Strategic Insight

Bean Counting in Baghdad: Debt, Reparations, Reconstruction, and Resources

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Introduction

The 1980s began with Iraq recognized as being one of the most promising countries in the Middle East and in the developing world. It was a donor country as well as a significant international creditor. The central bank held approximately $36 billion in foreign assets (Jiyad, 2001, p.15). Per capita income was around $4000 and, with a growing middle class and the start of a modern industrial sector, the country was poised for take-off to high-sustained growth. A plausible scenario at the time would have anticipated the country having a Gross Domestic Product (GDP) of close to $400 billion, with a per capita income of $15,000, self sufficient in food, and an exporter of a wide variety of industrial products.

Instead, Iraq sealed its demise in 1980 with its invasion of Iran. Two wars and a decade of sanctions later, GDP is not $400 billion but $30 billion—per capita income is $2000 at best. Industry has ceased to exist and unemployment is optimistically estimated to be around 50%. The agricultural sector is in complete disarray, leaving more than 60% of the population dependent on handouts from the United Nations' Oil-for-Food program. Approximately 40% of the nation's children are suffering from malnutrition. Even before the 2003 conflict, clean drinking water was increasingly scarce, with electricity generation having difficulty meeting the reduced needs of an impoverished nation. There is no banking system and, for the time being, there is not even a national currency. Perhaps even worse, the country's citizens are burdened with massive foreign obligations accrued largely by Saddam Hussein. These include foreign debts, war reparations, and outstanding contractual arrangements.

This *Strategic Insight* examines Iraq's fiscal challenges and possible financial strategies over the next decade or so. What options are available under UN Resolution 1483 of May 23, 2003, as well as the resolutions coming out of the May 2003 G-8 Finance Ministers' meetings? Which strategies seem best from the perspective of Iraq's reconstruction? Under reasonable assumptions, will there be enough money to reconstruct the economy and revitalize the oil industry?

The Debt Trap

The exact level of Iraq's debt is controversial. A generally accepted figure is $383 billion (Barton and Crocker, 2003): $127 billion in loans, including $47 billion in accrued interest; $199 billion in reparations and $57 billion in contractual obligations. Assuming the Arab Monetary Fund's (2002) population estimate of 22.81 million, this translates into a per capita debt of around $16,790. In perspective, this is about 10 times as great as Argentina's at the time of that country's economic meltdown in 2001. As another basis of comparison Germany's World War I reparations totaled about twice its gross domestic product (GDP). These debts were never paid in full; they proved to be an impossible burden. Iraq's debts amount to around 15 times its annual GDP (Francis, 2003). Iraq did not make any attempts at servicing the debt in the 1990s, but even if it had, its entire annual oil revenues during this period would not have met the yearly interest charges. Simply put, the country is bankrupt.

In short, not only is the country staggering under one of the world's highest debt burdens, but the situation is even worse because a significant proportion of loans made no contribution to the country's debt servicing capability. They were contracted for purely military or defense related purposes: $37 billion is in loans from the Gulf States ($17 billion from Kuwait alone) for support during the 1980-88 war with Iran. France is owed $4 billion much of it to pay for F1 fighters and Exocet air-to-surface missiles, and $9 billion is owed to Russia for purchases of MIG fighters and helicopters.

Many observers feel that unless Iraq is relieved of its debt burden in one way or another there will not be sufficient funds for any sort of meaningful reconstruction of that country's economy, together with restoration of the vital oil sector. An optimistic estimate of the country's likely oil revenues over the next decade or so is $22 billion per year, with a pessimistic forecast coming in at around $15 billion. Of this, around $11-$13 billion will be needed just to run the government and revitalize the oil industry. Restoring and revitalizing the oil industry through reconstructing its infrastructure and the development of new fields may run another $35 billion over the next 10 years (Powell, 2002; Alansrawi, 2001).

Even if all the $22 billion were earmarked for debt servicing, the total amount of outstanding debt would be reduced by only around 5% per year. Accrued and on-going interest payments might reduce this figure to 1% or 2%. Even if 50% of Iraq's anticipated future export income is diverted to meet debt repayment, it would take more than 35 years to pay off current obligations (Mitchell, 2003). In short, as it is currently structured, the country's debt is simply not serviceable.

Similarly, even if war reparations claims were dismissed, Iraq would still have $117 of foreign debt obligations. IMF and World Bank Guidelines suggest that debt for the very poorest countries should be no more than 150% of exports. With its GDP of $30 billion, Iraq could sustain a debt of perhaps around $21 billion (Guyon, 2003). Even here, there would be very little left over for reconstruction or repair of the oil industry which generates the country's debt servicing capacity in the first place.

Iraq's debts are among the postwar issues that continue to divide the United States from countries that opposed the U.S. led invasion. France, Germany and Russia, which led the anti-war camp, are owed a large portion of the debts run up during Saddam Hussein's rule. They have balked at U.S. proposals for debt forgiveness, but have said they would be open to relief in the form of delayed and stretched-out payments.

A Framework for the Future

For the next several years at least, Iraq's debt situation will no doubt be greatly affected by the implementation of UN Security Council Resolution 1483 of May 23, 2003. While dealing with a broad range of issues, the Resolution has particular importance for the future development of the Iraqi economy and resources available for that country. In this regard, the Resolution (BBC, 2003):

Ends 13 years of sanctions. Sanctions had been imposed to compel Saddam Hussein's compliance with WMD requirements and contain the threat of his regime. By lifting these outdated sanctions, leaving in place only the weapons ban, the resolution should greatly assist in the economy's recovery and economic transformation.

Enables Iraq to rejoin the global market. By abolishing trade restrictions, the resolution will permit Iraq to trade freely in the international market.

Returns oil revenues to Iraq. Oil revenues from export sales will be deposited in the Development Fund for Iraq, housed in the Central Bank of Iraq. The development Fund will be monitored by an international board that includes representatives of the UN Secretary General, the International Monetary Fund, the Arab Fund for Social and Economic Development, and the World Bank. Independent public accountants reporting to the board will audit the fund to ensure full transactional transparency.

Ensures Iraqi revenues are spent on Iraqi reconstruction. The resolution underlines that the Development Fund will be used in a transparent manner: for the humanitarian needs of the Iraqi people, economic reconstruction, and repair of Iraq's infrastructure, and the costs of Iraqi civilian administration.

Temporarily immunizes oil sales. To ensure that Iraqis have access to the critical resources needed for reconstruction during the transition period, oil sales will be immunized against attachment by international creditors or others with claims against the former regime until December 31, 2007. Clearly laying legal claim to Iraqi oil revenues had seemed the likeliest way for creditors to get some money back. At the very least, this wording would give Iraq a strong hand in any formal Paris and London Club debt renegotiations. It might even allow it to repudiate its oil debt and still raise fresh capital.

Terminates the Oil-for-Food (OFF) program in six months. The resolution allows the Secretary General, in coordination with coalition authorities and the Iraqi Interim Administration, to continue to prioritize contracts previously approved and funded by the UN for delivery to meet the immediate needs of the Iraqi people. Action on contracts judged to be of questionable usefulness in light of the changed circumstances will be postponed until an internationally recognized representative government is established and in a position to make its own determination. One billion dollars of unallocated funds in the UN escrow account will be transferred to the Development Fund for Iraq to provide for immediate reconstruction needs.

Provides for Compensation. There will be continued funding of the UN Compensation Commission, which deals with outstanding claims for victims of Saddam's aggression in Kuwait. Five percent of oil proceeds are to be deposited into the UNCC Compensation Fund. This is down from 25 percent under the Oil-for-Food program.

Basically, the Resolution grants broad power to the United States and Britain to manage Iraq for at least a year. For the economy and the country's debt burden, the resolution buys some breathing space. The resolution opens the way for putting the oil sector back on its feet and back generating the revenues the country needs. Because all proceeds from the sale of oil will flow into the newly formed Development Fund, its administrators (after allocating 5% for Kuwaiti claims) will have to grapple simultaneously with four competing claims on their funds—humanitarian needs, reconstruction, revitalization of the oil sector, and debt servicing.

The G-8 Resolutions of May 2003

At their mid-May 2003 meeting in Deauville on the Normandy coast, the G-8 finance ministers also addressed Iraq debt problems. The resolutions coming out of this meeting called for the Paris Club of creditor nations to overhaul its rules for negotiating financial relief for countries like Iraq that are heavily indebted, but do not qualify for the special assistance available to the poorest states—the HIPC initiative. The Paris Club's 19 members which include most of the advanced industrial countries are believed to be owed an estimated $26 billion. But that is only the principal. Most of the debt dates from the 1970s and has been accruing unpaid interest since then.

The move should lead to the Paris Club offering debt-relief measures tailored more to the individual needs of countries. There is also the possibility the new initiative would put pressure on creditors to write off some debts in exceptional cases. Still, the process of tackling Iraq's debt burden looks certain to be complex and protracted. Although some G-8 officials said that the Paris Club initiative should lead to debt restructuring and write-offs for Iraq, others questioned that this will necessarily be the case. In a related action, the G-8 Finance Ministers countries resolved not to attempt to secure any repayment on Iraqi debts for at least another year.

Unfortunately, despite these promising signs, the debt issue is likely to become increasingly contentious as the United States pushes for write-offs of large parts of Iraq's liabilities. One senses wide-spread reluctance or disinterest on the parts of many other countries and institutions (Mitchell, 2003):

1. In April 2003 after initial reluctance, the World bank and the IMF agreed to play the normal role in Iraq's redevelopment "at the appropriate time." They are sending a fact-finding mission to the country.
2. Also in April, Horst Kohler, Managing director of the IMF, said it was "premature to speak about debt forgiveness, which should be a matter for Iraq's creditors to discuss."
3. Some of Iraq's bilateral creditors appear inclined to oppose debt cancellation. In the case of Russia and Germany, for instance, Mr. Putin and Chancellor Schroder initially said that they would contemplate a write-off of some of Iraq's debt, but the Russian finance minister, Alexi Kudrin, has since declared that Russia does not have a policy of debt forgiveness, and Germany's finance minister Hans Eichel has categorically announced his intention of recovering the $4 billion owed to his government (Financial Times, April 14, 2003).

Strategies for Reducing Foreign Obligations

Realistically despite the resistance of Iraq's major creditors, the country's debt will have to be: (a) forgiven—in all or part, an application of the odious debt doctrine; (b) radically restructured to string it out over many years after an initial moratorium period on servicing; or (c) eased by eclectic solutions—contract cancellation, debt equity swaps, partial privatizations, etc. (IMF, 2003). The United States and UK as occupying powers will have, within the context of Iraq's reconstruction, considerable influence over the path and direction of Iraq's debt resolution. In this regard, Secretary Rumsfield (2003) has laid out some general guidelines with regard to financial assistance and other economic issues:

Favor Market Economy. Decisions will favor market systems, not Stalinist command systems, and activities that will begin to diversify the Iraqi economy beyond oil. The coalition will encourage moves to privatize state-owned enterprises.

Oil. The Coalition Provisional Authority will develop a plan for the Iraqi oil industry based on transparency. Iraq's oil wealth will be used and marketed for the benefit of the Iraqi people.

Priority Sources of Funds. In assisting the Iraqi people, the United States will play its role but should not be considered the funder of first and last resort. The American people have already made a significant investment to liberate Iraq, and stand ready to contribute to rebuilding efforts. But when funds are needed, before turning to the U.S. taxpayers, the coalition will turn first to Iraqi regime funds located in Iraq; Iraqi funds in the U.N. Oil-for-Food Program; seized frozen Iraqi regime assets in the United States and other countries; and international donors across the globe.

Conventional Debt Forgiveness

The case for debt forgiveness has gained increased credence in recent years. After many years of agonizing over developing country debt, the international financial community finally recognized in 1996 that the external debt situation of a number of low-income countries, mostly in Africa, had become dire, jeopardizing any prospects for future growth and development. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction, together with continued provision of concessional financing and pursuit of sound economic policies might not be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. A group of 41 countries were deemed in such a situation and considered candidates for the new Heavily Indebted Poor Countries (HIPC) initiative.

The HIPC initiative was launched in September 1999, although Iraq was not included in the group. To be eligible for special assistance under the program a country has to meet certain criteria: (1) be eligible only for concessional assistance from the IMF and World Bank; (2) face an unsustainable debt burden, beyond available debt-relief mechanism such as Naples terms (where low-income countries can receive a reduction of eligible external debt of 67% in net present value [NPV]); and (3) establish a track record of reform and sound policies through IMF and World Bank supported programs.

For Iraq to become eligible at this point, the country would have to complete a successful first phase. This would entail a three-year period of successfully adopting adjustment and reform programs supported by the IMF and World Bank. During that time, the country could receive debt relief from Paris Club creditors and other official bilateral and private creditors, as well as traditional concessional assistance from donors and multilateral institutions.

The HIPC route might seem a logical solution for Iraq once the country is back on its feet and ready to move ahead with reforms and a reorganization of the economy. Unfortunately, because it may take Iraq several years to reach this stage, HIPC is not a realistic near-term option for the country's policymakers.

Odious Debt

One radical option is for Iraq to repudiate all of its international debt. This action would be based on making the case that Saddam government was an odious regime. Michael Kremer of Harvard University, for example, argues that after a change of regime, a country's new government should have no legal obligation to service the odious debt of an illegitimate predecessor. The odious doctrine is an idea dating back to the Spanish-American war of 1898. In theory, establishing the right of a country such as Iraq to write off odious debt would have potentially huge benefits, not the least by discouraging banks from lending to similar tyrants that might one day be overthrown. Indeed, setting out precise rules for what counts as odious regime and thereby making it harder for such regimes to borrow may be a better form of economic sanction than the traditional approach of obstructing trade. Restrictions on trade hurt ordinary people, whereas making it harder to borrow hurts those in charge.

Beginning in the late 1990s, a worldwide campaign called Jubilee 2000 attempted to call attention to the concept of odious debt. Unfortunately, the doctrine of odious debt has gained little momentum in international law (Kremer and Jayachandran, 2003). As might be imagined, most western governments and bankers have shown little enthusiasm for the odious debt doctrine. "They'd prefer not be in the business of judging whether a regime is illegitimate. They also like to get paid back. And no one wants countries to renege every time a general stages a coup." (Surowiecki, 2003).

Some commentators have gone so far as to argue that increased use of the odious debt doctrine could destabilize the global credit markets by making creditors fearful that other countries might one day describe their debt as odious. Their main point: it is not hard to imagine circumstances in which, say, a newly democratic China might try to shed the external debt—$170 billion at the end of 2001—of the "odious" undemocratic regime it replaced (James, 2003).

Lenders to Iraq warn that adopting this policy could do irreparable harm to Iraq's ability to borrow in the future. Yet a debt-free, democratic (hopefully) Iraq, with a predictable stream of revenue from oil, should be a much more appealing country to lend to than one saddled with up-to $400 billion in debts (Craze, 2003).

Interestingly, two of the main arguments against forgiveness hardly apply to Iraq. There is no obvious "moral hazard": forgiveness would not reward any bad behavior of a new Iraqi government, nor—given the unique circumstances—would it generate expectations that similar generosity would be forthcoming in future. As the *Economist* (May 7, 2003) notes: "Likewise, because a new government would be clearly unconnected to the Saddam regime, refusing to repay all its debts might not hinder the government from borrowing fresh capital—though it is certainly plausible that creditors might look more kindly on Iraq, and thus charge it a lower rate of interest, if it continued to pay existing creditors something, after a formal rescheduling."

Certainly, from Iraq's point of view, the ideal solution is for creditor countries and commercial lenders to write off a substantial portion of the debt, perhaps as much as 80% and to allow a moratorium on all payments and reparations for five to ten years. The odious debt doctrine would be an ideal way to do this and, as noted above, there would not necessarily be a risk penalty attached to the country's future borrowing. The United States and other members of the Paris Club creditor group did essentially just that for Yugoslavia, another recent odious-type case, after the war in Kosovo in 2001 (Vieth 2003).

John Snow, newly appointed Secretary of Treasury, has given his tacit blessing to the odious debt doctrine: "certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who is now gone" (quoted in Beattie, 2003).

Given its position under resolution 1483 the United States has a lot of leverage in pressuring countries to write off their claims on Iraq—prolonged legal wrangling would no doubt mean they would be locked out of future lucrative contracts in a country with the world's second largest oil reserves.

The Issue of Reparations and War-Related Debt

Contemplating the victorious allies at the Versailles peace conference in 1919, the famous English economist John Maynard Keynes observed that "reparation was their main excursion into the economic field, and they settled it as a problem of theology, of politics, of electoral chicane, from every point of view except that of the economic future of the states whose destiny they were handling" (quoted in *Economist*, May 17, 2003). Keynes rightly foresaw that this neglect would have disastrous consequences. Unfortunately, Keynes' wisdom, if even acknowledged, is being largely ignored. Given the country's dire straits, the 5% of Iraq's oil revenues to be allocated for this purpose under Resolution 1483, even though it is down from 25% under the Oil-for-Food program, is still excessive.

Almost all of the personal claims arising from Iraq's previous wars have been settled. What remains is reparations demanded by other countries. These consist mainly of outstanding claims by Kuwait ($17 billion) , Saudi Arabia ($25 billion) and the other Gulf countries stemming from assistance provided Iraq during the Iran/Iraq war in the 1980s. Using the odious debt doctrine noted above, Iraq could easily build a good moral and probably legal case that that the population should not be burdened for wars they had no say in but were forced to participate in. If these obligations are grants, as the Iraqis claim, then they may be a moot point. If they are loans as the Gulf states argue, the situation becomes difficult for resolution, in part because any significant increase in Iraqi oil production is likely to drive down world oil prices into the low teens, something the Saudis and Kuwaitis do not wish to see. To stabilize the price at around $29 a barrel they will have to reduce their own output, while at the same time being asked to forgive their neighbor's past debt—something each country is unlikely to agree to readily.

Outstanding Contracts

The odious debt doctrine would also seem to apply to the $57 billion in outstanding contracts, mainly to Russia, France and China. Many of these claims are for questionable contracts for oil exploration and development. As noted, Resolution 1483 sets up a procedure for the evaluation of outstanding contracts. However, it is not clear whether the UN will have ultimate authority to approve or disqualify a contract.

In any case the Iraqis and American administrators are taking matters into their own hands. Just three days after the Resolution 1483 was passed, Iraq's oil minister announced that three oil production contracts signed by the previous regime with Russian and Chinese companies would be either terminated or frozen. Phillip Carroll, the former Shell executive chosen by the Pentagon to advise the oil ministry said that there was some doubt whether existing foreign contracts "gave the Iraqi people the full benefit of their oil wealth" (Clover May 26, 2003). No doubt, some of the outstanding contracts will meet Carroll's criteria for approval—20% would seem to be a safe bet.

As in the case above, long litigation by the Russians, French and Chinese would probably result in them being completely frozen out of future reconstruction and development projects in Iraq. The potential amounts of future work are enormous. The previous administration had developed a strategic plan to increase production capacity from 3 million barrels per day to 6 million in six to seven years at a cost of $25-30 billion. Every indication is that this plan will move ahead.

Bottom Line: Counting the Beans

The considerations noted above lead to some likely budgetary figures (summarized in Figure 1). For debt servicing, it is unlikely all will be written off under the Odious Debt Doctrine. Although ideal from Iraq's situation and that of the Middle East as a whole (and despite U.S. efforts) there is sufficient opposition amongst the creditors to make this a non-starter. Instead, the Paris Club is likely to work out some sort of debt restructuring that will amount to annual payments in the $2-3 billion range.

Similarly, reparations imposed on Iraq will probably not vary significantly from Resolution 1483's mandated 5% of oil revenues—depending on the likely range of oil revenues of $15-$22 billion, this adds another budgetary cost of $0.75-$1.25 billion annually.

While many of the contracts signed by the previous regime are likely to be invalidated, perhaps up to 20% will be approved on merit or because of intense political pressure. This would add around another billion to the budget. However given the likely cost of oil sector restoration of $35 billion annually, this would only reduce the share of other bidders and not be an additional charge to the anticipated $3.5 billion annual cost.

If we assume yearly government functions to run around $11 - $13 billion, a range often tossed out, and adding on $10 billion or so for reconstruction over the next ten years, this brings total expenditures annual expenditures up the $27.25 - $30.75 billion figure for the next ten or so years.

With projected oil revenues in the $15 - $22 billion range this leaves an annual shortfall of between $5.25 billion - $15.75 billion.

Conclusions

The reality is that Iraq is bankrupt and even under fairly optimistic debt restructuring and oil revenue assumptions will simply not have the resources to implement a successful reconstruction and recovery program. While the country would likely be able to thrive under an international aid program as ambitious as the Marshall Plan that helped Europe recover from the ravages of World War II, there is no indication that donor countries are lining up to provide funds of this magnitude. No doubt significant amounts of aid funds, both humanitarian and development will flow into Iraq, but these will be far short of the likely budgetary shortfalls associated with the necessary outlays to put Iraq's economy on a steady, self-sustained growth path.

However the situation is far from hopeless. There are a number of available options. The key for success is for the Iraqi authorities to look at the complete picture with each action evaluated in terms of its contribution to the restoration of self-sustained growth within a reasonable period of time—10 years or so. This strategy would include debt servicing alternatives, reconstruction costs, economic reforms (Clover, May 27, 2003), industrial diversification and so on. Within this context a number of initiatives might be explored by a new Iraqi government.

1. **Debt Servicing Priorities**. Link debt payment priorities so that they are proportional with the amount of new investment. Countries that are willing to loan/invest new funds in Iraq would receive priority on the servicing of their debts. An unambiguous formula could be worked out so that each country would know where it stood in terms of receiving speedy compensation for past loans. The idea is to provide a tangible inducement to countries to actively participate in Iraq's economic recovery.
2. **Debt Forgiveness Incentives**. Donor countries might set up a formula linking debt forgiveness to Iraq's economic performance. For example, each percent average annual increase in non-oil output might be linked to a certain percent of the country's debt forgiven. This would provide Iraqi authorities with a real incentive to diversify the economy away from oil through economic reforms,

privatization schemes, and supportive governmental budgets whose capital allocations went to projects with quick payoffs.

3. **Creative Debt Conversions**. No doubt, many countries are concerned with the environmental damage done under the previous regime. To speed up cleanup and restoration many might find debt conversion schemes similar to the highly successful debt for nature plans developed after the debt crisis of the 1980s.
4. **Privatization of the Oil Sector**. It is somewhat ironic to say that Iraq is bankrupt when it is sitting on an asset worth up to $200 billion or so. If the Iraqi authorities are serious about reconstruction, they will eventually have to come to grips with the reality that privatization of the oil industry, either partial or full, may be necessary for fiscal reasons. The type of privatization will affect the stream of revenues derived from the industry. Full privatization of producing reserves might bring in $100 billion early on (Adelman, 2003), but would diminish revenues in later time periods. One advantage of this option is that it would relieve the government of the cost of restoring and renovating the oil industry. As noted above this might come to around $35 billion. Partial privatization or selling off exploration rights in non-producing areas might bring in $50 billion, enough to cover projected budgetary shortfalls, while maintaining the Iraqi government's longer-term revenues at a much higher level.
5. **Creation of an Oil Fund**. Privatization of the oil sector should be done in a manner similar to that introduced in Alaska (Pardee, 2003) whereby a certain proportion of payments/royalties are placed in a fund earmarked for direct payment to Iraqis. This would not only make the sector's privatization more palatable, but it would also help create the purchasing power necessary to support the country's industrial diversification efforts.

Given the country's likely fiscal position over the next decade, how well a new Iraqi government handles technical and political challenges associated with the privatization of the oil sector will no doubt ultimately determine if Iraq will soon rejoin the ranks of the world's prosperous countries.

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