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Macro-Economic Distortion and Competitiveness of Iraqi Agriculture

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Macro-Economic Distortions and Competitiveness of Iraqi Agriculture

This paper describes major macro-economic distortions that reduce the competitiveness of Iraqi agriculture in the domestic foodstuffs market.[1]

Since the early 1990's, Iraqi Agriculture has been unable to compete with neighboring countries in domestic and international markets. Prior to that, commercial agriculture in Iraq supplied both domestic and export markets, albeit with the support of major direct public investment, as well as heavy input and output subsidies. Agriculture now is characterized by low output and productivity, weak and discontinuous product value chains with high transaction costs, total or major losses of domestic and export market shares for foodstuffs produced (or that were produced) in Iraq, and a downward spiral of de-capitalization and impoverishment.

Steadily expanding foodstuffs demand by a growing population of Iraqi consumers presents an opportunity for the agricultural sector to respond to expanding domestic demand, as well as to begin to displace current foodstuffs imports, especially of fresh produce. To become competitive with imported fresh produce in which it has potential comparative advantage, Iraq must adopt policies and prioritize public sector investments that provide incentives for commercial farmers and agribusiness enterprises to invest sufficiently in technological and managerial modernization that achieves productivity levels and transaction efficiencies equivalent to worldwide competitors.

Establishing such a policy climate is a necessary but not a sufficient condition to be competitive. In addition to the need to improve factor use efficiencies to world standards, Iraq must address three specific macro-economic investment and policy distortions that negatively impact the ability of Iraqi agriculture to compete with imports in domestic markets.

Overvalued Exchange Rate and Currency Value Distortions

An overvalued exchange rate caused by overwhelming dependence on oil exports for foreign exchange and public revenues results in increased costs and decreased returns (in dollar equivalence) to Iraqi agribusinesses, as compared to agribusinesses in competing neighboring countries. In effect, the overvalued exchange rate amounts to an implicit tax on domestic production, including agriculture. It is estimated that from 2004 to 2009, the Iraqi Dinar has been 35% overvalued as compared to Iranian currency, and 18% overvalued as compared to Syrian currency.

This high implicit tax burden discourages private sector investment in economically productive activities in Iraq.

[1] As compared to neighboring countries exporting agricultural products to Iraq, e.g., Iran, Jordan, Saudi Arabia, Syria and Turkey. The term "Iraqi agriculture" is used here to refer to all commercial activities along the various agricultural product value chains from input supply to the final consumer of output.

Opportunity Cost of Capital

As a means to reduce inflationary pressures, the Central Bank of Iraq (CBI) offers attractive interest rates for unlimited deposits in the CBI. Interest rates offered have been reduced from a high of 18% in 2008, to 9% in 2009, and currently are at 6% in 2010. However, even at the current rate of 6%, since such deposits carry no risk, many banks in Iraq prefer to deposit a significant portion of their funds in the CBI rather than lending to commercial enterprises. Furthermore, banks in Iraq have little recent experience in agricultural lending, and profitability of agricultural enterprises is highly uncertain. Thus, agricultural lending is avoided except when there is overlapping ownership/control of the bank and the agricultural enterprise.

Central banks in neighboring countries do not offer this no-risk option to depositors. Additionally, neighboring country financial systems are better developed, business and non-business risks and uncertainties are lower, and agricultural lending is institutionalized. This translates into capital rationing in Iraqi agriculture relative to agriculture in neighboring countries. Iraqi investors are discouraged from investing in agribusinesses because they cannot leverage debt capital with their equity investment.

Energy Reliability and Costs

For many agribusiness operations, lack of reliable grid electricity means that agribusiness owners must invest in and pay maintenance and operating costs for stand-by generating equipment. This greatly increases real costs that Iraqi agribusinesses must pay for electricity. Although Iraq and neighboring countries all heavily subsidize grid electricity, unlike its neighbors who provide reliable grid electricity 24/7, grid electricity in Iraq is available only sporadically, requiring agribusiness owners to privately generate 25-50% of their total electricity requirements, often using (unsubsidized) imported fuel.

For agribusiness operations requiring high amounts of thermal energy (e.g., many types of food processing), Iraq must rely on imported diesel/bunker fuel to heat boilers, etc. While its neighbors generate thermal energy from cheaper and more efficient natural gas, most of Iraq's plentiful supply of natural gas is burned off at the well-head.

Iraq's high energy costs impose extraordinary costs on many agriculture-related operations. To illustrate, it is estimated that, depending on the particular circumstances, irrigation water pumping can cost from $140 to $440 per hectare. This adds from 2% to 8 % to Iraqi per hectare costs of production as compared to neighboring countries (Turkey, Syria, Jordan and Iran). The cost burden is even more onerous if producers must rely on unsubsidized diesel fuel.

Agricultural enterprises that have high energy requirements are especially impacted, e.g., cold storage required for extending the market season for fresh fruits and vegetables, to extend the shelf life of meats and to preserve other perishables. Other agribusinesses that are high energy users also are at a competitive disadvantage, e.g., dairy, fruit and vegetable processing, frozen products, oilseed refining, etc.

With these distortions to a "level playing field", Iraqi farmers and agribusinesses are at a severe competitive disadvantage *vis a vis* those in neighboring countries. And since Iraqi importers routinely claim a 20-25% margin on imported agricultural products, these distortions do not provide a significant benefit to the Iraqi consumer. Thus, all Iraqis lose, and their neighbors gain.