

Transforming the Iraqi Economy

The Phoenix Plan

I. Intro

Good morning Senators, Congressmen, ladies and gentlemen.

First let me thank you for inviting me to speak on this important topic. “Transforming the Iraqi Economy”.

The subject is important not only because the fate of a nation and its people located in a supremely geo-strategic and volatile region is at stake, but also because the prestige of this country and its leaders (both administrative and legislative) will be judged in the present and for many years by the outcome and face of the new Iraq.

My career has been spent in commercial and investment banking in the Middle East, the United States and Europe. My sources are publicly available information, what little research that I could get my hands on, interaction with Iraqis both within the country and from the exile community and of course my personal experience and preferences. I have not tried to get the most precise numbers because I do not believe they are available from any definitive source at this time.

While I will attempt to cover a very broad area in my testimony I cannot possibly do it justice in the brief time available. The subject is too large simply because so many things need to be done, but that is also the advantage. We are starting from scratch with a nation anxious to get on with it and in possession of the means. If the program is successful it will be akin to the rehabilitation of an Olympic athlete who can compete again, not a cripple who at best will just walk.

To start with I would like to add two important provisos to this presentation. First, that Transforming the Iraqi Economy requires a pre-requisite of civil security; i.e. an efficient police force to maintain basic law and order, plus eventually an army potentially built on the Swiss model of an effective defence force. Second that the economic transformation will be far more achievable if it is led by an independent body, staffed by qualified technocrats combining certain functions of the ministries of Finance, Economy, Trade and Planning, with ability not just to develop and oversee the various programs but also and critically, the ability to

fast-track approval of the regulatory framework necessary for the success of such programs.

II. Resources

There are four major resources available to the country that can be immediately recognized:

- a. Oil: The last reliable estimate of proven reserves dates back over 20 years and put such reserves at 113 billion barrels. This is from a limited number of fields and wells where exploration work has been carried out. More recent and informed guesstimates put the reserves at three times this number and this does not take into account gas reserves. If this is accurate Iraq's reserves are 1.5 times those of Saudi Arabia and represent a significant portion of world reserves. The other very important fact is that Iraqi oil is one of the cheapest in the world in terms of production costs at about the \$1 per barrel.
- b. Water: Iraq has two major rivers running through it. Assuming historic water rights are respected and these rivers are not subjected to extensive dams in the north this resource is critical in a generally arid part of the world.
- c. Fertile Land: In combination with the water, the country can easily achieve self-sufficiency in agricultural products and livestock. Indeed Iraq can again become a net exporter of farm produce given the right circumstances.
- d. People: Lastly and perhaps most important the country possesses a large professional and technically competent labour force (doctors, engineers, lawyers, etc.). While this body of people may have gotten rusted over the past 10 years and has certainly been subject to a severe 'brain drain' these factors can both be quickly rectified. It is worth noting that the country had already started its industrialization program as early as the 1950's but hit the progressive calamities of nationalization, Baathism, two decades of war and sanctions. The professional and mercantile classes within the country are eager to update their skills and many of those abroad, the majority of whom are

successful in Western countries, are ready to return to help rebuild the country in the right environment.

One of the most critical issues is the ability to quickly address the problem of high unemployment rendered more severe since the de-commissioning of the army. This is an energetic and skilled young labour force that can become a main engine for growth.

III. Economic Blueprint: The Phoenix Plan

Over the past 23 years Iraq has slipped back into the 19th century while the rest of the world has moved on to the 21st. Examples of this economic regression abound, one needs to only look at per capita GDP, telephone penetration rates, internet access or any other plethora of indicators. It is imperative to develop a well thought out and comprehensive economic model for Iraq in which all the parts fit and work together in a synergistic manner.

We must immediately acknowledge two very important factors; first, that no economic rejuvenation and vitalization can happen without empowering the Iraqi private sector, therefore the role of the State has to be that of a facilitator and enabler to create the framework for a new economy. Second, that oil revenues alone are insufficient to lift the economy; the oil sector itself requiring significant investment, and therefore oil revenues are only a catalyst and not a panacea for the solution

The Plan will be implemented in three phases:

A short-term plan outlining immediate actions that can help to kick-start the economy, remove bottlenecks, clarify the regulatory environment, encourage the return of exile skills and attract foreign direct investment.

A medium-term five-year plan detailing expectations for each sector of the economy has to be clearly spelled out setting forth production levels, capacity, consumption and penetration rates as well as health coverage and

education. Target GDP per capita should be about \$10,000 (in 1979 it was about \$7,140) enabling a phasing-in of open markets.

A long-term ten-year plan with per-capita GDP objectives of about \$20,000 must be targeted, with a deregulated economy and full access to WTO.

Fiscal policy and monetary policy have to be designed to act in a supportive manner to achieve the desired objectives of the plan in a pro-active not a re-active manner.

Outstanding debt has to be broken down into its three categories, bona-fide commercial debt, government debt incurred by the Baath regime, and war reparations resulting from Saddam's adventurism. Each category has to be resolved in the corresponding manner.

IV. Components of the Phoenix Plan

A number of sectors have to be specifically addressed in the plan and are set out below. Due to the scope of this testimony only the most critical aspects of each are elaborated. Countless other details are important and their omission is not intended to downplay them but rather an admission of the complexity of each and the need for specialist experts. However, the following are the over-riding issues:

A. The Oil Sector:

The conventional wisdom holds that Iraq's rejuvenation program will be largely taken care of by the country's abundant reserves. While reserves may be plentiful, oil in the ground means nothing in the circumstances. Prior to the recent war Iraq produced 2.8 mbpd, with annual revenues of about \$17 billion (about one or two month's turn-over for General Electric or Exxon-Mobil). It is estimated that up to \$5 billion will be needed to restore this production capacity in the short term and up to \$30 billion will be needed over the next five years to produce 6.0 mbpd. At that production level (in five or so years) and using the Shell Oil long-term projections for

prices at \$15 per barrel Iraq's revenues could be about \$35 billion at the time. Given the overall needs and condition of the country and the size of the population it becomes very quickly clear that oil alone is not the solution.

Evidently Big Oil expertise and capital is necessary. Production Sharing Agreements may be appropriate but how those are structured and worded is critical. Experience has shown that oil in the hands of governments is a bane not a boon; however abdicating ownership to foreign interests under any circumstances is unthinkable. The Iraqi private sector itself must be encouraged to become a player and there are a number of methods of achieving this. Negotiating on a level playing field is not easy given the size of the respective negotiators (i.e. Iraq or Iraqi's vs. the oil majors). It is imperative that any agreements keep majority control in the hands of local ownership and fair and equitable exit clauses (put and call options) are available to keep both sides honest and working in the best long-term interest of the economy. While such clauses may not be standard and are novel in this context, they are not unusual in other transactions and can be easily adapted for the purpose.

The matter of whether Iraq should stay in OPEC or not has also been debated. It is obviously not in the country's interest to trigger a price war to achieve a pyrrhic victory. By the same token current quota allocations no longer have relevance in light of current needs and circumstances. A new formula has to be agreed that helps maintain market stability for consumers and viability for producers.

Finally Iraq should move quickly into the downstream sector, which in itself will require additional capital. This will not only benefit the economy directly through expansion and employment but also improve the added value of oil sales. In order to do this, agreements need to be put in place with end-user countries that receive some advantage for opening up their markets and removing trade barriers in advance of full WTO entry by Iraq.

B. Privatisation

It should be recognized that the Baath State, through inherited nationalisation and progressive expropriation, owned about 80% of the productive economic assets of the country. This, of course, must be brought back into the private sector. However, it is easier said than done since after all, this not only represents the wealth of the nation but arguably also the forfeited economic value of a population short-changed for the past three decades by the Baath State and reduced to living on rations. An economic programme must therefore be careful not to be accused of handing the economy over or selling assets too cheaply to a handful of oligarchs and foreign investors as the average Iraqi citizen does not have the means to participate in such programmes. The two problems, that of broad distribution of the wealth (assets) and 'fair' valuation must be solved simultaneously and quickly to get the economy firing on all cylinders and in a long-term socially and politically acceptable manner.

First, addressing fair valuation the problem is:

- i) The current condition of the assets is seriously degraded, true both for machinery and equipment that is out of date or poorly maintained (i.e. for hard asset companies), as well as market share that has been lost or is weak (i.e. for service companies);
- ii) Country risk as assessed by the major rating agencies will be near the bottom of the ratings;
- iii) There is significant competition from a number of countries in the world all vying to attract privatisation money making it very much of a buyers market – witness the failure of both the Egyptian effort over the past six years and the more recent failure of the Saudi gas initiative.

Given the above factors fair valuation means that today 'auctions' will not do the job! Better to develop a programme that values assets progressively over the next few years using a set of pre-agreed benchmarks; e.g.

EBITDA, Gross Sales or market share etc. This would give the buyer the assurance of the acquisition through an executed purchase and Sale Agreement, while giving the seller (the government) part of the cash price today and part at a later date when the full value of the asset is more properly measurable. Such Agreements can also incorporate Put and Call options between the parties that further ensure a “fairness” to both sides.

Second, as regards the broad distribution of the assets it is important to learn the lessons of Eastern Europe to avoid the economic disenfranchisement of the lower economic classes (essentially the overwhelming majority of the population in Iraq today) and prevent the emergence of a handful of oligarchs. This can be accomplished both through an extensive system of ESOPs and Trusts. For example, at every privatisation full vesting of any ESOP shares would be gradual, for example start paying dividend but delay conveying ownership (and thus the ability to sell) until full value was better reflected by actual performance and understood by the stakeholder. Alternatively, shares to be distributed to the population may be held by a specially created fund e.g. in the case of capital-intensive industries with small employee numbers. The Fund can then administer the assets until such time as value is realisable and it can find an equitable or attractive distribution strategy not only to the direct employees but also perhaps to a wider base of beneficiaries (e.g. regional or geographic within certain proscribed guidelines).

C. Debt Forgiveness & Re-Scheduling

An important feature of the economic plan is clear and final resolution of the debt issue as it impacts almost all aspects of the program. New lenders need to know what other creditors are owed before extending new facilities. Investors need to understand the solvency status of the country, the local government must properly budget to meet its obligations and individuals must achieve a level of confidence before they start investing or saving.

Bona-fide commercial debt should be re-scheduled in conjunction with the Paris Club. Government debt extended by the old supporters of the Saddam regime must be totally forgiven for obvious reasons. War reparations incurred as a result of Saddam's adventurism must not be allowed to become an albatross around the neck of future generations. Part of such forgiveness can be traded for a points program that the old creditors would receive; these points can then be used (redeemed) to enhance bids for licenses, contracts, concessions or other agreements. As the value of such points becomes recognized a separate market in these points will develop internationally (e.g. amongst the oil companies) thereby creating value to the original holders of these points.

D. Foreign Direct Investment

Funds need to be attracted from a variety of foreign sources, government, private, multi-national and multi-lateral; both commercial profit-motivated and charitable aid-related. If the economic plan is structured correctly the need for aid should be minimal and is better allocated to other countries in serious need. Already foreign investors are lining up at the gates of the Iraqi economy armed with know-how and capital. A proper regulatory framework and a clear path to open markets must be elaborated to encourage the making of such investments in the country. The conventional wisdom is unanimous in its view that if the Iraqi economic experiment is successful, it will result in a major economic boom that can spill over into the whole region.

However by the same token it is critical to avoid economic pillage by foreign investors. It should be recognized that while a lot of emphasis will be placed on the indigenous private sector, it will take some time before the local population is up on its feet and able to participate as an equal partner with foreign players. Here also it is imperative to establish a level playing field that gives breathing room and establishes safeguards for the local population during the first phase (five years) of the Plan.

E. Restitution & Private Property

During the past four decades respect for private property has been virtually non-existent. Starting with the nationalization in the early sixties the situation became progressively worse as the Baath regime could expropriate any property for any value or no value at any time and for any reason. Lack of respect for human life extended indiscriminately to property and ownership.

An independent Property Restitution Authority must be set up to look into all legitimate claims and provide proper compensation or restitution. In this regard the experience of Eastern Europe is valuable and needs to be carefully assessed to provide guidance. In addition to being ethically correct such action will have two added benefits; first, it will go some way towards redistributing assets away from the state and its cronies and second, it will inject a measure of wealth back into the middle class which having been totally dispossessed and decimated, will be able to revive and participate in the economy again.

While the work of such an Authority may not be straightforward, nevertheless a concerted and consistent effort has to be made.

F. Currency Stabilization

A stable local currency must be created as an ongoing tool of monetary policy and the creation of credit in the banking sector. The new currency should be pegged to a basket of the US dollar and the Euro reflecting the country's primary import and export position. Such currency stability will not only help the average Iraqi feel secure but also help to allay the concerns of foreign investors. At a later point in time and subject to the building up of adequate reserves the Central Bank may decide on changing the basket mix or free market floatation.

G. The Banking Sector

At present there is no proper banking sector to speak of. There are two large government owned and about twenty minuscule commercial and investment banks. The sector is utterly rudimentary by almost every standard. It is imperative to develop a strong and modern banking infrastructure to support economic growth both at the retail and the corporate level. A vibrant banking sector will accelerate the circulation of money, promote investment and capital expenditure to boost every sector of the economy, encourage consumer spending and saving, and contribute to an active deeper stock market.

Specialized lending such as consumer credit, leasing, mortgage lending, trade finance, agricultural finance and micro lending must be introduced and vigorously promoted. Foreign expertise will also be required in this sector and international banks should be encouraged to participate in a dynamic manner. Here again the participation of the Iraqi private sector must be safeguarded at the initial stage, which can be done by requiring foreign investors to have local partners with a minimum ownership during a pre-agreed initial period. As with other sectors involving large international players, ESOP and/or public listing requirements can be built into the license agreements as a partial means of providing such safeguards.

H. Capital Markets

Underpinning the whole economy a program to re-invigorate the country's stock market is of paramount importance. Such a market already exists but it is small and shallow. An independent regulatory authority is needed to promote and develop this vital aspect of the economy resulting in three main benefits; first, it will allow for a broader participation in economic activity and the resultant distribution of wealth. Second, it will allow for the classic ability of enterprise to raise capital. Third, it can be an efficient tool in the privatisation program, its ESOP features, the listing requirements and put/call options that may be negotiated with large foreign buyers.

The Capital Markets can be brought to a reasonable size fairly quickly if a requirement is imposed on certain large privatisation industries to list within a

specific time frame. These industries can include oil, petrochemical, power and telecom as an example. Strict requirements on transparency, disclosure, collusion and insider trading must be put in place to avoid the “oligarch syndrome” experienced in other countries both in the region and internationally.

V. Other Critical Issues

In addition to the above a number of other issues have a critical impact on the Phoenix plan, these are:

A. Employment & Empowerment: the Private Sector

The local professional and mercantile segment of the population has been reduced to poverty subsistence over the past 20 years. It is not realistic to expect them to participate in the economic program in any meaningful manner very quickly. This needs to be taken into account during an interim period (the first 5 years) while a reasonable amount of intrinsic wealth, self-confidence and skills are accumulated.

Vocational Training Centres (VTC) need to be established across the country to deliver technical training in a variety of skills with a very heavy emphasis on IT. This will not only help absorb the youth, significantly upgrade the quality of the labour force but also indicate to the population at large the start of new economic horizons. Vocational training will also play a key role in harnessing and re-directing the energy of the recently de-commissioned army, channelling this energy into a productive force in the economy.

Real and effective protections need to be put in place during the first five years of the plan to achieve a proper distribution of wealth to the population at large, limit the emergence of oligarchs and avoid economic pillage by cronies of the old regime and foreign vulture investors. Furthermore, specific provisions and benefits programs need to be introduced that start the process of reversing the “brain drain” and attracting competent professional Iraqi exiles back to the

country. One example is that followed in the GCC whereby regulation requires that 51% of any business activity is locally owned.

Furthermore it is not enough to limit control to Iraqi ownership, but in certain cases the identity of the owners must also be vetted. Already dubious characters and vulture investors are beginning to circle. The first category is more dangerous as it comprises many local cronies of the old regime who quietly accumulated large amounts of clandestine wealth in shady deals on their on behalf and on behalf of senior members of the Baath regime. Large and unaccounted for amounts of money held by persons with no discernable business backgrounds or worse still from unsavoury business backgrounds are waiting to transform their liquid assets into legitimate businesses in Iraq. Some of these characters are teaming up with gullible international investors, to gain legitimacy, by selling their supposed access and knowledge of the country. This also must not be allowed to happen. As the international community has cracked down on money laundering activities in other parts of the world, it must remain vigilant that another equally virulent strain of this activity does not happen in Iraq.

B. The Iraq Development Fund

There has been talk in the press of plans to set up an Iraq Development Fund that would receive all the oil revenues and be responsible in a transparent manner for reconstruction expenditure. While this sounds acceptable in theory there are two major questions that have to be answered.

First, what is the mandate of the Fund? If the Fund is just an accounting body, albeit transparent, then that is of very limited use. The Fund if it is to be set up must become a synergistic organ of the overall economic plan. It must work within the parameters and guidelines of the economic blueprint and must have some authority to make decisions not just take instructions to write checks and pay bills.

Second, what is the governance and oversight of the Fund? The Fund must have an un-conflicted and qualified Board with local participation. Such governance should have a phased transition to full local authority over a specific period of time. It is intelligent not to repeat the problems and inefficiencies that plagued the Oil For Food Program partially resulting from the governance of that program.

Finally thought should be given to The Iraq Development Board that was set up in the country in the 1950's, whereby 70% of oil revenues were allocated exclusively, outside of government budgets, to the fund to be expended towards economic development. Such a model or a variation thereof may be very relevant in the present circumstances.

C. Infrastructure De-Regulation

There are certain infrastructure sectors that would benefit from phased de-regulation and expedite the economic revival of the country. These include; power, water, transportation and telecommunications initially, to be followed by other sectors such as education and healthcare. The objective is to either get the state completely out of these sectors, fast (e.g. telecom & transportation), or over the medium term (e.g. power & water), or at least to run in parallel with the private sector (e.g. education & healthcare).

There are a number of well-documented examples one can learn from such as the successful British experience with extensive infrastructure privatisation under Margaret Thatcher; the minimal role of the state from the healthcare system in the USA which is one of the best in the world; and the recent mixed experience with de-regulating the power sector again in the USA.

In the context of de-regulation a separate note must be made of the role of the Media, which in the past was dominated by the Baath state and used solely to serve their purposes. A number of different media outlets have already started springing up, however all controlled by the different political parties. It is important to encourage independent and non-political outlets in radio,

television, newspapers and the Internet not just for education and information but also for entertainment and especially for the young.

VI. Role of the USA & other International Players

The US must continue in its leadership role in the reconstruction of Iraq; it is critical not to abdicate it to any other single or multinational authority. This leadership role is important for Iraq but also for the US. From the US perspective what was started must be successfully completed and should not be left half-baked. As the vision for the new Iraq was explained to Iraqis, the region and indeed the world only the US can bring it about. It is no secret that many countries, some overtly and some covertly are looking for the United States to stumble and be ultimately humiliated in the bold and noble initiative it has undertaken to remove tyranny and bring freedom and stability to the “cradle of civilization” and ultimately to the whole region. Only the close and continued involvement of the US can shoulder the burden and transform this vision into reality.

For Iraq this relationship is equally if not more critical. Devastated by a pathological tyrant, war and sanctions; surrounded by hostile and sceptical neighbours, the country must and can rebuild itself into a vibrant free market peaceful economy in record time. For this it needs not only a strong patron, but also one who shares its vision. From a practical perspective this translates to a number working arrangements including assistance in drafting a new constitution to using a number of the regulatory models in transportation, telecommunications, banking, securities and anti-trust laws amongst others. At another level assistance will be required in re-negotiating debt, free trade agreements where applicable, providing loan guarantees in the short term, technology transfer and other tools that will enable the country to leapfrog into the 21st century.

Iraq can be the beacon that transforms the region but will need US help to do so.

Other international countries can and should be given a role in the reconstruction of the country. Most notably other members of the G8 countries can make an important contribution and should be encouraged to come forward. In a similar manner these countries can provide financial resources, technical skills and know-how in areas as diverse as banking to education and oil-field services to water and sanitation.

Members of the Gulf Co-operation Council who share a destiny with Iraq want and should also be encouraged, to participate in the reconstruction effort. Many of the GCC countries have limited absorption capacity in their own economies relative to their wealth and are in a state of both excess financial liquidity and excess capacity in industry and services. A dynamic Iraqi economy will represent an interesting new market and can act as an economic spark to the regional insipid economic environment.

VII. Conclusion

1. The Phoenix Plan must be managed by an independent “Commission” combining certain functions of various ministries as Finance, Economy, Planning, and Commerce & Trade. The “Commission” must be staffed by technocrats and have the authority to draft regulations that can be fast-tracked for approval.
2. Any acceptable political system (let alone a vibrant democracy as a beacon to the region) will fail if it is not quickly underpinned by a healthy economy; these two are interlinked and mutually reinforcing in both directions.
3. Oil alone is not enough given the scale of the problem. While it is a big help it is definitely not a ‘cure-all’. Empowering the private sector in a comprehensive, transparent and publicly elaborated manner is the only solution.
4. The price of ‘losing the peace’ is not limited to Iraq or even the region. It will stab at the heart of America’s leadership in the 21st century and certainly there

are a lot of parties, alone and in collusion, waiting to push and twist the dagger. The “Domino Effect” can start in Iraq; better make sure it tips in the right direction.

There is not much time. At most the honeymoon in Iraq (if one could call it that) will last three to six months. Already other suitors (some unsavoury) are making ‘courting’ noises. A population, long oppressed, having recently found freedom will turn desperate without productive occupation and basic means of earning a livelihood. Immediate gainful employment is of the highest priority.

The Phoenix Plan is a way to get people off the streets and to work, fill their time, minds, stomachs and pockets in a constructive manner and start the “virtuous cycle” of economic growth.

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