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Iraq's Economy: Past, Present, Future

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Summary

For most of its history, the government of Iraq has played an active role stimulating and directing the Iraqi economy. This pattern was most pronounced during the recent regime of Saddam Hussein, which was at root a centrally-directed command economy with some trappings of market economics and crony capitalism. Iraq's industrial sector was created, in large part, as a result of government efforts to diversify the economy through economic development projects using the proceeds from Iraq's oil wealth and borrowed funds. Many of these initiatives were not viable without government subsidies. Much of the industrial base has now been destroyed, either by direct attack in the Iran-Iraq or the two Gulf wars or through atrophy caused by neglect. Iraq has suffered absolute declines in gross domestic product (GDP), chronic inflation, wholesale depreciation of its currency, virtually non-existent foreign investment and the accumulation of a crushing debt burden.

This report, which will be updated periodically, identifies issues to be addressed before Iraq can participate normally in the world economy. It will need civil peace and a new legitimate government – Hague and Geneva conventions place limits on the capacity of an occupying power to restructure or develop the economy of an occupied state by its own decisions alone. It will need a sound monetary system and a market-oriented banking and finance system. It will need to recast its industrial sector on sounder principles with attention to productivity and relative prices. It will also need to ensure that the government cannot use the massive oil revenues passing through its hands to establish once again a new authoritarian regime.

Should Iraq's oil fields be restored to their pre-war conditions, Iraq could re-enter the world oil market as one of the largest suppliers, generating up to $24 billion in annual revenues. It has large undeveloped potential. Long term, it may be the world's largest oil producer, generating even larger export revenues – perhaps doubling or more its income within a decade. How Iraq uses this prospective oil wealth – and its effect on the rest of the economy – will be a concern. At present, its oil revenue will go into the internationally-audited Development Fund for Iraq. Iraq's agricultural sector is small. Output during the 1980s was stimulated by incentives and subsidies, but production lagged and imports supplied most of the country's agricultural needs. During the 1990s, through poor practices, Iraq's farmland was heavily damaged by salinization. Years will be required to rebuild Iraq's agricultural productivity. In the meantime, Iraq will rely on imports to meet its agricultural needs. As a result, among other things, urbanization will increase.

Iraq has large foreign debts, with estimates ranging from $42 billion (plus unpaid interest since 1991) to $64 billion and $78 billion. This does not include 1980s war-loans from Gulf or other Arab states or war damage claims. Most of the debt stems from the Iran-Iraq war or from loans incurred before 1990 to fund consumer needs and industrial or infrastructure projects. The earlier U.N. sanctions regime and the Security Council resolution of May 22, 2003 shield Iraq against action by its creditors and claimants to settle claims. The issue will need to be resolved before normalization of Iraq's international trade and financial relations can occur.

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This report was originally prepared at the request of the Senate Committee on Foreign Relations. With the Committee's permission, it is being made generally available for the use of Members.

Iraq's Economy: Past, Present, Future

Introduction[1]

This report provides information on the economy of Iraq in the recent past and on current post-war conditions. It also discusses issues and factors which will likely influence Iraq's future economic prospects. In the 1980s, Iraq had one of the Arab world's most advanced economies. Though buffeted by the strains of the Iran-Iraq war, it had – besides petroleum -- a considerable industrial sector, a relatively well-developed transport system, and comparatively good infrastructure. Iraq had a relatively large middle class, per capita income levels comparable to Venezuela, Trinidad or Korea, one of the best educational systems in the Arab world, a well educated population and generally good standards of medical care. Nevertheless, Iraq was a centrally directed command economy that was heavily dependant on oil revenue to fund its key institutions and its development program. Iraq experimented in the late 1980s with privatization, functional autonomy for some elements of the economy, and limited use of market forces. This initiative ended, however, with the advent of the first Gulf war.

In the dozen years since 1991, Iraq's industrial and agricultural capacity has decayed, its transportation and infrastructure systems have deteriorated, and the education levels and standard of living for its population have declined. Oil exports resumed under the U.N. Oil for Food Program (OFFP) after 1995, albeit at a lower rate. However, its production capacity deteriorated from lack of inputs. Some economic facilities were damaged in the recent war and its chaotic aftermath. In effect, Iraq must start over as it rebuilds its economy. Its massive oil resources can serve as an engine of future growth and development. It does not start, though, with a blank slate. The experience, expectations, and aspirations of the past will have important – if unknown – effects on Iraq's future economy. What Iraq learns from its past and how it adapts itself for the future will be important considerations.

An important feature of centrally planned economies, such as Iraq under Saddam Hussein, is the absence of the legal, political, economic, and regulatory institutions that are the necessary underpinning of successful market economies. According to Dani Rodrik, a prominent development economist, "in the long run, the main thing that ensures convergence with the living standards of advanced countries is the acquisition of high-quality institutions."[2] Institutions are the "rules of the game," the sets of rules and norms that organize society and allow a market economy

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[1] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, and Martin A. Weiss, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

[2] Dani Rodrik. "Growth Strategies." April 2003. Available at [http://www.ksg.harvard.edu/rodrick.]

to function. Thus, the focus of the Iraqi reconstruction efforts must be the creation of institutions that not only stabilize the economy, but can serve as an engine for sustained long-term growth. Iraq will need to learn how to build and maintain good institutions and how to use them effectively to rebuild its economy.

This report provides background on the different sectors and institutions of the Iraqi economy. It also identifies some questions and issues which may have significant bearing on Iraq's future prospects and may need to be addressed as Iraq, the United States, and the international community seek to put the economy of Iraq on a sounder long-term foundation.

Government and the Economy [3]

The history of Iraq during the 20th century falls into three fairly distinct periods:

- 1921-1958: A constitutional monarchy under direct British control at first and later under significant British influence.
- 1958-1968: A series of nominally republican regimes headed by military officers who assumed power in most cases through a military coup d'etat.
- 1968-2003: A government controlled by the socialist, pan-Arab Baath Party, which quickly developed into a vehicle for one-man rule by leading party official Saddam Hussein.

The Constitutional Monarchy

Government. During the first period, Britain established a monarchy in Iraq under King Faysal I, a leading member of the prestigious Hashemite family (of which a collateral branch continues to govern Jordan). In 1932, Iraq became an independent country, but the bilateral treaties replacing the British mandate provided for a continued British role in Iraq, particularly in defense and foreign affairs. Rising opposition to Iraq's western ties and mounting nationalist sentiment among younger Iraqis including the armed forces created growing disaffection from the regime. In July 1958, a group of army officers led a coup in which the King and leading officials were killed, many other officials imprisoned, and a republic was proclaimed.

Economic Policies. Economic institutions developed slowly during the early years of the Iraqi monarchy as the nascent government sought to establish itself and deal with internal tensions and ripple effects of World War II. With the advent of mounting oil revenues in the 1950s, Iraqi were able to concentrate to a greater degree on the nation's economy. At this time, Iraq's economy was largely market-oriented, but based more on feudal and traditional rather than on modern principles. A development board, established in 1950, promulgated multi-year plans that emphasized three priorities: agriculture (including irrigation and flood control), transportation and communications, and construction. Commentators have praised the board for using most of the country's oil income for capital investment and

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[3] Prepared by Alfred Prados, Specialist in Middle East Affairs, Foreign Affairs, Defense and Trade Division.

infrastructure development. Some fault it, however, for over-emphasizing agriculture and under-emphasizing industry and human resources, which would have appealed to two increasingly important constituents: the educated elite and the workers.[4] By neglecting these groups, the government may have contributed toward the climate of disaffection that helped bring on the revolution in 1958, although political opposition appears to have been a more important factor in the demise of the old regime.

The Military Regimes

Governments. Three military leaders governed Iraq in succession during the decade that followed the overthrow of the Iraqi monarchy by left-wing nationalist army officers. The somewhat eccentric General Abd al-Karim Qasim, who led the coup of 1958, terminated Iraq's ties with the West, withdrew Iraq from the Baghdad Pact, and aligned Iraqi policies to a considerable degree with those of the Soviet Union. Steady erosion of his power base, sapped by growing domestic unrest (including the beginning of a Kurdish insurgency) and regional quarrels, led to a second coup in which Qasim was overthrown and killed in February 1963. Qasim's successors, Generals Abd al-Salam Arif and Abd al-Rahman Arif,[5] took somewhat more moderate positions on regional and international affairs, established better relations with other Middle Eastern states (particularly Egypt under then President Gamal Abd al-Nasser), and adopted a more friendly stance toward the West, while retaining ties to the Soviet Union. However, the Arif regimes faced further domestic instability, the Kurdish insurgency continued to simmer, and the government lost much of its credibility–as did other Arab regimes–after Israel quickly defeated Arab armed forces during the "six-day war" in June 1967. A year later, on July 17, 1968, the Arif regime was overthrown by the Baath Party.

Economic Policies. The revolutionary regimes of 1958-1968 reversed many of the economic policies of the old regime, although like the monarchy they continued to devote major resources to transportation and communications, as well as military modernization. General Qasim, the first of the military rulers, and his key advisors were influenced by socialist models and emphasized several themes which bore this stamp: a planned economy, elimination of foreign economic influences (notably in the oil sector), and land reform. The Development Board, associated by Iraq's new leaders with the old regime, was abolished and replaced by a ministry of planning, together with a planning board. In 1961, Qasim moved against one of the principal vehicles for foreign involvement in Iraq's oil sector, the partly British-owned Iraq Petroleum Company (IPC). Law Number 80 expropriated 99.5% of IPC's concessionary area, leaving the company only those areas currently in production. (Iraq subsequently nationalized the company itself, in June 1972.) Land reform, perhaps the most significant of Qasim's economic measures, was an ambitious undertaking designed to break up the old feudal system of land ownership

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[4] See, for example, Phebe Marr, *The Modern History of Iraq*, Boulder, Colorado, Westview Press, 1985, pp. 134-135.

[5] General Abd al-Salam Arif came to power in conjunction with the Baath Party but ousted his erstwhile Baathist collaborators in a third military coup nine months later. President Arif was killed in a helicopter crash in April 1966 and succeeded by his brother, General Abd al-Rahman Arif, who was serving as chief of staff of the armed forces.

and redistribute land to peasants; however, implementation was slow as the government sought to put in place the necessary machinery to administer the program. One commentator has said the early reform measures "did more to destroy the edifice of the old regime than to construct the foundations of the new."[6]

Basic economic policies inaugurated by Qasim continued under his two successors, although at a somewhat slower pace. The Arif governments adopted additional measures to increase the role of the public sector in the economy; in July 1964 it nationalized all banks and insurance companies and in the same month it nationalized the 27 largest privately owned industrial firms. The government also reorganized other companies, required profit sharing with workers, and participation by workers in management. These and similar measures contributed toward capital flight and departure of trained management, with an accompanying decline in industrial development during the 1960s.

The Baathist Regime

Government. Baathist leaders quickly established one party rule. By the early 1970s, Saddam Hussein, a dynamic but ruthless party official, had consolidated his control over the party leadership and government apparatus. In 1979, Saddam Hussein replaced the aging President Ahmad Hasan al-Bakr as president of the republic and in several ancillary positions. Saddam's position as president was endorsed in 1995 and 2002 by ritual majorities of 99.6% and 100%, respectively. Parliamentary life, suspended after the overthrow of the monarchy in 1958, was nominally restored in 1980, when a new law established an elected 250-member National Assembly; however, most observers have characterized Iraq's post-1980 assemblies largely as rubber stamps.

After a period of international strain in the early 1970s, Saddam mended fences with most Middle East countries in the later 1970s and 1980s and reestablished relations with the United States in 1984. Trade relations flourished with the United States, which–like the conservative Arabian Peninsula monarchies–regarded Saddam's secular regime as a bulwark against the militant clerical regime that came to power in Iran in 1979. U.S. concerns over Iran in the 1980s tended to obscure Saddam's poor human rights record (illustrated by a brutal campaign of repression and forced resettlement of his Kurdish population) and his efforts to develop weapons of mass destruction. Meanwhile, the inconclusive Iraq-Iran war, which lasted eight years and resulted in a total of perhaps a million casualties, left Iraq significantly weakened and encumbered with an $80 million debt to oil-rich Gulf states who had helped finance Iraq's war. The occupation of Kuwait, which Saddam may have thought would elicit no U.S. action beyond verbal condemnation, resulted in a major military defeat by a U.S.-led coalition, widespread damage to Iraq, and stringent economic sanctions, while relegating Iraq to the status of a pariah state.

Economic Policies. During the early years of his rule and in line with the socialist principles of the Baath Party, Saddam followed economic policies similar to those of the preceding military regimes. The government employed central

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[6] Phebe Marr, *The Modern History of Iraq*, p. 169.

economic planning to manage its resources. Expenditures were divided into three categories: a government operations budget, an investment budget, and an annual import budget. Flush with mounting oil revenues, Iraq was able for some years to pursue its socialist model without having to make hard choices between solvency and other priorities such as welfare benefits, infrastructure development, and even armed forces modernization. One commentator observes that in the early years of the Baathist regime, "[t]he responsibility of the state was not so much to allocate scarce resources as to distribute the wealth, and economic planning was concerned more with social welfare and subsidization than with economic efficiency."[7]

Growing economic burdens resulting from the protracted Iraq-Iran war led Saddam to change course in the mid-to-latter 1980s. Abandoning to some degree the socialist ideology that had dominated Baathist thinking in the past, he embarked on a more pragmatic course of economic reform. In June 1987, a speech by Saddam exhorted provincial governors that "[f]rom now on the state should not embark on uneconomic activity." That year, the government abolished a labor law that had guaranteed full employment; laid off thousands of government workers (many of whom were foreign nationals); transferred other civil service workers to factory jobs; and took steps to privatize government-owned enterprises, including: bus companies, gas stations, agricultural enterprises, department stores, and factories. In an even more profound departure from the three previous decades, Iraqi officials announced in late 1987 that the government would offer inducements for foreign companies to operate in Iraq by easing former restrictions on foreign direct investment.

Iraq's invasion of Kuwait and its aftermath dramatically altered the economic scene in Iraq. Henceforth, Iraqi efforts were concentrated on circumventing the international sanctions imposed as a consequent of the invasion, taking advantage of the Oil for Food Program, and obtaining additional assistance through humanitarian donations, illicit trade, and private barter arrangements. This "twilight" economy might well have lasted for some time to come had not the Bush Administration decided that the current situation was no longer tenable and required another application of military force.

Demographic and Social Conditions

Overview [8]

Before 1990, Iraq was one of the more prosperous and advanced countries of the Arab world. It was an upper middle income country with a substantial middle class, considerable technical capacity, high (by regional standards) female participation in education and the economy, and relatively high standards overall of education and health care. Since 1990, economic conditions in Iraq have deteriorated and

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[7] Helen Chapin Metz (ed.), *Iraq: A Country Study,* 4th ed. Washington, Federal Research Division, Library of Congress, 1990, p. 127.

[8] Prepared by Martin Weiss, Analyst in International Trade and Finance, Amy Thayer, Research Associate, and Jonathan Sanford, Specialist in International Political Economy, Foreign Affairs, Defense and Trade Division.

education, health and living standards have declined. A new generation has grown up having had little participation in or memory of the earlier years. Social, religious, and ethnic differences have become more pronounced and perhaps more significant.

Iraq's population has grown steadily in recent decades, from 9.4 million in 1970 and 13 million in 1980 to 22.3 million in 2000, a rate of increase comparable to most other countries in the region.[9] This is despite population losses due to war, civil conflict, and emigration. In 1965, 51% of the population lived in urban centers. The urban share rate reached 73% in 1988 and 77% in 2000. Baghdad held 35% of the population in 1960 and 55% in 1980. Its share has since declined to 27% as the other major population centers grew in size. This broadened pattern of urbanization is typical for most advanced developing countries. In 1989, Iraq had life expectancy and mortality rates comparable to those for Saudi Arabia, Libya, and other high income Arab countries.[10] By 2000, life expectancy in Iraq had fallen to 61 years while it had grown in the Middle East as a whole to over 67 years. Likewise, the Iraqi mortality rate for children under 5 rose from 95 per thousand in 1980 to 121 in 2000. Primary school enrollment rates fell from 100% of the relevant age group in 1980 to 88% in 1998, while secondary enrollment rates declined from 57% to 20%.

In the late 1980s, Iraq's middle class was a highly urbanized, secular, well-educated group, consisting mainly of state employees and civil servants. According to one estimate, the middle class rose from 28% of Iraq's urban population in 1958, to 54% in 1988.[11] The middle class benefitted greatly from the expansion of educational and government employment opportunities and from increased levels of government revenue. Since 1991, however, the lower ranks of state employees suffered greatly from years of war, economic sanctions, and the general decline of government revenues. Salaries did not keep up with hyperinflation. Many families were obliged to sell household items and other assets. The flow of population to cities also swelled the ranks of the urban poor. Unemployment or underemployment among former rural residents was a problem and has become more so in the past dozen years. In recent years, Iraqis have come to rely increasingly on kinship networks and religious charities for support the government no longer provides.

Iraq's population comprises a wide diversity of religious and ethnic groups. Some 95% of the people are Muslim, Islam being the officially recognized religion. Most of the Arabs in Northern Iraq, the Bedouins, the Kurds, the Turkomans and some inhabitants of Baghdad and Basra are Sunni, while most Arabs in the South are Shiite. There are also small Christian communities, particularly near Mosul, as well as other small groups such as the Sabian and Yazidis.[12] While the majority of Iraqi Muslims are Shiite, Sunnis are disproportionately represented among Iraq's wealthy

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[9] Unless otherwise stated, data in this section were taken from the World Bank's *World Development Indicators, 2002,* and its *World Development Reports* for 1990 and 1992.

[10] Life expectancy (years) in 1989: Iraq 63; Libya 62; Saudia Arabia 64/ Crude death rate (per 1,000): Iraq 8; Libya 9; Saudi Arabia 8.

[11] *War in Iraq: Political Challenges After the Conflict*, International Crisis Group Middle East Report No. 11, March 25, 2003.

[12] *The Middle East and North Africa, 2003*, Europa Publications, 2002, pp.477-78.

Muslims. The predominance of Sunnis in Iraqi political, economic, and defense institutions goes back to the Ottoman period and continues to be a major grievance of the Shiite community. The government of Saddam Hussein sought to mold from these disparate groups a common sense of Iraq nationality. It was successful in part during the Iran-Iraq war, as few Shiites went over to support the Iranian side despite commonalities in religion. Whether that identity is strong enough to weather the current difficulties remains to be seen. The answer to that question will have considerable bearing on Iraq's future economic and political prospects.

Role of Women in the Government and Economy of Iraq[13]

Iraq has a mixed record in its treatment of women. Under the relatively secular Baathist regime, women enjoyed significantly more privileges and opportunities (at least in theory) than they did under some traditional regimes that enforce Islamic tenets more strictly. Article 19(a) of the Provisional Constitution of 1970 specifies that "Citizens are equal before the law, without discrimination because of sex, blood, language, social origin or religion." Under the Baathist regime, women could vote, serve in the Peoples' Assembly (Iraq's rubber stamp legislature), and serve in the police. Though not subject to conscription, women holding university degrees in health care could serve in the armed forces, mainly in health care fields, and manpower shortages during the Iraq-Iran war of 1980-1988 led the government to allow women in other branches of the military service as well. According to the most recent U.S. State Department report on human rights practices, the government enacted laws to equalize women's rights in divorce, landownership, taxation, and suffrage. Women made strides in education; for example, female attendance in primary schools rose from 34% to 95% between 1970 and 1980. Government programs to improve the status of women helped increased job opportunities for women; in 2002, women comprised 20% of the labor force, and some were represented in medicine, engineering, academia, and the civil service.

In practice, women faced various forms of discrimination and mistreatment under Saddam Hussein's regime, despite legal protections. For example, Iraqi police and security officers frequently raped female detainees despite laws to the contrary. Furthermore, as the Iraqi regime sought to polish its Islamic credentials and appeal to tribal groups in the aftermath of the 1990-1991 Gulf war, the government became more lax in implementing official guarantees of equality. "Honor killings" of women by male relatives increasingly went unpunished. Despite greater access to the labor force, most female employees tended to work in fields where they had little contact with men and no authority over male employees. Even legal guarantees of women's rights had loopholes; women under age 45 are not allowed to travel outside of Iraq unless accompanied by a male relative. Finally, many women from more traditional segments of Iraqi society did not benefit to a significant degree by the progress achieved in women's status over the past 30 years.

The status of women in a post-Saddam era is open to conjecture. Some groups, particularly more fundamentalist elements within the Shi'ite Muslim community,

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[13] Prepared by Alfred Prados, Specialist in Middle East Affairs, with the assistance of Amy Thayer, Research Associate, Foreign Affairs, Defense and Trade Division.

probably look askance at an expanding role for women. Should such groups find themselves in a position to influence or dominate a post-Saddam government, they might seek to dismantle the legal protections women have gradually gained in recent years. Already, press reports indicate that many Iraqi women are feeling "sidelined" and have become fearful of moving about freely as they did before.[14] Should Iraq move toward a less centralized system of government or even toward fragmentation, some of the resulting mini-states or entities might pursue widely differing gender policies. The issue of women's roles in the months ahead will be an important one for those who seek to shape the future of Iraq.

Iraq's Economy in Recent Years

Macroeconomic Policy and Conditions[15]

The structure of the Iraqi economy has been characterized by heavy state control and involvement since the time of the Ottoman empire. According to one source, different governments from the British mandate and the monarchy, to Baathist rule and Saddam Hussein have all had the common goal: to fix prices and to stabilize consumption.[16] Government control of the economy tightened from one regime to the next. Nevertheless, an underlying goal was to satisfy the large sector of the population that was employed by, and dependent on, the state. During the 1970s, hard choices were avoided as oil revenues financed development projects and obscured economic mismanagement resulting from state control of the economy. The eight year war with Iran drained the economy of its surplus oil revenue and forced the regime into debt. The first Gulf war and economic sanctions imposed new constraints on an already crippled economy. Economic statistics were considered state secrets during the Baathist regime and were suppressed or not kept at all. Such fragmentary data that do exist indicate that the Iraqi economy since 1980 has suffered absolute declines in gross domestic product (GDP), chronic inflation, wholesale depreciation of its currency, virtually non-existent foreign investment, and the accumulation of a crushing debt burden.

Economic Policy. As noted above, the predominance of the state in the economic affairs of the nation was confirmed by a series of expropriations and nationalizations in the 1950s and 1960s. In agriculture, expropriation of land occurred faster than redistribution to the detriment of that sector. The petroleum industry was nationalized in stages from 1961 to 1973. Large-scale industry, banking, insurance and services were nationalized in 1964. These nationalizations also enabled the government to weaken rival power centers, whether landlords, the Shia business community or foreign oil companies.

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[14] "Iraqi Women Out of the Picture," *Washington Post*, May 17, 2003.

[15] Prepared by Ian Fergusson, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

[16] Kirin Aziz Chaudhry, "Consuming Interests: Market Failure and Social Foundations of Iraqi Etatisme,"in *Iraq's Economic Predicament*, ed. Kamil Mahdi, (Reading UK: Ithaca Press, 2002), p.234.

From 1968, the Baathist regime placed greater emphasis on the industrialization of the economy. The government embarked on two five-year development plans between 1970-1980. The first plan was primarily concerned with "economic independence"– the final nationalizations in the oil sector and investment in that sector. The modesty of the goals reflected a consolidation period for the regime, and in part, the lack of money to achieve more far reaching development goals.[17] This changed with the oil boom following the first Arab oil embargo. The second five-year plan (1976-80) reflected an Iraq that was flush with cash and ready to spend money, nearly $14.2 billion on economic development, often indiscriminately. Heavy industrial complexes such as the petrochemical complex at Basra, the iron and steel mill at Khor al-Zubair, the development of sulphur and phosphate extraction and processing, and the fertilizer industries were developed during this period.

Much of this industrial structure was not effectively utilized after the outbreak of the war with Iran in 1980, due largely to the shortcoming of Iraq's administrative apparatus. Direct attacks on Iraqi industry around Basra were less significant than the Iraqis' inability to obtain inputs, spare parts or to export oil or other products due to damaged ports. Iraqi economic management during the war was predicated on a belief that Iraq could fight a quick and limited border war without disrupting the home front or its economic development plans.[18] To pull this off, the regime borrowed to finance its continued spending.

As the war drained away funds that could have been utilized for economic development, weak points in the economic development strategy became apparent. Despite the pervasiveness of the state sector in the management and planning of the economy, there seemed to be very little actual planning. An industrial infrastructure was developed seemingly without regard for transportation or supply bottlenecks. There were no clear priorities for development. Workers often did not possess the technical capabilities that were required to operate the plants and there existed a shortage of managerial and administrative skills to run the public and private sector. Many of these shortcomings reflected problems in the state sector itself. Officials were often unwilling to assume authority or accountability, and rigid (and ideologically driven) economic policies were common.[19]

As noted, the government embarked on a series of economic reforms designed to make the economy more flexible and more market-driven in 1987. It removed price controls on commodities. It privatized several sectors of the economy either by selling assets directly to domestic investors, through public offerings on the newly constituted Baghdad stock exchange, or through long-term leases of state assets. The most prominent of these divestments was Iraqi Airways, in which a majority of the enterprise was sold off to the public. It also lowered or removed state subsidies to enterprises remaining in government hands and for agriculture. The country's labor

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[17] Anthony A. Cordesman and Ahmed S. Hashim, *Iraq: Sanctions and Beyond,* (Boulder CO: Westview Press, 1997), p. 128.

[18] ibid 133.

[19] Mahdi, "Rehabilitation Prospects...", p. 42; Cordesman and Hashim, *Iraq: Sanctions and Beyond*, p.129

law, which largely guaranteed lifetime employment, was abolished and thousands of white collar officials of state enterprises were laid off. The government also eased direct investment restrictions, allowing limited foreign ownership of investment projects. This last reform reflected the increasing unwillingness of western creditors to loan money directly to the Iraqi government for development projects.[20]

These economic reforms did not long survive the end of the Iran-Iraq war. By 1989, the economic crisis deepened and exacerbated the decline in living standards for most Iraqis, creating a threat to the viability of the regime.[21] In addition, the success of the privatization program was disappointing with many enterprises sold for under either book or replacement value. With the economy facing dire straits, the government reimposed price controls, re-nationalized some state enterprises, and raised industrial and agricultural subsidies.

The first Gulf war and the subsequent sanctions wreaked havoc on an already distressed economy. The bombing campaign of 1990-1991 severely damaged or destroyed much of the petroleum, transportation, power and industrial infrastructure. The government initially channeled its efforts to repairing the oil infrastructure, communications, and the state security apparatus. It instituted a rationing program to spread available food and consumption items. However, government policy essentially has been reactive, because the sanctions regime (and the regime's priorities) left little for reconstruction and development of the economy. Because Iraq relied on international trade in oil for the functioning of its economy, the sanctions regime had an immediate deleterious effect. The Oil for Food Program ameliorated this situation somewhat, but shortages, rationing, hyperinflation, and the absence of international trade characterized the Iraqi economy in the 1990s.

Gross Domestic Product (GDP). Economic data were considered state secrets during the Hussein era, thus no reliable data are available for much of the period. The figures available for the sanctions era are based on extrapolations from oil production and anecdotal evidence. According to one source who estimated GDP for the period 1950-2000 on constant 1980 dollar prices[22], the gross domestic product peaked at $53.9 billion in 1980 because of the oil boom, and fell by about one-half to $26.9 billion in 1989. GDP reached its low point in 1994 falling to $6.5 billion under the weight of economic sanctions. Since the resumption of oil shipments under the Oil for Food Program, this source estimates GDP has recovered to $46 billion. However, these figures may be suspect. It seems optimistic to report that the Iraqi economy in the late 1990s could nearly recover to its 1980 level *in constant dollars* in the presence of sanctions, a heavily depreciated currency, and chronic inflation. However, the figures may reflect the use of the fixed exchange rate of 1ID=$3.11, although the usefulness of such figures is limited.

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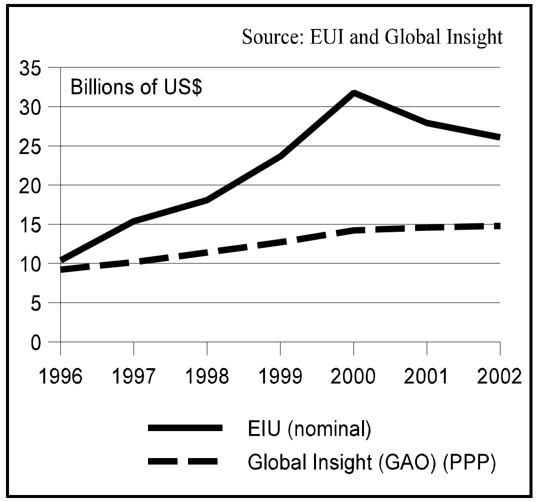
[20] Metz. *Iraq: A Country Study*, p. 128-9.

[21] Chaudhry, p. 233.

[22] See Abbas Al-Nasrawi , *Iraq's Burdens: Oil, Sanctions, and Underdevelopment*, (Westport CT: Greenwood Press, 2002), p. 103.

According to the Economist Intelligence Unit (EIU),[23] Iraq's GDP stood at $66.2 billion 1989, measured in nominal dollars. In the 1996-2002 period (see figure 1), the EIU data also showed a gradual recovery as GDP (in nominal dollars) increased from $10.8 billion in 1996 to $31.8 billion in 2000, before falling back to $26.1 billion in 2002.[24] These figures are subject to a wide margin of error, given the limited data on which they are based. Another source, quoted by GAO,[25] estimates nominal GDP, in purchasing power parity terms, to have risen from $9.2 billion to $14.8 billion from 1996-2002.

Figure 1. Iraq's Gross Domestic Product



Per capita GDP figures have also experienced wide swings. According to Al-Nasrawi, GDP per capita reached $4,083 (in 1980 constant dollars) at the height of the oil boom in 1980. By the end of the Iran war, he says, it had plummeted to $1,537 and reached a nadir of $343 in 1996. Again, the Oil for Food Program boosted per capita GDP in the late 1990s to reach $1,941 in 2000. In nominal dollars, EIU figures indicate per capita GDP was $3,675 in 1987. From 1997-2000, EIU reported per capita GDP increased from $503 to $1,385, before falling to $1,184 in 2001. Per capita GDP, in nominal terms was estimated to have risen from $448 to $644 from 1996-2002.[26] Such per capita figures, as they are derived from the GDP data above, are also highly speculative. Income inequality probably grew during this period. With wealth being concentrated increasingly in the hands of regime adherents, most Iraqis probably subsisted on a much smaller figure than the average would suggest.[27]

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23 Economist Intelligence Unit, Country Profile Iraq, 2002/2003, July 24, 2002. Obtained from [http://www.fggm.osis.gov/EIU/CP/CPCIQD00.htm].

24 Using purchasing power parity, the CIA estimates 2001 GDP to be $59 billion.

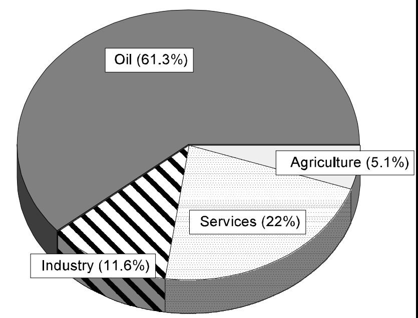
25 GAO-03-792R (GAO), *Rebuilding Iraq*, May 15, 2003, Enclosure 1, p.6. Source, *Global Insight.*

26 Ibid.

27 The figures from EIU and Global Insight do not appear to be directly comparable. The EIU data seem to use the exchange rate conversion method for calculating GDP. In other words, it takes the local currency value of the economy and converts it to dollars using the prevailing exchange rate. By contrast, the PPP method looks at what local people can buy from a common international marketbasket of goods using their local income and then states the U.S. dollar value of those goods as though they were purchased in the United States. In effect, it shows what standard of living those people would have if they lived in the United States on their dollar-equivalent local income. The two methodologies often produce widely different results, both of which are accurate in their own way but are not interchangeable.

Attempts to disaggregate Iraq's GDP into its sectoral components are also hampered by the lack of hard economic data. Figure 2 shows one source's effort in 1989.[28] According to this source, oil comprised about 60% of the economy during the 1980s. Its share declined as the economy shrank with the imposition of sanctions, but later recovered as oil became the sole source of export earnings during the 1996-2003 U.N. Oil for Food Program. Agriculture's share of GDP had been declining since the 1960s. However, since the 1991 war, its share of GDP reportedly expanded as the economic pie shrank and food imports were cut off.[29] The resumption of agricultural imports (under the OFFP) has caused a decline of domestic production and probably shrank the sector's share of GDP once again. Although the industrial sector accounted for an increased share of GDP in the 1970s and 1980s due to extensive economic development programs, later war damage and diminished operability probably lowered its contribution to GDP. Both industry and agriculture's true share of GDP, after accounting for subsidized raw materials and inputs, may have been overstated during the 1970s and 1980s.

Figure 2. Sectoral Composition of GDP, 1989



Source: Economist Intelligence Unit, 1995

Currency and the Balance of Payments. The Iraqi dinar was long considered a strong currency aided by oil revenues and rising foreign exchange reserves. Some of this reputation may be attributable to the decision, by the National Bank of Iraq in the 1950s, to maintain 100% reserves behind outstanding domestic currency.[30] The official rate was variously set between \$3 per dinar to \$3.38 per dinar in the 1970s, the last official rate of \$3.11 per dinar was set in 1982. During the 1970s, the official and markets rates generally corresponded and by 1980 the country had \$35 billion in foreign exchange reserves. By 1987, that figure had fallen to \$2 billion.[31] The currency depreciated steadily during the Iran-Iraq war, and the pace of descent quickened after the first Gulf war. One estimate had the currency depreciate from 4 to 8 dinars per dollar in 1990-91.[32] The advent of sanctions paradoxically stabilized the currency for a brief time as foreign exchange transactions virtually ceased. However, the onset of limited food and medicine trade under sanctions renewed the downward slide. The dinar reached an all-time low of 2,660 per dollar in December 1995. It has slowly appreciated from that low, yet has fluctuated widely from 1,000 to 2,300 dinars per dollar in the period 1997-2001 on

[28] Economist Intelligence Unit, *Country Profile: Iraq*, 1995-1996, p. 13.

[29] One source, Ahmad, p. 179 reports agriculture share of GDP expanding during the 1980s. However, these figures are hard to interpret as they are based on current dinars during a period when GDP in dollar terms was declining.

[30] Metz. *Iraq, a Country Study*, p. 131.

[31] *Middle East and North Africa Yearbook, 2003* p. 599.

[32] Mahdi, "Rehabilitation Prospects...", p. 48.

the black market. Although the regime did not alter the official exchange rate, it acknowledged the rate differential in 1999 by allowing state banks to exchange hard currency at the rate of 2000 per dollar. The depreciation of the exchange rate in the 1990s was enhanced by capital flight and emigration, the restrictions of the sanctions regime on exchange transactions, and the progressive dollarization of the economy.

Up to the 1980s, the country ran consistent balance of payments surpluses with oil sales producing increasing foreign exchange reserves. While the earnings of the oil fields allowed the government to implement development plans without becoming indebted, the dependence on oil revenue also had less salutary effects on other sectors of the economy. With increased income from oil exports, the value of the dinar appreciated. This made the country's non-oil tradable goods less competitive with imports and depressed those sectors of the economy. (See the discussion of "Dutch Disease" in the concluding discussion of factors affecting the non-oil.) Falling oil prices in the 1980s put heavy pressure on Iraq's balance of payments. Iraq responded by increasing its oil production and by borrowing heavily from abroad. The problem was acute by the end of the Iran war. Relatively low oil prices, the exhaustion of its foreign exchange, growing import bills, and debt service payments all strained Iraq's balance of payments.

Ironically, in the 1990s, Iraq regained a trade surplus position with sanctions and the Oil for Food Program in place. Imports were tightly controlled and income from oil exports exceeded outlays for imports – even after 25% to 30% of OFFP revenue was diverted for war compensation. As of May 2003, the OFFP reported it had an unencumbered balance from oil sales of $3.2 billion maintained in escrow accounts.[33] It should be noted, however, that Iraq made no payments on its foreign debt after 1990.

Inflation. As with other indicators, data on inflation are spotty and, during the 1990s, price data have a highly anecdotal quality. Before the oil boom, the Iraqi economy was characterized by price stability with an inflation rate at 5-6% during the period 1960-73.[34] This source calculates inflation increasing from 18% to 68% between 1975-79 as a consequence of substantial currency inflows related to the oil boom.[35] Prices continued to rise during the Iran-Iraq war as resources were diverted toward the military and government borrowing from the central bank expanded the monetary base. Inflation was recorded at 95% in 1980 and had increased to 400% by 1989. During the 1990s, a period of hyperinflation occurred. The government continued to print money to meet expenditures while economic sanctions shut off the supply of imported goods leading to a classical monetary overhang. A yearly inflation rate of upwards of 2,000% per cent was reported in open market food prices between 1990-1991.[36] Another source estimated that inflation increased 5,000% between 1990

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[33] United Nations, Office of the Iraq Program, Oil for Food Program site, [http://www.un.org/Depts/oip/]

[34] Abbas Al-Nasrawi, *The Economy of Iraq*, (Westport CT: Greenwood Press, 1994), p. 164

[35] ibid.

[36] Mahdi "Rehabilitation Prospects...", p. 48.

and 1995.[37] In the period 1996-2001, however, another source estimated that consumer price inflation gradually declined from about 200% to about 60% due to the reappearance of goods as a result of the Oil for Food Program.[38]

The deepening inflationary spiral had many consequences. Most importantly, it led to a decline in living standards and the impoverishment of the great majority of the population, especially of state sector employees whose salaries did not keep up with inflation. Two decades of high inflation – at times, hyper inflation – also led to the loss of confidence in the dinar as a store of value. This led to the widespread dollarization of the economy. Many Iraqis also sought to convert their liquid assets into other assets, real estate and gold. Goods were purchased and hoarded when available and then bartered for other goods.[39] Another consequence of inflation was capital flight, as money left the country to avoid further erosion in its value. Declining confidence in the currency and capital flight further weakened the economy and led to new rounds of inflation, deteriorating confidence and capital flight. These patterns of behavior will need to be changed if the economy is to recover. (See the concluding discussion of monetary policy below.)

Foreign Investment. Foreign direct investment (FDI) was discouraged in the Baathist era for reasons of economic nationalism. During the 1970s oil boom, Iraq paid directly for economic development projects (plants, industry, and infrastructure) without resorting to credit or foreign ownership. During the Iran-Iraq war, Iraq continued to contract for economic development projects, but it borrowed from overseas creditors to pay for them. The regime attempts at economic reform in the late 1980s provided for some limited venues for foreign investment. However, such reforms provided little incentive for foreign investors, and the UN sanctions regime specifically prohibited foreign investment. Thus, Iraq has little experience with foreign direct investment and will require extensive capacity and institution building in order to attract and facilitate such investment.

Foreign Debt. Iraq's indebtedness primarily has been the result of the war with Iran. Iraq traditionally had been free of foreign debt and had accumulated foreign reserves that reached $35 billion by 1980. These reserves were exhausted in the early stages of the war. One source cites estimates of Iraqi arms purchases alone during the 1980s as between $52 - $102 billion.[40] Borrowing was heightened by the government borrowed increasingly to pursue its economic development strategy. Foreign creditors initially were willing to provide loans to Iraq in order to preserve access to the Iraqi economy, but as oil prices slumped in the mid-1980s investor enthusiasm waned.[41] After the war with Iran ended, Iraq faced a particular concern with its short-term debts, estimated at $35 to $45 billion, from western creditors. However, the regime was resistant to western attempts to reschedule the debt on

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[37] Cordesman and Hashim, *Iraq: Sanctions and Beyond*, p. 141.

[38] Economist Intelligence Unit, *Country Profile: Iraq, 2002-3*

[39] Al-Nasrawi , *The Economy of Iraq*, p. 165.

[40] Mahdi,"Rehabilitation Prospects...", p. 60

[41] Iraq Country Study, p. 129.

terms more favorable to Iraq. This stance was, in part, due to its reluctance to engage in greater transparency with regard to its economy.[42] Based on the calculations of one source, Iraq has the highest debt burden in the world in terms of debt to GDP or debt to exports.[43]

Figures vary widely as to the extent and composition of the debt. In 1991, at the end of the first Gulf war, Iraq told the United Nations that its debt totaled $42.1 billion. This submission stated that this debt had a maturity of five years at 8% interest.[44] This figure excluded interest and funds from the Gulf Cooperation Council (see below). OECD figures indicate that Iraq's outstanding total debt was $18.4 billion at the end of 2001. However, these figures only include OECD country bilateral loans and export credits. The joint Bank of International Settlements/International Monetary Fund/ World Bank debt tables list the debt as $26.6 billion at the end of 2001. This likely does not include accrued interest. The Economist Intelligence Unit estimated total debt in 2002 to be $64.3 billion. Of this, EIU estimates $35 billion is long-term principal, $8.5 is short-term principal and $21.7 billion is interest arrears.[45] Another estimate placed accrued interest at between $23.6 billion to $30.1 billion depending on the whether the interest is capitalized.[46] A survey of the debt conducted by the Center for Strategic and International Studies breaks down public and private debt at more than $108.1 billion, $47 billion of which is calculated as interest. The CSIS figures include an estimate of $30 billion payable to the Gulf states.[47]

Iraq's foreign debt originated from several sources. Western credit provided military assistance, development finance and export guarantees. This assistance has been estimated at $35 billion in principal. In the 1980s, the Soviet Union and other eastern European states provided loans for military assistance and development projects estimated at $7-8 billion. The Gulf states of Saudi Arabia, Kuwait, and the United Arab Emirates provided between $30-40 billion to fight Iran. One source suggests much of this latter figure represents oil sold on behalf of Iraq from the two shared neutral zones between Iraq and Kuwait and Saudi Arabia, respectively.[48] The Gulf states consider these funds to be loans, but Iraq considered these to be grants in a common endeavor to curb the spread of Iranian fundamentalism.

Compensation Claims. Claims have been made on Iraq based on damage inflicted on Kuwait as a consequence of the war with Kuwait. The United Nations

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[42] Cordesman and Hashim, *Iraq: Sanctions and Beyond*, p. 134.

[43] Al-Nasrawi, *Iraq's Burdens: Oil, Sanctions, and Underdevelopment*, p. 145.

[44] Mahdi, "Rehabilitation Prospects...", p. 60.

[45] Economist Intelligence Unit, *Country Profile: Iraq, 2002-3*, Table 16.

[46] Ahmed M. Jiyad, "The Development of Iraq's Foreign Debt," in *Iraq's Economic Predicament*, p, 115.

[47] Center for Strategic and International Studies, *A Wiser Peace: An Action Strategy for Post-Conflict Iraq,* Supplement One, "Background Information on Iraq's Financial Obligations", January 23, 2003.

[48] Mahdi, "Rehabilitation Prospects...", p. 61.

Compensation Commission (UNCC) has received and processed such claims since its establishment in 1991, pursuant to U.N. Security Council Resolution 692. The Oil for Food Program provided that 30% of oil sales would be used to settle compensation claims authorized by UNCC. During the operation of this process, individual and family claims of $148 billion were received, and from that $43 billion has been awarded. Oil sales had netted $16 billion for this fund by the end of 2002. Additional claims of $172 billion from companies, governments, and international organizations have been received, though not resolved, by the UNCC.[49] This figure does not include potential reparations claims by Iran, estimated by one source at $97 billion, for damaged inflicted during the Iran-Iraq war. [50]

Pending Contracts. This category of claims represents contracts signed with public and private foreign companies. According to CSIS, the overwhelming majority of these contracts have been with Russia, although companies from the Netherlands, Egypt, the United Arab Emirates, China, and France have also been identified. These contracts have been estimated at $57.2 billion primarily in the energy and telecommunications sectors. Many of these contracts have not been executed due to the sanctions regime, and it is unclear whether they will be honored.

The Oil for Food Program[51]

In August 1990, the United Nations Security Council imposed on Iraq (Resolution 661) a comprehensive international trade embargo as a consequence of its invasion of Kuwait. Following the first Gulf war, the Security Council resolved in April 1991 (Resolution 687) that the embargo on oil exports established in 1990 would remain in effect until Iraq fully complied with U.N. efforts to end its weapons of mass destruction (WMD) programs.

The first version of the OFFP was approved by the Security Council on August 15, 1991 (Resolution 706). It allowed Iraq to export $1.6 billion in oil every six months. Iraq rejected it as too limited in scope and an infringement on Iraq's sovereignty. Without oil revenues, Iraq was not in a position to import sufficient quantities of food and medical supplies, and living conditions in the country deteriorated sharply.

In April 1995, the Security Council adopted a new plan (Resolution 986) which allowed Iraq to export $2 billion in oil every six months. A memorandum of agreement between Iraq and the United Nations went into effect in May 1996 and the first oil exports occurred in December 1996. When the Secretary General determined that the program was not meeting the food and medical needs of the Iraqi people, the Security Council raised the oil export ceiling in February 1998 (Resolution 1153) to $5.256 billion every six months. The Council abolished the export limit in December

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[49] Ibid.

[50] Al-Nasrawi, *Iraq's Burdens: Oil, Sanctions, and Underdevelopment*, p. 158.

[51] Prepared by Kenneth Katzman, Specialist in Middle East and African Affairs, Foreign Affairs, Defense and Trade Division. For more on the Oil for Food Program, see CRS Report RL30472, *Iraq: Oil-For-Food Program, International Sanctions, and Illicit Trade*.

1999 (Resolution 1284) to encourage Iraqi cooperation with the effort to eliminate its weapons of mass destruction.

Under the OFFP, Iraq's State Owned Marketing Organization (SOMO) sold oil (under the supervision of the U.N. Sanctions Committee) to international oil companies. The oil was exported through an Iraq-Turkey pipeline and from Iraq's terminals in the Persian Gulf. The purchasers deposited their payments directly into a U.N.-monitored escrow account held at the New York branch of France's Banque Nationale de Paris (BNP). Recently, U.S. firms purchased a third to half (often the latter) of the 2.1 million barrels Iraq exported daily under the OFFP program.

The revenues from OFFP exports were allocated by the Sanctions Committee. Most recently, 25% of the total was transferred to the U.N. Compensation Commission to pay reparations to the victims of Iraq's invasion of Kuwait. Another 59% was allocated for purchases of humanitarian items for Baghdad-controlled Iraq and 13% was used for purchases by the Kurdish-controlled areas in northern Iraq. The U.N. took the remaining 3% to fund the costs of administering OFFP and the UNMOVIC weapons inspection program.

Under the OFFP, Iraq purchased goods and services directly from supplier firms. The OFFP program specified what share of the oil revenues could be spent for various categories of goods. The Sanctions Committee reviewed all contracts for such purchases. Any member of the Committee could place a "hold" on a contract for goods to be imported by Iraq. The United States often placed holds on exports of dual use items (civilian items that could have military applications).

Petroleum[52]

Oil Resources – Overview. Iraq has 112 billion barrels of proven oil reserves, the world's second largest endowment. The U.S. Department of Energy (DOE) also notes that "probable" and "possible" reserves may be as high as 220 billion barrels.[53] Saudi Arabia, with 260 billion barrels, holds the largest proven reserves. While Iraq's reserves are smaller than those of Saudi Arabia, they rank well ahead of other important oil producers, including the United States.

The United States – which by contrast has high output from relatively small reserves – produces 5.6 million barrels per day (mbd) from 24 billion barrels of proven reserves. Iraq was able recently to produce 2.8 mbd of output from an estimated 1,500 to 1,700 operational wells. Compared with U.S. production, which comes from over 150,000 wells in Texas alone, Iraqi oil can be produced easily and at low cost. The ease of production in these fields has permitted Iraq to remain in production since 1980, when its war with Iran began, without a steady supply of spare parts, state-of-the-art technology, or the ability to drill many new wells.

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[52] Prepared by Larry Kumins, Specialist in Energy Policy, Resources, Science and Industry Division.

[53] Energy Information Administration (EIA). *Iraq Country Analysis Brief*, February 2003. p. 10.

Adding to the appeal of Iraq's resources are possibilities of much greater output from the country's 73 known fields – of which only a fraction are in production. Greater reserves could result from re-evaluation of known fields using the advances in geophysical science made during the past 25 years. And there is a likelihood of even further new field discoveries – especially in the unexplored Western Desert region[54] – which could boost reserves and possibly raise production even further.

Iraq certainly holds the potential to become the world's largest oil producer. For this to become a reality, however, the Iraqi oil industry would require large financial investments for all manner of technical services, capital equipment, and infrastructure. As a recent Council on Foreign Relations report notes, Iraq's oil sector is being held together by "Band-aids." "War, sanctions and political manipulation have all seriously challenged Iraq's highly skilled oil industrialists."[55]

The fact that Iraq's oil output has been so resilient speaks to the quality and size of the underlying resource as well as the abilities of those keeping the oil fields operating. With sufficient technology, spare parts, and infrastructure reconstruction, Iraq's oil fields should be able to return to output levels of the recent past and reach higher levels in a few years.

Oil Production – History. Iraq's all-time peak oil production was 3.5 mbd[56] in 1979, just prior to the war with Iran. Output dropped sharply as the war began and gradually recovered to 2.9 million barrels per day by 1989. The Gulf Crisis sharply cut production again in 1990. U.N. sanctions imposed after the war prohibited oil exports, so post-war production was limited to the amount needed to meet internal demand plus small amounts that may have been illegally exported. Domestic demand was estimated at 450,000 barrels per day before the recent war began. Figure 3 shows Iraq's annual oil output and domestic consumption since 1980.

Iraqi oil exports resumed under the Oil for Food Program in May 1995. Production rose accordingly, peaking at 2.6 mbd in 2000. During 2001 and 2002, frequent disputes with the United Nations over pricing and other aspects of program administration led Iraq to halt exports sporadically. Despite approaching 3.0 mbd on a monthly basis several times, annual output trended down, with a brief spurt above 2.5 mbd during January and February 2003. This spurt suggests that, despite a shortage of parts, production techniques that allowed water intrusion into oil-bearing geologic zones, isolation from increasingly powerful geophysical technology, inability to work-over production wells, and generally deteriorating infrastructure, Iraq's oilfield workers were able to sustain relatively high production capability.

Current Situation. Iraq's oil deposits lie in two general regions: the north, in and around Kirkuk, and in the south, in and around Basra and Umm Qasr, near the

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[54] EIA, *Iraq Country Analysis Brief*, February 2003. p. 2.

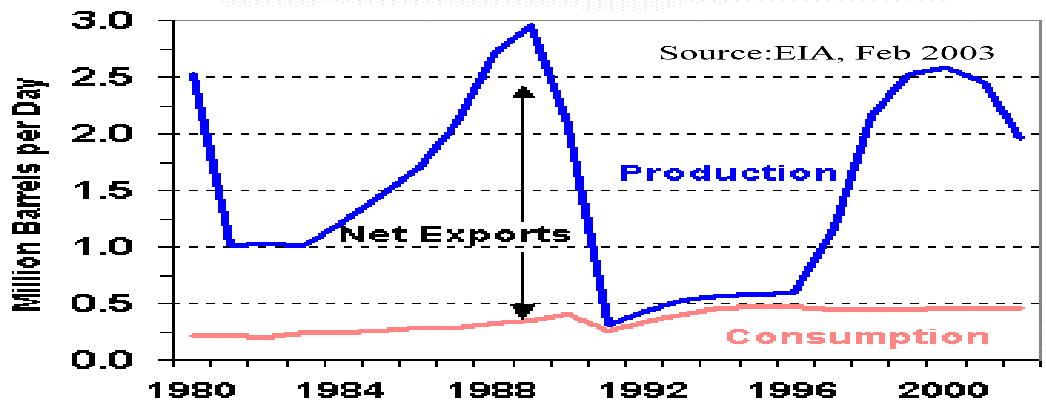
[55] *Guiding Principles for U.S. Post-Conflict Policy in Iraq*, Report of an independent Working Group Cosponsored by the Council on Foreign Relation and the James A. Baker III Institute for Public Policy of Rice University. January 2003. See Addendum, page 17.

[56] Energy Information Administration, *Monthly Energy Review*, Table 11.1.

Persian Gulf port of Mina al-Bakr. Production is centered on the Rumaila field – the largest producing field in the south, with 663 producing wells. Together with adjacent fields, it has produced more than half of Iraq's output. In the north, production from Kirkuk (the largest northern deposit) and satellite fields has accounted for about 40% of Iraq's production since it restarted under the OFFP.

Port facilities for southern oil were severely damaged during the first Gulf war but were sufficiently repaired to handle the amounts of oil – exceeding 1 mbd – exported under the Oil for Food Program. Oil from Kirkuk and nearby fields was exported via the 600-mile pipeline to Ceyhan, Turkey, a port on the Mediterranean. This 40-inch pipeline – which appears operable – has a capacity of 1.1 mbd, although it is not clear that it can be run at that throughput level in its current condition. A second, parallel pipeline with 500,000 barrels per day of nominal capacity exists, but it is reportedly inoperable.[57] Potentially, the two pipelines could have a combined capacity of 1.6 mbd, although extensive rehabilitation of the unused pipeline and some repair to the operable pipeline would likely be needed.

Figure 3. Iraq's Oil Production and Consumption, 1980-2002 (Est.)



Note: Production includes crude oil, lease condensate, natural gas liquids, ethanol, and refinery gain.

In February 2003, DOE characterized Iraq's near-term production capacity "at no higher than about 2.8-3.0 million barrels per day, with net export potential of around 2.3 to 2.5 million barrels per day...."[58] It appears possible that this level of production could be reached in less than a year were oil production facilities, pipelines, ports, and other infrastructure in operation before the current conflict to be restored and deferred maintenance performed.

Iraq's Oil Industry – Current Status. While oil field security is in the process of being established, oil to meet domestic needs is beginning to flow. *Platts*

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[57] EIA. *Iraq , Country Analysis Brief.* p. 6.

[58] *Iraq, More Details,* A supplement to EIA, *Iraq, Country Analysis Brief.* p. 2.

Oilgram News reports that production has reached 700,000 barrels per day,[59] 500,000 from northern fields and 200,000 from the south. This is more than current daily needs, although refineries are unable to turn this oil barrel-for-barrel into the products desired, chiefly gasoline and propane. These fuels remain in short supply.

An interim oil minister, Thamer Abbas Ghadhban, has been appointed, and is soliciting new bids for contracts of Iraqi crude. Brig. Gen. Robert Crear heads the U.S. Army Corps of Engineers team that is helping rebuild the oil industry and infrastructure. He is aided by Phillip Carroll, a former head of Royal Dutch/Shell's U.S. operations. The Halliburton subsidiary KBR is performing the work using local oilfield workers. The *Washington Post* reported the Minister's goal is to increase production to 1.5 mbd "within weeks." More recently, *Platt*s reports a June 1 goal of 1.13 mbd, although this goal may be difficult to achieve.

Several barriers must be overcome for Iraqi oil to be successfully marketed in international commerce. First, needed production increases must be achieved. It is unclear that Halliburton and the U.S. Corps of Engineers are successfully engaging the Iraqi oil workers. Exportable output seems much further off than expected.

Next, clear title to the crude must be established, so that a would-be purchaser can be assured that he is buying oil from its rightful owners. Until very recently, this was a problem. Under the old regime – exporting oil under U.N. auspices – title was granted by the Iraqi Ministry of Oil. In April 2003, it was unclear who had the authority to certify that oil had been properly sold. The U.N. Security Council resolved this issue May 22, 2003, in lifting the U.N. sanctions on Iraq. The U.N. resolution allows essentially free trade in non-military goods, authorizes procedures whereby Iraq can legally export oil, and specified that the proceeds from oil sales must be put into the Development Fund for Iraq (DFI). (See the discussion of this below.) The resolution also shields Iraq's oil revenues(until December 31, 2007) from seizure, attachment, or garnishment by creditors and claimants. *Platts* quotes Ghadhban: "We are now free.... The sanctions are out. We are free to go back to the market and also an open market so we can maximize the return....We want to get the maximum price for the Iraqi barrel...No more discounts, etc, etc."

Iraq and OPEC. Iraq was a founding member of the Organization of Petroleum Exporting Countries (OPEC). It has always participated in its deliberations, even after 1991. There are too many unresolved issues to attempt a reliable analysis of a future Iraq-OPEC relationship, although many factors point toward Iraq's continuing OPEC participation. In addition to OPEC membership being an accustomed situation, there is the fact that Iraq's geographic neighbors are all participants, and its stake in the world oil market will grow as exports expand, and that OPEC offers an oil price security blanket as well as a voice – most recently effectual – in price determination. Looking further forward in time, OPEC could be useful to any efforts by Iraq to reach the pre-Iran war's production levels of 3.5 mbd, an amount that OPEC would most likely act to accommodate. However, the length

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[59] Iraq to begin exports in two weeks: oil minister: US, *Platts Oilgram Price Report*, May 28, 2003. P. 1.

of time it might take to get production up to that level is a matter of speculation, given current difficulties in Iraq's oilfields.

From a U.S. perspective, Iraq's return to OPEC as a full-fledged cartel member would not dovetail with stated policy of encouraging non-OPEC supply sources. If the United States establishes broad control over Iraq's oil industry during its rebuilding phase, it seems unlikely that Iraq will be able to participate in OPEC strategy and decision making during that period. But if Iraq's Ministry of Oil is reconstituted, it is more likely that OPEC will be seen as a help in getting exports flowing, since it may take some time for Iraqi production to ramp to 3.5 mbd.

In the first months of 2003, most OPEC members increased production to offset lost Iraqi supplies as well as coincident (but unrelated) losses from other members. In June 2003, new OPEC quota figures rolled back most of the 2003 Saudi Arabian increase (up nearly 1.5 mbd[60]) as well as significant increases by Algeria and Kuwait. Presumably, this would make room in world markets for Iraqi exports (initially about 1.0 mbd, according to Oil Minister Ghadban's recovery plan discussed above) without adverse impact on OPEC pricing goals. OPEC has set a target price band for the weighted average price of members' crudes (the so-called OPEC basket) of $22 to $28 per barrel, FOB at export facilities.

The target price band was likely chosen to fall within OPEC's market power to influence prices. In order to exert market power, an entity must have control over supply or demand, or some combination of the two. OPEC has scant influence on demand, and limited influence over supply. But that limited influence over incremental amounts of supply appears to give the cartel some price leverage, given current demand and supply from non-OPEC producers. To the extent that OPEC can control supply from its own members, it can influence prices given current market conditions, as evidenced by its ability during the past two years to keep prices mostly within its target range.

Compared to prices during the post-war crisis period –1992 to 2001 – prices have been quite stable since OPEC started implementing the price band in December 2000. Prices have remained in the band except for a brief spike early in 2003 – which has now corrected – and a brief drop below the band in late 2001/early 2002. In contrast, prices previously fluctuated more significantly, touching a low of $10 per barrel in February 1999 and reaching a top of $35 in September 2000.

Potential Iraqi Oil Revenues. Were production, development and export issues to be fully resolved, Iraq could generate great wealth from oil exports. Much depends on world oil prices, which have fluctuated between $10 and $35 during the past decade. Given its pre-2003 production capacity of 2.8 mbd, Iraq could export 2.3 mbd (after subtracting 500,000 barrels per day for domestic consumption.) Annual *gross* revenues would be $18.5 billion at an assumed $22 price, and $23.5 billion at an assumed $28 per barrel price. Each million barrels per day amounts to $8.0 billion per year at the lower end and $10.2 billion at the upper end of that range.

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[60] CRS Report RL31676, *Middle East Oil Disruption: Potential Severity and Policy Options.* Updated April 29, 2003. See Table 1.

Table 2. Iraqi Oil Production, Current and Potential

Time Period	**May 2003**	**Near Term (12 to 24 months)**	**Within a Decade**
Production Capacity	700,000 barrels per day	2.3 to 2.8 million barrels per day	up to 6 million barrels per day or more
Annual Revenue	Domestic Use	$19 to $25 billion	$50 to $60 billion

Prepared by Jonathan E. Sanford, CRS, based on discussion in text.
Sources: DOE, *Iraq, More Details*, A supplement to EIA, *Iraq, Country Analysis Brief*. *Platts Oilgram Price Report*, May 28, 2003. Energy Intelligence Group, in *Petroleum Intelligence Weekly*, March 12, 2003.

How much revenue could Iraqi oil exports generate? That depends on such variables as how much total production can be achieved, domestic consumption, world market prices, and to what extent Iraq can participate in international oil markets without driving down market prices. The last variable depends at least in part on how and if OPEC makes room for Iraqi exports.

The volatile history of oil prices is an important part of Iraq's revenue equation. This parameter has fluctuated almost as much as the volume of Iraqi exports since the Iran-Iraq war. For Iraq's economy, the combination of price and quantity – and its unpredictability – provide some real uncertainty about monies that might be available for reconstruction and development. These imponderables weigh on the monetary contribution of oil to Iraq's economy. Oil can be a potent revenue generator, and Iraq has the potential to produce and export more oil than it ever has in the recent past.

What might the future hold for Iraqi crude production? While there are many imponderables, were these unknowns to be resolved over time in a manner favorable to developments supporting greater exploitation of already known proven reserves, future crude output could be far greater than the highest levels of production realized at any time in the past.[61]

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[61] Some analysts estimate that Iraqi oil exports could reach 6 mbd within a decade. See Energy Intelligence Group, Inc. "Iraq is well primed for big oil opening." *Petroleum Intelligence Weekly*, March 12, 2003. Estimates differ from the various sources, but all agree that future output could be very much greater than that likely in the near future.

Agriculture[62]

Overview. Before the first Gulf war, Iraq imported a large share of its agricultural needs and was a major agricultural export market for the United States. During the prior regime, due to drought, lack of inputs, poor methods and weak administration, Iraq had been unable to achieve agricultural production levels near its potential. After 1991, the irrigation system fell into disrepair and much of the irrigated cropland in central and southern Iraq was severely damaged by salinization. Several years will be needed to remedy the situation. In the meantime, Iraq will rely on imports once again for most of its agricultural needs. Absent a strong agricultural sector, population movements from rural to urban areas will continue, adding to the country's social problems and further worsening unemployment. Absent positive incentives (see the section on the non-oil economy and "Dutch Disease" below), Iraq may have problems restoring productivity in the agricultural sector.

Agriculture comprises a relatively small share of the Iraqi economy. In the past two decades, the sector has been injured by the pressures of military conflict (particularly the 1980-88 Iran-Iraq War and the 1991 Gulf war) and by varying degrees of government efforts to promote and/or control agricultural production. In the mid-1980s, agriculture accounted for only about 14% of the national GDP. After the imposition of U.N. sanctions and the Iraqi government's initial refusal in 1991 to participate in the proposed U.N. Oil-for-Food Program, oil production fell and agriculture's share of GDP rose to an estimated 35% by 1992 [63].

Rapid population growth during the past three decades, coupled with limited arable land and a general stagnation in agricultural productivity, has steadily increased dependence on imports to meet domestic food needs since the mid-1960s. In 1980, Iraq imported about half of its food supply. By 2002, under the OFFP, between 80% and 100% of many basic food staples were imported.

In the early stages of the post-2003 Iraq War period, the country's agricultural sector remains beset by the legacy of past mismanagement and the lingering effects of a severe drought during 1999-2001. Iraq's irrigation infrastructure is only partially functional; salinization of prime cropland is widespread throughout the irrigation system; and the fertility of cropland and rangeland has been badly depleted from over exploitation due to poor soil management practices. The poultry and livestock sectors have been devastated by a general lack of feedstuffs and pasture, as well as from a lack of veterinary medicines used to control common parasites and diseases.

Agro-climatic setting. Iraq has a total surface area of 43.7 million hectares (about the size of Wyoming and South Dakota combined) of which 34.0 million (78%) is not viable for agricultural use. Less than 0.4% is in forest and woodlands

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[62] Prepared by Randy Schnepf, Analyst in Agricultural Policy, Resources, Science and Industry Division.

[63] Mahmood Ahmad. "Agricultural Policy Issues and Challenges in Iraq" Short- and Medium-term Options," in Mahdi, *Iraq's Economic Predicament*, pp. 179-180.

situated along the extreme northern border with Turkey and Iran.[64] The remaining 22% (about 9.5 million hectares) are involved in agricultural activities, although almost half of this is very marginal and used only for seasonal grazing (mainly goats and sheep).[65] An estimated 340,000 hectares are in tree crops (mostly dates, but also some figs, grapes, and olives).[66]

Area cultivated annually to field crops such as cereals, pulses, fruit, and vegetables varies with weather and market conditions, but generally averages between 3.5 to 4 million hectares.[67] Between 75% and 85% of crop area is generally planted to grains (mostly wheat and barley). Iraq is divided into a rain-fed northern winter-grain producing zone and a center-south irrigated zone that produces vegetables and fruit, as well as cereal crops. According to the U.N. Food and Agriculture Organization (FAO), 2.55 million hectares were irrigated in 1989.

Pre-U.N. Sanctions (1980-89). During Saddam Hussein's early years in power (1979-1990) the state attempted to foster private sector control and investment in Iraq's agriculture. Surging oil revenues were used to acquire Western technology and to lavish extensive government subsidies on the sector. Area and production expanded through the 1980s for cereals, vegetables, and fruit.

However, cereal yields stagnated due to poor production practices and limited varietal development. The Iran-Iraq War also diverted labor and other resources away from agriculture. Population growth continued to outpace agricultural production, increasing the importance of trade. Despite government efforts at stimulating agricultural output, cereal and poultry imports nearly doubled as a share of domestic consumption, 69% and 48 %, respectively, during the 1980s. By 1989 Iraq was importing over $2.5 billion in agricultural commodities annually including 78% of its cereals and nearly 100% of its vegetable oils and sugar.

Cereals, mostly wheat and rice, comprised 60% of calories consumed by the average Iraqi in the 1980s. Meat – the principal source of dietary protein – provided an estimated average132 calories per day per capita between 1985 and 1989. Poultry production made strong gains during the 1970s and 1980s. By 1989 poultry had surpassed beef as the main source of calories from meat in the Iraqi diet.[68]

In the 1980's, U.S.-Iraqi agricultural trade expanded rapidly on the strength of large USDA export credits to Iraq to buy U.S. agricultural products. From 1983 through mid-1990, Iraq received nearly $5 billion in U.S. export credit guarantees to

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[64] FAOSTAT, FAO, United Nations. (A hectare equals about 2.47 acres.)

[65] PECAD, FAS, USDA. "Iraq Crop Production." January 16, 2003. http://www.fas.usda.gov/pecad/highlights/2003/01/iraq_update/index.htm

[66] FAOSTAT, FAO, United Nations.

[67] In the early 1990s, cultivated area temporarily expanded to nearly 5.5 million hectares before returning to under 4 million.

[68] FAOSTAT, FAO, United Nations.

purchase significant quantities of U.S. agricultural commodities.[69] By the mid-1980s Iraq was the major destination for U.S. rice exports and also an important purchaser of U.S. wheat, feed grains, oilseed products, cotton, sugar, dairy products, poultry, and tobacco. In addition, Iraq also participated in other U.S. agricultural export programs including the Export Enhancement Program, the Targeted Export Assistance Program, and the Cooperator Foreign Market Development Program.

U.N. Sanctions period (1990 to 2003). Under the U.N. sanctions regime adopted in 1990, the importation of agricultural products was not banned; however, foreign companies were prohibited from investing directly in Iraq.[70] In addition, because the Iraqi government was unwilling in 1991 to participate in the Oil for Food Program, the country could not legally export oil and so had no revenues it could use to buy food and agricultural inputs on the international market. From 1990 to 1994, Iraq's agricultural imports averaged slightly above $1 billion or less than half of the pre-war level. USDA's export credit offers to Iraq were stopped, and USDA's Commodity Credit Corporation had to pay over $2 billion in unpaid Iraqi export credit guarantees. U.S. agricultural trade with Iraq fell to nearly zero.

After 1991, the northern portion of Iraq fell under de facto local Kurdish control while the fifteen governorates in central and southern Iraq remained under central government control. This corresponds roughly to the rain-fed northern agricultural zone and the irrigated center-south zone. The central government took steps to increase both production and control of domestic food within its zone of control. These changes included Government monopoly control over most grain production and the introduction of a state-managed system of rationing of basic foodstuffs.

Government incentives coupled with rising internal food prices encouraged Iraqi farmers to expand crop area by planting on marginal pastureland and fragile hillsides. Record cropped area was attained in 1992 and again in 1993. However, agricultural productivity suffered for lack of fertilizers, agricultural machinery and the means of spraying planted areas with pesticides.

Anecdotal evidence suggests that the 1991 Gulf war resulted in significant damage to the irrigation and transportation infrastructure vital to Iraq's agricultural sector, but it is difficult to evaluate the extent or severity of the damage. Iraq's irrigation infrastructure fell into disrepair and salinity has spread across much of the irrigated fields of central and southern Iraq. Once severe salinization has occurred in soil, the rehabilitation process may take several years according to FAO officials.[71]

In addition, rural areas were left with a severe labor shortage further hurting agricultural productivity. According to the U.S. Census Bureau, in 1991 Iraq experienced a 3.7% decline in population as an estimated 663,000 persons died or

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[69] U.S. General Accounting Office. *Iraq's Participation in U.S. Agricultural Export Programs*, NSIAD-91-76, Nov. 1990, p. 2. [http://161.203.16.4/d22t8/142766.pdf]

[70] Country Factsheet, The Economist Intelligence Unit, *The Economist*. [http://www.economist.com/countries/Iraq].

[71] *The Economist*, "Digging for defeat: Iraq," May 2, 1998, Vol. 348, No. 8066, p.44.

left the country following the first Gulf war.[72] Much of this exodus included foreign guest workers from the agricultural sector.

Iraq's poultry and livestock populations were devastated by the loss of rangeland to grain crops and the drop off of feed grain imports and veterinary medicines needed for routine control of parasites and diseases. A 1997 screw worm epidemic and a 1998 outbreak of foot-and-mouth disease resulted in further losses of animals.

By the mid-1990s severe macroeconomic problems related to the international sanctions led the government to end most support to the sector and instead to implement austerity measures that further curtailed agricultural investment. Declining food availability resulted in a significant rise in malnutrition in Iraq, particularly in the center and south of the country.[73]

By 1996, Iraq agreed to U.N. terms for establishing the OFFP. Once started, however, OFFP food imports made Iraq's trade dependence nearly complete for many basic foodstuffs. According to the World Food Program, by early 2003 nearly 60% of Iraq's population was totally dependent on imports via the OFFP. The Iraqi population's failing nutritional status and growing trade dependence was further aggravated by a severe drought that persisted throughout much of the Middle East from 1999 through 2001 and devastated crop output in Iraq.

Prospects. Some progress has been made at restoring lost agricultural productivity; however, a return to normal weather patterns is critical for domestic cereal production in Iraq. With the action of the U.N. Security Council on May 22, 2003, lifting trade and financial sanctions on all non-military goods, Iraq will be able to import food and needed agricultural inputs. However, political stability and increased internal security will also be necessary before Iraq's agricultural sector witnesses significant investment and growth. Restoration of the irrigation infrastructure (including a long-term de-salinization program), as well as the grain marketing infrastructure for handling, storing, and distributing agricultural inputs and outputs will be vital. In addition, the development of a viable agricultural research and extension service to develop and disseminate improved varieties and successful production practices are needed to restore agricultural productivity.

Clearly, Iraq will be dependent on imports for meeting domestic food demand for several years to come. In the long term, after the economy has regained its viability and vibrancy, market forces and international competition will likely be the driving forces behind Iraq's agricultural trade patterns. Historical trade and food consumption patterns suggest that food grains such as wheat and rice, feedstuffs including corn, barley, and protein meals, vegetable oil, sugar, meat, and dairy products are all likely to be important imports into Iraq.

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[72] U.S. Bureau of the Census, International Data Base (IDB), Iraq, Oct. 10, 2002; [http://www.census.gov/ipc/www/idbacc.html]

[73] UNDP, *Iraq Country Office, 1999-2000 Report*, June 2000.

Banking and Financial Institutions[74]

Iraq has never had what most Western analysts would call a market-oriented banking system. Nevertheless, before 1991, it had one of the most modern financial systems in the Arab world. The government created most of the country's financial institutions, with the exception of some private banks established after 1988. Iraqi banks seem to have gotten most of their funds, not through borrowing in the market or from deposits, but from allocations from the national treasury. Access to capital and financial services seems to have been determined more by political factors than by independent considerations of creditworthiness, profit and risk. Between 1991 and 2003, government control over the Iraqi financial system tightened further.[75]

Iraq's banking system was limited, until the 1930s, by the size of its economy and the small level of savings. In 1936, the government created an agricultural and industrial bank which split in 1940 into two separate institutions. Other specialized banks, for real estate, mortgages, and cooperatives, were created in the 1940s and early 1950s. A commercial bank, the Rafidain Bank, was created in 1941. It also served for a few years as the central bank. A state-owned institution, the National Bank of Iraq, was founded in 1947. It became the Central Bank of Iraq in 1956, one of the earliest Arab monetary authorities. The Rafidain Bank was, for many years, the only commercial bank in the country.[76] Its original ownership is unclear. In 1964, all Iraqi banks and insurance firms were nationalized. The government's specialized banks were consolidated at that time into separate institutions for agriculture, industry, and real estate. The industrial bank made loans to both public and private sector firms and held equity positions in several public/private joint-stock companies. Government policy evidently played a major role in its decisions and those of the other specialty banks. In the early 1980s, for example, the industrial bank was instructed to expand its lending to private and state-owned firms in order to promote development. The real estate bank meanwhile was instructed to increase its lending in order to promote the construction of housing and to encourage more people to build their own houses.

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[74] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, Foreign Affairs, Defense and Trade Division.

[75] Much of the factual and descriptive information presented here on Iraq's financial system is drawn from the Europa Middle East and North Africa yearbook for 2003 and from Metz. *Iraq, a Country Study*.

[76] The Rafidain Bank was the only commercial bank in the country until 1988 and it remained the predominant institution thereafter. Some analysts have questioned whether it was truly independent of the central bank. For most of their history, both were owned and controlled by the government. With assets of more that US$17 billion in 1983, the Rafidain Bank was reportedly the largest Arab commercial bank. In 1982, according to one report, the American Banker newspaper named Rafidain the world's fastest growing bank. In early 1989, Rafidain ranked number 83 in the world, with $54.5 billion in assets. In 1996, it had 152 local branches and nine branches abroad. Given the strength of the Iraqi economy during this period, it seems likely that much of the capital to fund the bank's operations came from government or from regime sources.

Until the late 1980s, Iraq had one of the most modern financial systems in the Arab world. It reportedly helped Jordan (and perhaps others) establish their own central banks. The Rafidain Bank was a shareholder in several European-Arab consortia banks and one of the seven founding shareholders of the Gulf International Bank, a regional commercial bank founded in 1977. In 1981, Rafidain created a joint venture bank with Banco do Brasil, with a capitalization of US$17.5 million. In 1987, its own capital base was doubled (to ID 100 million) as the first stage in a plan to expand the national banking system. In 1988, the Iraqi government announced that another commercial institution, the Rashid Bank, would be created (also at a capitalization of ID 100 million) to compete with the Rafidain Bank. Some sources report that Rafidain emphasized foreign connections while Rashid focused more on the domestic economy. The government seems to have been the source of the new capitalization for both banks. The government also encouraged more competition among the three state-owned insurance firms. The banks and insurance firms were encouraged to expand and given administrative and financial autonomy, bound officially only by the Government's fiscal policy.

In May 1991, the government rescinded the 1964 decree nationalizing all financial institutions. According to recent reports, there were 17 privately owned banks in Iraq in 2002. The role of the private banks is unclear. Given the legal restrictions on access to foreign capital and the weakness of the Iraqi economy, most of their resources likely came from official or regime sources. No information is available as to where or for what purpose they invested their funds. In June 1991, the government created a state-owned Socialist Bank, with a capitalization of ID 500 million, to make interest-free loans to civil servants and decorated war veterans.

Events since 1991 have substantially limited the capacity of Iraq's financial institutions. Much of the flexibility and autonomy implicit in the legalization of private banking, in 1988 seems to have been overtaken by events. Most of the country's overseas assets were impounded ("frozen") in October 1992 or shifted to escrow accounts. This made it very difficult for Iraqi financial institutions to operate internationally. The post-1991 sanctions regime and the Oil for Food program also centralized financial control within Iraq in the hands of the government and the international bodies administering the system. Iraqi banks had little access to capital other than through official channels. Much of the lending by these institutions in the past decade seems to have been based more on personal or political connections than on normal banking principles. In many cases, it is not clear that these were in fact loans which the borrowers were expected to repay.

Since the end of the recent war, most of Iraq's banks have been severely battered by looting. The Central Bank and other banks have been thoroughly looted, by officials of the former regime as well as by post-war thieves.[77] The financial capacity of Iraq's banks and their ability to continue operations may be in serious doubt. For its part, the Rafidain Bank served during the 1970s and 1980s as the government's principal agent for borrowing funds abroad. After 1990 it became the principal venue through which Saddam's government defaulted on its foreign debts. The bank was

[77] Some money has been recovered, however, and turned over to occupation authorities but its source and ownership are unknown.

sued by most of the country's creditors for collection of those debts. It is, in effect, bankrupt. In April 1993, British liquidation experts informed creditors meeting in London that the liquidation of the Rafidain Bank's international operations would yield only a minimal recovery.

Transportation and Infrastructure[78]

Iraq's transportation and infrastructure systems have deteriorated substantially in the past dozen years. The government invested heavily in them, during the1970s, thanks to the inflow of oil revenues and, in the 1980s, as a matter of strategic necessity due to the Iran-Iraq war. Much of this infrastructure was destroyed during the first Gulf war, and rebuilding efforts were hobbled by the sanctions regime. The telecommunications network was subsequently targeted in the 2003 hostilities.

Shipping. Iraq's main port is at Basra, about 50 miles inland from the Persian Gulf along the Shatt-al-Arab waterway. Before the oil boom of the 1970s, it was a relatively small port, most trade being oriented overland through Syria and Jordan. The port was damaged by Iranian shelling during the Iran-Iraq war and by coalition bombing during the first Gulf war. The Shatt-al-Arab also was blocked by sunken ships until cleared and dredged in 1993. Ports were built at Umm Qasr and Khor al-Zubair in the 1980s, connected to the Gulf by the Khor Abd-Allah waterway. Limited shipping was resumed at Umm Qasr in November 1993, although the condition of the port prevented intensive use. The port at Khor al-Zubair was designed to handle cargo destined to and from the large industrial and petrochemicals industries there, most of which remain idle. Certain contracts for forklifts and dredging equipment were allowed by the UN sanctions commission in order to improve the ports for food and medical shipments. The regime dredged stretches of the Tigris between Baghad and Basra to facilitate barge traffic, and it commissioned navigation studies for other areas along Tigris and Euphrates. A barge canal between Al-Nasiriyah on the Euphrates and Baghdad was completed in December 1992.

Railways. The Iraqi railway system has five major routes. A northwest route links Baghdad with Mosul and the Turkish border. A second runs north from Baghdad to Kirkuk and Arbil. The third runs south from Baghdad to Basra and Umm Qasr. A fourth line stretches from Baghdad west to Qusaybah at the Syrian border and continues west to link the industrial complex at al-Qaim with the phosphates mines at Akashat. A fifth line connects this route at al-Hadithat with Kirkuk, thus linking the minerals processing complex at al-Qaim with sulphur mines in the country's northern region. Due to the dilapidated condition of the rails and equipment, service is reportedly infrequent and unreliable. The U.N. sanctions committee allowed the importation of 30 new mainline locomotives in 2000. The Hussein regime commissioned studies to improve and expand the railways, but lack of funds prevented the execution of these projects. In 1994, Iraq possessed 1,259 miles of operating track. No new construction has occurred since.

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[78] Prepared by Ian Fergusson, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

Air Transportation. Iraq has international airports at Baghdad and Basra. Civil international air traffic was prohibited under UN sanctions, but several Middle Eastern states and France and Russia operated flights sporadically into Baghdad. Iraqi airways was effectively grounded by sanction, not only due to the prohibition on flights, but also due to the lack of access to spare parts. In 1989, the last full year of 'normal' operations, the airline carried approximately 1.2 million passengers to 42 destinations within Iraq and abroad. In 1987, the fleet contained 14 Boeing passenger aircraft and 35 Russian-built Antonov and Ilyushin cargo planes. Iraqi airways was divided into its aviation and ground services components in 1987 and the two entities were partially privatized a year later. However, its virtual disappearance from the air after the imposition of sanctions did not bode well for investors.

Roadways. In 1994, Iraq had an estimated 27,410 miles of paved roads and highways. The road network received priority during the 1980s due to its strategic value in the war against Iran. Consequently, the roads connecting the central population centers with the Iranian frontier received the most attention. The International Expressway #1, a six-lane highway linking Safwan on the Kuwaiti border north to Baghdad and west to the Jordan border, was completed in 1989. It was designed to link the Gulf states with the Mediterranean. Iraq's roads and bridges were heavily damaged during the first Gulf war, but they reportedly received priority in the regime's later reconstruction efforts. In 1994, approximately 765,000 passenger vehicles and 265,000 trucks were registered in Iraq.

Communications. Iraq's telecommunications infrastructure was severely damaged by the first Gulf war, the 1998 allied airstrikes, and the 2003 hostilities. Before 1991, there were approximately 37 land-lines per thousand residents, declining to 30 lines per thousand in 2001. The earlier figure indicates that the system was not particularly widespread before the destruction of the central switching facilities and trunk lines. The U.N. Sanctions Committee (UNSC) blocked most contracts to replace damaged infrastructure on grounds that such equipment could be utilized for military purposes. In 2001-2002, the UNSC approved several upgrades to improve international connectivity and the domestic trunk networks. A wireless phone network in the northern Kurdish-controlled operates with the European-originated GSM standards.

Power Generation.[79] Iraq's government invested heavily in electric power generation in the 1980s, contracting with Britain, West Germany, France, Italy, South Korea, the Soviet Union, and Yugoslavia to build or expand thermal and gas generating plants, hydroelectric facilities, and transmission wires. A great majority of these installations are oil or gas fired, although hydro power accounts for about 2% of capacity. A nuclear reactor at Osirik was destroyed in an Israeli attack in 1981. Iraq's transmission grid was linked with that of Turkey in 1987, and Iraq became the first Middle Eastern state to export power. In 1990, capacity was reported to be 9,000 MW. Bombing during the first Gulf war reportedly destroyed about 90% of its electronic generation and transmission facilities and electricity generation capacity

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[79] In addition to other sources cited in this section, information on Iraqi power generation was also obtained here from the Energy Information Administration, *Country Analysis Brief: Iraq*, February 2003 (http://www.eia.doe.gov/emeu/cabs/iraq.html#elec).

fell precipitously to 340 MW by March 1991. Although the regime declared that 75% of generating capacity had been restored by early 1992, subsequently in 1998 an Iraqi energy official claimed that the system was operating at 50% of capacity due to lack of spare parts. Recently in 2002, the U.N. Iraq Program declared that operating capacity to be 4,300-4,400 MW. Contracts for spare and maintenance equipment were approved in 2001-2 to aid in boosting production, but chronic shortages of power remained. Power was available only 12 hours per day in many areas. The power supply deficit was estimated at 1,100 MW overall, with a peak load deficit of 2,500 MW estimated in 2001.

Industry[80]

For the most part, the industrial sector of Iraq was created during the 1970s and 1980s as a result of government attempts to diversify the economy through economic development projects using proceeds from Iraq's oil wealth. While some projects were undertaken to exploit available economic resources, others were developed to foster national identity or to enhance the prestige of the regime. Industrial enterprises sustained heavy damage in the 1991 Gulf war. Such facilities that were not destroyed were degraded or rendered inoperable during the remaining years of the Baathist regime due to the shortage of spare parts and technical know-how. The age and debilitation of the infrastructure, and the presence of a technically competent workforce, may determine the economic viability of the industrial sector.

Industrial Development. Since the days of the monarchy, Iraq's economic development programs have emphasized the development of industry as a means to modernize the nation. In the 1950s, the monarchy used oil revenues to undertake large infrastructure projects, but most manufacturing industry remained in private hands. After the overthrow of the monarchy and extensive nationalizations of industry in 1964, industrial development was characterized by extensive state planning and public sector control of industry. Generally, however industrial development programs sought to advance common goals, namely, (1) to diversify the economy and to lessen reliance on oil revenue, (2) to provide employment opportunities for the labor force, (3) to develop and exploit local resources, and (4) to encourage import substitution industries.[81]

Large scale industrialization expanded during the oil boom in the late 1970s. With more money in hand, the government was able to purchase heavy industrial plants from foreign contractors on a turn-key, ready-to-operate, basis. Several industrial zones sprang up in this fashion, notably at al-Qaim (minerals processing), Khor al-Zubair (including a large French-contracted iron and steel plant) and a petrochemical complex near Basra. Light manufacturing, including textiles, food processing, and household goods, was centered around Baghdad.

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[80] Prepared by Ian Fergusson, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

[81] Tariq al-Khudayri, "Iraq's Manufacturing Industry: Status and Prospects for Rehabilitation and Reform,"in Mahdi, *Iraq's Economic Predicament*, p. 202;

The Soviet Union and other eastern bloc countries also contracted for the construction of several projects in the 1980s. Among these were steel works and an electrical equipment manufacturing plant in Baghdad, a tractor works in Musayib, and a pharmaceutical plant in Samara. Romania provided two cement plants, in al-Qaim and Sinjar. They reportedly produced 7.5 million tons of cement in 1987, of which 4.5 million tons were exported. Iraq purchased these facilities through Economic Cooperation Agreements signed with various eastern-bloc countries beginning in 1985, which provided credits arrangements considered to be more favorable to Iraq than those offered by western creditors at that time.[82]

To diversify away from petroleum dependency, Iraq sought to develop its mineral resource industry. Sulphur mining and processing has been conducted in northern Iraq near Mosul since 1972. Proven sulphur reserves in 1988 were reportedly 515 million tons. At its peak in 1989, production was estimated at 1.4 million tons, of which 1.2 million tons were exported. Sulphur production was enhanced by the opening of a sulphur recovery and sulphuric acid plant built by Japanese firms in 1988. Phosphate extraction and processing is located in the northwest region of the country in mines around Akashat. The reserves of the Akashat mine, opened in 1981, have been estimated at 3.5 billion tons. Phosphate is processed in al-Qaim, in a plant built by a Belgian firm in 1984. Production was estimated at 1.2 million tons in 1989, of which 766 thousand tons were exported. Before the first Gulf war, Iraq was self-sufficient in fertilizers.

Several problems have been identified in the manner of industrialization undertaken in the 1970s and 1980s. Due to the large influx of petrodollars, these projects were often ill-conceived and unproductive. They were often undertaken for symbolic reasons, were grandiose in scale and did not reflect the absorptive capacity of the economy. Plans for needed technical expertise, sources of supply input, and transportation needs were often inadequate.[83] One source estimated that at the peak of its operations, the manufacturing sector imported 80% of its inputs. Hence it was highly vulnerable to supply disruptions and currency volatility.

War and Sanctions. Aside from the internal weaknesses in the sector, war and sanctions also crippled Iraqi manufacturing. During the Iran-Iraq war, most industry escaped direct damage from Iranian attacks. However, much of the industrial infrastructure was sidelined by the inability to obtain intermediate inputs and spare parts due to interference with shipping and damage to ports. As the conflict dragged, the government concentrated its resources on military industrialization projects and this emphasis contributed to the decision to privatize some state industries in 1988. In the manufacturing sector, approximately 50 state operations were sold to the private sector or listed on the Baghdad stock exchange. Many of these entities were sold at well below what was considered market cost.[84]

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[82] Ahmed M. Jiyad, "The Development of Iraq's Foreign Debt," in Mahdi, *Iraq's Economic Predicament*, p. 98

[83] Cordesman and Hashim, *Iraq: Sanctions and Beyond*, p.129.

[84] al-Nasrawi, *Iraq's Burdens: Oil, Sanctions, and Underdevelopment*, p.99.

Much of the industrial infrastructure that survived the Iran-Iraq war was destroyed or severely damaged by bombing during the first Gulf war. The Khor al-Zubair heavy industry complex was heavily hit, and although some reconstruction work has occurred, it has not operated since. For industries not destroyed, the sanctions regime in effect between 1990 and 2003 closed off the possibilities of obtaining inputs or spare parts or exporting manufactured products legitimately. Reconstruction efforts did not concentrate on the revitalization of the manufacturing sector, but rather focused on the more lucrative oil industry and on instruments of the regime's power.[85]

Prospects. The future outlook for the manufacturing sector is clouded. Most facilities have been destroyed by war or degraded by sanctions. Few new inputs have been put into the sector sine 1990. Iraqi manufacturing is saddled with aging, if not damaged, equipment and infrastructure. The capacity and skills of the labor force have deteriorated over time. In addition, much of the economic rationale for Iraqi industry has evaporated, since much of the capacity built in the 1970s and 1980s was based on national prestige, import substitution, or other non-market considerations. New policies to facilitate and encourage the growth of industry on better and more sound foundations will be needed. Given the large size of the urban population and the limited growth prospects for agriculture, new employment opportunities in industry likely will be needed. Iraq will need to take care (see the section on the non-oil economy and "Dutch Disease" below) not to allow its currency to appreciate so much in value (due to large oil exports) that the incentives and prospects for industry and other sectors are unnecessarily diminished.

International Trade[86]

Exports. Oil has been Iraq's main export since the 1930s. By 1953, oil exports accounted for 49.3% of national income.[87] In the 1980s, crude oil made up 83% of all Iraqi exports.[88] The figure in 2001, under the Oil for Food Program, was over 95%. Non-petroleum export products included portland cement, fruit (mainly dates), fertilizers, and reaction engines. Table 2 illustrates Iraq's top exports in 1989. In 2001, Iraq's exports totaled $12.6 billion. Its largest export markets were the United States ($6.3 billion), Canada ($1.1 billion), France ($887 million), the Netherlands ($791 million), and Jordan ($736 billion).

International sanctions were imposed by the United Nations in August 1990[89] following Iraq's invasion of Kuwait. (See the section on the Oil for Food Program above.) The U.N. Security Council created the OFFP in 1995, allowing Iraq to

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[85] Cordesman and Hashim, *Iraq: Sanctions and Beyond*, p.149.

[86] Except for the portion on customs duties, this section was prepared by Cathi Jones, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

[87] Slugett, M. & Slugett, P. *Iraq since 1958: from revolution to dictatorship*. New York: KPI Limited, 1987, p. 35.

[88] Economist Intelligence Unit (EIU) calculations.

[89] United Nations Security Council Resolution 661, August 9, 1990.

export $2 billion worth of oil every six months. The first Iraqi oil exports began on December 10, 1996, after it agreed in May to implement the program.[90] The first shipments of food under the OFFP arrived in March 1997, followed by imports of medicines in May 1997. From the implementation date to March 2003, approximately $26.8 billion worth of food, humanitarian supplies, and equipment was delivered to Iraq under the program.[91]

Table 2. Iraq's Top Exports, 1989

SITC Rev3 Commodity	Millions of U.S.$
3330-Crude oil from bituminous minerals	$11,545.4
3344-Fuel oils, not elsewhere specified	$211.3
3343-Gas oils	$119.8
3341–Gasoline (motor spirit) and other light oils	$78.8
2741- Sulfur of all kinds (except sblmd, prcpt, or coll)	$39.2
6612-Portland cement aluminous, slag, supersulfate, etc.	$35.7
0579-Fruit, fresh or dried, not elsewhere specified	$30.8
5629-Fertilizers, not elsewhere specified	$29.6
7144-Reaction engines	$29.2
5222-Chemical elements, not elsewhere specified	$27.7

Source: United Nations international trade data

The six-month ceilings on oil sales were raised from $2 billion to $5.3 billion in 1998 and abolished altogether in 1999. This allowed Iraq to export and import without limit so long as it complied with the U.N. screening process. Despite this, Iraq's oil exports ran significantly below capacity in 2001 and much of 2002, due, in part, to disputes between Iraq and the U.N. over the formula for pricing Iraq's oil. Iraq imposed surcharges of about 30-50 cents per barrel on its oil buyers, resulting in illicit kickbacks that the government allegedly used to buy unapproved goods. In September 2001 the UN Sanctions Committee changed the pricing formula to "retroactive pricing" in an attempt to block the surcharges. This policy reduced Iraq's oil sales by about 25%, although the UN noted a rebound to previous sales levels by September 2002. In addition, Iraq has sometimes unilaterally interrupted the sale of oil to protest Security Council policy or to challenge the United States and its allies. For example, Iraq suspended its oil sales for the month of April 2002 in protest of Israel's military incursion in the West Bank.

Imports. Prior to the implementation of the Oil-for-Food Program, Iraq was essentially a command economy with virtually all transactions conducted through government contracts. Little or no private sector trade flowed across borders. Major imports included food, motor vehicles, spare parts, iron and steel, and medicines. Table 3 shows Iraq's top ten imports in 1989. In 2001, Iraq's imports totaled $4.2

[90] United Nations Document number S/1996/356.

[91] United Nations. Office of the Iraq Programme. Oil-For-Food. [http://www.un.org/Depts/oip/factsheet.html].

billion. Its top suppliers were France ($592 million), Australia ($439 million), China ($397 million), Italy ($327 million), and Vietnam ($320 million).[92]

Importing via the public sector continued during the operation of the OFFP, however, all government purchases were monitored by UN staff, who reviewed all contracts and ensured that imported goods were on a list of commodities approved by the UN Security Council. Besides food and humanitarian supplies, Iraq was permitted to import spare parts for repair of its oil infrastructure, limited quantities of transportation and communications equipment, and some consumer goods. Table 4 represents Iraq's imports under the OFFP. From 1997 to 2003, almost 60% of Iraq's people were, to some extent, dependent on food and other humanitarian supplies provided by the program.

Illicit Trade. As noted earlier, the regime of Saddam Hussein imposed surcharges on oil buyers, solicited kickbacks from suppliers of humanitarian and other civilian goods, and conducted illicit oil dealings with its neighbors.[93] This helped generate funds it could use without restrictions. Although there are no authoritative figures for the value of Iraq's illicit trade, the most widely cited estimates come from a General Accounting Office (GAO) study released in May 2002 that estimated Iraq's illegal earnings at $6.6 billion from 1997-2001. Countries receiving illicit exports allegedly included Syria, Turkey, and Jordan.[94]

Table 3. Iraq's Top 10 Imports, 1989

SITC Rev3 Commodity	Millions of U.S.$
0412-Wheat (including spelt) and meslin, unmilled,	617.3
7843-Tractor, motor vehicle	170.4
6793-Iron and steel seamed	160.9
0112–Meat of bovine	144.6
7812–passenger motor	139.6
6791–Iron and steel	137.8
0423–Rice, milled	132.2
6762–Alloy steel bars, rods	130.7
5429–Mendicaments	124.5
6911–Metal structures and parts	105.4

Source: United Nations Trade Data.

Table 4. Iraq's Imports under OFFP, 1997-2003

Sector	Millions of U.S. $
Food	13.5
Food Handling	3.3
Health	3.0
Oil Spares	3.6
Electricity	3.5
Water and Sanitation	2.0
Agriculture	3.7
Education	1.1
Communication and Transportation	2.0
Housing	2.7
Special Allocation	293.6

Source: United Nations. Office of the Iraq Program

[92] International Monetary Fund trade data.

[93] CRS Report RL30472, p. 12.

[94] General Accounting Office, *Weapons of Mass Destruction: U.N. Confronts Significant*

(continued...)

Prospects. Since so much of its GDP depends on oil exports, Iraq's economic prospects are linked to its ability to pump oil. Given the deterioration and current disarray in the manufacturing and agriculture sectors, it does not appear that Iraq will be able to produce sizable quantities in either sector for export any time soon. Indeed, it appears that imports in the near term will need supply much of the country's demand for food, other agricultural products, and many manufactured goods. Reconstruction and improvements in Iraqi competitiveness may diminish this situation in the next few years, if the country pursues appropriate policies and establishes adequate incentives for non-oil economic activity. In the meantime, as discussed in the section on petroleum above, Iraq seems poised to became a major exporter of oil to the world market. Some experts believe that it can double its capacity to 6 million barrels per day within a decade.[95]

Fiscal Levies on Foreign Trade.[96] No quantitative data are available on Iraq's past revenues from duties, taxes or fees on imports or exports. Likewise there is little information available on government revenues in general. The future Iraqi government's fiscal system will have to be built from the ground up. The size of the government's fiscal needs and their financing will depend on the prospective activities of the government as reflected in the budget. The extent to which Iraq will rely on duties or taxes on foreign trade – as opposed to other domestic and foreign sources of revenue such as income and business taxes (e.g. on petroleum and/or its products, various fees, foreign assistance) – to finance such activities (as well as their scope) is a matter yet to be decided by Iraqi's future governing authorities.

Speculatively, the obvious source of a foreign-trade related fiscal levy would be an export tax or duty on crude petroleum and/or its products, traditionally the most important component of Iraq's foreign trade. Similar levies on other exports would not be a likely source of significant revenue because of the small share they hold in Iraq's exports. Moreover, at least in the short to medium run, in certain areas the availability of output for export will be modest because of past deterioration of production facilities and the damage caused by recent wars.

A likewise less likely source of significant (if any) trade-related fiscal levies would be Iraq's imports, which consist mainly of articles for basic personal consumption (food, medicine) and inputs for agriculture and industry, and for the rehabilitation of Iraq's economy. The obvious broad need for imports of this type and the ultimate locus of the burden of such taxation (the general public) would make this approach somewhat counterproductive. It would also lead to increases in the prices of such commodities with their concomitant inflationary effect. This may have a negative impact on the country's non-oil economy. (See discussion below.)

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[94] (...continued)
Challenges in Implementing Sanctions against Iraq, GAO-02-625, May 2002.

[95] Energy Intelligence Group, Inc. "Iraq is well primed for big oil opening." *Petroleum Intelligence Weekly*, March 12, 2003.

[96] Prepared by Vladimir N. Pregelj, Specialist in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

In the matter of any levies on domestic and/or foreign transactions in petroleum and its products, some consideration would have to be given to certain aspects of world petroleum trade. In view of the overall uniformity of the world prices of such products, for instance, an export levy could not be passed to the importer, but would have to be absorbed by the exporter if Iraqi petroleum is to remain competitive on the world market. Another aspect to be considered in this context is Iraq's membership both of the Organization of the Petroleum Exporting Countries and of the Organization of Arab Petroleum Exporting Countries (OAPEC) and their role in Iraq's petroleum exporting policy and activities.

The Post-War Situation[97]

Assessing the Damage

Rebuilding the physical and social infrastructure of Iraq is a necessary prerequisite to the functioning of the Iraqi economy. In addition to fixing utilities and transportation, the government must be able to assure the basic welfare of its citizenry through adequate food supplies, medical care, and security arrangements. This cost of the reconstruction will likely be borne by the newly constituted government of Iraq through oil revenues, by national and multilateral aid organizations, and by the Iraqi people themselves.

Critical Infrastructure. Although the United States did not target much of Iraq's electrical, water, and telecommunications infrastructure during the war, collateral bombing damage and the chaos which ensued following the downfall of the Saddam Hussein regime has prevented coalition forces and local Iraqis from rapidly repairing and restoring vital services such as electricity, water, sanitation, and telecommunications. Some of Iraq's power plants were looted after U.S. forces entered Baghdad. Power lines also have been damaged, and in some instances, were deliberately cut down by looters. In Baghdad, several towers, which hold up high voltage power lines were wrecked by bombing and a central dispatch center that coordinates the allocation of electricity was ravaged by looters. Most of all, many employees of Iraq's electricity system have been to afraid to go back to work, forcing coalition forces to have to find vital electric engineers and other employees of Iraq's electricity system in order to restart service.

The water supply in Iraq's main cities also was damaged both during and after the war. Even before the war, Iraq's water system was old and decrepit as nearly 40% of all water is lost due to leaky pipelines. The war exacerbated this situation. In Baghdad, there were breaks in the main water line that required repairs before residents could receive water service. Some of Iraq's water and sanitation infrastructure was damaged by looters in the days and weeks following the cessation of heavy fighting. The lack of electricity has had an impact on water service, as engineers have had to rely on generators to power water stations. Many sewer treatment plants are not functioning, allowing sewage to drain into water systems.

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[97] Prepared by Jeremy M. Sharp, Analyst in Foreign Affairs; Rhoda Margesson, Analyst in Foreign Affairs; and Curt Tarnoff, Specialist in Foreign Affairs, Foreign Affairs, Defense and Trade Division.

There also has been no garbage collection service, other than local efforts in neighborhoods to collect and dispose of trash.

In an effort to disrupt Iraqi communications during the war, coalition forces bombed Iraq's telephone exchanges, cutting off telephone service for many Iraqis. Some telephone lines also are down due to a combination of war damage and post-war looting. Iraqis with satellite phones, which were banned under Saddam Hussein's regime, can make long distance calls and have begun charging other Iraqis for calls abroad. Outside the Kurdish area, Iraq has no mobile phone network.

Transportation Infrastructure. Iraq's roads, bridges, and highways were not seriously damaged during the recent war. However, the war and the ensuing civil unrest have disrupted the distribution of fuel throughout the country. Many drivers of gasoline tankers have stopped making shipments, due to the insecurity on the roads. This has caused shortages and long lines of cars waiting for gas at fuel stations. The port of Umm Qasr, Iraq's main outlet to the Persian Gulf and only deep-water port, was only partially damaged during the war. British and Australian forces continue to sweep it for mines, but massive dredging and rebuilding are required to prepare the port for large cargo ships. A team of port management specialists and engineers are reported assessing the damage and determining what needs to be done to make it operational for the distribution of humanitarian aid.

Damage to Iraq's airports varied during the war. During the first Gulf war, Iraq's national airline, Iraqi Airways, had lost many of its planes, some of which it had flown to safety in neighboring states. Furthermore, international sanctions preclude incoming commercial flights from flying into Iraq. Some legal experts believe that these sanctions must be lifted before Iraq's airports can be reopened to commercial traffic.[98] Business analysts believe that it will take 2-3 years before Iraqi Airways will be up and running, as the airline requires an entirely new fleet of planes.

Security. Police services have also been seriously diminished. Many observers believe that one of the greatest challenges to Iraq's recovery from war and future economic growth is the security situation in Iraq's population centers and rural countryside. In the aftermath of the war, there has been a complete breakdown in law and order with the dissolution of the Baath Party and Saddam Hussein's repressive security apparatus. With no cohesive local police forces, judicial system, or national army, Iraq is entirely dependent on coalition forces to provide security. In Baghdad, several hundred Iraqi police officers have returned to work. However; many officers have remained at home. Police officers who are back on duty face shortages in equipment and have complained of being outgunned by armed bandits. There are widespread shortages of reliable manpower to provide stability in many areas in Iraq. In areas where U.S. forces do not have a large presence, local neighborhood associations have started to organize security patrols. In more dangerous areas, armed militias, some of which are associated with clerics and tribal sheikhs, have sprung up to become the de-facto police, enforcing the rule of a local leader.

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[98] Over the last several years, some international carriers, in violation of sanctions, had started offering flights to Baghdad.

Humanitarian Assistance and Post-War Relief[99]

The war, which was followed by massive looting, destroyed critical infrastructure, disrupted the delivery of basic services and food supplies, and impacted the humanitarian situation inside Iraq. So far, the overall disruption has not reached the crisis levels some predicted before the start of hostilities: Widespread hunger, massive population movements, and severe health epidemics have not occurred. However, basic services have essentially collapsed and the conditions are serious and deteriorating. Lack of water, fuel, and electricity and inadeqate shelter, sanitation, and medical care are creating hardship for many. While the humanitarian situation continues to change with developments on the ground, the amount of assistance that is ultimately needed will depend on the nature and duration of the post-hostility phase.

Provision of Relief. In the short term, security of humanitarian aid delivery and distribution is a major concern. Looting and lawlessness have been extensive; the situation remains volatile. Recurrent insecurity problems have made it impossible to launch a full-scale humanitarian effort. Many aid agencies remain on Iraq's borders unwilling to enter for security reasons. There are more than 150 U.N. staff and approximately 50 non-governmental organizations (NGOs) in Iraq. Local Iraqis are also involved in the aid effort. Deliveries of priority items – water, food, and medical supplies – are getting through slowly, although at times the chaos and violence hamper the efforts of those trying to provide the most minimal vital assistance. While they need protection, aid agencies fear that receiving it from coalition-led forces could mean an increase in security risks for their staff. Coalition troops are now patrolling cities and have been successful in controlling the looting in some areas. Troops are also helping with the emergency restoration of critical services, such as water and power. But it is slow going. Many Iraqis are growing impatient with the lack of order and public service.

Medical Services. Many Iraqi hospitals were looted after the dissolution of the Iraqi government, causing widespread shortages in medical equipment and medicine. In some cases, hospitals have been stripped of furniture and plumbing. Some looters stole ambulances, or stripped them of their tires and other parts. Despite these challenges, many Iraqi doctors and medical staff have persisted and have managed to provide treatment in emergency situations. At some hospitals, staff took up arms to protect their facilities from looting during the immediate post-war chaos. The International Committee of the Red Cross has reported that hospitals have varying levels of capacity and security. There are reports of dramatic increases in diarrheal cases, especially among children, as well as confirmed cases of cholera in southern Iraq. The situation at the hospitals has been complicated by an insufficient clean water supply along with a lack of electricity.

Food Supplies. At present, food supplies seem adequate, in part because extra rations were distributed prior to the war and because the World Food Program (WFP) has increased its food deliveries through humanitarian corridors. There is a high

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[99] For more on humanitarian and reconstruction efforts, see: CRS Report RS31833 *Iraq: Recent Development in Humanitarian and Reconstruction Assistance.*

dependence on WFP rations. Until their activities were suspended on the eve of war, U.N. and other humanitarian agencies were providing aid to Iraq through the Oil for Food Program, under which 60% of Iraq's estimated population of 24 to 27 million were receiving monthly food distributions. The WFP, Ministry of Trade (MOT) and ORHA have launched a $2 billion post-conflict Public Distribution System (PDS), which took effect on June 1.

U.S. Activity. Among the key policy goals the Bush Administration specified when launching a war in Iraq was the economic and political reconstruction of the country. An Office for Reconstruction and Humanitarian Assistance (ORHA), staffed by personnel from State, USAID, Defense, and other agencies, was created within the Pentagon for the purpose of implementing such a program, and it is now deployed in Iraq. Until recently, retired Lt. Gen. Jay Garner headed the Office. Recently appointed Presidential envoy to Iraq, Paul Bremer, is the senior official responsible for the reconstruction program and the establishment of an Iraqi civilian government.

The FY2003 emergency supplemental appropriations bill (P.L. 108-11) provides $2.48 billion for an Iraq Relief and Reconstruction Fund, roughly $1.7 billion of which is expected to be used for reconstruction activities. Most analysts expect Iraq reconstruction needs to greatly exceed this amount , likely needing supplements from other sources, such as additional U.S. appropriations, contributions from other donors, debt reduction or rescheduling, and profits from oil resources.

According to the statements of U.S. officials and budget justification documents, U.S. reconstruction objectives in Iraq include the formation of an Iraqi Interim Authority (IIA), leading to a constitutional commission and establishment of a new Iraqi government. U.S. assistance is envisioned for repair of economic and social infrastructure – including roads, schools, hospitals, and markets. U.S. and Iraqi exile experts are to advise each of the 23 Iraqi ministries. U.S. funds are intended to support efforts to encourage adoption of reformed judicial, legal, and electoral systems; to provide education to all children, and basic health care for all Iraqis. U.S. advisers are expected to help promote appropriate macroeconomic policies and open the Iraqi economy to free-market private enterprise.

Most reconstruction efforts are in their early stages. General Garner announced earlier that he expected the nucleus of an interim government to emerge by mid-May and be fully established by early June. On May 21, U.S. civil administrator Bremer postponed the formation of an interim government until at least mid-July due in part to security concerns. Some suggest that a longer time period is needed to insure that the interim government is sufficiently inclusive of all political groups Contractors and grantees have been selected to implement programs in seaport and airport administration, capital construction, theater logistical support, public health, primary and secondary education, personnel support, and local governance. However, there are few reports of actual work on the ground. Bechtel is reportedly actively undertaking a dredging operation at the port of Umm Qasr. Iraqi exiles and U.S.-appointed advisers are taking up positions in Iraqi ministries. USAID grants are being provided to meet identified community needs, such as a sports facility and communications center in Umm Qasr. Civil servants, including teachers, are reporting to work. However, as the time since the end of hostilities lengthens, there is increasing criticism of the lack of observable progress in the reconstruction effort, including slow restoration of domestic fuel and gasoline production, shortage of supplies at hospitals, and lack of public order and essential services.

Major Issues Affecting Iraq's Economic Future

Preconditions for Economic Development[100]

A number of key issues will need to be addressed in order to normalize Iraq's economic situation and to open the door to its normal future participation in world commerce. These are conditions which must exist before any substantial economic development can occur.

A first requirement is the **re-establishment of civil peace.** Some economic activity can proceed behind walls or surrounded by armed guards. Generally, though, little progress can be made in Iraq so long as looting and civil conflict continue. International law requires that the occupying powers in Iraq "take all measures in [their] power to restore, and to ensure, as far as possible, public order and safety."[101]

The United States and its coalition partners have a few thousand soldiers patrolling and performing police functions.[102] Some commentators (military and civilian) say that several multiples of the current total are needed. Some Iraqi police from the former regime are also on duty. Additionally, several foreign governments have indicated that they would be willing to assign police to Iraq to help restore order. No final steps have yet been taken for internationalizing the police function or restoring control to Iraqi police officials who are not tainted by their prior connections to the old regime. In the meantime, U.S. troops are in the uncomfortable position of serving both as the military instrument of the occupying power and as the force providing civil police functions. The Iraqi public will likely have mixed feelings about this situation. The situation is rendered more complex if, as has been reported, some of the civil unrest and looting seen in recent weeks has been perpetrated by supporters of the Hussein regime (or perhaps others) in hopes of destabilizing the current scene.

A second requirement is the **establishment of a legitimate government**. International law sets limits on the actions an occupying power may take and the

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[100] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, Foreign Affairs, Defense and Trade Division, with the assistance of Jennifer K. Elsea, Legislative Attorney, American Law Division.

[101] *See:* Hague Convention No. IV Respecting the Laws and Customs of War on Land, Oct. 18, 1907, 36 Stat. 2277, Annex art. 43 [hereinafter "Hague Regulations"]. *See also:* Department of the Army. *The Law of Land Warfare* [hereafter "LLW"], section 363. This is a compilation of the laws, prepared by the Department of the Defense and issued to U.S. troops. See Department of the Army, Field Manual 27-10, July 18, 1956, updated July 15, 1976, at [http://www.adtdl.army.mil/cgi-bin/atdl.dll/fm/27-10/toc.htm].

[102] *Newsweek* reported in late May that 2,200 additional military police would arrive soon in Baghdad, bringing the total to 4,000. Joshua Hammer and Colin Soloway. "Who's in Charge Here." *Newsweek* , May 26, 2003, p. 29.

initiatives it may pursue.[103] Legally, under the Hague Regulations, an occupying power may use movable assets such as money, equipment, and oil from existing wells to pay current obligations, such as health care, schools, transportation infrastructure and the administrative costs of the occupation regime, until a viable Iraqi government is established.[104] However, the occupying power must serve as a trustee of the assets.[105] Title for property does not pass to the occupation authorities and property must be restored to its original owner at the end of the occupation. Compensation to the owner may be required. The civil and penal laws of the prior regime continue in effect and the occupying powers must enforce them (though they can be altered, repealed or suspended if they constitute a threat to the security of the occupying forces, restrict the political liberties of the subject population, or are inconsistent with the duties of the occupant, for example, contravening international law.)[106] The occupation authorities may "regulate commercial intercourse in the occupied territory [and] may subject such intercourse to such prohibitions and restrictions as are essential to the purposes of the occupation."[107]

Under the Hague Convention, the occupying power may not reorganize, sell, allocate, restructure or otherwise alienate immobile property (such as oil wells, forests, mines, or farms). It can control property to prevent its military use against the occupant and to meet the humanitarian needs of the population, but that "measure of control must not extend to confiscation." The occupying power does not have the right of sale or unqualified use of such property.[108]

In 1967, the United States insisted to Israel when it held Egyptian oil fields that it could not drill new wells or otherwise develop those facilities.[109] The 1967 case

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[103] For a discussion of this, see the CRS General Memorandum "The Law of Belligerent Occupation: Rights and Responsibilities of an Occupying Power Regarding the Use of Oil Resources," by Jennifer K. Elsea, CRS American Law Division, April 8, 2003. See also testimony by Robert Ebel, Director of the Energy and National Security Center at the Center for Strategic and International Studies (CSIS) before the House Energy and Commerce Committee Subcommittee on Energy and Air Quality, May 14, 2003. Several authorities are cited on current issues and the rights and responsibilities of an occupying power.

[104] *See generally* ERNST FEILCHENFELD, THE INTERNATIONAL ECONOMIC LAW OF BELLIGERENT OCCUPATION (1942). Hague Regulations art. 53, 55; LLW, sections 399, 400, 402-404.

[105] Hague Regulations art. 55; 2 OPPENHEIM'S INTERNATIONAL LAW § 166 (7th ed. 1952) [hereinafter "OPPENHEIM"].

[106] Hague Regulations art. 43 (requiring the occupant to "respect[], unless absolutely prevented, the laws in force in the country"); LLW sections 369-72.

[107] LLW section 376.

[108] LLW, sections 399, 402. Hague Regulations art. 53.

[109] *See* United States Department of State, Memorandum of Law (Oct. 1, 1976), *reprinted in* 16 I.L.M. 733 (1977). *But see* Evan J. Wallach, *The Use of Crude Oil by an Occupying Belligerent State as a Munition de Guerre*, 41 INT'L COMP. L. Q 287, 296-300 (1992) (documenting that U.S. and Allied practice during post-WWII occupation of Europe was to treat oil as war material). Jordan J. Paust asserts that "an occupying power cannot engage

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is complex, as it involves privately owned assets and plans for using the oil for the benefit of Israel itself. Some authorities believe the occupying powers in Iraq can drill new wells if the proceeds are used to benefit of the Iraqis.[110] Others disagree.[111] In any case, the principles of trusteeship would apply. Any contracts, regardless of the nationality of the companies, could last no longer than the occupation, and would be subject to Iraqi contract law. Some assert that actions favoring U.S. firms, over and against those of other countries such as Russia or France, would likely be contrary to the requirements of the Geneva and Hague conventions.[112]

Iraq has strict laws (put into place during the prior regime) limiting foreign investment in the country. Under the provisions of the Hague and Geneva treaties, they cannot be altered by the occupation authorities – except perhaps to facilitate the needs of the occupation regime – until a new independent government decides whether they should be changed. The occupation authorities can establish courts, with binding permanent authority to adjudicate among conflicting property claims.[113] In Iraq, such courts could sort out the conflicting claims of foreign firms that signed contracts with the former regime (for the development of oil fields, for example.) However, it could not substitute parties having no such claims for the exiting claimants. The occupation authorities could also defer action on these claims until a new Iraqi government in place to evaluate and decide them.[114]

On May 22, 2003, the Security Council directed, in Resolution 1483, that countries should transfer to the Development Fund for Iraq (see below) any financial

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[109] (...continued)
or participate in 'privatization' of Iraqi oil or the state-owned oil production and distribution industry and must not tolerate rates of extraction beyond prior 'normal' rates of extraction or excessive fees or profits by others administering such properties." He notes that violations of these provisions of the Hague convention would be a war crime. See: "The U.S. as Occupying Power over Portions of Iraq and Relevant Responsibilities Under the Laws of War." Available from the National Institute for Military Justice web site, [http://www.nimj.com].

[110] Gerson argues that the development of such assets will make them more valuable when they are returned to local control, so long as they are not spoilt or exhausted. Allan Gerson, Notes and Comments, *American Journal of International Law* 71:725 et seq. (1977).

[111] Langenkamp says that the consensus of legal opinion is against such expanded use. R. Dobie Langenkamp. *What Happens to the Oil: International Law and the Occupation of Iraq.* Unpublished paper, National Energy-Environment Law and Policy Institute, University of Tulsa College of Law, January 17, 2003. . 18. Available from [http://energy.uh.edu].

[112] See: Suzanne Nussell, in *Legal Affairs*, May-June 2003, cited by Ebel in his May 14, 2003 testimony. She says that new production could be developed so long as preference is not given to U.S. firms. Earlier Jessup said the occupant's use of property has "a solid basis in law" if, among other things. the use is "not for his own enrichment." Philip Jessup. "A Belligerent Occupant's Power over Property." *American Journal of International Law* 38:461 (1944). Langenkamp says, *op. cit*, pp. 39-40, that efforts by the occupation authorities in Iraq to use Iraqi oil output to push down the world price of oil, to the benefit of their home economies would violate the Hague rules.

[113] Hague Regulations, art. 43.

[114] See Langenkamp, *op cit*, p. 25.

assets or economic resources in their territory belonging to the Iraqi government or to officials of the former regime.[115] Claims by private individuals on those funds or assets will be held in abeyance until decided by an internationally recognized, representative government of Iraq. Earlier, the Administration had asked other countries to transfer Iraqi assets, frozen in 1990 and 1991, to the occupation authority for use in Iraq. It also asked countries to turn over illicit Iraqi funds. The U.S. Treasury Department announced serious penalties for foreign governments and financial institutions that fail to turn over such funds.[116]

Unilateral action by occupying powers without confirmation by recognized local authorities may be questionable. In an extreme case, the Japanese and Germans were found to have committed war crimes during the second world war, when local officials in puppet regimes allowed them to make permanent social and economic changes and to remove assets and develop resources for the benefit of the occupying power. By contrast, in Japan after 1945, U.S. occupation authorities worked through the existing Japanese government to effect major changes. In Germany after 1945, the quadripartite agreement for the post-war administration had broad international support, including support by the wartime United Nations.

Most authorities believe that Iraq will need a legitimate government before permanent changes can be made in its laws, economy and institutions. Moreover, it would likely need a government which is broadly recognized by other countries.[117] Some believe the occupying powers have the authority to create mechanisms for the establishment of a new Iraqi regime. Others believe that an international body, be it the United Nations or another body, must be involved in the process.[118] In Resolution 1483, the U.N. Security Council created a process, involving a Special

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[115] United Nations Security Council Resolution 1483, document S/2003/556.

[116] Treasury General Counsel David Aufhauser observed, in testimony before the House Financial Services Committee on May 14, 2003, that the USA PATRIOT Act gives the Secretary of the Treasury authority to require U.S. financial institutions to take appropriate countermeasures against foreign jurisdictions or foreign financial institutions that the Secretary finds to be of primary money laundering concern. He noted that the Administration was asking foreign governments and institutions to turn over all Iraqi assets that might belong to Saddam Hussein or his associates. He stated that "Should it be necessary, a jurisdiction's or a foreign financial institution's refusal to search for and eliminate accounts holding illicit proceeds may fall within the purview of this [legislation]." In other words, the Administration might cut off their access to the U.S. financial system if countries or institutions failed to comply with the U.S. request. Aufhauser did not say how illicit assets owned by members of the prior regime could be distinguished from assets held abroad legally by other persons or by agencies or instrumentalities of the Iraqi government.

[117] Countries may not recognize regimes installed by a foreign power. See *Restatement of the Foreign Relations Law of the United States,* 3d ed., 1987, § 203 (2) "A state has an obligation not to recognize or treat a regime as the government of another state if its control has been effected by the threat or use of armed force in violation of the United Nations Charter." Also "In principle, an unlawful successor should not succeed to rights in property or to rights under a contract, but the illegality of the succession should not be a defense to the responsibility of the successor state for the debts of the predecessor." *Id.* comment h.

[118] For a discussion of this issue, see CRS Report RL31871, *Post-War Iraq: Potential Issues Raised by Previous Occupation and Peacekeeping Experiences,* April 24, 2003.

Representative appointed by the Secretary General, whereby an interim and a new sovereign government could be created for Iraq. It is unclear whether the occupying powers must use this procedure and whether they will avail themselves of it.

The next concern for Iraq would be **lifting of sanctions** and other restrictions on its freedom to transfer assets, receive or make foreign investment, and buy and sell in world markets. The U.N. Security Council moved far in this direction on May 22, in Resolution 1483, when it rescinded almost all the trade and financial restrictions embodied in the earlier sanctions regime. (Restrictions on military supplies not needed for police functions were retained.) Foreign investors and lenders are unlikely to transfer assets to Iraq so long as the status of its existing debt is not clarified and its immunity status (see below) remains in effect.

The resolution also approved a mechanism (replacing the OFFP) whereby Iraq can export oil without legal doubt as to the authenticity of the sale. Under the plan, SOMO can sell Iraqi petroleum through normal commercial channels. Of the proceeds of those sales, the Security Council directed, 5% shall be transferred to the U.N. Compensation Fund, which addresses claims by individuals, firms, governments and other for direct losses or damage caused by Iraq's invasion and occupation of Kuwait. The remaining proceeds of those sales are to be placed – "until such time as an internationally recognized, representative government of Iraq is properly constituted" – in a Development Fund for Iraq, an account held by the Central Bank. The DFI will be audited by independent public accountants reporting to a special international advisory board.

The Security Council said that the occupation authorities (the "Authority") can use the resources in the DFI – in consultation with the Iraqi interim administration – for specified purposes. These are (1) to meet the humanitarian needs of the Iraqi people, (2) for economic reconstruction and repair of Iraq's infrastructure, (3) for the continued disarmament of Iraq, (4) for the costs of the Iraqi civilian administration, and (5) for other purposes benefitting the people of Iraq. The leeway the occupation authorities may have in their interpretation of this last purpose will depend considerably on the overall scope of their authority in Iraq.

Resolution 1483 seems a careful weaving together of the authorities held respectively by the Security Council and by the occupying powers. A certain degree of ambiguity may have been left for resolution in the future. The Council notes (but did not itself create) the DFI, which was established by the occupying powers. It underlines (but did not direct) that Iraqi oil revenues shall be used for purposes that were previously announced by the occupying powers. However, it directs that a portion of those revenues shall be transferred to the Compensation Fund. It transfers $1 billion from the OFFP to the DFI and it directs that member states shall transfer frozen Iraqi assets to the DFI. In that case, its underlining of the purposes of the DFI seem to be conditions under which that $1 billion and the frozen assets may be used.

The Security Council calls on the occupying powers, consistent with the U.N. Charter and other relevant international law, "to promote the welfare of the Iraqi people through the effective administration of the territory." It may be, but it is not evident, that the Council conferred new powers on the occupation authorities. It recognizes the "specific authorities, responsibilities and obligations under international law which they have as occupying powers." It calls on them to act in a manner consistent with the U.N. Charter and international law. It also calls upon "all concerned" to comply fully with their obligations under international law, "including in particular the Geneva Convention of 1949 and the Hague Regulations of 1907."

The Security Council included in Resolution 1483 provisions whereby long-term changes could be made in Iraq. It said that the Special Representative appointed by the Secretary General shall promote, in coordination with the occupation authorities, "economic reconstruction and the conditions for sustainable development, including through coordination with national and regional organizations, as appropriate, civil society, donors, and the international financial institutions." The syntax of this phrase makes interpretation difficult. However, it would appear that the Special Representative may promote the implementation of conditions which are conducive to long-term development in Iraq. The word "sustainable" would suggest that changes in current procedures and institutions would be possible, so long as broad consultation occurs. Presumably, those changes will have validity after the occupation period is concluded.

It is less certain that unilateral actions by the occupation authorities which exceed their legal mandate under the Hague and Geneva standards would be equally sustainable. Actions by the occupation authorities to allow the sale or transfer of Iraqi assets or to changes the laws governing commerce in Iraq – done without the participation or confirmation of an independent Iraqi government – may have uncertain long-term prospects. The authorities might believe they have acted for "purposes benefitting the people of Iraq." However, their decisions and the economic activities undertaken by private parties pursuant to those decisions might face subsequent legal challenges. In the past, courts have ruled in some instances that questionable actions by occupation authorities were valid at the time they occurred but may be cause for later action for damages.[119] Courts have also ruled, as did the U.S. Supreme Court in 1913, that acts by occupation authorities which exceeded their authority were null and void from the beginning.

The uncertainties in that situation may put the future economic prospects under a cloud. Investors or purchasers may hold back until the legal situation is clarified. Those who acted on the basis of questionable decisions by the occupation authorities in Iraq might find themselves subject later to lawsuits for damages or they may find that they have paid money for activities whose legal basis was null and void.[120]

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[119] Tesstdorf v. German State, quoted in Felice Morgenstern, "The Validity of Acts of the Belligerent Occupant." *The British Yearbook of International Law, 1951*, p. 291 et seq. Cited by Langenkamp, *op. cit.*, p. 24.

[120] Actions to shield investors or purchasers from suit in this situation might themselves be violation of international law. "Protected persons who are in occupied territory shall not be deprived, in any case or in any manner whatsoever, of the benefits of the present Convention by any changes introduced, as the result of the occupation of a territory, into the institutions or government or the said territory." LLW 365. "It is especially forbidden...to declare abolished, suspended, or inadmissible in a court of law the rights and actions of the nationals

(continued...)

The former sanctions regime and Resolution 1483 are the principal shields protecting Iraq against lawsuits that would attach its assets or oil revenue to satisfy the demands of foreign creditors and claimants.[121] This immunity was retained in the new resolution, in the words of the U.S. State Department, "to ensure that the Iraqi people are not penalized because of Saddam and can receive the benefits of their national patrimony...." Absent other action by the Security Council or a general procedure for settling (or in some cases re-adjudicating) these claims, Iraq's ability to trade and the ability of the government and Iraqi citizens to hold assets abroad might be endangered. Whether this immunity from legal action can or should be continued, as Iraq normalizes its international trade and financial situation is a matter which may require future examination.

If the prior concerns are addressed satisfactorily, Iraq can begin to **normalize its economic relations** with the outside world. Despite the predominant role that oil exports will likely play in the Iraqi economy, if the necessary conditions occur, Iraq could become a so-called "normal" diversified economy. Oil investors will probably go into Iraq even if the economy is a shaky, since they need only focus on a small portion of the economy. However, other investors may be reluctant act unless the economic climate in Iraq is conducive.

The *Arab World Competitiveness Report,*[122] published by the World Economic Forum, identifies two sets of institutions: (1) conditions for growth and (2) engines of growth. On the first score, Iraq will need macroeconomic stability, low levels of corruption, a stable currency, rule of law, good governance, and improvements in the education, skill level and health of its people. On the second score, Iraq will need policies conducive to growth. In particular, it may need to give special attention to the non-oil sector. Incentives may be necessary to encourage local and foreign investors and to overcome the intrinsic problems the country will face in this sector of its economy. (See the section on the non-oil economy and "Dutch Disease" below.) Broader programs of assistance and encouragement ("industrial policy")

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[120] (...continued)
of the hostile party." LLW 372, Hague Regulations art. 23. The Hague reference is to the law of hostilities, but the reference to courts appears to make it applicable to the occupation period. The LLW considers it so.

[121] U.N. Security Council Resolution 712, September 19, 1991, para. 5. "It decided "that petroleum and petroleum products subject to resolution 706 (1991) shall while under Iraqi title be immune from legal proceedings and not be subject to any form of attachment, garnishment, or execution...." Resolution 1483 says that, until December 31, 2007, unless the Council decides otherwise, oil and gas "originating in Iraq shall be immune, until title passes to the initial purchaser from legal proceedings against them and not be subject to any form of attachment, garnishment, or execution." The Development Fund for Iraq will have privileges and immunities "equivalent to those enjoyed by the United Nations" except respecting legal decisions in connection with a future ecological accident such as an oil spill.

[122] Peter K. Cornelius and Klaus Schwab (eds.) *The Arab World Competitiveness Report, 2002-2003.* World Economic Forum. Oxford University Press, 2003.

might be considered, if Iraq decides to emulate the policies pursued by some Asian countries in recent decades.[123]

Avoiding Rentier State Authoritarianism[124]

A major goal of the United States and the international community in Iraq may be the establishment of a democratic regime which is accountable to its people and pluralistic in its base of support. This will be a very difficult challenge. With the exception of Israel, a unique case, there are no democracies in the Middle East. While there have been substantial reforms in many Middle Eastern countries – including Egypt and Jordan, plus growing democratic pressure in Iran– those reforms and pressures have not translated into the emergence of a democratic Arab government.

In Iraq, efforts may need to be made, during the reconstruction process and through the creation of new political and economic institutions, to counter the centralizing effects of high levels of oil revenue and its subtle encouragement of authoritarianism.

Oil and Authoritarianism. For the foreseeable future, oil exports will be the principal source of income for Iraq for much of its reconstruction needs and the principal source of revenue for its government. Academics have observed that resource abundance (such as oil) can have a negative effect on the emergence of democracy and stable economic growth. Ross found, in a recent study,[125] which looked at 113 oil-rich countries, that the presence of oil and other mineral-rich resources impedes the growth of democracy for at least three reasons. First, he said, a *rentier effect* enables governments avoid taxation and use high public spending to consolidate their political control and dampen democratic pressure. Second, a *repression effect* lets governments build up their security forces. Third, a *modernization effect* leads to a situation where the middle class (if any) will be created by government largess rather than independently through the emergence of autonomous industrial, manufacturing, and service sectors. The latter was crucial to the democratization process in Central and Eastern Europe. The problem for Iraq is how to make an abundance of centralized oil wealth compatible with a pluralistic and democratic form of government.

Possible Alternatives. First, the proceeds from oil sales or taxes on oil production could be deposited in special trust funds where the proceeds may be spent only for certain activities – education, health, economic development, for example – and are beyond official control. This is the case in Chad. In exchange for the World Bank helping to develop Chad's oil industry, the Bank stipulated that 80% of

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[123] Marcus Noland and Howard Pack. *Industrial Policy in and Era of Globalization: Lessons from Asia.* Institute for International Economics. Washington, D.C. 2003.

[124] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, and Martin A. Weiss, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

[125] Michael L. Ross. "Does Oil Hinder Democracy?" *World Politics* 53. April 2001, pp. 325-61.

the revenues be spent on health, education, and rural infrastructure, 5% spent on people living near the oil fields, and 10% be saved for future generations. Only 5% of the revenue can go directly to the government. For Iraq, such a program could promote spending in certain areas and limit government patronage. However, it would allow the managers of the trust accounts to build their own patronage systems with limited accountability or control. Second, the proceeds could be distributed periodically directly to the Iraqi people on a per capita or some other basis. This would put the funds directly into the hands of the people and encourage private spending. However, it would starve the government for revenue and require the imposition of some form of direct taxation on the public. Third, as a variation on the second option, ownership of the Iraqi petroleum industry could be broadly distributed among the Iraqi people so that they receive the proceeds not as a government distribution but rather as capital gains or stock dividends, similar to the Alaska Permanent Fund.[126] Fourth, the government could continue receiving oil revenues directly (either as profits from state firms or as taxes and royalties on private producers) but all transactions would be transparent and allocations of those funds would be determined by open competition among political figures rather than by quiet consensus within the leadership. According to some experts, Iran is moving in this direction.

Reviving the Non-Oil Economy[127]

When Iraq's petroleum sector comes fully on line, as discussed above, Iraq will likely be one of the world's largest oil exporting countries. As long as it does not export so much oil as to drive down world prices to its own detriment, Iraq will likely obtain considerable income from this source. However, the impact this inflow of oil wealth may have on Iraq's non-oil economy may be less favorable. A phenomenon called the "Dutch Disease" often occurs in countries where natural resource exports comprise a large share of their total exports. The term comes from the experience of the Netherlands in the 1960s, when large new exports of natural gas brought a major inflow of foreign currency. This increased the value of the Dutch currency, making the country's non-oil exports less competitive and foreign goods cheaper as potential imports. This pushes up domestic prices, raising the cost of other potential exports. Meanwhile, capital and labor shift away from manufacturing and agriculture towards the booming sector, natural gas in the case of the Netherlands and petroleum in the case of Iraq. Resources also shift to the domestic sectors producing non-traded goods, to meet the increasing demand for goods and services from those participating in the booming sector. As a result, production in the country's traditional non-oil export sectors declines and domestic producers are less able to compete with imported agricultural and manufactured goods.

Some economists believe that the "Dutch Disease" is not really a problem at all but rather a natural and efficient shift of resources from lesser to more productive

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[126] Christian Bourge, Alaska Oil Model Could Work For Iraq, United Press International, 5/14/2003.

[127] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, and Martin A. Weiss, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

uses within the economy. Many economists believe that steps should be taken to protect the domestic non-oil sector from this effect. Oil prices fluctuate, they note, and countries can be very vulnerable to external shocks if they are overly dependant on the export of only a few products – even ones as potentially lucrative as oil.[128] Furthermore, there is no necessary reason why productivity and comparative efficiency in the non-oil sectors of the economy should be lower in countries that produce petroleum for export than in those that do not.

Accumulating foreign reserves or – in the case of Iraq – using oil revenue to pay off foreign debts and claims would be means to this end. This would keep Iraq's currency from appreciating excessively but it would also deny the Iraqi people most of the benefit of their oil wealth. A more popular remedy for "Dutch Disease" would be efforts to improve productivity in the non-oil sectors through investment, privatization, restructuring, worker training and limits on taxation. Tariffs that fall heavier on the non-oil sector than on the oil sector would appear counter productive in this regard.

Another tactic involves direct effort to encourage diversification in the non-oil sector in order to develop products that can better meet the test of foreign competition. Most efforts of this type have tended to emphasize larger enterprises in order to capture economies of scale. Some authors suggest, however, that more emphasis might be put on small-scale entrepreneurship in order to achieve possible gains from flexibility, initiative, and innovation.[129]

Another concern, if Iraq accrues high levels of oil wealth in the future, will be the possible negative impact that oil wealth may have on incentives to work and produce. This is an evident concern in some other countries in the Gulf region. If living standards are increased, either through direct payments to individuals (through such mechanisms as the Alaska Permanent Fund) or through less direct means, higher wages may be needed to encourage people to enter the labor market. This could have serious social and economic effects.

Settling Debt and Overhanging Claims[130]

A major burden overhanging the future prospects of the Iraqi economy is uncertainty about the disposition of the foreign debts and claims currently pending against it. Iraq may have trouble selling oil abroad if unsatisfied creditors are able to seize or attach the assets. Investors and new lenders may be reluctant to put money into Iraq if the status of the old credits and claims is unresolved. In August 1990, the former government of Iraq repudiated its foreign debt. In March 1991, the U.N.

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[128] Paul Cashin, Luis Cespedes, and Ratna Sahay, Commodity Currencies, Finance and Development, International Monetary Fund, March 2003.

[129] Information for this section was drawn from Christine Ebrahim-zadeh, "Back to Basics." *Finance and Development* 40:1, March 2003 and Richard Heeks, "Small Enterprise Development and the 'Dutch Disease' in a Small Economy: the Case of Brunei." IDPM Discussion Paper No. 56. Consult [http://idpm.man.ax.uk/wp/dp/dp_wp56.htm].

[130] Prepared by Jonathan E. Sanford, Specialist in International Political Economy, Foreign Affairs, Defense and Trade Division.

Security Council declared that Iraq's repudiation of debts was null and void and it demanded that Iraq accept responsibility and repay all its foreign debts.[131]

As noted above, Iraq's foreign debt obligations are considerable. Iraq told the United Nations in 1991 that it owed $42.1 billion (an amount doubtlessly increased now through compounded interest) to private banks, suppliers, international agencies, and foreign governments. The World Bank, IMF, and BIS estimated in 2001 that debt owed to creditors in OECD countries totaled $26.1 billion, exclusive of debt which may have already been written off. The Economist Intelligence Unit put the total at $64.3 billion while the Center for Strategic and International Studies reported the figure as $108.1 billion. This latter includes $30 billion owed to Gulf states, which is not included in the other totals. Most of the loans came from Western sources – Iraq owes the U.S. Government some $4 billion, including accrued interest, for defaulted agricultural export loans – though a substantial amount also came via loans from the Soviet Union financing exports of military equipment and supplies.

War damage claims are not included in the above. The United Nations has found that Iraq owes Kuwait $43 billion for individual and family compensation claims in connection with the 1991 war. A share of Iraq's export income from the OFFP was used for this purpose. Some $16.6 billion has been paid to date. Iran is seeking $97 billion for war damage during the 1980s, though the status and likely outcome of this claim is uncertain.

The issue is whether Iraq has the capacity to service these debts and claims as they stand or whether it needs some form of debt forgiveness or debt rescheduling. So long as the immunities provided by the Security Council's May 22, 2003 resolution (and by the earlier sanctions regime) remain in effect, Iraq will be shielded from action by claimants and creditors. A framework to resolve outstanding debts and claims will need to be in place when those immunities are removed by the end of 2007, to prevent disruption to Iraq's international trade and financial relations.

It is unclear if Iraq will be able to service its current debts. It seems likely, however, that Iraq's debt could be rescheduled for payment over a longer period of time. As discussed above in the sections on petroleum and trade, Iraq will likely be able to export 2.3 million barrels per day (mbd) as soon as the current uncertainties are resolved. Depending on price, this would yield $18.5 to $23.5 billion in annual export income. Some analysts believe the volume of Iraqi oil sales could be increased substantially, to perhaps double the likely rate in the near future, if restrictions by OPEC or technical factors do not intervene. On this basis, Iraq's annual oil revenue might be in the neighborhood of $50 to $60 billion within a decade. Further study will be necessary to determine the actual size of Iraq's debts and debt payments and whether such oil revenues are likely.

Broad agreement among creditors is necessary before a country's foreign debts can be forgiven or rescheduled. The London Club (debt to private creditors) and Paris Club (debt to bilateral official creditors) are the normal venues for such discussion. In recent years, only debt owed by the poorest countries has been

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[131] U.N. Security Council Resolution 686, March 2, 1991, paragraph 15.

forgiven outright. Iraq does not meet the economic criteria for debt forgiveness. Regular Paris Club rescheduling terms would likely apply.[132] The Paris Club met on April 24, 2003 for a preliminary discussion and is ready to "engage on Iraq's debt."[133] At the Paris Club, debtors must be in a state of imminent default before they can avail themselves of these bodies. They must also have in place a loan or economic policy program approved by the IMF. The IMF will likely need many months before it can reach a satisfactory agreement with Iraq. Iraq will need a recognized regime. It will need to repay its arrears and subscribe to the recent IMF quota increases.

The IMF normally requires that applicants present credible economic statistics and a cogent economic plan and program before it will discuss terms and conditions for a new loan package. For Iraq, this will not likely be a quick process, given the current dislocations, the scarcity of data, and the recent destruction of records.

Some have proposed that Iraq's foreign debts should be forgiven, either to allow more revenue to be available to improve Iraqi living standards or to wipe out "odious" debt. Action on the former will depend on future calculations showing the amount that will be left over for Iraqi use after payments for debts and claims are subtracted from its oil revenues. It will depend also on the amount the creditor countries value the aspirations of the Iraqi public over the expectations of Iraq's creditors and claimants.

Odious debt is a more complex concern. Odious debt is normally considered to be debt which benefits the ruler (through life style or through graft and corruption) but has little benefit for the people ruled. The question is whether successor regimes should be obligated, under international law, to repay money that was stolen, wasted, or otherwise used in ways having little benefit for them.[134]

The concept of odious debt has not been endorsed by any international legal or financial body. It has been used successfully by a few successor regimes to repudiate

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[132] For more on the Paris Club, see CRS Report RS21482, *The Paris Club*, April 3, 2003.

[133] The Russian news agency ITAR-TASS reports that the G-8 also agreed on May 19, 2003 to grant a moratorium on Iraq's foreign debt payments through 2004. See: RFE/RL *Iraq Report* 6:23, May 23, 2003.

[134] See, for example, Michael Kremer and Seema Jayachandran, "Odious Debt." *Finance and Development* 39:2, June 2002. They suggest that an international panel might declare that future debt incurred by a regime would be "odious" and would not need be repaid by successors. This would seriously discourage new lending except at inordinate rates. They say there are serious problems applying that standard retrospectively to existing debt. By contrast, Jubilee South argues that "debt is odious and not transferable to a successor government if the previous regime was any form of dictatorship acting contrary to the needs and wishes of the subjugated population." *Odious Debt Revisited*, October 30, 2002, at [http://www.jubileesouth.org]. The debate was framed in terms whether the post-apartheid government of South Africa should have to pay the debt which funded the military and security services which suppressed the majority population. Ironically, the successor governments decided to service that debt in order to avoid damage to its creditworthiness. Under Jubilee South's definition, almost any government in a non-democratic country could declare that the bills and debts of its predecessor were "odious" and therefore not its responsibility.

war debt owed by defeated opponents or debt incurred by former colonial regimes. Some people have suggested that the concept might be relevant to the issue of Iraqi debt. On April 10, 2003, for example, Treasury Secretary John Snow told Fox news that "Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who is now gone."[135]

Most observers will agree that the regime of Saddam Hussein was odious. It is less certain, however, that the debt incurred by the regime was also odious. A portion of Iraq's debt may have been incurred to support an enhanced lifestyle and privileges for the regime and its close supporters. Much of these expenditures seem to have been funded with oil export revenue, however, particularly those after 1990, when new loans were prohibited by the sanctions regime. Most of Iraq's debt was incurred to pay the cost of the Iran-Iraq war, to finance construction of industrial and transportation facilities, to pay for imports (such as agricultural imports from the United States), and to support economic policy schemes which proved (given the centrally-directed nature of the regime) to be wasteful and unsound. Whether these are the types of debts which ought to be categorized as "odious" will be a matter requiring future consideration.

Establishing a Currency and Monetary System[136]

For the foreseeable future, though other currencies will also circulate, the U.S. dollar may serve in effect as the basic currency for Iraq. Other currencies likely will be defined in dollar terms. "Dollarization" implies currency credibility, but also monetary dependence on the United States. From a political and economic perspective, this will likely not be an acceptable long-term response to Iraqi needs. Oil will play a dominant role in the economy for the foreseeable future and this has important implications for Iraq's choice of an exchange rate regime. If Iraq remains basically on a dollar standard for its currency, however, its inflation level and business cycle will be determined by U.S. monetary policy and not by its domestic needs. Levels of economic activity in Iraq may be overly stimulated or depressed and the non-oil sectors of the economy may suffer. In the long-run, Iraq needs monetary institutions and exchange rate procedures which are capable of maintaining stability and credibility for its currency as well as sufficient flexibility in monetary policy to address adequately its internal needs.

The Dinar Lacks Sufficient Credibility. A new currency may be needed to enhance the new monetary system's credibility. The dinar's credibility and the stability of Iraq's monetary system under the Hussein regime were undermined by high inflation and a black market exchange rate. Due to the economic and fiscal pressures caused by the first Gulf War and the sanctions regime, Iraq was unable to finance budget deficits through tax revenues and bond issuances, and was forced to print money instead, resulting in high inflation. Thus, an early step that may be taken in reconstructing the economy will be the introduction of a new currency that is not tainted by the dinar's unreliability nor by symbolic association with the old regime.

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[135] U.S. Treasury Secretary John Snow, interview on *Your World With Neil Cavuto*. April 10, 2003. Transcript No. 041003cb.140.

[136] Prepared by Marc Labonte, Economist, Government and Finance Division.

The U.S. Treasury announced on April 21 that a new currency would be introduced in 90-180 days.[137]

Interim Dollarization by Default. Three currencies are widely circulating at present in Iraq: two Iraqi currencies from previous regimes and the U.S. dollar.[138] With no new currency in place, *de facto* dollarization of the economy seems to be taking place. Individuals avoid holding dinars if possible. Foreign currencies are now the favored medium of exchange, with the dollar in ascendence. Dollarization will have a stabilizing effect in the short term. As U.S. aid and economic ties increase, more dollars will be available for circulation relative to other currencies and the process of dollarization will continue. For example, American officials recently made "emergency payments" in dollars to Iraqi civil servants.[139] Dollarization provides Iraq with stable prices but also dependence upon U.S. monetary policy.

A New Currency Requires Key Decisions. Under the current dollarized system, Iraq has no control over its money supply, interest rates, and the exchange rate. To change that, Iraq will need to introduce a new currency and authorize a monetary authority to manage it. Until faith in the new currency is established, alternative currencies will circulate alongside it. To make the transition to a new currency occur as quickly as possible, the current trends promoting dollarization will have to be reversed. To this end, the new government and the United States could make and accept payments in the new currency and not in U.S. dollars. To introduce the new currency, the government can temporarily allow dinars to be exchanged for the new currency. If authorities wish to soften the blow on individuals whose wealth is trapped in dinars, they can make the trade on terms favorable to the dinar's current market rate. This will increase the cost of the currency reform, however. The authorities may also have to decide whether to allow the old dinar to be exchanged for the new currency even though it was not the official currency of the Hussein regime.

Importance of Monetary Control. The first hurdle a new Iraqi monetary system must pass is the elimination of high inflation, which depends on the successful reform of the fiscal system. Once sanctions are completely lifted, at least some fiscal pressures will be relieved. Iraq may be less vulnerable to fiscal weakness

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[137] Oxford Analytica, *Daily Brief*, April 24, 2003.

[138] At present, the other main currency circulating is the "old" or "Swiss" dinar, which was used before a "Saddam" dinar was introduced in 1991 and has been (and still is) widely used in the Kurdish north since the 1990s. Because the central bank stopped printing the old dinar when the new one was introduced, the supply is fixed and has maintained its value. The Bush Administration is reportedly considering using its design for the new currency. See Michael Phillips, "U.S. Wants Fresh Supply of Iraqi Currency," Wall Street Journal, May 19, 2003.

[139] Bob Davis, Chip Cummins, and Simeon Kerr, "Dollars Are Sent to Iraq to Replace Dinars," *Wall St. Journal*, April 16, 2003, p. A8. Commenting on this policy, Treasury Undersecretary John Taylor said "It's an interim arrangement, and we're not going to do it any longer than we have to." Quoted in Edmund Andrews, "Iraq to Run on Dollars Till It Gets New Currency," *New York Times*, April 17, 2003.

than most developing countries because of easy access to revenue through state control of the oil industry – at least when oil prices are high.

Five other steps may be needed to establish an effective monetary regime. First is renegotiation of the large external debts incurred by the Hussein regime. (See the discussion of debt below.) Second, Iraq may need a central bank which is able to operate somewhat independently from the country's fiscal authorities and cannot be compelled (as was the case during the former regime) to automatically finance government budget deficits. Third, Iraq may need to clearly define the goals of its monetary policy. Some countries, like Canada, set numerical inflation targets for their central bank to meet; others, like the United States, have looser, multiple goals. Fourth, the Iraqi monetary authorities may need adequate foreign reserves to stabilize their operations – particularly if the exchange rate is fixed – and to build confidence in the currency. Finally, Iraq may need a sound banking system, both because the economy will need adequate banking services and because it will provide the monetary authorities with effective means for controlling the money supply and managing monetary policy.

Choosing an Exchange Rate Regime. The creation of a new monetary system requires choice of an exchange rate regime. Exchange rate regimes and monetary policy are best thought of as going hand in hand since one determines the other. There are a number of monetary/exchange rate regimes that have been successfully used around the world from which Iraq can choose. The choices fall under two broad categories: fixed exchanged rates (including dollarization, currency boards, and exchange rate pegs maintained by a central bank) and floating exchanges. Philosophically, these systems can be thought to fall on a continuum of less or more freedom for Iraq to adjust monetary policy at its discretion.

The Iraqi authorities could let the current process of dollarization continue. Adopted in countries such as Panama and Estonia, dollarization does away with an independent monetary system entirely. The money supply is instead determined by the foreign currency inflows that occur through international trade or capital flows. Since the political symbolism of dollarization would probably be unacceptable in Iraq, a currency board might be an alternative. A currency board is also very restrictive since the local currency is 100% backed by foreign currency reserves, although it can be reversed more easily, as was the case in Argentina.[140] But unless Iraq has large foreign reserves, a currency board could prove to be unstable.

A floating exchange rate, the least restrictive option, allows the market to determine the exchange rate so that Iraqi authorities would be able to focus on setting monetary policy to the needs of the domestic economy. In between, a fixed exchange rate regime would greatly – but not completely – limit Iraqi monetary policy to maintaining a fixed relationship between the domestic currency and a foreign currency or basket of foreign currencies (unless capital controls are adopted). Iraq used this system with the dinar. The huge difference between the black market rate and the official rate is the strongest sign that the system was abused by authorities.

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[140] For more information, see CRS report RL31093, *A Currency Board as an Alternative to a Central Bank*.

Short-run Credibility vs. Long-run Flexibility. The best monetary system depends on Iraq's specific circumstances Politically, the freedom to alter monetary policy at will in response to changing economic conditions is only valuable if it is not abused. The Iraqis could adopt a more restrictive exchange rate regime as a way to "tie their hands" and regain credibility after the previous monetary abuse. Dollarization and currency boards are a means to achieving instant monetary credibility, at least in the short run. But if Iraq can establish a strong, independent central bank and an effective fiscal regime and tax administration, a restrictive monetary system would serve little purpose. Economically, the value of a floating exchange rate, and the freedom it provides to adjust monetary policy to domestic needs, depends upon how closely Iraq's business cycle will ultimately follow those of its trading partners. If Iraq is closely tied to a large country through trade, it may have little to gain from setting a monetary policy that is different from its large partner. By contrast, if it does not depend heavily on trade with any one partner and has a unique business cycle, it would find it advantageous to set its monetary policy independently. What can be said of all countries, including Iraq, is that economic conditions are never static and the proper monetary policy can help a country adjust to the changes. A static exchange rate arrangement will only be supportive under new economic conditions if the country to which Iraq's exchange rate is tied has undergone similar changes. Many economic crises of the past two decades have been precipitated by a country being forced to abandon its exchange rate peg.

Oil and Monetary Policy. Because Iraq's economy has been stifled for so long by geopolitical events, it is difficult to envision how it will look in the future. The one certainty is that oil will play a dominant role in the economy for the foreseeable future. This has important ramifications for Iraq's monetary system. On the one hand, pegging the Iraqi currency to the dollar would be useful since the international oil market is conducted using the U.S. dollar and many of Iraq's neighbors in the Gulf, like Saudi Arabia, have pegged their exchange rate to the dollar. On the other hand, the business cycles of oil-producing countries widely differ from oil-consuming countries by their very nature. A rise in oil prices is likely to cause a boom in oil-producing countries and a slowdown in oil-consuming countries, and vice versa. If the Iraqi exchange rate were tied to the dollar, its monetary policy, determined by U.S. monetary policy through the exchange rate peg, would move in the opposite direction of the economy's needs every time there was a large shift in oil prices.

Rebuilding the Financial System[141]

Rebuilding - or rather, forming for the first time - a market-based financial system in Iraq may need to accompany the rebuilding of the economy for two reasons. First and fundamentally, economic activity always has a financial side. Second and empirically, rebuilding experiences in other countries suggest that it is important from the beginning of economic reconstruction to have in place a financial system featuring market-based incentives, risk management and a safety net to insure confidence. Lessons learned from those experiences are that the system could be simple initially, but that supervisory and regulatory arrangements also matter.

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[141] Prepared by Anne Vorce, Economist, Government and Finance Division.

Whatever form the system takes, its primary function is to allocate capital sufficiently well to allow the Iraqi economy to operate efficiently. Past experience also shows that capital is needed quickly to get an economy up and running. Iraq is expected to face a capital shortage, and foreign capital may be desirable initially. The Administration has held extensive planning discussions on rebuilding the Iraq economy and financial system, but details are not yet available.

Change to a Market-Based System. As noted earlier, Iraq has never had a functioning, market-oriented financial system, although there have been limited attempts at reform. The basic tasks are daunting. How can Iraq create a functioning market-oriented financial system when it has never really experienced one? How should Iraq design its institutions and its system of incentives so that market-based behavior rather than political influence and/or cronyism are rewarded ? Can Iraq use the networks and expertise built up in the past to help establish its new financial institutions without creating opportunities for the corrupt practices of the former system to reemerge anew? To tackle these challenges, lessons from financial sector reforms in countries that had similar circumstances are relevant for Iraq:[142]

(1) A priority might be the immediate establishment of a financial system based on basic market principles. Rebuilding the financial system in Iraq must go hand in hand with rebuilding the Iraqi economy from the start. The efficient operation of a financial system is the backbone of any market economy. It links the suppliers and users of funds in order to support economic activity. It is critical infrastructure but, unlike water and electricity, is largely invisible to the average citizen when it is working properly.

(2) There is no "one size fits all" system design. The types of private sector institutions to be chartered by the financial authority vary with the economy. In Iraq, a case can be made for a very simple system consisting of a single bank with extensive branching in the early phase of reconstruction. Problems that might otherwise arise in such a monopoly situation can be addressed with market-oriented pricing, which matches supply and demand for funds. Other options for financial institutions range from universal banks, which may provide the widest range of services, to specialty banks, which may have particular features important for the smooth functioning of key sectors.

(3) Institutions matter in the efficient conduct of a financial system. In similar situations elsewhere over the past 15 years, the weakness of the reconstituted

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[142] For reform of the Iraqi financial system, valuable lessons can be learned from financial market reform in many state-planned economies and economies affected by war over the past decade. For example, see Malcolm Knight et al [eds.], IMF, *Transforming Financial Systems in the Baltics, Russia, and other Countries of the Former Soviet Union*, 1999; IMF, *Capital Markets and Financial Liberalization in the Baltic States,* Country Report No. 03/115, April 2003; UNU/WIDER, *Financial Reconstruction in Conflict and Post-Conflict Economies*, Discussion Paper No. 2001/90; R. Barry Johnston and V. Sundararajan (eds.), IMF, *Sequencing Financial Sector Reform, 1999;* Alan Roe et al, World Bank, *Analyzing Financial Sectors in Transition: with Special Reference to the Former Soviet Union,* 1998. There is extensive discussion of foreign capital issues in the World Bank's publication, *Global Development Finance 2002*, Chapter 3.

central banks (and, if separately established, other financial supervisory authorities) have often resulted in financial market crises. Many analysts believe that, in Russia and other similar situations, powerful interests were given too many resources and too much regulatory forbearance because their support was considered politically necessary to build consensus for the new system. Many also believe that financial sector liberalization was done too quickly, to foster competition, without adequate legal and prudential safeguards first being in place. Major crises ensued in several instances which were costly to resolve and undermined attempts to build depositor and investor confidence.

(4) Strong institutions may require substantial budgetary resources. Iraq may need to spend money to get the best qualified staff available for its regulatory and oversight bodies. Most experts believe that the employees of supervisory agencies should be paid enough to discourage them from private activities or side deals which conflict with their official duties. Training may also be necessary. For example, central bankers and financial regulators from the former Soviet republics were trained in their countries, the United States, or Europe on best practices of central banking and financial market supervision.

(5) Establishment and enforcement of a sound legal framework, featuring viable contract, bankruptcy and property law plus judicial review, may be as important as, if not more important than, the design of new financial institutions in the transitional phase of reform. A sound legal framework is linked to fundamental financial considerations related to risk management. For example, enforcement of an agreed contract is a bedrock of any economic or financial transaction; collateral-based lending depends on a functioning legal system; bankruptcy law sets out the framework for redress under certain circumstances.

(6) Private foreign capital may be required to increase the capital base of the economy, to fund development and to foster competitive conditions in the longer run. It is widely believed that Iraq does not have sufficient resources to adequately fund its financial system because: a solid earnings stream from its oil exports will not resume for awhile; its foreign debt situation needs to be worked out; and the shift from an economy dominated by state-owned enterprises to a functioning private sector needs to be funded. Past experience in rebuilding economies elsewhere suggests that encouraging private foreign capital inflows can be a quick way to capitalize an economy and create competitive conditions initially, particularly in the absence of taxpayer-funded resources from other countries. Opening up the financial system to well-run and capitalized foreign banks and permitting foreign direct investors to have a stake in the privatization of state-run enterprises are often seen as the most effective ways to meet basic needs.[143] These experiences do not suggest that domestic firms are eliminated by foreign firms, despite concerns over basic competitive inequities between large, deep-pocket institutions and more thinly capitalized firms. Domestic firms have often had a comparative advantage because of their ability to exercise judgment on non-economic risk factors in a familiar setting.

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[143] World Bank, *Global Development Finance 2002*, pp.61-69.

Administration Plans. Over the past few months, the Administration has been developing a blueprint for the rebuilding of the Iraq economy and financial system. Initial plans are reportedly contained in a document *Moving The Iraqi Economy From Recovery to Sustainable Growth* that is being circulated among potential private sector U.S. contractors.[144] On the financial side, this document is said to include plans (1) to reform the central bank and the commercial banking system; (2) to work out problem loans in the banking system; (3) to set up a "tough" securities commission to limit abuse; (4) to form a stock market with electronic trading capability; (5) to privatize state-controlled companies (which would bring with it associated financial market activity); and (6) to grant loans of as much as $8 billion to small and medium sized enterprises within the first year (which may require a separate financial facility). The traditional Islamic money transfer system would be incorporated into the banking system.[145]

The Administration's plans are taking concrete shape. Security Council Resolution 1483, passed May 22, 2003, laid out some basic institutional arrangements for rebuilding the economy and financial system. The Development Fund for Iraq – including oil revenues and overseas assets previously frozen – can be used to rebuild the Iraqi economy. (See the section on pre-conditions for economic development above.) The Administration has also announced that the Central Bank will be rebuilt by a team led by Peter McPherson, the Financial Coordinator of the Office of Reconstruction and Humanitarian Assistance (ORHA) with the assistance of Treasury Deputy General Counsel George Wolfe.[146]

Export and Border Control Capabilities[147]

Prior to Operation Iraqi Freedom, the export control problems most observers worried about were Iraq's capability to smuggle in material, technology and equipment related to weapons of mass destruction (nuclear, chemical, biological weapons and ballistic missiles)and smuggle out oil. In addition, some observers worried about the export of sensitive materials to other rogue states or terrorist

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[144] Neil King Jr, "Bush Officials Draft Broad Plan for Free Market Economy in Iraq," *Wall Street Journal***,** May 1, 2003, pp.A1,A8.

[145] An Islamic banking system is one in which the conduct of financial services conforms to Islamic principles. Certain activities are prohibited but financial vehicles can be used to manage this situation. A number of countries are either moving to a full system (Pakistan) or have an Islamic system operating along side a conventional system. For a more extensive discussion, see V. Sundararajan and Luca Errico, IMF, *Islamic Financial Institutions and Products in the Global System: Key Issues in Risk Management and Challenges Ahead*, IMF WP/02/192.

[146] U.S. Treasury Department, "McPherson named Financial Coordinator for Office of Reconstruction and Humanitarian Assistance (ORHA) in Iraq," *press release*, April 25, 2003. He will "work closely with the Iraqis in rebuilding the finance ministry, the central bank and the banking system." U.S. Treasury Department, "Wolfe Named Deputy Financial Coordinator for Office of Reconstruction and Humanitarian Assistance (ORHA) in Iraq, *press release,* April 25, 2003.

[147] Prepared by Sharon Squassoni, Specialist in Weapons of Mass Destruction-Nonproliferation, Foreign Affairs, Defense and Trade Division.

organizations or individuals. With a change in regime, most of those concerns are probably diminished from the perspective of state-sanctioned exports. However, some provisions for controlling exports and patrolling borders may be desirable.

Currently, none of the nonproliferation treaties (Nuclear Nonproliferation Treaty, Biological Weapons Convention and Chemical Weapons Convention) requires member states to create export laws and implement them, although they all contain prohibitions or restrictions on receipt and transfer of sensitive materials, technology, and equipment. Rather, the control of such goods is administered at the national level and coordinated multilaterally through the Nuclear Suppliers' Group, the Missile Technology Control Regime, and the Australia Group. Iraq is not a member of any of these groups and does not belong to the Chemical Weapons Convention, although this may be an opportune time to press for Iraqi membership.

Despite the lack of legal requirements to implement export and border control, it is likely that Iraqi leaders may want to show goodwill by doing so. The creation of a legal framework, processes and implementation will have costs. The United States has helped other countries, including former Soviet states in a variety of areas, including providing legal advice, detection equipment, and training for border police, among other things. For several years, the U.S. State Department has provided global export control and related border security assistance (about $40 million), which is designed to help other countries prevent an outflow of sensitive items from their borders. Iraq may be a good candidate for such assistance.

Access to Foreign Resources[148]

Iraq and the International Financial Institutions. At their fall 2003 meetings, the International Monetary Fund (IMF) and World Bank – the major international financial institutions (IFIs) – both expressed their willingness and ability to assist the reconstruction efforts in Iraq. The International Monetary and Finance Committee (IMFC), the IMF's ruling body, and the joint IMF/World Bank Development Committee stated that "The World Bank and the IMF stand ready to play their normal role in Iraq's re-development at the appropriate time." On April 29, the Bank announced that its management had the authority to decide what the appropriate time would be. The IMF and World Bank cannot lend to Iraq until several major steps have been taken to normalize its relations with them. However, now that the former restrictions on their activities have been lifted, the Bank and Fund will be able to send staff missions to Iraq, for technical and policy consultations, as soon as their assistance is requested and the physical security of the persons involved can be assured.

Iraq has been a member of both the IMF and the World Bank since these institutions were founded in 1945. However, neither institution has had official contact with Iraq for twenty years. The last IMF Article IV consultation (an official assessment of an economy) for Iraq was in 1980. In 1983, the next consultation was begun, but never completed. Iraq owes the IMF 52.31 million special drawing rights

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[148] Prepared by Martin A. Weiss, Analyst in International Trade and Finance, Foreign Affairs, Defense and Trade Division.

(SDRs) or approximately $72 million for prior loans.[149] Its current IMF quota is SDR 504 million or $695 million. The last World Bank loan to Iraq was a grain storage project in 1973. Between 1945 and 1973, the World Bank made six loans to Iraq (totaling $106.5 million) mainly for education and infrastructure. In 1990, Iraq's loans were put on a "non-accrual status," when it failed to make loan payments. Including interest, Iraq owes the World Bank $82 million in payment arrears.

On May 22, 2003, the U.N. Security Council rescinded the restrictions in the earlier sanctions regime barring international agencies from operating in or providing assistance to Iraq. Instead, Resolution 1483 calls on the international financial institutions "to assist the people of Iraq in the reconstruction and development of their economy and to facilitate assistance by the broader donor community."

The IMF and World Bank will not lend new money to Iraq until it clears its existing arrears. To borrow from the IMF, Iraq would also need to subscribe to the last two IMF quota increases. It would need to pay to the IMF money sufficient to raise its IMF quota from SDR 504 million ($695 million) to SDR 1188 million ($1.64 billion). One-quarter of the amount would need to be paid in hard currency. (Iraq would then be able to borrow back the hard currency. The IMF has a fund for immediate post-conflict lending, up to 50% of a member's quota, but since Iraq has not subscribed to the last two quota increases, and is in arrears to the IMF, it is unlikely they would be able to receive IMF emergency assistance. Iraq "graduated" from the World Bank in 1973 due to the oil boom, making it ineligible to borrow Bank funds. It might be able to borrow during the reconstruction period, once a government takes power which has authority to sign long-term contracts that are binding on Iraq. However, this would depend on a variety of conditions which cannot be assessed at this time and would likely be a temporary situation pending restoration of Iraq's oil export capacity.

The Bank and Fund can move more quickly to provide technical assistance and policy advice. This is the "normal role" mentioned earlier. The World Bank and IMF are both authorized to send full "needs assessment" teams to Iraq and will do so as soon as personal security can be guaranteed. Until that time arrives, Nicholas Crafft, formerly the World Bank's point person for West Bank and Gaza, is accompanying Sergio Viera de Mello, the UN special representative in Iraq. Moreover, the World Bank has also approved the appointment of a Bank official to the International Advisory and Monitoring Board of the Development Fund for Iraq. (It is not clear, however, whether occupation authorities are authorized to make that request or whether an interim government is required.) Normally, the Bank and Fund identify experts who might help address the problems identified by the mission and procedure for coordinating and evaluating their activity. The Bank and Fund team may also identify broader projects or programs which may be needed. The cost of the technical assistance program is normally borne by foreign aid donors rather than by the Bank and Fund themselves.

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[149] IMF loans are formal lending arrangements; arrears are unmade payments on prior loans or quota increases.

The IMF expressed a willingness, at the fall meetings, to help Iraq reconstitute its monetary and financial sector. It is unclear whether the occupation authorities will pursue this offer. The Bank and Fund have been actively involved in post-conflict situations in many countries, including Kosovo, Afghanistan and East Timor. They have also helped post-Soviet and East European governments make the transition from Soviet-style command economies to market-based systems. The Bank and Fund have also advised post-conflict and transition countries on ways they can rebuild their statistical and administrative capabilities and improve monetary, fiscal, and exchange rate policy. The World Bank has also served as the lead agency on foreign assistance donor coordination committees in many countries.

In summary, like all other international institutions planning to operate in Iraq once an internationally recognized government is in place, the IMF and World Bank are currently trying to acquire as much information as possible from second-hand sources, basically a "watching brief." Initially, IMF/World Bank activity will most likely be limited to a technical assistance and advisory role. Once Iraq's arrears, which are small compared to its possible future GDP, are resolved and Iraq is in good standing, formal lending arrangements could be discussed.

The United Nations Development Programme. Since 1976, the United Nations Development Programme (UNDP) has been operating in Iraq. UNDP had over 500 staff in Iraq and offices in Baghdad, Dohuk, Erbil, and Sulaimaniyah before the recent war. According to its mandate, UNDP's involvement in post-war Iraq will focus on humanitarian needs. They have proposed a three-fold agenda for their operations in Iraq: (1) emergency infrastructure rehabilitation focusing on the electricity sector; (2) generate income by providing short-term immediate employment; and (3) coordinate de-mining activities by creating an Iraq Mine Action Centre (IMAC).[150] Like IFI involvement, any long-term UNDP activity in Iraq requires UN Security Council authorization. Some humanitarian aid can be administered immediately and requires no international authorization.

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[150] For more information, see UNDP's Iraq website See [http://www.iq.undp.org/].