Managing Volatility of Oil Export Revenues

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Background note:
This is part three of a research work commissioned by the Natural Resource Governance Institute-NRGI (USA) as part of the preparation for NRGI’s strategic plan for interlinked and complementary interventions in Iraq during the upcoming three years.¹

The Executive Summary of the study was posted on this IBN website and accessible through the following link:
http://www.iraq-businessnews.com/2015/05/26/expert-blog-iraqi-extractive-industry/

Part One was posted on the same IBN website and accessible through the following link:

and Part Two was posted on the same IBN website and accessible through the following link:

The last part and list of consulted reference will be posted on this website after two weeks.

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Part Three

Managing Volatility of Oil Export Revenues

This part aims to address the following four questions

1. Does government smooth’s domestic spending of revenues to account for revenue volatility?
2. Resource revenue volatility: Is government spending stabilized relative to resource revenues?
3. Savings fund: Does government use saving funds efficiently to limit the economic impact of large and volatile resource revenues?
4. As a test of its volatility protections, how effectively has the government been able to manage the recent drop in oil prices?

NRC Precept 8 considers revenue volatility as one of the serious fiscal challenges facing governments in their investment planning as well as managing exchange rates, inflation and spending; and the related tools and institutions. This is no easy task, and government decision

¹ Disclaimer: This part of the study is intended solely for the use and information of the client-NRGI; is for public education and knowledge and thus it is not intended to be and should not be construed as legal, economic and political recommendations or advice. NRGI holds no responsibility or liability for the contents of this study and any errors are, however, my responsibility.
makers should be cognizant of the uncertainty, cyclicality and volatility of resource revenues. In this regard NRC discusses few available strategies by highlighting their suitability, applicability and success requirements. Strategies considered are: how the extractive industry tax regime affects volatility; using hedging contracts; accumulating foreign assets (stabilization funds); short-term borrowings; and make changes to investment expenditure before recurrent expenditure.

For monitoring government decisions precept 8 calls for non-discretionary rules that are useful to guide government’s use of hedging, saving funds and borrowing instruments. Also it emphasizes some degree of flexibility for the government to employ a mechanism to regulate deviations or alterations to the rules, subject to public debate and formal oversight.

Despite Iraq’s structurally high dependence on oil export revenues and the many fiscal crises this dependency had caused in the past, the issue of managing revenue volatility in an institutionalized fashion has been very weak at best, if existed at all. In other but precise words there are no specific legal instruments concerning precautionary measures against possible revenue volatility. For example the word “volatility” does not appear in the Constitution; there are no established institutions or official entities mandated to address various aspects pertaining to revenue volatility management and there are no apparent policies to confront revenue volatility and remedy its consequences.

That said, some sort of “fire-fighting” approach appears to exist to deal with circumstantial volatility when it occurs. But once circumstances change and revenues begin to recover the government spending returns back to business as usual; and the “boom-bust” characteristics of revenue flows are forgotten. Example of such attitude was the government reaction to the collapse of Iraqi oil prices and its consequences on oil export revenues from during the period July-December 2008 and during June 2014 to date (July 2015).

Volatility in oil revenues for Iraq could result from different factors:

1. Price fluctuation in the international markets. As the following Chart 5 demonstrates Iraqi average export oil prices (the red colored line) through two periods of deep collapse and fluctuating patterns between them. The first of two deep collapse price periods was in 2008 when Iraqi oil export prices dived from $113.81 a barrel in July 2008 to $34.57/b in December same year. The second period began in June 2014 when the price was $102.61/b and by end of January 2015 it reached $41.77/b. In February 2015 Iraqi oil prices recovered to $47.43/b and continued on this pattern reaching its highest of $55.9/b in May, then declined slightly to $55.6/b. This slight decline in June might indicate that international oil price has not reached its floor yet. EIA asserts that Brent crude oil prices averaged $61/b in June, a $3/b decrease from May. Crude oil prices fell by about $4/b on July 6 in the aftermath of the "no" vote in Greece on the economic program; and EIA now (7 July) forecasts that Brent crude oil prices will average $60/b in 2015, $1/b lower than its June forecasts.²

2. Production variation due to technical and or logistical infrastructure. Data indicates that when total production reached a high record of production, as was the case in February 2014 with 3.410 million barrels per day –mbd that production was not

² See EIA, Short-Term Energy Outlook, July 7, 2015 Release  http://www.eia.gov/forecasts/steo/
sustained and went down before recovering in December 2014 to 3.356mbd went down again the following month.

3. Weather conditions at the export terminals on north Arabian Gulf causes very often a disruption on the loading terminals for few days; and because of limited storage capacities onshore the temporary suspension of loading creates two adverse effects: reduce oil production and reduce oil exports depending on the length and severity of the weather conditions. In mid-February 2015 the Fao tank farm linked to export terminals crude-storage capacity increased from 9.5 million to 10.5 million barrels, with another four to five million barrels capacity will be added by the end of this year.\(^3\) This will help also in increasing or keeping oil flowing to the export terminals to reduce the lengthy loading stoppages and allow for segregation of heavier crude grades that are affecting the quality of Basra Light.\(^4\)

4. Security conditions, especially pipelines sabotage attacks had effectively reduced oil export through the northern evacuation system Kirkuk-Ceyhan before completely suspended of such exports during the period April-September 2014.

5. Domestic political disagreements between the federal government and KRG regarding the fulfilment by KRG of oil delivery agreed at when preparing the State annual budgets and the agreements concluded between the two governments. The last of such non-fulfilment is 2015 state budget when KRG committed to deliver to the federal government 250kbd from KR own production and facilitate additional 300kbd from Kirkuk; the actual delivered oil by KRG during the first half of 2015 was only 296kbd instead of 55kbd.\(^5\)

6. Finally, the quality of the crude and blending practices has on actual Iraqi oil export price. Pricing formula comprises many factors and one of them is the quality of crude measured by the API gravity. The blending of fuel oil or heavier crude could result in price discount and thus impacts realized revenues.

7. Despite fluctuations in the monthly oil exports (the blue colored columns) the export trend line (black colored straight line) is moving upwards. This indicates that revenue volatility would be more sensitive to oil price variations more than to production

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4 MEES, V58. N. 08, 20 February 2015

Since 2009 and after the Ministry of Oil had concluded many upstream petroleum development contracts the indications are that Iraq’s oil production capacity could, theoretically, overpass 12 mbd by 2017. Many senior government decision makers claimed Iraq could be an energy game-changer; and such development would generates billions of revenues stream.

The Integrated National Energy Strategy-INES estimates oil export revenues for the period 2012 to 2030 based on 9mbd plateau production level and different Brent price assumptions. The Net Present Value-NPV of cash flow (in real term 2011) over the span of the INES varies between $5.1 trillion at Brent $110/b and $2 trillion at $50/b. NPV rises or falls by roughly $1 trillion as average oil prices rises or falls by $20/b.\(^6\) The increase in oil production and oil export volumes coupled with an average oil price of more than $100/b during 2011, 2012, 2013 and 2014 (up to July) have created a sense of “soft-budget”, promoted politics of populism and kept the mindset of “high oil price forever” among many senior Iraqi decision makers, parliamentarians, politicians and pro-government professionals- forgetting quickly 2008 fiscal crisis!

On the other hand many experts and informed professionals, including this author, raised concerns of the cyclicality in oil prices, warning about vulnerability of the Iraqi economy to price & revenues fluctuations, and calling for adopting coping-strategies to deal with boom & bust or honeymoon & nightmare situations.\(^7\)

For addressing the above four questions the same methodology used for Part Two will be used here also regarding scoring.

The first question


As mentioned earlier state budget dependence on oil export revenues is rather heavy and thus it is highly vulnerable to revenue volatility; and due to the absence of financial buffer for fiscal stabilization such vulnerability becomes visible and immediate.

Data presented in Chart 5 shows that since 2007 Iraq witnessed two cases of oil price collapse, and both took part at the second half of the year: 2008 and 2014.

The impact of such decline was directly reflected on the drafting of the state budget for the following year- a short-term direct impact.

Based on state budgets total expenditures the impact of 2008 oil price crash had resulted in reducing total expenditures for 2009 budget by ca. 19% compared to 2008 budget. But since oil prices and volume of exports began to increase from January 2009 onwards total budget expenditures continued the fluctuating upwards trend until July 2014 when the second price crash has begun.

Unlike 2008 the floor price in 2015 has not been reached yet and thus the recovery in oil prices has not been set on the sustainable upward direction. Thus, the 2014/5 price crash left its unavoidable marks on government spending as reflected in 2015 state budget, which was less by 13.6% than for the previous year.\(^8\)

The effect of shrinking state budget appears more on the investment allocation share in total budget expenditures. Investment allocation was reduced from 22.3% to 17.7% during the first price crash (2008/9) and from 39.8% to 35.1% during the second price crash. On the opposite to that the share of the recurrent expenditures in total budget expenditures increased from 77.7% to 82.3 % during the first price crash (2008/9) and from 60.2% to 64.9% during the second price crash.

Both observations of short-term impact and such impact is more on investment allocation are in conformity with NRC precept 8 expectation of making changes to investment expenditure before recurrent expenditure. Moreover, this impact reflects weak structural base of high natural resource-based dependency on one hand and poor management of revenues at boom times.

Therefore the YES answer reflects only the fact of government action to reduce, or smooth by default, its spending, but should not be taken or consider as “positive” assessment of the

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\(^8\) Since state budget for 2014 was not approved by the Parliament the spending during the year was limited by the same level for 2013. However, the security condition post 9 June 2014 could drive actual expenditures much higher.
government action. On the contrary, the government has in fact failed to save the surpluses during high oil prices that prevailed in previous years.

The second question

### Resource revenue volatility: Is government spending stabilized relative to resource revenues?

**NO**

Analytically, answering this question do not differ much from the previous answer but the emphases here is the relationship between total budget expenditures and total budget revenues by highlighting the significance or the consequences of oil revenues in state budget.

Short term impacts of revenues fluctuation on government decisions are reflected best through planning and drafting phase of the annual state budgets first; and the actual accrued revenues and actual spending on both investment and recurrent expenditures.

This study has addressed earlier, in answering second question in Part one, the relationship between planned and actual budget revenues and expenditures; and highlighted the resulting fiscal deficit or surplus.

It is a general knowledge that due to structural features of the Iraqi economy, state budget and government spending depend largely on oil revenues. But from 2011 onwards state budget laws became more transparent by specifying the parameters for calculating oil revenues in terms of the assumed oil price and volume of crude oil export.

And because of such dependency the estimation of both budget revenues and expenditures follow exactly the pattern of budgeted oil revenues. Such close correlation between the three budget parameters, as exhibited in Chart 6 below, indicates high sensitivity of government spending relatives to resource revenue movement. In other wards government spending during the period 2011 to 2015 (and even prior to 2011) was not insulated from revenue volatility.

**Chart 6**

**Budget Expenditures (TBE), Budget Revenues (TBR) and Budgeted Oil Revenues (BOR) in $ billions: 2011-2015**
Therefore, government spending that follows closely oil revenues in their fluctuating pattern during the covered period does not indicate stabilization of government spending (even at budget planning and preparation phase). Hence the answer to this question should be NO.

The third question

**Savings fund: Does government use saving funds efficiently to limit the economic impact of large and volatile resource revenues?**

This question assumes the formal *existence* of “saving funds” with, presumably, legal base and frameworks (instruments), specialized entities (institutions and governance) and defined rules, objectives and strategies (policies). What followed from that the question is about whether such funds been used or not, and whether the usage of existing saving funds have been efficient or not; and finally, whether or not the outcomes demonstrate success in limiting the economic impact of large and volatile resource revenues.

Obviously, this is both composite and generic question involving four components: existence, utilization, efficiency and outcomes; each is open for further questions with factual and judgmental answers. Hence, the YES or NO scoring-answer might be unwarranted without further analysis. But the existence of a legally saving fund with defined institutional setting, governance and policy is the pivotal issue rendering the remaining three components redundant or not.
The first draft of federal oil and gas law—FOGL refer to the establishment of “Oil Revenue Fund-ORF”, while the second draft does not refer to ORF but suggest “Future Fund”; but neither drafts elaborated on basic fundamentals for the suggested entities.9 In the environment that prevailed in 2007 a draft for Revenue Sharing Law—RSL was suggested, but not much circulated or debated due to its obvious biasedness and absurdness. RSL calls for establishing “Financial Resources Fund” and “Future Fund”. And when the drafts of FOGL surfaced again in 2011 the draft of RSL followed the same path and again with the same 2007 text and principles.10 On its part KRG proposed in 2011 a draft law establishing oil and gas “Commission” in the Region and oil and gas “revenue fund” and refereed the proposal to KR Parliament. But as at the time of writing (July 2015) the KR Parliament website provides no information on the proposed law.

That said, legally and institutionally there is no “saving fund” in Iraq. Operationally and technically the “surplus” in Development Fund for Iraq-DFI11 was used by the government to partially finance planned deficit and thus they provide short-term fiscal buffer. Using DFI surplus was specifically mentioned in state budget laws for 2012 and 2013.12 Budget law for 2014 has not been promulgated yet; and DFI was not mentioned in budget law for 2015 because there was no surplus left in it!

According to MEES13, DFI had a balance of $18bn at the end of 2012; and statement at the end of an IMF Mission on Iraq asserts that DFI was already down to $6.5bn at end-2013, and declined further to around $4bn in November 2014.14 Finally, on 5 February 2015 Iraq Oil Report-IOR wrote “The DFI has dipped to $1 billion, according to two officials with access to the data.”15

10 I was invited by the Chairman of oil and energy Committee in the Iraqi Parliament to participate in an informal discussions focusing on the drafts of the following laws: FOGL; INOC; RS and RS Committee. I provided my comments on these draft laws prior to the meeting that took place in Beirut, Lebanon, 15-18 April 2011. The meeting was not productive due to the politically biased motivations behind the presented drafts and the entire meeting.
11 DFI was created according to United Nation Security Council Resolution—UNSCR 1483 of 2003 to administer the proceeds from the export sales of petroleum and petroleum products of Iraq that should be deposited in the DFI’ Oil Proceed Receipt Account—OPRA held at the Federal Reserve Bank of New York –FRBNY. UNSCR 1483 also called for the creation of an International Advisory Monitoring Board (IAMB) including representatives from several international financial institutions such as the World Bank and the IMF. In January 2011, the Iraqi Committee of Financial Experts (COFE) took over the task of IAMB in order to promote transparency and financial accountability with regards to the DFI. Now DFI is managed by the Central Bank of Iraq-CBI on behalf of the Iraqi Ministry of Finance.
13 MEES, Vol. 56. No. 42, 18 October 2013
There is some confusion, misunderstanding and lack of information among some Iraqi politicians and parliamentarians about the balance at DFI. Some still think there is surplus at DFI that should be used; other state that Iraq has $100 billion “at DFI in CSI American Bank.”16 This rather surprising even after the Minister of Finance had confirmed before the Parliament the depletion of surpluses from 2012 and 2013 in DFI during 2014.17

In Iraq, fiscal surpluses occur as a result of higher oil revenues (due to higher oil prices or higher oil export volumes or both) or budget surplus (due to lower spending compared with allocation for investment or recurrent expenditures or both).

Budget surpluses due to lagging spending behind allocation are usually carried forward to the following year thus contributing to its finance. Budget Law 2008 mentioned a carried forward from 2007 an amount of more than 9 tIDs that was used to cover the entire planned budget deficit for that year18. For 2009 budget there was 18.8 tIDs carried forward from 200819; Budget Laws for 2010 and 2011 mentioned the carried forward as item but do not provide specific amounts; No mention was made to any carried forward amounts in Budget Laws 2012 and 2013, but Budget Law 2015 mentions 3 tIDs carried forward from previous year.

However, the comparison between allocation and actual spending indicts significant amounts of what should be considered as carried forward “budget surpluses” in the absence of a saving fund or similar entity. Data available indicates that actual spending during 2010-2013 was ca. 81% of budget allocation; resulting in budget surpluses totaled to ca. 84 tIDS (or ca $72 billion)20. In fact 46.5% of the total budget surpluses was related to budget year 2013, meaning that 40 tIDs was practically carried forward to budget year 2014. Since budget law for 2014 was not passed up-to-date, and according to the fiscal role of monthly spending of 1/12 of previous year, then actual spending in 2014 should not have exceeded 99.4 tIDs (or $85.2 billion).

Furthermore comparing oil export revenues with actual budget spending provide the profile of fiscal surplus or deficit. Our calculation indicates that total oil export revenues for the five year period 2010-2014 is ca. $402.6 billion compared to total actual spending of ca. $387.6 billion; giving a fiscal surplus of $15 billion by end of 2014.

The above comparison indicates that both budget surplus and fiscal surplus for the last five years have been positive, and thus it is rather unclear why there is no carried forward asset at DFI.

Based on the above analysis the answer to the above mentioned main question is NO, and the same applies also to the three secondary questions pertaining utilization, efficiency and outcomes.

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18 Budget Law Nr. 20 of 2008, Article 2-Second.
19 Budget Law Nr. 6 of 2009, Article 2-Second.
20 Budget spending and allocation data are from Behnam Elias Puttrus, Remarks on the Relationship between GDP and Iraqi Oil Prices. PowerPoint presentation (in Arabic) delivered before Progress Institute for Development Policies-CEDID Seminar, Baghdad, 21 February 2015.
The fourth question

As a test of its volatility protections, how effectively has the government been able to manage the recent drop in oil prices?

In July 2013 the Cabinet requested a formation of ad-hoc group to formulate a mid-term strategy for state budget 2014-2016. Despite such ad-hoc approach to a serious issue, that was a welcoming initiative in providing better framework to facilitate planning and preparations of the annual state budgets and help in improve management and utilization of the financial resources of the country in such a medium-term horizon.21

Unfortunately, except holding one meeting nothing is available on whether such mid-term fiscal strategy was formulated, prepared, presented, discussed and approved or not.22 But for sure the state budget for 2014 has not been promulgated (up to date) despite numerous meetings on different levels: at the Council of Ministers, cross-ministerial and parliamentary Committees.

From 9 June 2014 onwards the financial position for the country suffers from two serious challenges or “double-whammy”.23 The first is related to the existential security challenges caused by and following Da’esh (ISIL/S) attaches and occupation of Mosul city. This has serious multiple implications on oil production in the affected areas; escalating military and security costs; and the problem of the internally displacement people- IDPs estimated to be over two millions with estimated monthly cost of more than $500 million to feed, shelter and protect them.

The second is the known crash in international oil price that began descending in and continued since July 2014.

Under such politically charged circumstances and high security uncertainty it becomes rather difficult a task to assess objectively how effectively has the government been able to manage the recent drop in oil prices. Undoubtedly, the deteriorating security conditions and their consequences ought to have their effective marks on the government economic and financial decisions.

Against this backdrop the above question will be addressed.

On May 2014 total monthly export revenues had its highest level in the year then went down to reach in January 2015 its lowest record of $3.26 billion since May 2009. Similarly,

23 A “double whammy” concept is mostly used in American legal and business writings referring to a circumstance when two bad things happening close together.
monthly Iraqi oil price had its highest level of $102.61/b in June 2014 then dived sharply to $41.77/b in January 2015, as shown in Chart 7 below. Both oil revenues and Iraqi oil prices reversed course slightly in February and continued gradual move upwards, but declined slightly in June. The June decline, in export revenues, is attributed primarily to KRG’s failure to deliver oil in a quantity as per its budgetary commitments.

Chart 7
Export Revenues (ExpRev, left hand side in $billions) and Oil Price (in $/b, right hand side): January 2014- June 2015

Notes and Source for Chart 7: Original data from MoO website compiled by this author/ consultant AMJ/ IDC&R

The dramatic and continued decline in oil price and the absence of real prospect for reaching a floor for international oil price had caused very serious uncertainty on what price level should be adopted to estimate the revenue side during preparation of 2015 state budget. Moreover, the fluctuation in oil production and oil export, due to logistical and infrastructural difficulties, had complicated the mission further. The strained political relationship between the federal and KR governments adds more difficulties and complications in the process of budget preparations.

On 12 October 2014 the Ministry of Oil said that for 2015 budget it will propose $80/b and export of 3.6 mbd.24 Two weeks later one parliamentarian reportedly said 2015 budget will be based on “$75/b though oil prices are much higher than that”25. By end of October a senior economic advisor to the Prime Minister expected oil prices to “settle” at $80/b, while a former oil minster suggested $70/b.26

After many revisions the government approved its draft budget and sent it to the Parliament, which in turn debated the draft through first and second readings. When it became clear that certain changes and reductions have to be made; requiring sending-back the draft law to the Cabinet, the later authorized the Parliament to make the needed changes in order to save time and approve the budget without further delay. Accordingly, the budget was passed by the Parliament on 29 January 2015 and referred the budget law to the President of the Republic for approval; the budget law becomes effective from the date of its publication on the Official Gazette.  

The approved budget does not differ much from either of the two proposed estimates by the government (very minor differences in total revenues and total expenditures). The following table provides a comparison on the main budget components between what was proposed by the government (two reportedly versions) and what has been finally approved by the parliament.

### Table 2
State Budget 2015:
Proposed by Government vs. Approved by the Parliament

<table>
<thead>
<tr>
<th></th>
<th>Government Proposals</th>
<th>Parliament Approval</th>
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<tbody>
<tr>
<td>Total Revenues (trillion IDs)</td>
<td>99.8 (100)</td>
<td>94.2</td>
</tr>
<tr>
<td>Total Expenditures (trillion IDs)</td>
<td>125.2 (123)</td>
<td>119.6</td>
</tr>
<tr>
<td>Budget Deficit (trillion IDs)</td>
<td>25.4 (23)</td>
<td>25.4</td>
</tr>
<tr>
<td>Budget Deficit/ Total Expenditures (%)</td>
<td>20.3 (18.7)</td>
<td>21.2</td>
</tr>
<tr>
<td>Oil Export volume (mbd)</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Oil Price ($/barrel)</td>
<td>60</td>
<td>56</td>
</tr>
<tr>
<td>Oil Export Revenues ($billion)</td>
<td>72.1</td>
<td>67.3</td>
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<tr>
<td>Oil Export Revenues/ Total Revenues (%)</td>
<td>84.2 (84)</td>
<td>83.2</td>
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Notes and Source for Table 2: $=1166 ID; Figures in () represent reported minor modifications to what was originally sent to the Parliament; Original data compiled from budget 2015 Law by this author/ consultant AMJ/ IDC&R

As mentioned above the financial consequences of the security situation, the military activities and related expenses must have had their real impacts on the budget.

Expenditures in the adopted budget could lead to different fiscal breakeven oil price-FBOP: defined as the price of a barrel of oil that reduces the fiscal balance to zero; meaning that oil export revenues and budget expenditures are equal. Hence at a given total expenditures the FBOP depends largely on quantity of exported oil.

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27 Budget Law Nr. 2 was published on *Al-Waqqee Al-Iraqia*, number 4352 on 16 February 2015.
It is important to highlight the significance of FBOP (Blue colored trend-line) because of the high dependency on oil revenues, especially when the assumed non-oil revenue contribution does not materialize.

As the following Chart 9 demonstrates, the FBOP declines as oil export increases. But since export levels are not expected to increase significantly in the short-time (i.e., 2015) the FBOP could be as high as $108/b at the current export level of 2.6mbd (Green colored arrow-left hand side) or $85/b at the budgeted oil export level of 3.3mbd (Black colored arrow-left hand side).

Both FBOP are much higher than the price of $56/b adopted in the budget. Hence, there will be a Fiscal Deficit-FD that decreases as oil export increases. At February export level of 2.6mbd, the annual FD (Red colored trend-line) could be $50 billion (Green colored arrow-right hand side) or $35.3 billion at the budgeted oil export level of 3.3mbd (Black colored arrow-right hand side).

Chart 8
Iraqi Budget 2015
Fiscal Breakeven Oil Price-FBOP ($/b) and Fiscal Deficit-FD ($billion) at different Oil Export Levels (mbd)

Note and source for Chart 8: For each oil export level the FBOP is calculated by dividing total budget expenditures (in $US) on the annual oil export at that oil export level; compiled from budget 2015 Law by this author/consultant AMJ/IDC&R.

On the other hand total fiscal deficit depends, at a given budget expenditures and a given oil export level, on oil price. This is more meaningful and indicative since oil price variation is more possible and frequent than changes in volume of oil export.
Based on the above the following Chart 9 indicates that Iraq suffers from fiscal deficit as long as its oil export price is less than $85.4 a barrel; the further down are the Iraqi oil export price from this benchmark price, the more is the fiscal deficit. However, the country enjoys fiscal surplus if it manages to export it oil at a price over $85.4 a barrel benchmark price; the further up are the Iraqi oil export price from this benchmark price, the more is the fiscal surplus.

**Chart 9**
**Iraqi Budget 2015**
Fiscal Deficit ($billion) at different Iraqi Oil Prices ($/b)

Note and source for Chart 9: For each oil price level the FD is calculated by subtracting total budget expenditures (in $US) from oil export revenues at a given 3.3mbd oil export fixed in the State Budget Law; compiled from budget 2015 Law by this author/ consultant AMJ/ IDC&R

Despite the fact that the budget adopted oil price of $56 is lower by 39% of the average actual oil price for 2014, the approved budget expenditures for 2015 was higher than the “assumed actual spending” for 2014 by 20.3%. In other words instead of been guided by the actual spending of last year or adopting austerity policy to counter reduced revenues, budget 2015 showed different responses to revenue volatility.

A midyear assessment indicates that deficit in actual monthly export revenue was at its peak of $2.471 billion in January 2015 then began declining due to improved oil prices and increase in export quantities (primarily from the southern Iraq) reaching its lowest of $226 million in June when both thresholds for oil exports and prices are approaching the vicinity of what was adopted by the budget, despite the marked reduction of Kirkuk oil due to KRG failure to fulfil its obligations under 2015 budget law.

Anyhow, total deficit in oil export revenues during this six month period reached $6.756 billion; and to reach their breakeven during the second half of 2015 at $56/b, oil export has to
reach 3.959mbd; and even more if oil price falls below this threshold. Moreover, KRG has to deliver through SOMO 800kbd for the entire second of the year to equalize it budgetary obligations. Can Iraq’s production capacity support an export level of such magnitude and can KRG willingness and capacity equalize its legal obligation? Most likely not!

The reduced dependency on oil export, as main source for revenues, to 83% against a historical level of more than 90% is, in essence, “accounting” primarily attributed to resource revenue bust; and should not be interpreted as a positive structural reality caused by non-oil sector contribution. The financing of budget deficit explains such reduced dependency on oil export revenues.

The budget suggests many channels for financing the planed deficit including domestic and external borrowing; “mandatory” savings by state employees; treasury bonds and bills, among others. Domestic borrowing from commercial banks could be much more than what these banks can afford from capital and liquidity perspectives. The Central Bank of Iraq- CBI is forbidden by its law from directly and indirectly lending the government. Thus CBI proposed what has been termed a “triangle scheme”: Iraqi commercial banks will buy government bonds and then sell them to the CBI on secondary markets. 28 Thus, the cash infusion from the CBI will then allow the banks to give more cash to the government, in exchange for more bonds, and so on.29

There is high possibility that this involvement by CBI might compromise its credibility and could impact negatively its policy in stabilizing the Iraqi Dinars. Such a fear can be supported by the decline in the country’s (CBI) Gross Official Reserves has declined from $77.8 billion in 2013 to $69.1 billion in 2014; and the IMF projected further decline to $55.8 billion in 2015.30

On the other hand many Iraqi experts have argued recently for the need to amend CBI Law (56 of 2004) so that it can support the development efforts and needs in addition to currency stabilization and inflation control; and calling for changing the priorities and more coordination between monetary policy, fiscal policy and national development requirements.31

The above analysis exposed the weak management of resource revenues by identifying the most obviously manifestations such as the exhaustion of any surpluses in DFI, the declining in CBI official reserves and increasing budgetary deficits.

Since this fourth question is about how effectively has the government been able to manage the recent drop in oil prices, the scoring answer must be weak from the following: bad, weak,
good or excellent. Rephrasing the question for a Yes or No answer: has the government been able to **effectively** manage the recent drop in oil prices; the answer is **NO**

### Key highlights, challenges and opportunities

The “fire-fighting” approach appears to have been used to deal with circumstantial volatility when it occurs. But once circumstances change and revenues begin to recover the government spending returns back to business as usual; and the “boom-bust” characteristics of revenue flows and their consequences are quickly forgotten.

The experience of 2008 price collapse and their recovery afterward was an outstanding example. The Chairman of the Parliamentarian Finance Committee, Ahmad Chalabi - an advocate of distributing all oil revenues to the citizenry- has admitted recently that Iraq made a mistake by not establishing an oil fund, “We made a major mistake in the past 10 years: when the price of oil was high, we did not use the surplus funds to create a reserve for the country.”

The proposed budget 2014 (not approved yet!) stipulates that any surplus revenue generated during the year would be allocated to the reserves of the Development Fund of Iraq-DFI. That goes without saying when it comes to oil revenues; but the question is does this provision cover the budget surplus resulting from actual spending that lagged behind allocation.

Hence when addressing surpluses it is vital to distinguish between fiscal surplus (actual oil export revenues are more than budgeted oil export revenues) and budget surplus (actual spending are less than budgeted allocation).

Within budget surplus it is important to know the source: investment allocation vs recurrent expenditures; and whether budget surplus resulting from investment spending deficiency are “carried forward” to finance next year budget. If this occurs it indicates to absorptive capacity limitation leading to reallocating investment funding to recurrent consumption. A safeguarding opportunity could be considered by adopting mandatory fiscal rule obliging the government to deposit unspent investment allocation in a special “investment fund” instead of carrying that surplus forward to finance recurrent expenditures.

The mid-term budget strategy proposal of July 2013 was good opportunity and a step in the right direction, but the ad-hoc nature and the failure to develop the initiative further had aborted the entire strategy. Alternatively, this author had proposed earlier a “Coping Strategy”


to manage revenue volatility at different resource-revenue situations; with defined legal framework, institutional structure, policy mandate and operational arrangements. The following table provides summary of scoring for questions addressed in part three of this study.

Table 3
Scoring/ Benchmarking for questions of part three

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<tbody>
<tr>
<td>Does government smooth’s domestic spending of revenues to account for revenue volatility?</td>
<td></td>
</tr>
<tr>
<td>Resource revenue volatility: Is government spending stabilized relative to resource revenues?</td>
<td>NO</td>
</tr>
<tr>
<td>Savings fund: Does government use saving funds efficiently to limit the economic impact of large and volatile resource revenues?</td>
<td>NO</td>
</tr>
<tr>
<td>As a test of its volatility protections, how effectively has the government been able to manage the recent drop in oil prices?</td>
<td>NO</td>
</tr>
</tbody>
</table>

End of Part Three