about the sharing of oil revenues and the budget transfer has not been resolved. Oil exports, which had been received from the central government as budgetary transfers, constituted about 85 percent of government revenues. However, this sector accounts for only one percent to employment. The very high level of dependency on oil sector has resulted in "Dutch disease" effects. These mean that non-oil exports have been discouraged and imports encouraged. Related to this is the difficult environment for the private sector, inadequate skills development, and strong incentives for people to seek jobs in the public sector. These factors have undermined the non-oil sectors' competitiveness locally and internationally and have limited private sector development and domestic production in tradable sectors and exports. High oil dependency has created, (1) a rentier state, in which government redistributes resources; (2) an unstable business cycle; and, (3) a very uncertain business environment. In the past, when the government had plenty of money, it became complacent and failed to identify and tackle structural problems. The current period of recession has brought these structural problems to the fore.

The second problem is the dominant role of the public sector in the economy. The public spending to GDP ratio is over 50 percent, compared to 61 percent for the whole Iraq. The KRG is the main employer with a share of more than 50 percent in total employment (26% in non-military employment). As in the rest of Iraq, payments for salaries, pensions, social assistance and subsidies (electricity, fuel, water supply, and agriculture) comprise over 50 percent of the budget. Taxes constitute only 4.7 percent of total revenue! As a result, public expenditure is a primary driver of economic growth. A key problem is high volatility of public expenditure, which results in fluctuation of economic growth. The volatility of expenditure results from that of revenues. These have fluctuated widely due to changes in oil prices, interruptions in production and transportation of oil driven by the dispute with the Iraqi central government in Baghdad about how to share oil revenues. Despite the strong entrepreneurial spirit and potential that exists in the KRG, the local private sector is small and under-developed due to significant crowding out by the public sector.

The service sector accounts for the largest share in employment, however it is public-sector oriented. The labor market, as a whole, is skewed towards service-oriented jobs. Labor force survey data shows that the service sector dominated by the public sector. The labor force participation rate among women is one of the lowest in the region. It is lower than that in Iraq as a whole and Iran. Most female employment is in the service sector (93 percent), with just under five percent in agriculture, and the rest in industry.

The third problem is the reliance on imports. Due to the relatively undiversified nature of the Iraqi economy, there is a large gap between demand for and local production of tradable products. The gap is filled by imports, which amount to about 90 percent of non-oil GDP. Local production is confined to retailing of imported products, small-scale internationally traded goods, and other services including bloated public services. Exports of locally produced goods are very limited. This is a typical feature of a rentier economy. In the current economic environment, it has been hard for the local businesses to compete with imports to diversify and grow.

The financial system is weak and relies on a cash-economy. An inclusive and efficient financial system is critical for private sector development by funding greater investment for larger numbers of people. The KRG has a poorly developed financial sector, including weak financial infrastructure and low access to finance, especially for small and medium-sized businesses. There is a strong preference for cash in business transactions. Around three percent of companies rely on the banking sector for investment and working capital (over 20 percent in the Middle East and North Africa). This is explained partly by the pervasive atmosphere of mistrust in the banking sector created by financial disruptions and regional instability.

In addition to these structural problems, since 2012, the KRG has faced two crises. The first was the result of the conflicts in Syria and Iraq. The influx of some 1.8 million refugees resulted in a 28 percent increase in the KRG's population. The second was the result of the decline in international oil prices, from $115 a barrel in June 2014 to $35 in December 2015, which resulted in sharp falls in oil revenues. In addition, there was a sharp fall in revenue transfers from the Federal Government of Iraq, from $12 billion in 2013 about $1 billion in 2014. In June 2015, these were suspended.

The influx of refugees and the collapse of oil revenues severely constrained the government's ability to provide health, education, and social protection programs. The standard of living has deteriorated, and many people have fallen into or are vulnerable to falling into poverty. As a result, the poverty rate for doubled among refugees and internally displaced persons (IDPs)—with the largest increase in Dohuk which experienced the highest influx of IDPs. When the IDP and refugee population is included, the poverty rate increased even higher: poverty in increased to 12.5 percent in 2014. More than 75 percent of the refugees and IDPs are women and girls who are very vulnerable. The KRG is providing public goods for the entire region and delivering services to this increased population. The needs of the displaced population are significant and cannot be adequately met under the fiscal crisis confronting the KRG.

After strong growth during 2011 to 2013, economic performance mirrored that of the Iraq as a whole and it experienced a significant downturn since 2014. The economy remains highly dependent on oil, with most of the labor force employed by the public sector. The oil sector, which is the main engine of growth is capital intensive industry and absorbs only about one percent of the labor force. Since mid-2014, the fall of revenues has dried government liquidity and curbed public investment and economic growth, which has discouraged foreign investment in oil developments and other private investment. Consumption has been also affected by the increasing tighter government finances and growth of arrears on the government's payroll. The regional conflict is adding on this crisis. The violence driven by ISIS and clashes with the KRG's armed forces weakened economic growth in the oil and non-oil sectors.

The tribal nature of Kurdistan's society has come to the forefront recently, but there is another issue that has been overshadowed. This is the role of women. Despite the prominence of women in the Kurdish armed forces, their role in the economy is very limited. In this respect the KRG is similar to Iraq and much of the Arab world. In 2016, female participation in the labor force was only 14.8 percent. In that year, unemployment increased in the Kurdistan Region, especially among youth and women. According to official statistics, the unemployment rate among women was 29.4 percent and among men, 9.7 percent. Among Kurdish youth aged between 15 and 24, the unemployment rate was 24 percent for men and 69 percent for women. The KRG therefore faces major socio-economic as well as political challenges in its struggle for independence.