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Sarp Kalkan[1]
Policy Analyst, Economic Studies

THE TRANSFORMATIVE POWER OF THE TURKISH PRIVATE SECTOR IN IRAQI KURDISTAN

Prime Minister Recep Tayyip Erdoğan's visit to Iraq, which began on March 29, was full of firsts. After the meetings on the first day in Baghdad with President al-Maliki and other central government officials, Erdoğan met with Ayatollah Ali al-Sistani, one of the highest ranking Shea marja in Najaf, and Mesud Barzani, the President of the Iraqi Kurdistan Regional Government (KRG) in Arbil. All three episodes of the visit are of significance for the establishment of political unity in Iraq. However, the visit to the KRG by the Prime Minister is of critical importance for Turkey's economy.

The economic relations between Iraq and Turkey have grown substantially since the overthrow of the Saddam regime. The Iraqi market is currently the fourth biggest export destination for Turkey with exports that amounted to more than US$ 6 billion by 2010. The investments and products of the Turkish private sector are known throughout Iraq. Nevertheless, the KRG has a substantial position within the bilateral relations between Turkey and Iraq. The trade and investment efforts are concentrated in the KRG due to the relative stability of the region.

The objective of this note is to review the economic relations between Turkey and the KRG and lay out the growth potential of the KRG in the coming period. This will enable a clearer understanding of the importance and the potential economic impacts of the visit on the KRG at the Prime Minister level.

[1] http://www.tepav.org.tr/en/ekibimiz/s/1034/Sarp+Kalkan

The transformative character of the bilateral economic relations and trade

The socioeconomic development of the Iraqi Kurdistan Regional Government in the recent period reveals that the region is more advanced than the rest of Iraq. It is possible to talk about three factors that differentiate the KRG from the other regions.

First is the deep-rooted ability of the KRG at self-administration. The first regional assembly in the KRG was established in 1972 while the rest of Iraq was feeling the oppressive nature of the Baghdad administration. Though the regional assembly was abolished under the pressure of the Saddam regime, the tradition of regional government was maintained with the leadership of the Barzani and Talabani families. The infrastructure of the permanent autonomous government was laid down in 1993 after the First Gulf War.

Thanks to almost two decades of experience with self-government, the KRG felt the political instability that arose with the overthrow of the Saddam regime to a relatively limited degree. Ethnic and denominational conflicts were rare and more funds were made available for socioeconomic development.

Proximity to Turkey is another important factor that has enabled a relatively more peaceful development in the KRG compared as to the rest of Iraq. Turkish investors and labor force have undertaken major roles in the restructuring of the KRG. As official figures suggest, by the end of 2010, 740 Turkish firms were operating in the KRG and 20-25,000 Turkish workers were employed in the region.

Turkish contractors and construction materials have been involved in the reconstruction of the region since 2003. However, the investments have been concentrated not only in the construction sector. In the recent period, Turkish funds have been invested in a wide spectrum of sectors, from iron and steel to education.

Moreover, Turkish firms are involved actively in the oil production activities in the KRG region. As of the end of 2010, there were 4 Turkish firms as consortium leaders or partners in 14 out of 40 production licenses. Given that the oil pie is shared by firms from 17 different countries and that US firms have 11 licenses and the British and Canadian firms have 8 licenses each, the success of the Turkish firms becomes even more remarkable.

Turkey's impact on the KRG's economy is not limited to contracting and production investments. Turkish products have a large share in the KRG's consumption expenditures. A substantial proportion of the food products are imported from Turkey. With the opening of modern shopping malls in the region in the recent period, many different Turkish brands, from ready-made clothing to furniture, have given Turkey a dominant place in the KRG market.

This dominance can be traced also in the foreign trade figures. Turkey's exports to Iraq, which was one of Turkey's largest trade partners before the First Gulf War, total approximately US$ 445 million. The bilateral relations that almost evaporated during the wars and embargo periods returned after the collapse of the Saddam regime. As of the end of 2010, Turkey's exports to Iraq exceeded US$ 6 billion. Currently, Iraq is the fourth largest export market for Turkey following Germany, the United Kingdom and Italy.

Table 1. Turkey's Exports to Iraq by Sectors (1989-2010)

Turkey's Exports to Iraq (1989)	USD	%	Turkey's Exports to Iraq (2010)	USD	%
Iron and Steel	165,067,863	37.2%	Iron and Steel	712,130,032	11.8%
Vegetables and Fruit	42,700,622	9.6%	Electrical Mach. Appar.	508,474,530	8.4%
Textile Yarn, Fabric, etc.	40,653,817	9.2%	Cereals, Cereal Preprtns.	501,278,249	8.3%
Electrical Mach. Appar.	16,285,985	3.7%	Non-Metal. Mineral Manfct.	425,350,289	7.0%
Plastics in Primary Form	14,411,247	3.2%	Metals Manufactures	370,272,867	6.1%
Paper, Paperboard, etc.	13,104,226	3.0%	Vegetables and Fruit	337,005,699	5.6%
Metals Manufactures	12,470,533	2.8%	Miscalenaus manufactured products	248,618,230	4.1%
Non-Metal. Mineral Manfct.	10,670,683	2.4%	Furniture, Bedding, etc.	206,854,698	3.4%
Essentl. Oils, Perfume, etc.	10,296,605	2.3%	General Industl. Mach.	183,189,685	3.0%
Non-Ferrous Metals	10,104,143	2.3%	Paper, Paperboard, etc.	173,884,435	2.9%
Plastic, Non-Primary Form	9,088,852	2.0%	Clothing and Accessories	173,362,358	2.9%
Telcomm. Sound Equipm.	9,057,389	2.0%	Textile Yarn, Fabric, etc.	173,206,249	2.9%
General Industl. Mach.	8,777,904	2.0%	Dairy Products, Bird Eggs	155,568,180	2.6%
Cork, Wood Manufactures	8,283,487	1.9%	Essentl. Oils, Perfume, etc.	145,175,807	2.4%
Inorganic Chemicals	7,559,274	1.7%	Plastic, Non-Primary Form	135,355,212	2.2%
Dairy Products, Bird Eggs	6,090,147	1.4%	Meat and Meat Preparations	135,153,602	2.2%
Clothing and Accessories	6,081,955	1.4%	Petroleum, Petr. Products	128,782,078	2.1%
Meat and Meat Preparations	5,941,909	1.3%	Road Vehicles	121,546,113	2.0%
Miscalenaus manufactured products	5,531,035	1.2%	Special. Indust. Machinery	114,807,261	1.9%
Special. Indust. Machinery	5,058,355	1.1%	Electricity	99,724,036	1.7%
TOTAL (1989)	**445,362,940**		**TOTAL (2010)**	**6,042,549,876**	

Source: TURKSTAT, Comtrade

In the same period, Turkey's export basket diversified to a large degree. In 1989, the volume of exports exceeded US$ 10 million only in 10 sectors whereas the number increased to 39 by 2010. Turkey, exporting to Iraq in more than 800 product groups, has become competitive in many sectors in the Iraqi market.

The diversification of the trade pattern and the resultant know-how transfer have brought a gradual transformation in the KRG region. The rapid change in the production patterns also has translated into the social life. In other words, the Turkish private sector has played a key role in the socioeconomic transformation of the KRG. The process of rapid development and transformation is expected to continue in the period ahead.

Rich resources and rapidly-developing consumption demand

The oil revenues have had a major role in the rapid development of Iraq in general and of the KRG in particular. Approximately the entire amount of the KRG's income of US$ 9 billion by the end of 2010 came from 17 percent of Iraq's total oil revenues. Customs taxes constituted the second most important source of income.

The mentioned resources have been allocated broadly as per the 70-30 rule, according to which 70 percent of the budget goes to current expenditures and 30 percent goes to investment expenditures. In 2010, US$ 5.6 billion was allocated for current expenditures and US$ 3.5 billion was allocated for investments. Out of this amount, US$ 1 billion was used for new projects and US$ 2.5 billion for ongoing projects.

There are 2,472 ongoing public investment projects, amounting approximately US$ 9 billion. Private sector investments concentrated in the housing sector are estimated to be around US$ 13 billion.

A majority of the current expenditures that constitute a substantial proportion of the budget expenditures go to personnel payments and social assistance payments. Personnel payments go to war veterans and the families of martyrs as well as currently employed personnel. This way, a system in which one person is entitled to an income via more than one channel and in which the majority of the citizens are entitled to some wage is established.

Social assistance payments have a broad coverage. Food and the basic needs of all citizens are financed through public resources. To support housing, hundreds of billions of dollars have been transferred to the housing fund in addition to free land provisions.

The public assistance and expenditures bring about a dynamic consumption demand. There also exists a political preference to improve the life quality. The shopping malls and other social recreation areas newly opened in Arbil, Sulaymaniyah, and Duhok constitute good examples of this. The rapid growth in consumption demand has enabled the KRG to become a center of attraction in a short span of time, whereas it has affected adversely the establishment of a working culture and the development of a market-based competitive environment.

Budget revenue estimations are of significance with respect to the sustainability of consumption demand. According to the 2011 budget that was submitted to the regional assembly in March due to the delay in the preparations of the central government budget, budget revenues and budget expenditures stand at US$ 10.5 billion and US$ 11.8 billion, respectively. Budget revenues are calculated on the basis of the assumption that the per barrel oil price will be $ 76.5 on average in 2011. In light of the recent hike in oil prices, a leap in the budget revenues can be expected.

As the National Development Plan for the 2010-2014 period suggests, the total budget revenues of Iraq are expected to increase from US$ 58 billion to 83 billion in the 2011-2014 period. It is estimated that in the same period the budget revenues of the KRG will increase from US$ 10 billion to 14 billion.

Table 2. Iraq Central Budget and KRG Budget Estimates

USD		Oil Price	Oil Revenues	Other Revenues	Total Budget Revenues	KRG's Budget Revenues
Nat. Devel. Plan (2011-2014)	**2011**	63	52,889	4,810	57,699	9,809
	2012	68	62,050	5,431	67,481	11,472
	2013	68	69,496	5,852	75,348	12,809
	2014	68	76,942	6,329	83,271	14,156
TEPAV's Revized Projections	**2011**	105	88,148	4,810	92,959	15,803
	2012	105	95,813	5,431	101,243	17,211
	2013	105	107,310	5,852	113,162	19,238
	2014	105	118,808	6,329	125,136	21,273

Source: National Development Plan of Iraq (2010-2014), TEPAV Calculations

The budget revenues of Iraq and KRG are re-estimated in Table 2 in tandem with the recent rise in oil prices and the expectations that the prices will remain high in the long term. According to this, the budget revenue of the KRG might reach as high as US$ 15.8 billion in 2011. Budget revenues might increase to US$ 21 billion by 2014, which implies that the consumption potential of the KRG might double the level in 2010 in as short a period as 4 years.

Political stability is important; but there exists a sound agreement on fundamental principles

The sustainability of the political stability is a critical prerequisite for seizing the mentioned potential and for the Turkish private sector to increase its activities in Iraq in general and in the KRG in particular. Political instability in this context can be analyzed in two respects.

First is the political instability across the Kurdish Regional Government. The uniting of forces by the KDP led by the Barzani family and the PUK led by the Talabani family, the two most powerful actors in the region, following years of power struggle is of significance for the establishment of stability in the region. Nevertheless, it appears that it will take long time to overcome the memories of the conflict period. Though unity appears to have been secured at the senior administration level, the province of Arbil-Duhok differs from that of Sulaymaniyah when one moves from the top to the bottom.

The Gorran (Change) List winning almost half of the votes in Sulaymaniyah in the 2009 election is a clear example to this. Furthermore, the protests recently initiated by the Gorran List in Sulaymaniyah have tended to spread towards the other regions of the KRG. The protests against economic problems including corruption, poverty and unemployment as well as against antidemocratic practices do not represent the demands for a change in the regime unlike in other regions of the Middle East. The protests do seek to alter actors or practices within the boundaries of the existing order.

Another factor that raises the risk of instability in the KRG is related to the questions about who the third prime minister of the region will be. In the period of the first Prime Minister, Nechervan Barzani, a number of sound reforms for restructuring were initiated. Infrastructure and town planning works were accelerated and the transformation to a market-friendly economic setting was ensured. In the following period, Barham Salih from PUK assumed the office of Prime Minister. Although reforms slowed down in Saih’s period, steps were taken to strengthen public administration and human capital as well as to sustain the rule-based climate.

One of the biggest questions now is who of the KDP will replace Barham Salih in the next period. However, whoever the prime minister is, it is critical that there remain a mature judgment that the region will embrace an economic growth model based on the market economy, opened to the west and seeking close relations with Turkey.

The second important factor that might risk the stability across the KRG is the relations with the Iraqi central government. The delay in the establishment of the central government last year in particular has brought a standstill to the KRG’s oil exports, pushing the region into financial difficulties. After the establishment of the central government, it was decided in February 2011 that the KRG would restart oil exports.

The future of the relations between the central government and the KRG are prone to conflicts in three domains. The first is about the sharing and determination of oil revenues. It is expressed that the level of oil production and the volume of exports in the territories under the control of the two parties are not transparent. The second issue concerns the long-debated population census and the re-setting of the principles of income sharing in this regard. There is a risk that conflicts might arise if the share of KRG in revenues, currently at 17 percent, is increased or decreased. Conflicted territories constitute the third risk domain. The fact that the KRG seeks to involve a number of regions, Kirkuk to begin with, into its territories has the potential to trigger conflicts between the KRG and the central government.

Despite all of the risks of political instability facing the KRG, there remains a strong belief that the region will manage to maintain stability. The critical assumption here is that even if the actors change, the approach that takes market-friendly modern democracy as the reference point will prevail. The steps the KRG has taken in the last two decades and the economic reforms launched after 2003 in particular imply that the mentioned assumption is a sound one.

Remarkable improvements observed in the investment climate

As summarized above, the KRG achieved remarkable progress in terms of the transition to the market economy after 2003. Particularly the steps taken as of 2006 during Nechervan Barzani's term in the office played an important role in this transformation. Similar to Turkey's attempts to integrate into the global economy in the 1980s with Özal's reforms, the KRG has established a healthy structure over the last five years despite all the elements of instability that are unique to the region.

The investment law that was enacted in July 2006, only 4 months after Nechervan Barzani assumed office, lies at the heart of this achievement. The law, introduced by the Kurdistan Board of Investment as the "most investor-friendly law in the region", ensured a more liberal framework compared to the central legislation of Iraq.

The law stipulated that foreign investors and domestic investors would be treated equally in the eyes of the law. Foreign investors were granted the legal rights to own the entire stake of any project, to buy land for investment purposes and to transfer the profits and interests of his capital abroad.

Apart from these, the law allowed project-based investment incentives. According to this, an investor with an authorized project could benefit from land allocation free of charge and would be entitled to tax exemptions for 10 years starting from the date of production. In addition, imported investment goods and intermediate materials were exempted from customs duties for 10 years.

Efforts towards the enhancement of the investment climate in the KRG are not limited to the investment law and incentives. Remarkable improvements also have been achieved with respect to the rule of law and the efficiency of judicial processes. The rights of business people who carry out activities in line with the relevant legislation and that bind their activities with rules and contracts are under legal protection. However, it is not possible to talk about legal protection for Turkish business people who carry out small/medium scale and generally non-contracted commercial activities.

On the other hand, the above-mentioned enhancements must not be interpreted as the establishment of a completely transparent public procurements and investment system. Close relationships with the senior administrators still bring advantage in the tender and implementation processes. In this line, it is a commonly voiced argument that many influential public administrators take common action with foreign investors. This reveals that the rule of law has not matured completely in the region yet. Nevertheless, this is not an unfamiliar environment for Turkish firms, which could create an advantage for them against international rivals.

Severe constraints in the investment climate prevail

Despite all these positive developments, it is not possible to talk about a healthy investment climate in the KRG region. Severe constraints are observed particularly in attracting investments in the industrial sector.

The first impediment to investment is the lack of enough electricity to support production. Daily electricity usage increased from 2 hours in 1991 to 14-16 hours. Efforts being made to improve capacity rapidly via 11 production and 96 distribution stations installed over the last decade. But the rapid increase in production will fail to meet the rise in the demand. In 2011, US$ 533 million, corresponding to 60% of the new project budgets, are allocated for electricity production; however, it appears that the electricity shortage problem will not be overcome in the short term. Waste of electricity at substantial levels also has a role in the failure to meet the electricity demand despite the rapid increase in production. Electricity was provided free of charge for a long time, which plays a significant role in the escalation of its waste.

The second important impediment to investment is the lack of a qualified labor force. That the region lived in conflicts in the last 20-30 years has substantially weakened the education infrastructure. The recent attempts have enabled a considerable improvement in the education infrastructure. In 1991, 1,320 schools provided education to 550,000 students, whereas in 2010 the number of schools and the number of students reached 5,500 and 1,400,000, respectively. A total amount of US$ 220 million transferred via two projects aims to increase both the number of schools and the number of students who hold master's degrees.

However, the current skills set of the labor force remains far from fulfilling those required by the industrial and services sectors. Moreover, substantial social assistance schemes push up the cost of even unqualified labor. Another important challenge regarding the labor force is that the working culture is not matured due to the lack of the habit of continuous employment. Daily working hours are quite low, affecting the labor productivity adversely.

Problems with the banking system constitute another major source of investment climate challenges. Despite the tens of million dollars of trade volume the region enjoys, there exists no healthy payment mechanism that meets international standards. A large proportion of trade transactions are carried out in cash. Due to the absence of letters of credit and guarantee letter mechanisms, Turkish exporters have to export goods via open account schemes, which push up the risks facing them.

In the recent period 4 Turkish banks (Ziraat, İş, Vakıf and Al Baraka) have accelerated efforts to open up branch offices in Arbil. Moreover, HSBC Bank has bought the majority shares of a domestic bank. Nevertheless, despite these, it appears that it will take quite a long time to effectuate the system and spread it throughout the entire economy.

Improvement of the bilateral relations is of critical importance for the Turkish private sector

As stressed above, the bilateral relations between Turkey and Iraq have been growing continuously. The trade relations between the Iraqi Kurdistan and Turkey and the investments of the Turkish private sector in the region play significant roles in the transformation of the KRG. Estimates that the oil revenues of Iraq will increase in the future indicate that Iraq will become a more important market for Turkey.

The visit to Iraq and to Iraqi Kurdistan in particular at the Prime Minister level is of critical importance for the enhancement of bilateral economic relations between Turkey and Iraq. The advance in economic relations with Iraq so far has been enabled via the initiatives of the private sector, preventing Turkey from undertaking the desired role, especially in large investments. With the right steps to be taken in the future, the two countries can work together on the investment plans and large Turkish investors will be able to enter the Iraqi market more easily.