

Transforming Iraq's Economy

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Mr. Chairman, thank you for the invitation to speak before the Joint Economic Committee about the challenges confronting Iraq's economic transformation. As you may know, I co-directed "Guiding Principles for U.S. Post-Conflict Policy in Iraq," a December 2002 report co-sponsored by the Council on Foreign Relations and the James A. Baker III Institute for Public Policy. Ambassadors Edward P. Djerejian and Frank G. Wisner co-chaired the report. In addition, during "Operation Iraqi Freedom," and the weeks prior to it, I traveled twice to the Persian Gulf to discuss the war and its aftermath with those in the region. Although the Council on Foreign Relations makes my research possible, it bears no responsibility for these remarks.

MAGNITUDE OF THE CHALLENGE

The task we confront in Iraq is enormous. Iraq sits in the strategic heartland of the Middle East. Historically, Baghdad has been a major player in Middle Eastern affairs and has been at the center of inter-Arab politics since its independence in 1932. Economically, Iraq has the second largest proven oil reserves in the world, estimated at 112 billion barrels, with as many as 220 billion barrels of oil resources deemed probable. Culturally, Iraq's universities and religious seminaries have shaped the thinking of large sectors of the region's citizenship. In short, what happens in Iraq matters immensely to millions of people in the region and beyond, as it does, of course, to the Iraqis themselves.

We have set high expectations for ourselves and the Iraqis. But even establishing a basic level of stability, security and economic recovery will be time-consuming and expensive. As Secretary of Defense Donald Rumsfeld has pointed out, after the American Revolution “it took eight years of contentious debate before [the United States] finally adopted a Constitution and inaugurated our first president.” In Germany, it took four years to move from the end of the war to a constitution. The German experience, of course, also benefited from approximately \$8 billion of Marshall Aid money (in current dollars), a robust American and international security presence, and an international political context that America organized around Europe’s recovery. Time, money and security were required in Germany. In Iraq, there is no reason to expect it will take anything less. If anything, it could take more.

The challenge confronting the United States is to initiate a process that creates a reasonable level of security, maximizes international political and economic support, addresses the aspirations and needs of Iraq’s various ethnic and religious groups and allows as many Iraqis as possible to participate in the positive political and economic transformation of their country. Such an Iraq could provide the region with a new political and economic model. It would supply a win for America’s dwindling base of support throughout the Muslim world. But it will require a strong and serious American commitment. Failure to stay committed, politically, militarily and financially would have pernicious effects throughout the Middle East, North Africa, South Asia and beyond. The costs of getting Iraq right will be exceedingly high, second only, perhaps, to the costs of getting it wrong.

THE COMPONENTS OF ECONOMIC RECOVERY

Unfortunately, hard economic data or statistics for what is needed in Iraq are few and disputed. Still, the obstacles confronting recovery are many and include:

Re-establishing law and order. Iraq's recovery is challenged primarily by a lack of law and order. The looting and violence that has occurred, and is still occurring, has all but undone the hard work of military planners who largely tried to avoid targeting sites necessary to Iraq's reconstruction. Destroyed infrastructure along with missing documents and equipment are delaying reconstruction projects and attempts to get Iraq's oil flowing.

Iraq's economic recovery depends on its workforce returning to productive economic activity. But today a large portion of Iraq's workforce remains sequestered in their homes, fearful that leaving would risk the safety of family and property. Others simply can not go back to their jobs because of the damage done by the war, the civil disorder that followed, or both. Unless this situation is reversed, the time-table for Iraq's recovery will continue to slip.

Worse, the breakdown of law and order and the resulting power vacuum is providing Saddam's loyalists from the Ba'ath party, the military and other armed groups the opportunity to reconstitute. Knowledgeable Iraqis suggest that Saddam's security forces, that melted away during the fighting and that have not been disarmed, are trying to hasten an American withdrawal by inflicting a steady stream of low-level casualties. The use of guerilla tactics that is beginning to emerge in western Iraq is an ominous warning of things to come. Unless America and its partners deal firmly with such opposition, and make clear their commitment to provide for a better future for all Iraqis, all other goals for Iraq will be illusory.

A heavy security presence will be necessary to fill the power vacuum left in Iraq. Prior to the war, a Council on Foreign Relations task force estimated that a stability force of 75,000 American troops would cost no less than \$15 billion per year. This estimate did not include reconstruction and humanitarian costs. U.S. administration officials now estimate that the current force levels of about 150,000 (and expected to remain steady for the near future) are costing in excess of \$3 billion per

month. The original hope of reducing American presence to 30,000 by this fall is no longer viable given the chaotic reality on the ground.

The Administration deserves credit for the growing evidence that law and order is slowly being restored. Maintaining large number of soldiers in the country, supplemented by military police and Special Forces, is helping to stabilize the situation. However, the looting and violence that occurred unchecked during the first weeks of the post-conflict phase has set back Iraq's reconstruction.

Recovering Iraq's oil potential. Even if law and order had seamlessly transitioned from occupational authority to local control, Iraq would still require considerable outside assistance.

Iraq's reconstruction will not be self-financing. Oil is its major source of government revenue. Iraq's oil infrastructure is in decline. After years of sanctions and poor political rule, Iraq's production capacity is decreasing at an annual rate of 100,000 barrels per day. Prior to the war, Iraq generated \$10–12 billion in oil revenue per year. Over 70% was spent on basic humanitarian assistance such as food and medicine that still is required today. While official assessments have yet to be concluded, repairing and restoring Iraq's previously used oil facilities may cost \$5 billion, in addition to the \$3 billion needed for annual operating costs. Up to \$20 billion may be required to restore Iraq to its pre-1990 electricity capacity.

Before the war, questionable assumptions were made about the cost of the conflict, and the likely speed of reconstruction. Despite heady predictions for Iraq's recovery, there are limited short-term resources available for repairing Iraq's oil industry and decaying infrastructure. Considerable American and international support is required. It is unlikely that the Administration's one time request of \$1.7 billion will produce the stable promising Iraq that many advocated before the war.

Diversifying the economy. To get Iraq back on its feet economically, greater attention must be given to diversifying Iraq's economy. Over 90% of its export earning comes from oil. In 1980, Iraq relied on oil for only 39% of its gross domestic product. Reliance on a single source of revenue makes Iraq vulnerable to the chronic corruption, monopolistic behavior, under-development, and under-employment that have afflicted other energy-reliant economies in the region, while leaving Iraq hostage to the whims of the market. Throughout the twentieth century, the value of economic output for those working with raw materials, in this case energy has declined by 50%, relative to skilled labor.

Re-structuring Iraq's debt. Iraq shoulders a massive debt load. While the exact debt amount is unclear, it is generally agreed to be between \$100 and 200 billion. Iraq's debt is largely a result of the Iran-Iraq war of the 1980s, reparations from Desert Storm of 1991, and payments for pending contracts with foreign companies.

UN resolution 1483 "welcomes the readiness of creditors, including those of the Paris Club, to seek a solution to Iraq's sovereign debt problems." When possible, incentives will be required to encourage debt forgiveness. Unfortunately, even if they wanted to forgive Iraq's debt, some of Iraq's creditors are by law unable to do so. In such cases, generous refinancing conditions should be encouraged.

Supporting a stable, transparent political order. The Middle East has been woefully unable to attract foreign direct investment. Opaque authoritarian leadership has chased away such funds. To successfully attract capital and keep local capital at home, Iraq will require a transparent, stable, rule-based political system. While a transfer of power from the occupiers to local leaders is necessary, it will not happen quickly. America must plan to remain actively involved until local political experiments in places such as Mosul and Kirkuk can be replicated at the national level. A speedy transition will either return to power the scions of the old system, as happened in many former communist societies, or result in the assumption of power of a regime

viewed as an illegitimate puppet of the occupiers. Neither alternative is attractive to foreign capital. For this reason, the Administration's decision to delay the selection of an Iraqi Interim Authority was a correct one. Initially raising the possibility of an early transfer unnecessarily increased expectations and distracted Iraq's potential leadership from the difficult tasks of recovery.

MANAGING EXPECTATIONS

We must remember that the pre-Saddam Iraq that many hold in their memories is not the Iraq of today, nor will it be the Iraq of tomorrow, even under the best of circumstances. With high unemployment and 42% of its population below the age of 15, Iraq's economic base is considerably worse off than it was before Saddam took office and during the first few years of his rule. At all times, America must make clear to the Iraqi people the reason for our actions and seek to include them in the implementation of policies to the greatest degree possible. Inflated expectations will only lead to discontent and instability.

THE WAY FORWARD

If done well, the reconstruction of Iraq holds the promise of a better and more enduring security situation for the entire region. Successful reconstruction is a hope that many around the globe share with the United States. To the greatest extent possible, the United States should harness the capabilities of those who are able to contribute to the Herculean task we have set before us. The road to Iraq's reconstruction will be long, difficult, dangerous and costly. We can travel it alone, or we can travel it with others. It is our choice.