MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

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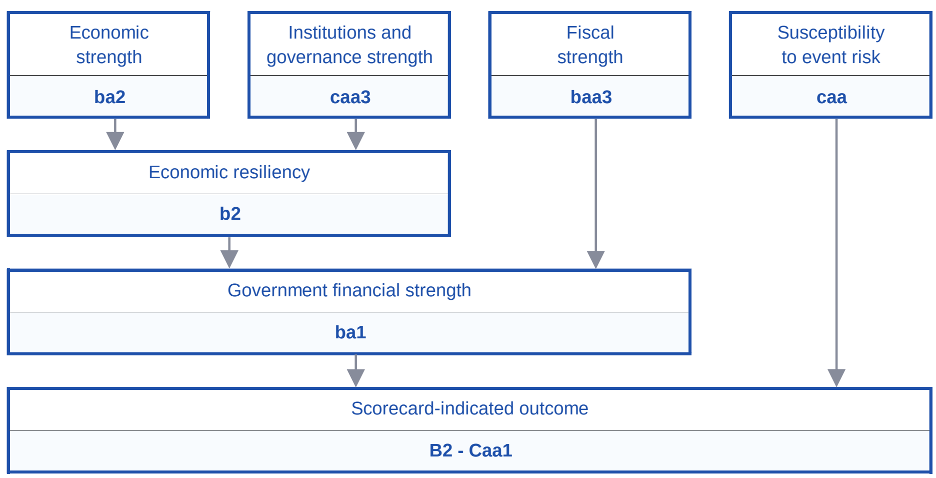
Government of Iraq – Caa1 stable

Regular update

Summary

Our credit view of Iraq reflects credit challenges posed by very weak institutions and governance that weigh on the economy's competitiveness, limit policy effectiveness and constrain the government's capacity to respond to domestic and external shocks. Iraq's economy, government finances and external accounts rely heavily on the hydrocarbon sector, exposing the sovereign to significant carbon transition risks, which we capture in our very highly negative environmental risk assessment. Weaknesses in Iraq's institutions and the economy's heavy concentration in the hydrocarbon sector are further exacerbated by the country's inherently high exposure to domestic political and geopolitical event risk. High youth unemployment and inadequate access to basic public services elevates the risk of sociopolitical unrest.

Exhibit 1
Iraq's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Relatively large, but undiversified, economy with substantial hydrocarbon wealth;

» Growth potential, including in oil production capacity, hampered by low competitiveness;

» Foreign-currency reserves providing a robust buffer to external shocks

Credit challenges

» Weak institutions, governance challenges and limited progress on structural reforms;

» High fiscal and economic vulnerability to declines in oil prices and exposure to carbon transition risks;

» Inherently very high sociopolitical and geopolitical event risks.

Rating outlook

The stable outlook indicates that upside and downside risks to Iraq's creditworthiness are broadly balanced. Higher global oil prices have driven a significant turnaround in Iraq's fiscal and current accounts, after the large twin deficit recorded in 2020. However, the current upswing in oil prices as well as the fractured political system will limit momentum on reforms that would reduce the vulnerability of the public finances to future oil price declines.

In the medium term, upside risks stem from the government's plans to increase oil production capacity to 7-8 million barrels per day (mbpd) by 2027 from less than 5 mbpd currently. Such an expansion would support Iraq's growth and its fiscal and export revenue generation capacity. However, the upside risks associated with the plans are dampened by the uncertainty around the outlook for global oil demand, which may constrain the capacity of Iraq to translate higher production capacity into actual higher production, given Iraq's commitments under its membership of the Organization of Petroleum Exporting Countries (OPEC). Furthermore, Iraq's persistent governance and political stability challenges will continue to hinder investment and participation from international oil companies in the oil and gas sector expansion, which will make it challenging to achieve higher production rates at existing mature oil fields.

Factors that could lead to an upgrade

Over the medium term, signs that Iraq's institutions are strengthening, with material improvement in governance, control of corruption, management of public finances and overall policy effectiveness, would support an upgrade. Such improvements would likely be reflected in a strengthening of the sovereign's fiscal metrics, independent of fluctuations in oil prices, stemming from the implementation of structural measures that reduce the level and increase the efficiency of public spending. An improvement in Iraq's institutions would likely take place in the context of a lasting easing of domestic political and geopolitical tensions.

Factors that could lead to a downgrade

Given the already low rating, a downgrade would likely reflect our view that risks of a government default on private sector-held debt and the related losses for investors are rising. This would most likely arise if the government was unable to implement significant consolidation measures in order to avoid depletion of its foreign currency buffers in the face of significantly lower oil prices. A material increase in domestic political tensions and/or violence that would threaten to disrupt oil production and interfere with the government's ability (or willingness) to collect revenue and service its debt would also increase the likelihood of a downgrade.

Key indicators

Exhibit 2

Iraq [1]	2017	2018	2019	2020	2021	2022E	2023F	2024F
Real GDP (% change)	-3.4	4.7	5.8	-15.7	7.7	8.1	3.3	3.1
Inflation rate (% change average)	0.2	0.4	-0.2	0.6	6.0	5.0	4.0	2.9
Gen. gov. financial balance/GDP (%)	-1.5	7.8	0.8	-12.7	-0.4	6.7	-2.2	-5.4
Gen. gov. primary balance/GDP (%)	-0.5	9.1	1.8	-11.5	0.1	7.6	-1.3	-4.6
Gen. gov. debt/GDP (%)	60.6	47.7	45.2	77.4	58.8	44.4	45.1	49.5
Gen. gov. debt/revenues (%)	175.9	121.5	125.7	269.2	161.3	104.2	109.9	126.0
Gen. gov. interest payment/revenues (%)	2.9	3.4	2.8	4.1	1.4	2.1	2.2	2.2
Current account balance/GDP (%)	-4.8	4.4	0.5	-10.0	7.7	16.9	7.5	4.0
External debt/CA receipts (%)[2]	103.4	70.2	73.4	130.3	85.2	39.1	43.6	45.2
External vulnerability indicator (EVI) [3]	2.0	2.0	1.7	3.1	5.2	8.0	5.7	3.4

[1] Economic forecasts based on an assumed average price for the benchmark Brent crude oil of $85/b in 2023 and $83/b in 2024. Our broad expectations are that prices will remain volatile within a range of $50-$70/b in the medium term.
[2] Current Account Receipts
[3] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves

Source: Moody's Investors Service

Detailed credit considerations

Our "ba2" assessment of Iraq's **economic strength** balances its size and ample natural resources endowment against volatile economic growth, inadequate infrastructure and the economy's lack of diversification. We have adjusted the score down from the initial score of "baa3" to reflect the damage caused to Iraq's productive capacity and infrastructure by several years of armed conflict, which limits the economy's competitiveness and flexibility and constrains its capacity to grow more rapidly and diversify away from its high concentration in the oil and gas sector.

Iraq's proven oil reserves are the fifth-largest in the world, which at current levels of production would last approximately 87 years. Iraq also holds significant gas reserves, which are estimated at almost 5% of proven gas reserves in the Middle East. However, the country's hydrocarbon wealth remains underexploited due to many years of armed conflict, international sanctions and an inadequate level of investment in the oil and gas sector. Infrastructure and technology constraints prevent Iraq from being able to take full advantage of its natural resources wealth, limiting its oil production capacity to below five million barrels per day (mbpd). Moreover, the Iraqi economy's heavy reliance on this sector exposes it to significant carbon transition risk as the global economy moves to reduce its carbon emissions.

Despite its significant potential for growth and development, Iraq's actual growth performance over the past several years has been very volatile, in part due to the economy's very high concentration in the oil sector. Furthermore, a poor security situation, very weak business environment and challenges with regards to electricity supply have constrained growth in the non-oil sector.

Our "caa3" assessment of Iraq's **institutions and governance strength** reflects significant institutional challenges and very weak policy effectiveness. Iraq's quality of institutions is very poor, as highlighted by its very weak performance in the Worldwide Governance Indicators (WGI). Iraq's WGI scores are among the weakest of the countries we rate and well below both the B- and Caa-rated medians. Iraq also continues to score among the worst countries on corruption indicators. Furthermore, it ranked 157th in the Transparency International Corruption Perceptions Index 2022, which positions Iraq in the bottom quintile of the 180 countries surveyed.

Widespread corruption, lack of transparency and accountability at every level of government, and poor public services delivery – the latter of which we capture in our social risks assessment score for Iraq – have contributed to deep popular dissatisfaction with the authorities. Many years of armed conflict have led to public underinvestment in basic physical and social infrastructure and housing supply because the government prioritized security spending. However, spending has also been constrained by concerns over potential misappropriation of public funds and weak capacity to manage and implement projects. Furthermore, corruption has weakened the efficiency of public services distribution.

Iraq's fiscal policy is highly reactive, structurally constrained by low tax collection, and highly vulnerable to oil price declines, with oil revenues accounting for around 90% of total government revenue. The government's ability to manage public finances is limited. For example, capital expenditure is systematically under-executed, while the structure of current spending is highly rigid with wages and pensions accounting for two-thirds of the total. Government accounts are opaque, and fiscal and macroeconomic data have significant shortcomings relative to most other sovereigns. While detailed monthly oil sector data is available, the analysis of the non-oil sector is hampered by the lack of reliable higher-frequency activity indicators and quarterly expenditure-side national accounts data. Quarterly balance of payments data is only available with very significant lags and significantly understate imports. Historical current account and fiscal balance statistics published by the authorities are substantially different from those estimated and published by the IMF.

Our “baa3” assessment of **fiscal strength** balances a moderate debt burden and relatively favourable composition of government debt against Iraq's very high fiscal vulnerability to declines in global oil demand and prices. The score is four notches below the initial score of “a2”, in part to reflect this very high sensitivity, underpinned by an exceptionally high share of oil revenue in total government revenue as a share of GDP. This vulnerability has led to large fiscal deteriorations following the previous oil price shock in 2015-16 and during the 2020 oil shock triggered by the pandemic. Moreover, government guarantees – mostly in the electricity sector - and other non-financial sector contingent liabilities present fiscal risks.

Moreover, 35%-40% of government debt at the end of 2020 consisted of domestic long-term debt held by the central bank or the state-owned commercial banks. While supporting Iraq's strong debt affordability metrics, the prominent use of quasi-fiscal operations further increases contingent liabilities and highlights constraints to fiscal flexibility, which we also reflect in our assessment. Our assessment also incorporates Iraq's high share of foreign-currency debt. That said, the composition of external government debt is favourable, with more than a third of total public debt at the end of 2020 representing unresolved (and, hence, currently not serviced and paying no interest) external arrears to non-Paris club creditors.

An inherently very high level of political risk governs our assessment of Iraq's **susceptibility to event risk**, which is “caa”. The political situation is complex, and domestic and geopolitical risks are relatively closely intertwined, reflecting ethnic and sectarian divisions and Iraq's exposure to regional tensions. Notwithstanding the Iraqi army's successes in the campaign against ISIS in 2017, the country still faces very significant challenges that stand in the way of a lasting and significant improvement in security conditions.

Delays in government formation following both the 2018 and October 2021 general elections are a crystallization of the country's very high domestic political risks, as are widespread and violent protests throughout 2019 and 2020 against the lack of employment opportunities, widespread corruption and poor delivery of public services – which we capture under our social risk assessment framework and are reflected in our S-5 assessment. Political instability also weighs on policy effectiveness. It has held back structural reforms and led to a reversal of the fiscal consolidation achieved during 2016-17 under the last IMF programme, which went off track and expired without achievement of the key reform targets.

Domestic political risks are augmented by the absence of a full reconciliation between the federal government and the autonomous Kurdistan Regional Government. Iraq is also significantly exposed to multiple geopolitical risks, including any renewed escalation in geopolitical tensions in the Persian Gulf that threaten disruptions to the maritime transport routes through the Strait of Hormuz, on which Iraq depends for most of its oil exports. Iraq's susceptibility to rising geopolitical tensions is heightened by its extensive economic, military and political links with Iran, even as the government strives to maintain a good relationship with Saudi Arabia (A1 positive) and hosts United States (US, Aaa stable) military bases on its territory.

In terms of other potential event risks, we set Iraq's government liquidity risk at “b” to reflect the government's very narrow range of funding sources, as demonstrated during 2020, when the government was unable to access external borrowing and domestic borrowing came at the cost of erosion of central bank foreign currency reserves. The restructuring of domestic debt held by public sector banks, including the central bank, during 2020 has significantly reduced the size of the government’s gross borrowing needs. However, this near-term benefit is offset by a further deterioration of the financial health of state-owned banks and will increase the size of the future contingent liabilities stemming from an already weak banking system.

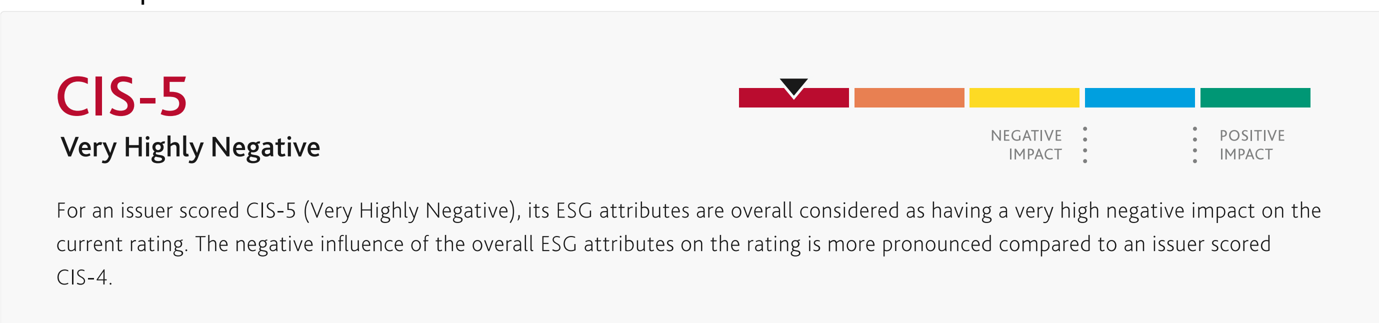
We set Iraq's banking sector risk at “b”, below the initial score of “ba” to reflect a very high concentration of banking assets in two state-owned banks that are undercapitalized, and saddled with large exposures to loss-making state-owned enterprises. Our banking sector risk assessment stems from the potentially significant contingent liabilities for the government from the state-owned Rasheed and Rafidain banks, which account for over 70% of banking sector deposits and more than 50% of all credit, although the size of these liabilities cannot be accurately estimated prior to a long-overdue international audit which in turn is hampered by a slow implementation of core banking systems that make take several more years to complete.

We assess Iraq's external vulnerability risk at “ba”, which highlights the sensitivity of the current account balance to fluctuations in oil prices and is set against robust, but volatile, central bank foreign currency reserves. Iraq's external vulnerability – measured by the adequacy of central bank reserves to meet upcoming cross-border debt repayment obligations – has declined significantly since 2003 due to accumulated foreign exchange reserves and a restructuring of Iraq's external debt. Foreign currency reserves (excluding gold and SDRs) fell during the pandemic but are now being rebuilt and have reached very robust levels, equivalent to close to ten months of imports of goods and services in 2022. The central bank avoided an even larger reserve erosion during the pandemic by allowing the peg of the Iraqi dinar to the US dollar (maintained effectively unchanged since 2008) to devalue by 23% in December 2020, but has since partially rolled this back through a revaluation in February 2023.

ESG considerations

Iraq's ESG Credit Impact Score is Very Highly Negative CIS-5

Exhibit 3
ESG Credit Impact Score



Source: Moody's Investors Service

Iraq's ESG Credit Impact Score is very highly negative (**CIS-5**), reflecting its very highly negative exposure to environmental risks, very highly negative exposure to social risks, and very weak institutions and governance, which will hamper the sovereign's ability to respond to negative environmental and social trends.

Exhibit 4
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

Iraq's very highly negative exposure to environmental risks, reflected in its **E-5** issuer profile score, mainly relates to carbon transition risk (scored 5) due to its economic and fiscal dependence on the hydrocarbon sector, but also water management (4) and physical climate risk (4). Poor management of the hydrocarbon sector and chronic underinvestment in oil and gas infrastructure offset advantages presented by very low hydrocarbon production costs. Iraq is among the world's most arid countries and its water stress levels are exacerbated by poor management of water resources and chronic neglect of water infrastructure, which has limited the potential of the agriculture sector and eroded the population's access to safe drinking water.

Social

Exposure to social risks is very highly negative (**S-5** issuer profile score). Iraq's social risks are broad based, related first and foremost to health and safety (scored 5), followed by access to basic service (4), education (4), housing (4), and labour and income (4). A major source of pressure arises from the labour market due to elevated unemployment, especially among the youth, and the current and expected rapid population growth. Social risks are further exacerbated by inadequate access to basic public services, including healthcare, education and housing, Iraq's poor security situation, and unsettled sectarian and ethnic tensions.

Governance

Iraq's weak track record of fiscal policy effectiveness, its weak executive, legislative and judiciary institutions, and its weak control of corruption are captured by a very highly negative **G-5** issuer profile and presents the key impediment to the sovereign's ability to adjust to adverse social and environmental trends and future shocks.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the “Detailed credit considerations” section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

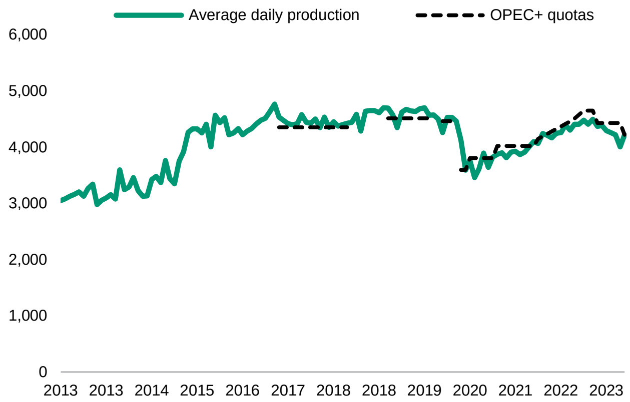
Recent developments

Growth and current account surplus will moderate as oil prices gradually decline from 2023 onwards

Elevated global oil prices have supported Iraq’s post-pandemic recovery and allowed a rebuilding of external buffers over 2022. We estimate that growth reached 8.1% in 2022, supported by a 12.7% increase in crude oil production to an average of 4.5 million barrels per day (mbpd). Crude oil export revenues reached a record $115.6 billion (44% of estimated 2022 GDP), up by 53% from the previous year. Notwithstanding much higher imports as a result of high global commodity prices, we estimate that Iraq posted a current-account surplus of more than 16% of GDP last year, helping to drive a significant recovery in the Central Bank of Iraq's foreign exchange reserve position. Foreign-exchange reserves (excluding gold and SDR) stood at $94.3 billion in January 2023 - equivalent to around ten months of imports - from $58.2 billion at the end of 2021.

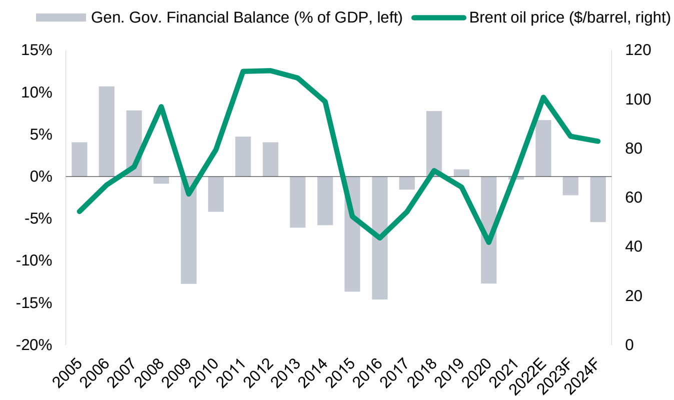
We expect Iraq’s economy to grow at a more moderate pace this year and next, as oil revenue gradually declines and Iraq's underlying socioeconomic fragilities and business environment challenges constrain the growth potential of the non-oil sector. Under the April 2023 OPEC+ agreement, Iraq will voluntarily reduce its oil production by 211,000 mbpd from May until the end of the year. We assume that oil prices will average $85/barrel in 2023 and $83/barrel in 2024, which combined with a continued high import bill and the impact of the February 2023 dinar revaluation will drive a narrowing of the current account surplus to around 4% of GDP by 2024.

Exhibit 5
Oil production has fallen in line with the tightening of OPEC+ quotas
Thousands of barrels per day (tbpd)



Source: Haver Analytics, OPEC, National authorities and Moody's Investors Service

Exhibit 6
We expect a return to Iraq's traditional pro-cyclical fiscal policy
General Government financial balance (% of GDP, left); oil price (right)



Note: Moody's forecasts for 2023 and 2024.
Source: IMF, Haver Analytics and Moody's Investors Service

The 2023 draft budget points to a return to Iraq's traditionally pro-cyclical fiscal policy

Higher global oil prices also drove a significant turnaround in the fiscal account in 2022. The absence of an approved budget for 2022, owing to the political deadlock during that year, also constrained the use of the revenue windfall. Despite a 48% increase in annual terms in central government revenue (as reported by the Ministry of Finance) in 2022, expenditure rose by only 14% in nominal terms. This was in spite of support measures adopted in June 2022 under the "Emergency Law on Food Security and Development" allowing additional spending of ID 22.2 trillion (5.8% of GDP) on food and energy subsidies, agricultural subsidies, increase in the wage bill and other social assistance.

However, an expansionary triennial budget for 2023-25 currently being reviewed by parliament, combined with the partial reversal of the 2020 exchange rate devaluation implemented in February 2023, point to a return to Iraq's traditional pro-cyclical policy mix. Combined with declining oil prices, we expect fiscal metrics to see a steady renewed deterioration over our medium-term forecast horizon. We forecast that Iraq will register a fiscal deficit of 2.2% of GDP in 2023 (from our estimate of a surplus of 6.7% of GDP in 2022), that will continue to widen in the coming years to 5.4% of GDP in 2024. The draft budget calls for total spending of IQD199 trillion (53% of GDP) at the federal level in 2023, although given the late timing and Iraq's systematic under-execution of capital spending we expect this to be only an indicative target.

We forecast Iraq's debt burden to increase again from this year, after a sharp reduction from the 2020 peak. In our projections, the debt ratio will reach close to 50% of GDP by the end of 2024 (from our estimate of 44.4% in 2022). The government's financing needs are expected to be almost entirely met from domestic sources, through central bank financing and funding from the state-owned commercial banks.

Moody's rating methodology and scorecard factors: Iraq - Caa1 stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				**baa3**	**ba2**	**50%**
Growth dynamics	Average real GDP growth (%)	2018-2027F	2.4	baa3		25%
	MAD Volatility in Real GDP Growth (%)	2013-2022	2.8	b3		10%
Scale of the economy	Nominal GDP ($ billion)	2022	264.2	a2		30%
National income	GDP per capita (PPP, Intl$)	2022	12,322.3	ba1		35%
Adjustment to factor 1	*# notches*				-2	max ±9
Factor 2: Institutions and governance strength				**caa3**	**caa3**	**50%**
Quality of institutions	Quality of legislative and executive institutions			ca		20%
	Strength of civil society and the judiciary			ca		20%
Policy effectiveness	Fiscal policy effectiveness			ca		30%
	Monetary and macroeconomic policy effectiveness			caa		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				**b1**	**b2**	
Factor 3: Fiscal strength				**a2**	**baa3**	
Debt burden	General government debt/GDP (%)	2022	44.4	a2		25%
	General government debt/revenue (%)	2022	104.2	aa2		25%
Debt affordability	General government interest payments/revenue (%)	2022	2.1	aa1		25%
	General government interest payments/GDP (%)	2022	0.9	aa1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			-3	-4	max ±6
	Debt Trend - Historical Change in Debt Burden	2014-2022	10.6	0	0	
	Debt Trend - Expected Change in Debt Burden	2022-2024F	5.1	-1	-1	
	General Government Foreign Currency Debt/ GDP	2022	23.8	-2	-2	
	Other non-financial public sector debt/GDP	2022	0.7	0	-1	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2022	1.9	0	0	
Other adjustment to factor 3	*# notches*				-3	max ±3
F1 x F2 x F3: Government financial strength				**baa3**	**ba1**	
Factor 4: Susceptibility to event risk				**caa**	**caa**	Min
Political risk				caa		
	Domestic political risk and geopolitical risk			caa		
Government liquidity risk				b	b	
	Ease of access to funding			b		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				ba	b	
	Risk of banking sector credit event (BSCE)	Latest available	caa2	caa-c		
	Total domestic bank assets/GDP	2022	--	<80		
Adjustment to F4 BSR	*# notches*				-1	max ±2
External vulnerability risk				ba	ba	
	External vulnerability risk			ba		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				**B1 - B3**	**B2 - Caa1**	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

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