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THE ECONOMIC AND FINANCIAL SITUATION IN IRAQ

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The Economic and Financial Situation in Iraq

Institutional arrangements – Financial obligations – Reconstruction issues

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May 31, 2003

The economic and financial situation in Iraq

Institutional arrangements – Financial obligations – Reconstruction issues

The overall situation in Iraq remains very unsettled and the future of the country is still unclear on all fronts.

There is no doubt that Iraq is now an impoverished third world country. It used to be one of the wealthiest developing countries before embarking in its war against Iran and then Kuwait that brought so much hardship on its population due to the strict UN economic embargo imposed on it in 1990.

The level of salaries in the Iraqi economy is now equivalent to that of the poorest countries in the world and all TV pictures that one can see of the Iraqi population show the deprivation of its people.

Although the last UN Resolution on Iraq is giving some indication about the economic and financial framework for the transitory period whereby no Iraqi sovereign government will be in existence, many issues regarding economic and financial policies of the "Authority" (i.e. the occupying troops) remain in the limbo.

There is no doubt, in any case, that the social crisis will be increasing during the next months due to the dismantling of the Iraqi armed forces, the suppression of some ministries and the fact that all Baath party members in the government machinery have been asked to quit their posts. This will increase the number of unemployed Iraqis that had already dramatically expanded due to the effect of the embargo on the domestic economy.

This is why the future economic and financial policies will have to be carefully designed so as to avoid imposing on Iraqi society additional suffering and loss of regular income.

I. The present institutional arrangements

UNSC Resolution 1483 have outlined some basic institutional arrangements:

1. The establishment of a Development Fund for Iraq (paragraphs 12,13,14) is at the core of the resolution.
 - 1.1. The legal nature of this entity is not clearly defined. It seems to be more of an account than a full-fledged institution.
 - 1.2. Paragraph 12 states that the Fund is to **be held at the Central Bank of Iraq** and audited by independent public accountants, which implies that it is only a book-keeping operation that replaces the standard public accounting legal procedures that exists in every country and is implemented by the Ministry of Finance. This is not a very positive arrangement as it will totally dispossess the Iraqi MOF of his most important legal functions, i.e. controlling spending activities of the

government machinery. Except for assessing and collecting domestic taxes the Iraqi MOF is by virtue of this resolution dispossessed from its traditional functions. But the Central Bank of Iraq will emerge stronger as the funds of the Development Fund will be held by it.

1.3. Paragraph 14 identifies the various **types of spending** that must go through the Fund:

- i. Humanitarian needs,
- ii. Economic reconstruction and repair of infrastructure,
- iii. Continued disarmament of Iraq,
- iv. Cost of Iraqi civilian administration,
- v. Other purposes benefiting the people of Iraq.

This list is rather odd as it includes recurrent budgetary expenditures (civilian administration) together with the reconstruction expenditures, so that it is not exactly a Reconstruction Fund. It looks more like a **Budgetary Fund**.

1.4. As for **receipts**, the Fund should receive:

- 1.4.1. The proceeds of the sale of oil exports until an internationally recognized government is properly constituted in Iraq (paragraph 20).
- 1.4.2. In the mean time, paragraph 17 requires the SG to transfer to the Development Fund \$ 1 billion from the unencumbered Iraqi funds with the UN under resolution 986.
- 1.4.3. The Fund should also receive (paragraph 23):
 - ✓ Any external funds or financial assets of the previous Government of Iraq or its State entities,
 - ✓ Any funds or financial assets or economic resources removed from Iraq by members of the previous regime and their families

1.5. The only authority to **disburse** from the Fund is the occupying powers (the Authority) "*in consultation with the Iraqi interim administration*". There is no mention of the need to consult the International Advisory & Monitoring Board of the Development Fund (IAMB) for specific expenditures related to reconstruction activities.

1.6. The IAMB is composed of "duly qualified" representatives of the SG of the UN, the Managing Director of the IMF, the DG of the Arab Fund (AFESD) and of the President of the WB. Except for the power to approve the nomination of a public accountant to audit the accounts of the Fund, no special function has been identified in the text of the resolution. It is to be noted that this accountant will also be auditing all export sales of petroleum, petroleum products & gas (paragraph 20).

1.7. In short, the resolution has dramatically altered the management of Iraqi public finances and State financial management to give full control of it to the

occupying powers. It is most probable that any future Government of Iraq will ask for an amendment of the paragraphs of this resolution that distort so much the institutional and legal mechanism of Public finance management in the country.

2. It is interesting to note that the resolution deals also with some length with the financial claims on Iraq.
 - 2.1. Concerning **the debt**, paragraph 15 "*welcomes the readiness of creditors, including those of the Paris Club, to seek a solution to Iraq's sovereign debt problems*". Paragraph 22 protects Iraq proceeds from oil sales and the Development Fund assets until December 31, 2007 from any legal action in respect to reimbursement of external debts. The text mentions "*the desirability of prompt completion of the restructuring of Iraq's debt through the process referred to in paragraph 15*" (mentioning the readiness of creditors to seek a solution for the debts of Iraq through the Paris Club).
 - 2.2. Concerning **claims** on the Iraqi Government from the invasion of Kuwait, the resolution confirms the financial obligations of Iraq under resolution 687, but limits annual payments to 5% of oil sales that will have to be deposited in the Compensation Fund instituted by resolution 687 (paragraph 21). This requirement can only be changed by mutual consent between the future recognized Government of Iraq and the Governing Council of the UNCC. This is a good measure that will protect Iraq from a total financial squeeze. It would have been better if the resolution mentioned also a ceiling for payments on external debts.

A very long paragraph of the resolution (16) deals in details with the many legal points and issues related to the phasing out of the "Oil for Food Programme" within six months. All remaining operations under this Programme will have to be transferred to the Authority and the Iraqi administration. Remaining shipments will have to be approved by the Authority and the Iraqi administration. All phasing out operations are to be conducted also with their approval, under the overall review by the Security Council.

3. However, nothing in the resolution is said about the functioning of monetary system in Iraq and especially the use of other currencies than the Iraqi dinar as legal tenders. The Authority has been using US dollar banknotes to pay some of the salaries and one can said that "de facto" Iraq is now under a bi-currency system where Iraqi dinars and US dollars are being used. Up to now the Central Bank has not reopen. Press reports are announcing that the Central Bank and the commercial banks will be opening in the very near future. Some estimates of amounts looted in the banks have circulated (400 million US \$ and 48 billion ID), in addition to what has been stolen from safes in the banks (cash and gold). There is also the question of the amounts that Saddam Hussein and his family have been taking out of the country, previous to the war through undue commissions on the selling of oil, or during the war. It seems that

the Authority has sized some of these last amounts. In fact, several types of amounts belonging to Iraq are now scattered inside and outside Iraq :

- 3.1. Amounts with the UN under the oil for food program originating from official proceeds of oil sales under UN supervision
 - 3.2. Amounts belonging to Iraqi official entities (the Central Bank, Rafidain Bank and other public sector entities) and frozen at foreign banks either since the beginning of the embargo in 1990 or since the beginning of the war,
 - 3.3. Amounts stolen by Saddam Hussein and his family; these amounts can be divided into two categories:
 - 3.3.1. amounts that have originated from undue commissions on oil sales and transferred to nutshell companies in certain off-shore centers. Some of these companies could be identified with time and proper research,
 - 3.3.2. amounts looted in cash from Iraq banking institutions
 - 3.4. Amounts in cash seized by the American British forces in Iraq and that Saddam Hussein's son most probably looted during the war.
4. In fact, Iraq is not cashless, but the problem is one of regrouping all of these amounts under a renovated Central Bank. Another additional problem is the value of the different types of Iraqi dinar that have been issued by Hussein regime. Apparently, one currency issue printed in Switzerland has more value than currency issues printed locally and there have been wide fluctuations in the different conversation rates of these different Iraqi dinar issues. However, news about the evolution of exchange rates and the inflation rate due to price increases are very rare. This is a vital issue for the well being of poor Iraqis that have no access to foreign exchange.

II. Financial claims on Iraq

There have been numerous reports about Iraqi financial obligations. Many of these reports were not accurate, especially those concerning claims related to the invasion of Kuwait. In fact, the UN Compensation Commission issues a status of claims that was not well interpreted by financial journalists or various institutions producing reports on these claims.

It is worthwhile noting that *The Economist* in one of its last issue has rightly advocated a total relief from any reparation if Iraq is to be put on the path of economic recovery; it is reminding the readers about the big mistake done by Allied countries after the First World War in having Germany to pay high compensation, which facilitate the rise of Nazism. The *Financial Times* and other western newspaper have been discussing the principle of "odious" debts contracted by a tyranny and that might be repudiated by a new government (as the Soviet did in respect to debts contracted by Czarist Russia). But the main trend in western circles is that could be rescheduled favorably but not cancelled.

There are three types of financial claims on Iraq : debts, claims and contracts signed but not executed.

1. *Iraqi official indebtedness*

Estimates of Iraqi foreign indebtedness are haphazard. In fact one has to separate what is recognized debt to OECD countries and Ex-Soviet Union countries from debts due to Kuwait and Saudi Arabia that has been one of the cause of the Kuwaiti invasion in 1990.

Pre-invasion of Kuwait debt level was around \$ 70 to 80 billion, with the largest part (30 to 40 billion due to Kuwait and Saudi Arabia); the rest was due mainly to the former USSR and to a few industrialized countries (like Germany and France).

It is worth to note here that debts due by developing countries to the former USSR have been repaid usually at the rate of 10 to 15 cents to one dollar, which means that Iraqi debts to Russia will in no case constitute a big financial burden.

In addition, one should recall that Saudi Arabia had relieved Iraq from its debt before the invasion of Kuwait (against the signing of a non-aggression treaty). This means that the foreign debt of Iraq is not such a huge problem, unless Saudi Arabia and Kuwait will claim back the amounts lent during the Iran/Iraq war (which is unlikely) and Kuwait will continue, as it was already doing in 1989 and 1990, to ask for repayment of its loans to Iraq during the war against Iran.

European countries are asking for a Paris Club deal to reschedule and eventually cancel some of their loans to Iraq, while the US has been hinting at the necessity for Russia and Europe to forgive totally such debts as a contribution to the reconstruction of Iraq. This delicate issue between Europe, Russia and the US has now been addressed in UNSC Resolution 1483, as mentioned before.

In fact, the Paris Club had a short meeting during the last week of April concerning the Iraqi debt where it was decided that creditor countries should identify their claims on Iraq. As it is well known, the Paris Club deals only with Western countries loans to LDCs. It is only exceptionally that non-OECD countries (like Russia) are invited to include their lending. According to figures that have been circulated after the meeting, Iraqi debt to the 18 permanent members of the Paris Club had reached the equivalent of 20 billion Euro in 1990. If we consider the debt due to the ex-USSR (6 to 8 billion dollars) and probably to some former eastern European countries (a few billion) as well as to Kuwait (30 billion), we are close to an estimate of 60 to 80 billion dollars, excluding interests accumulated.

Of course, if we add the interests due on these unpaid debts for 13 years at the average annual rate of 5%, the amount might become \$ 130 billion. However, Iraq could argue that the UN embargo was preventing it from servicing the debt and paying its interests.

According to recent financial report some Investment funds specializing in Emerging countries debts have been buying pieces of Iraqi debt. The price of such debt has climbed from 8 cents to the dollar in September 2002 to 16 cents in January 2003 and now to 25

cents. And it is estimated that \$ 11 billion of the Iraqi debt is now trading on the market. Investment funds have 2.6 billion dollars in Iraqi debts in their portfolio.

If this is the case, it means that the future Iraqi government will not be able to borrow for its reconstruction needs before settling these old loans due to OECD countries (Government Agencies or commercial banks) or reaching a consensus on a rescheduling.

A recent report on the Iraqi foreign debts by a London based firm, called Exotix, which trades in emerging market debts estimate the Iraqi foreign debt as follows:

- ✓ Paris Club debt is standing at around 17 billion dollars, with an additional debt of 2.6 billion due to commercial banks of OECD countries and not covered by a government guarantee from their own country (these debts are rescheduled in the so-called London Club);
- ✓ Debt to Russia would be 8 billion.
- ✓ Total Iraqi foreign debt is standing at 116 billion dollars (including an amount of 26 billion for unaccounted debts and including unpaid interest estimated by some sources to be \$ 47 billion).

This estimate is not far from the BIS/World Bank estimate of \$ 127.7 billion, including arrears in interest payments.

One main question here is whether the Authority could sign on behalf of Iraq a rescheduling agreement with the Paris Club or would such a deal have to be signed by a Iraqi Government fully recognized by the UN and the international community.

2. *Compensation claims*

An in-depth look at the work of the United Nations Compensation Commission (UNCC) shows that more than 2.6 million claims has been received by it for a total value of \$ 351 billion. The majority of claims have been resolved (1.5 million) for an amount of \$ 44 billion and \$ 17.5 billion has been paid from the proceeds of oil sales under the UN control. 96 governments on behalf of their nationals, corporations and for themselves have filed these claims. The claims have been divided by the UNCC in the following way (see annexed table):

- ✓ Individual claims (category A) relates to individual departures from Kuwait due to the invasion. 919 701 claims were resolved for an amount of \$ 3.5 billion. \$ 3.2 billion has been awarded for 860 129 claims which has almost been paid totally.
- ✓ Individual claims (category B) relates to injuries and death. But the amount involved is insignificant (\$13.5 million) and has been paid entirely.
- ✓ Individual claims (category C) relates to other types of damages inflicted to residents of Kuwait up to \$ 100 000 by individual claim. The number of claims resolved is 1 659 835 for an amount of \$ 8.8 billion of which \$ 5 billion have already been

awarded for 633 125 cases and almost entirely paid. But there are still 43 824 cases to be resolved with compensation sought for \$ 3.4 billion.

- ✓ Individual claims (category D) relates to other types of damages above \$ 100 000. The number of claims resolved is 7 274 for an amount of \$ 3.6 billion. Of this amount, \$ 1.6 billion has been awarded and almost paid for 6 585 cases. There are 6 051 remaining cases with compensation sought for \$ 17 billion.
- ✓ Oil sector claims (category E1) resolved (66 cases) amounting to \$ 44.3 billion. The UNCC has awarded \$ 21.4 billion representing 41 cases but paid only \$ 660 million. Claims still to be resolved (39 cases) represent an amount of 285 million.
- ✓ Claims of non-Kuwaiti corporations (category E2 which excludes the oil and contracting sectors) that have been resolved (1765 cases) represent an amount of \$ 12.2 billion; \$ 830 million have been awarded for 720 cases and \$ 771.6 million have been paid. Pending cases (679) represent an amount of \$ 1.5 billion of compensation sought.
- ✓ Claims of non-Kuwaiti corporations in construction and engineering sectors (category E3) that have been solved (372 cases) represent an amount of \$ 7.1 billion. Compensation awarded for 149 cases amounts to \$ 362.2 million, and compensation paid to \$ 336.7 million. Pending cases (26) amount to \$ 948 million of compensation sought.
- ✓ Claims of Kuwaiti corporations (E4, which excludes the oil sector) that have been solved amount to \$ 10.1 billion for 2 299 cases. \$ 3 billion have been awarded (2 020 cases) and \$ 2.9 has been paid. Pending cases (578) amount to \$ 1 billion of compensation sought.
- ✓ Export guarantee and insurance claims (category E/F) have all been solved (123 cases) for an amount of \$ 6.1 billion; compensation was awarded for 57 cases amounting to \$ 311.3 million, of which \$ 180.1 million has been paid.
- ✓ Claims by governments and international organizations for losses in connection with departure and evacuation of individuals or damages to property (category F1) that have been resolved amount to \$ 18.6 billion (100 cases). Compensation awarded for 70 cases amounts to \$ 291.2 million of which 244 million has been paid.
- ✓ Claims filed by the governments of Jordan and Saudi Arabia (category F2) and resolved amount to \$ 17.6 billion for 63 cases. Compensation awarded for 46 cases amounted to \$ 264.4 million of which \$ 256.1 million has been paid.
- ✓ Claims filed by the government of Kuwait (category F3, excluding environment damages) and resolved amount to \$ 17.6 billion for 60 cases. Compensation awarded amounted to \$ 6.7 billion for 59 cases of which \$ 2.1 billion has been paid. Two claims for \$ 96.3 billion are still to be resolved.

- ✓ Claims for damages to the environment and depletion of natural resources (category F4) that have been resolved amount to \$ 1.8 billion for 135 cases. Compensation was awarded for 91 cases amounting to \$ 954.3 million of which \$ 314.9 million has been paid. 36 cases claiming \$ 79.6 billion of compensation have still to be resolved.

In all, we can conclude that:

- a) \$ 17.6 billion has been paid out of a total of \$ 44 billion awarded by the UNCC, which means that Iraq has still to pay \$ 26.4 billion. This is an obligation of the future Government of Iraq certified by a UN body.
- b) The number of claims yet to be resolved is 51 235 with compensation sought to the amount of \$ 200.1 billion, but the bulk of these claims are from Kuwait, Jordan and Saudi Arabia and it seems difficult that the UNCC under the new circumstances that have emerged in Iraq will award the amounts sought by these governments, especially in light of UNSC 1483 limiting the amount of compensation that Iraq could paid annually to 5% of its oil receipts.

3. *Claims under signed but not executed contracts*

There are two types of claims under signed contracts:

- ✓ Contracts signed under the Food for oil programme. UNSC Resolution 1483 has provided for a mechanism to identify those contracts that will be implemented. It is to be assumed that the other contracts will not be paid without legal consequences for Iraq, but this remains to be seen.
- ✓ Contracts signed by the Hussein regime outside the UN supervision. The Russian oil company (Lukoil) has already declared that it intends to go to court if its contract is not respected.

It is difficult to give an estimate of amounts due under all these contracts.

III. Iraq reconstruction

This is an issue that is creating a lot of confusion. Two separate issues have to be dealt with.

- *Estimates of Iraq needs*

These estimates are totally unreliable. They go as high as the need to finance 20 billion dollars annually for several years. Here again, it is not clear if this estimate includes the need for rehabilitating and expanding oil facilities. Even in such a case we believe it is grossly inflated.

Lebanon needs for instance was estimated in 1992 by Bechtel Corporation at \$ 3.5 billion. Later this figure was boosted by Mr. Hariri first Government to \$ 18 billion (Horizon 2000 Ten years Plan), while some estimates were putting the reconstruction bill as high as 60 billion.

For Iraq, a fair estimate should be based on the first and realistic Lebanese estimate multiplied by 7 or by a maximum of 10, i.e. an amount ranging from 25 billion to 35 billion, excluding the rehabilitation and expansion of the oil sector. But the game will be to inflate the needs as much as possible so that large companies could make undue and unjustified profits.

- *Legal and institutional issues*

There are several legal issues originating from the fact that the Authority has granted reconstruction contracts to some American companies before resolution 1483 would clarify the legal framework of financing reconstruction in Iraq.

Another set of problems relates to the weakness of the framework as detailed by the Resolution. A set of issues should be discussed:

a) Monetary and financial

- ✓ A new currency will have to be established and a new banking law should decide what type of monetary system Iraq will adopt.
- ✓ Debt and claims restructuring
- ✓ New financial policy of the State, including new borrowings that will be needed

b) Social

Since 1980, three wars and 13 years of economic embargo have impoverished the Iraqi population.

What type of social policies should be adopted?

- ✓ Paying pensions to widows and orphans from the different wars
- ✓ Paying compensation to the victims of persecution and oppression and their heirs in case of death
- ✓ What kind of social security handouts should be established (especially if prices are freed and stop being heavily subsidized)
- ✓ How to compensate the groups that have been materially affected by loosing their properties or their way of earning their life (Kurds, Arabs of the marches)

c) Economic

Although the former regime had allowed the private sector to develop during the last ten years, many issues are pending:

- ✓ Privatization of the many State entities
- ✓ Compensation of private sector losses during the last war
- ✓ Imposing transparency on private sector activities and securing a healthy domestic competition
- ✓ Organizing the embryonic stock exchange that was established a few years ago
- ✓ Diversification of the economy, in particular the agricultural sector
- ✓ How to induce the well trained Iraqis abroad to return to their country ?
- ✓ How to make proper use of reconstruction policies to stimulate local industrial potential (see below)?

d) Cross sectoral issues

Many issues need to be debated:

- ✓ Centralized process through one institution or decentralized through giving to local bodies and to sectoral ministries the responsibility of defining the needs and conducting the operation.
- ✓ Should the same institution (s) plan and implement on the Lebanese model of the CDR or should it be better to split these two functions?
- ✓ How to contain the costs of reconstruction and prevent overcosting and overcharging for goods and services?
- ✓ How to link reconstruction efforts to stimulating the domestic economy and activating the links between the local productive sectors?

How to deal with multilateral financial institutions and bilateral official assistance?

These issues will be debated at the Workshop that ESCWA will be organizing at the beginning of July.

G. CORM
May 31, 2003

Annex: Summary of Iraq financial obligations under UNCC decisions

ANNEX

Summary of Iraq Financial Obligations under UNCC decisions

Catg.	Nature of claims	Number of claims resolved	Amount claimed under resolved cases	Amounts awarded under resolved claims	Number of claims satisfied	Amount paid up to april 2003	Difference remaining to be paid	Number of claims to be resolved	Amount of compensation sought unresolved claims
A	Individual claims (transportation)	919 701	3 451 522 500	3 202 262 000	860 129	3 197 917 485	4 344 515	0	0
B	Individual claims (injury & death)	5 734	20 100 000	13 450 000	3 941	13 450 000	0	0	0
C	Individual claims (losses under \$ 100 000)	1 659 835	8 755 552 413	4 986 789 671	633 125	4 981 328 363	5 461 308	43 824	3 430 000 000
D	Individual claims (losses above \$ 100 000)	7 274	3 634 805 278	1 622 625 908	6 585	1 615 879 740	6 746 168	6 051	17 030 000 000
E1	Oil sector claims	66	44 330 696 719	21 425 210 612	41	659 807 078	20 765 403 534	39	285 000 000
E2	Non Kuwaiti corp. (excluding oil & contracting)	1 765	12 230 305 329	829 964 567	720	771 603 671	58 360 896	679	1 480 000 000
E3	Non Kuwaiti corp. : construction & engineering	372	7 137 077 146	362 264 120	149	336 741 714	25 522 406	26	948 000 000
E4	Kuwaiti corp. (excluding oil)	2 299	10 116 875 609	2 959 719 149	2 020	2 845 939 096	113 780 053	578	1 030 000 000
E/F	Export guarantee & Insurance	123	6 122 977 002	311 282 688	57	180 071 703	131 210 185	0	0
F1	Governments & Internat. Org.	100	18 607 934 491	291 171 423	70	243 987 026	47 184 397	0	0
F2	Gov. Of Jordan & Saudi Arabia	63	17 573 716 993	264 422 123	46	256 121 518	8 300 605	0	0
F3	Government of Kuwait (excluding environment)	60	17 562 849 707	6 754 381 226	59	2 146 155 723	4 608 225 503	2	96 300 000 000
F4	Environment & natural resources	135	1 858 510 866	954 322 704	91	314 947 423	639 375 281	36	79 600 000 000
	Total	2 597 527	151 402 924 053	43 977 866 191	1 507 033	17 563 950 540	26 413 945 651	51 235	200 103 000 000

Source: UNCC financial statement, Geneva.