



# Iraq

as a  
Transition  
Economy

*By Robert Looney*

# Report Documentation Page

Form Approved  
OMB No. 0704-0188

Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

1. REPORT DATE <b>2004</b>		2. REPORT TYPE		3. DATES COVERED <b>00-00-2004 to 00-00-2004</b>	
4. TITLE AND SUBTITLE <b>Iraq as a Transition Economy</b>				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) <b>Naval Postgraduate School,Center for Contemporary Conflict,1 University Circle,Monterey,CA,93943</b>				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT <b>Approved for public release; distribution unlimited</b>					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT <b>unclassified</b>	b. ABSTRACT <b>unclassified</b>	c. THIS PAGE <b>unclassified</b>			



**W**ith order yet to be re-established in Iraq as these words are being written, any appraisal of its postwar economic prospects may seem premature. But it is important to begin asking how best to reconstruct the Iraqi economy – if only because broad-based economic development is one prerequisite to the creation and maintenance of a civil society.

By no coincidence, much of the initial address to the nation by the interim prime minister, Iyad Allawi, focused on economic issues. Allawi, a Baathist who served in the Iraqi intelligence services until falling out with the regime in 1971, cited inflation, unemployment and weak purchasing power as the main economic problems facing the country. While he offered no specifics for addressing these issues, he did make the case that, a year after the fall of Baghdad, security and economic progress were inextricably linked. The key reason that Iraqi support for suppressing the insurgency that followed the invasion has been modest has been resentment over poverty and lack of jobs.

Many of the most pressing economic decisions touch on the temptation to resort to interventionist policies in an economy

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currently lacking the infrastructure to support competitive markets. Washington would plainly prefer that Iraq opt for restraint, in part because free markets are more likely to deliver the goods in the long run and in part because Baathist-style intervention would undermine the prospects for democracy and political pluralism. A third plausible option, the establishment of a Saudi-style, oil-dominated economy in which stability is maintained by paying off disaffected interest groups, would hardly be likely to evolve into a prosperous, viable democracy.

### THE ECONOMIC LEGACY OF THE COALITION PROVISIONAL AUTHORITY

In the fall of 2003 with Iraq in ruins, the American-led Coalition Provisional Authority imposed a series of reforms reminiscent of the shock therapy attempted in the 1990s in most of the transition economies of Central and Eastern Europe. Overnight, Iraq became the most open economy in the Arab world. "If carried through," *The Economist* concluded, "the measures will represent the kind of wish list that foreign investors and donor agencies dream of for developing markets." Five provisions were key:

- With the exception of oil production and refining, foreigners are allowed 100 percent ownership of Iraqi assets, full repatriation of profits, and legal standing equal to local firms.
- Foreign banks are welcome to establish operations immediately, or to purchase equity in existing Iraqi financial institutions.
- Income and corporate taxes are capped at 15 percent.

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- Import tariffs are reduced to a flat 5 percent, with no duties at all imposed on food, drugs, books and other humanitarian imports.
- With the exception of oil, Iraq's state-owned enterprises are to be privatized (though at a time and by a method not specified).

The Coalition's reforms were complemented by a series of measures designed to strengthen institutions needed in a free-market economy. Most important were the banking initiatives. Order Number 40 defined the rules establishing and governing a new Iraqi banking system based on the Western model. It gives the Central Bank of Iraq full legal and operational authority over the payments system. More important, it gives private banks broad discretion to serve as financial intermediaries, with none of the limitations imposed by fundamentalist Islamic interpretations of lending practices.

In addition, a new Iraqi dinar was introduced, with the central bank given independence in its pursuit of stable monetary and exchange-rate policy. While many experts recommended a fixed exchange rate (or even a "currency board" arrangement that locked the value of the dinar to major foreign currencies), the central bank opted for a managed floating-rate regime.

The management mechanism is relatively simple. The central bank exchanges dollars for dinars in a daily auction. It can sell dinars if it deems the local currency too dear, or it can buy them if the dinar depreciates. By mid-2004, the central bank had intervened in this manner on several occasions to curtail speculator-driven appreciation.

With the reduction of tariffs to levels that raise some much-needed revenue without significantly protecting domestic producers, Iraqi producers and consumers face world price levels. This exposure has already forced



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painful adjustments in employment, wages and prices. What's more, the shock is likely to be reinforced by the recovery of oil production and the expenditure of foreign donor funds. Both will increase the quantity of foreign exchange in the hands of Iraqis, putting upward pressure on the exchange value of the dinar and raising the likelihood that domestic goods other than oil will be priced out of world markets.

The overvaluation of a currency linked to booming exports of raw materials – dubbed “Dutch disease” because of the economic damage suffered by the Netherlands after

the discovery of vast quantities of natural gas – is not a trivial problem. Indeed, it partly explains the relatively poor long-term performance of a host of economies that seemingly had the advantage of generous export earnings.

The main advantage of the dinar's managed float is that adjustments to compensate for the effects of changing oil prices can be made in the exchange rate, rather than in wages and prices. However, this will not cure Dutch disease if the country is also prone to inflation. Faced with a similar situation, other oil exporters have established



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stabilization funds to “sterilize” export revenues. These accounts segregate part of the foreign currency earned from oil sales in a centrally managed fund, thereby reducing upward pressure on the local currency. The idea is to accumulate cash in good times and deplete it in bad times, providing a stable balance-of-payments environment.

Thus, if current plans go forward, Iraq will develop as a highly open economy. It will also have many of the modern financial institutions needed to operate in the world environment. Economic theory suggests that an open economy with modern financial institutions would be best served by a combination of a managed floating exchange rate and an oil-stabilization fund. But while the former is in place, the latter is not.

The establishment of enforceable, well-

defined property rights, needed to underpin free markets, has also been neglected. Perhaps the Coalition Authority intended to defer creation of the legal architecture to an elected Iraqi government. But unless the interim government and its elected successors do complete the reform, most Iraqis will continue to experience a darker sort of free-market capitalism in which might makes right.

**THE COALITION PROVISIONAL AUTHORITY REFORMS IN PRACTICE**

The economic-policy challenges facing the new government are daunting. Among the most immediate: creating jobs for millions of dislocated workers, establishing a social safety net, rehabilitating agriculture, guaranteeing stable food supplies – and, of course, funding all these tasks without triggering unaccept-

able rates of inflation.

Anecdotal accounts suggest that the Coalition Authority drew up the shock-therapy program with minimal Iraqi consultation. Iraqis, no doubt, will be able to exercise some control over the details of implementation. However, undertaking a full-scale shift in development strategy makes little sense until an elected government is in place. Perhaps for this reason, the interim government has shown little inclination to deviate from the path laid out by the Coalition Authority.

Arguably the biggest risk associated with this rigidity is that Iraqi governments will not be able to pursue the fiscal policies necessary to revitalize the economy. As noted, the highest income tax bracket is set at 15 percent. Other constraints on the government's finances involve treatment of past government domestic debt and limits on official borrowing from the central bank. In June the Coalition Authority's administrator, Paul Bremer, signed the Public Debt Law, requiring the Iraqi government to honor all domestic debts to Iraq's commercial banks – debts largely contracted by Saddam Hussein. This paper is estimated to be around 1.3 trillion dinars (more than \$1 billion). The Public Debt Law, therefore, can be seen as a way to recapitalize Iraq's private banks, which would otherwise face insolvency.

The central bank also holds about \$2.5 billion in Iraqi government debt. Under the Bond Market Plan put together by the Coalition Authority, this debt must be paid as it matures. However, because the central bank is now formally independent, the government cannot force the bank to buy government debt (as Hussein did).

It should be no surprise, then, that the interim government is attempting to develop a domestic bond market as an additional source of finance. In July, the central bank

raised about 150 billion dinars (then, \$103 million) by selling debt due in three months. The bonds paid interest of between 5 and 8 percent – not enough to entice foreign participation in light of the risks involved. Instead, the vast majority of buyers were local banks.

The short maturity of the bonds was designed to allow the government to prove its creditworthiness to a skeptical market. Baghdad plans to issue six-month and one-year bonds later on, hoping to raise as much as \$1.2 billion by the end of the year. One ancillary benefit: the development of a government debt market will introduce another constraint on the government – if it overspends the way Hussein did, investors will demand higher interest rates.

In a related move, the interim government began implementing a Coalition Authority initiated revamp of the Baghdad Stock Exchange. The new Iraq Stock Exchange, which opened in June, is the product of more than a year's work by the 12 brokerage firms and banks that jointly own it. And, at least on paper, it is buttressed by a strong regulatory framework stressing transparency and accountability. At the proverbial opening bell, the exchange listed 27 companies; a total of 180 to 200 are expected by the end of the year. The tea leaves offer positive signs: in five sessions, trading volume nearly quadrupled and the value of stocks surged.

While the old stock exchange contained only Iraqi companies and traders, the new one will eventually be accessible to foreigners. The exchange plans to shift to an electronic trading system in the near future. With luck, the stock market will begin to lure money from Iraqis living overseas.

While it is too early to make firm judgments, the Coalition Authority's program's fiscal and monetary aspects do not appear to place impediments on the Iraqis other than

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those found in any sound financial system. The rules and institutions simply represent the steps responsible governments must take to lay the foundation for sustainable growth.

The Authority's enthusiasm for privatization is more controversial. U.S. officials see privatization as part of a broader conservative economic agenda. The state still controls almost all large businesses; the 61 major industries under the Ministry of Industry and Minerals account for 90 percent of Iraq's industrial production, including oil, leather goods and textiles. When the interim government assumed power, most state enterprises



were in dire straits, with only the oil and cement industries showing a profit. State-run enterprises brought in the equivalent of \$73 million in revenue in the first five months of 2004, but paid out \$85 million in salaries alone – much of it to the two-thirds of their employees who were not working. More than half the state-owned companies are not operating at all, and the rest are functioning at a fraction of capacity.

On first glance, privatization would appear to be a plausible start to solving the underutilization problem; private enterprises subject

to market forces are generally more efficient. Moreover, the sale of the state enterprises would both generate needed revenues for the government and relieve it of the ongoing drain of subsidies to the losers.

A closer look, however, suggests that the difficulties owners would face are likely to dampen interest in the transition for some time. The State Company for Woolen Industries provides a useful illustration. The company has power generators, which can keep machinery moving even when Baghdad's electricity supply is down. Nonetheless, its five functioning plants are running only one shift out of three. And while the 3,700 workers are putting in far less than a full week on the job, they are still being paid full salaries.

One major source of the firm's difficulties is the Coalition Authority's arbitrary doubling of worker salaries after it took over in April 2003 – a move to reduce political unrest. That huge increase in operating costs makes the company's woolen blankets, tents and clothing much more expensive than imports, which are now entering the country essentially duty-free as a result of the decision to slash tariffs. Compounding the problem, factory suppliers refuse to deliver materials over Iraq's bandit-ridden roads.

The bottom line: privatization is a non-starter, at least for the moment. Uncertainty over security makes it impossible to arrive at fair-value bids, and the political need to keep underemployed workers on the job makes restructuring highly problematic.

### THE SPECTRE OF UNEMPLOYMENT

The U.S.-sponsored reforms have come under intense criticism both inside and outside Iraq. Much of this criticism has been focused on



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their most immediate consequence – unemployment.

After the fall of Hussein's government, Ambassador Bremer and the Governing Council decreed that the top three levels of the Baath party membership could not be on the government payroll. Estimates vary, but a safe guess is that more than 120,000 people lost their jobs. Some were diehard Saddam loyalists. But many were doctors, nurses, university professors and other professionals who probably joined the Baath Party just to get jobs or to advance their careers. Not only were their productive services lost, but their foregone wages also had a familiar negative multiplier effect on aggregate demand for consumer goods. Only in April of this year, after much of the damage was done, did Ambassador Bremer reverse the wholesale de-Baathification policy and make many laid-off Baathist teachers eligible for jobs.

Employment also fell after the war because of the Coalition Authority's decision to disband the army, which consisted of about 7 percent of the labor force. The coalition would later pay stipends to former soldiers, but the decision to put soldiers back on the streets without jobs has been blamed for much of the increase in violent resistance to the occupation.

In addition, delays in reconstruction have taken a toll on employment. Seven months after Congress approved an \$18.4 billion aid package for Iraq, less than 5 percent had been spent. By late May of this year, the pace of expenditure appeared to be picking up. However, by then, the damage to Iraqi goodwill caused by unaddressed unemployment was all too apparent.

Reconstruction contracting has also played a part in slowing the pace of job creation. In principle, the system for disbursing the \$18

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billion should give Iraqi companies a boost. They were given priority in subcontracting, although firms from the 69 coalition countries could also bid. However, Iraqi companies suffered in competing with foreign firms because they have inadequate working capital and could not obtain financing from the country's nascent banking system.

As a result, reconstruction projects are not putting much money into the hands of Iraqi entrepreneurs. By May 2004, fewer than 25,000 Iraqis were working on projects funded by the United States, a tiny fraction of the original projections.

As noted above, most Iraqi companies are not able to win reconstruction contracts because they lack access to credit. Yet most development experts agree that the success of midsize businesses in creating new jobs is critical for stability. Again, delays in restoring the country's banking system are severely limiting the pace of economic recovery.

In sum, Iraq's current economic malaise has its origins in a series of miscalculations by the Coalition Provisional Authority. Too many decisions were made without examining the economic dimension. Once unemployment got out of control, violence and insurgency increased, the economy suffered, and aid flows dried up due to the lack of safety, creating a vicious cycle that the belated reforms could not correct.

### **PEERING INTO THE FUTURE**

The interim government seems committed to staying the course, hoping that, with a number of new construction projects coming online, unemployment will be brought under control – and, with it, the insurgency. One hopes improved security will bring more capital from abroad, stimulating reconstruction and job creation. Accordingly, it is possible

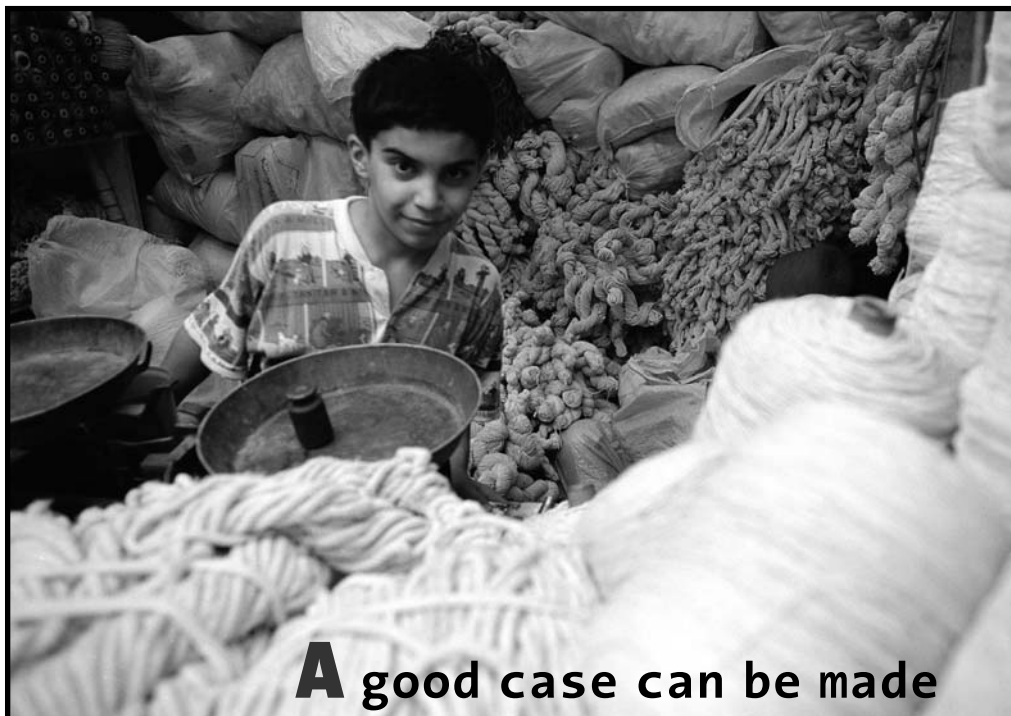
that growth and reform will fit into a virtuous circle, just as they did in the successful transition economies in Eastern Europe.

None of this will happen, however, unless Iraq gets the breathing room to shift from an expenditures/reconstruction mindset to a reform/development/growth orientation. Past experience suggests that for oil-based economies like Iraq's, increased efforts in four areas appear critical: rule of law, voice and accountability, banking and finance, and foreign investment. Interestingly, the most important are the first two, which fall under the rubric of governance.

Of course, sustaining reform is a daunting task. As in other transition economies, reform can take Iraq in one of two directions. Some countries, including Hungary and the Czech Republic, have experienced a sustained economic revival and have even met the conditions for membership in the European Union. By contrast, some transition economies – for example, Moldova, are still struggling to deregulate prices, establish institutions to support competitive markets, rationalize the reach of government and impose effective rule of law.

Why have some countries succeeded while others failed? Recent research links the failures to the strength of interest groups that benefit financially from the status quo. One can already see these groups forming in Iraq – for example, among workers in the state enterprises, whose jobs often amount to sinecures. Note, too, that many Iraqis who are receiving subsidized gasoline, food and the like can profit by selling these goods on the black market. The more chance these groups have to tighten their grip on the middle levels of power, the greater the obstacle they present to Iraqi advancement.

To offset the influence of these groups, Iraqi reformers will have to create their own winners – groups with a vested interest in the



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success of the reforms. In Eastern Europe, these groups have often been workers and entrepreneurs associated with new small- and medium-sized businesses. And it is in just these categories that most of the new jobs will have to be created in Iraq. Thus, one of Iraq's top economic priorities should be improving the infrastructure that supports these businesses – everything from dependable telecommunications to an efficient banking system.

Although the Coalition Authority reforms do not appear to be a major impediment to the economy's recovery, they are unlikely to perform miracles by themselves. Eventually, Iraqis will have to implement a development strategy that reduces dependence on oil. While the current low-tariff policy is useful in allowing a clearer identification of the country's comparative advantage outside the ener-

gy sector, a good case can be made for temporary import protection to nurture infant industries. In addition, the tax system will have to be revamped so that the authorities are better able to shift resources in desired directions and, in the absence of an oil fund, to offset oil price fluctuations.

Finding ways to solve technocratic problems is easier than finding the will. The greatest challenge facing Iraq's transition to a stable free-market democracy will be sustaining support for reform. For, as Ronald Rotunda, the George Mason University Foundation professor of law, observed, "It seems that many Iraqis do not understand ... why a market economy can make the poor people much better off than they ever were when Saddam controlled the oil wealth and doled out perks to the Iraqis like a stern parent rewards small children for being seen and not heard." **M**