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### **Financial Reconstruction in Iraq: Strategy and Tactics**

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Senate Banking, Housing, and Urban Affairs Committee  
Subcommittee on International Trade and Finance

Chairman Hagel, Ranking Member Bayh, other members of the Subcommittee, thank you for inviting me to testify on the financial reconstruction of Iraq. Given the importance of trade and finance for Iraq's reconstruction, this Subcommittee is an ideal forum for this discussion. And the presence of my colleagues, Under Secretary Larson and Chairman Merrill, further underscores the importance of active government-wide participation in the reconstruction effort.

When I last testified on this subject, on June 4 before the Senate Committee on Foreign Relations, I stressed that "the international community and the Iraqi people face an enormous task in the reconstruction of the Iraqi economy. A quarter century of repression and economic mismanagement under Saddam Hussein cut the size of the economy to only a small fraction of what it was before his regime took over. In 1979 GDP in Iraq was \$128 billion...by 2001 it had declined to \$40 billion." I also stressed the *strategy* of financial reconstruction—the contingency plans developed in advance of the military conflict—and the *tactics* followed on the ground since the conflict began. I would like to stress these same issues in my testimony today, with emphasis on the additional information we have obtained on the state of the Iraqi economy and on what has happened on the ground during the summer months.

Much has been accomplished in the financial area since the fall of Saddam Hussein's repressive regime, and many potential financial catastrophes have been avoided. In my view, months of advance planning by the United States government before Saddam's fall as well as the

dedicated work of the Coalition Provisional Authority and the Iraqi people since Saddam's fall are responsible for these accomplishments.

Starting late last year, we began developing a strategy for financial reconstruction based on the information we had at the time. The strategy addressed such issues as (1) payments to Iraqi workers and pensioners, (2) the currency, (3) the banking system, (4) Iraq's international debt, (5) an assessment of reconstruction costs, and (6) the international fundraising efforts. I want to review how that strategy is playing out today. But before doing so I must emphasize that an important part of our advance planning has been the selection of people to participate in the financial reconstruction effort. We began selecting financial experts in January; the first wave of people was deployed to Kuwait in March and to Baghdad in April. Early on we decided that a financial coordinator was essential and we are very grateful to Peter McPherson who took leave from the Presidency of Michigan State University and has served most ably in this position, advising Ambassador Bremer and the rest of the Coalition Provisional Authority.

### **A Strategy for Paying Workers and Pensioners**

It was clear that we had to have a strategy for paying Iraqi workers and pensioners after the fall of Saddam Hussein, and thus we crafted a strategy well in advance of his fall. Keeping workers on the payroll with stable purchasing power would be essential to prevent severe hardship and economic collapse. But how many workers were there and how much should they be paid? What currency should be used to make the payments? Where would the funds come from? Would the payments system be in good enough condition after the conflict to actually make payments? How could we prevent hyperinflation and a sharp depreciation of the currency, which would further impoverish people? After all, one of the reasons for the terrible economic performance under Saddam was that he resorted to the printing press to finance his spending, causing high inflation and a drop in the dinar to about 1/5000th of its former value.

Starting late last year we developed such a payments strategy, which was approved interagency after much valuable discussion and debate about alternative strategies. The strategy called for paying workers and pensioners in U.S. dollars on an interim basis. This was not dollarizing the economy, because the strategy called for the continued use of local currencies—such as the Saddam dinar in the center and south and the Swiss dinar in the north—and their eventual replacement by a new national currency, as described below. Using U.S. dollars on an interim basis would create stability and would help prevent a collapse of the dinar.

Finding a way to secure the funds to make these payments in advance of the conflict proved to be a challenge. After much discussion and debate, we decided that the best approach was to use Iraqi regime assets that were frozen at U.S. commercial banks back in 1990 at the time of the first Gulf War. In order to use the assets for this purpose, they had to be “vested” for the use of the Iraqi people. Our estimates were that there was about \$1.7 billion that could be vested in the United States and that this amount would probably be sufficient to last until a new currency could be issued in Iraq. A vesting strategy was worked out and approved by interagency legal experts. Under this plan the President would call for the vesting of the assets in the Federal Reserve Bank of New York near the time that the military conflict began.

To make such a strategy operational, many tactical issues and contingencies had to be considered. For example, the plan called for the military on the ground to issue public statements—worked out with the Departments of Defense and Treasury—that the dinar would continue to be accepted as a means of payment after the fall of the Saddam regime. The plan also called for the first wave of financial advisers into Baghdad to assess the payments system's capability for making dollar payments.

Another essential operational issue concerned the actual shipping of the currency to Iraq, and a plan for making the payments to workers and pensioners on the ground had to be developed. We estimated that enough currency in the right denominations was in storage in the New York Fed's warehouse in East Rutherford, New Jersey, and we determined that it was feasible to ship the currency by tractor trailer to Andrews Air Force Base, load it on military aircraft, and fly it to Camp Arifjan in Kuwait for the last leg into Iraq. Many tons of currency were involved because of the need for small denominations: one-dollar or five-dollar bills. On the ground, the military would assist in the actual shipment of the currency around the country. Financial experts would develop lists of eligible workers and pensioners who would be paid. The currency would be distributed to Iraqis who would then actually make the payments. In some cases, the currency would be paid at the state owned enterprises or government ministries. In other cases, pensioners would come to local banks to receive payments.

I am pleased to say that this strategy along with all its tactical details has been carried out with great success. On March 20, at the start of the conflict, President Bush issued an order calling for the vesting of the frozen assets. As a result, approximately \$1.7 billion was vested in the New York Fed. With these funds at the New York Fed, the first shipment of currency from the Fed's East Rutherford, New Jersey warehouse to Camp Arifjan was made on April 13. Even as major combat operations were winding down, a mechanism for shipment of cash and distribution of emergency payments was established and began to function. Thanks to this system, we were able to make monthly emergency payments to dock workers, rail workers, power plant workers, and others essential to restoring basic services. We soon transitioned to regular civil service salary and pension payments to over 2 million Iraqis.

Despite tremendous logistical challenges, the system of payments has worked well. Our financial experts in Baghdad consider this to be a major force for stability in the country, as well as a significant spur to economic growth. As of this date all but \$64 million of the vested assets has been shipped to Iraq where they have been used principally to support salary and pension payments to the Iraqi people. The Department of Defense's logistical support has been crucial in this enormous undertaking.

Throughout this period there has been no collapse of the currency, no hyperinflation, and no serious glitch in the payments process itself. In sum, this major and essential success in the reconstruction was due in large part to pre-conflict planning and to adjustments that were made as we implemented the plan and learned from experience.

## **A New Unified Currency for Iraq**

As I indicated, the payments strategy called for the use of U.S. dollars on an interim basis only. Our goal was for the Iraqi people to choose a new national currency to replace the Saddam dinar and the Swiss dinar, and to provide the necessary financial and logistical assistance to do so. A stable unified currency is an essential part of a market economy and therefore one of the key parts of financial reconstruction.

I am happy to say that this part of the financial reconstruction strategy is on track as well. Last July 7, after consulting with representatives from the Central Bank, the finance ministry, and other interested Iraqis in the north and the south, the Coalition Provisional Authority announced that a new currency would be issued starting in October. The new currency would replace the old currencies at fixed rates that were also announced. Hence, the Coalition Provisional Authority and Iraqi officials in the Central Bank and the finance ministry are about to begin one of the most important parts of the financial reconstruction to date: issuing a new currency to replace the Iraqi currencies that are now circulating. The new currency is a key component in the effort to establish a stable financial system.

The new currency bears the designs of the old Iraqi, or Swiss, dinar and is being produced at printing facilities around the world on schedule. There will be six denominations to replace the current two denominations. About 2200 tons of currency will be shipped from printing facilities in England, Spain, and other countries. A sufficient supply of new notes will be available when they are introduced.

The exchange period will begin on October 15 and last until January 15. A public education campaign is underway in Iraq to ensure that the Iraqi people are well informed about the new currency and are prepared for the currency exchange. The new currency will improve the ease of transactions, since it will be issued in more denominations than are currently available, and will have built-in security features that will enhance public confidence by making the notes more difficult to counterfeit.

### **Restoring and Revitalizing the Banking Sector**

We knew well before hostilities began that strengthening and modernizing Iraq's financial sector would be central to achieving overall economic reconstruction, and that a thorough on-the-ground assessment of Iraq's financial sector would be needed as soon as conditions allowed. Thanks to extensive pre-war planning, Treasury was able to position advisors in Iraq's finance ministry, Central Bank and two main commercial banks even as hostilities were winding down.

The challenges they faced to perform seemingly simple tasks, such as schedule a meeting with Iraqi bankers, were enormous due to security concerns, the lack of working phones or faxes, and language barriers. Despite these difficulties, I am pleased to report some major successes. One of the most important is the reopening of most of the branches of Iraq's two large state-owned banks – Rafidain and Rasheed – which enabled cash-strapped Iraqi families to gain access to their savings. Opening these branches was no small feat. Many of the banks' branches were

damaged and we were fearful of a bank run once the banks reopened. Due to careful planning, individual Iraqis now have access to their deposits and there were no bank runs.

The initial assessments conducted by our advisors have provided much insight into the operations of Rafidain and Rasheed banks. As our pre-planning analyses indicated, these banks did not function independently of the former regime. We now know that these banks were not permitted to make loans based on commercial viability and a borrower's ability to repay, but instead on the ability of the borrower to fulfill a Ba'athist party political objective. The Coalition Provisional Authority, with the support of Treasury, is hard at work reviewing ideas for restructuring the two major state-owned banks.

Analyses of Iraq's private banks are almost complete. While these banks are small in relation to the two large state-owned banks, they will play a role in Iraq's future. We know that remittances through these banks are starting to occur. Remittances by Iraqis overseas will soon form a large pool of resources in Iraq that will finance investment and consumption. According to some estimates, about 4 million Iraqis live abroad, and in recent years they have transferred over \$1 billion per year to relatives in Iraq.

In addition to strengthening specific banks, the financial system more broadly – including the relevant laws and regulations – will require significant work to ensure that an efficient and effective system for financial intermediation is achieved. In consultation with the International Monetary Fund, we are working with the Iraqi Governing Council, other Iraqi officials, and the Iraq Bankers' Association on a revision of Iraq's Central Bank law and commercial banking law. Creating a sound supervisory and regulatory regime is also critical to establishing a strong financial system. We have reached out to countries in the region, including Jordan, Bahrain, and the UAE, who have offered to provide technical training to Central Bank and commercial bank employees.

As work proceeds on these broad objectives, some initial bank lending has started, with the focus on loans directed towards Iraqi small- and medium-sized enterprises. Additionally, the Treasury has approached the International Finance Corporation, the private sector arm of the World Bank, about setting up a facility in Iraq to provide loans to micro-, small- and medium-sized businesses. This would be a multilateral facility modeled after other highly successful programs in Russia, Central Asia and Southeast Europe.

One major initiative that is now getting off the ground is the creation of the Trade Bank of Iraq. This Iraqi-staffed institution will facilitate imports to and exports from Iraq by putting in place the people and systems needed for the country to trade more efficiently and on a larger scale with the rest of the world. Currently, trade is taking place at the retail level. In Baghdad's markets one can find consumer goods – from refrigerators to satellite disks – imported from neighboring countries. But in order for Iraq's reconstruction to move forward as quickly as possible, and for private sector activity to take off, there needs to be an efficient system for importing a broad range of capital goods and services. Our goal is for Iraqi banks to provide trade finance services. But as the process of strengthening Iraqi banks goes forward, there is an immediate need to do this. The Trade Bank of Iraq is intended to fill that gap.

Following a competitive bidding process, the CPA is negotiating a contract with a consortium of international banks which will facilitate the operations of the Trade Bank. Additionally, the Trade Bank will be the entity by which Export Credit Agencies around the world support trade with Iraq. There is precedent in creating institutions such as the Trade Bank in post-war Japan and Germany. Those institutions evolved and took on functions akin to export-import banks, although how the Trade Bank evolves will be up to the Iraqi people.

### **Iraq's International Debt**

Early on we recognized that dealing with Iraq's substantial foreign debt problem would be crucial to the country's medium-term economic health. We therefore developed a strategy to resolve this problem.

First, using the financial information we had, we ensured that Iraq would not have to service its debt following the end of the war and during the critical reconstruction phase. Demands for repayment would have greatly reduced the resources available to a new Iraqi government. Therefore, we secured recognition from the G7 that Iraq would not service its external debt at least through the end of 2004. Subsequently, the Paris Club group of official creditors stated their expectation that Iraq would not make payments over this time period.

Next we sought to obtain the best possible data on Iraq's foreign debt and its economic condition. Without any reliable data, it would be difficult to reach an international consensus on a debt strategy. We began collecting data by sending several technical assistance advisors to Iraq to review the government's debt records once the war ended. At the same time, we worked intensively through the Paris Club and the International Monetary Fund to obtain data from creditors.

We have made significant progress. The latest available information indicates that Iraq's external debt amounts to at least \$70 billion and is probably closer to \$100 to \$120 billion. Paris Club members report that they are owed roughly \$40 billion -- \$21 billion in principal and roughly an equivalent amount in late interest. The IMF has polled non-Paris Club governments and, as of September 10, reports creditor claims of \$28 billion in principal and interest. Since 20 governments have yet to respond to the IMF poll, this figure is likely to increase.

With better data in hand, we can now proceed with our strategy and work out a long-term solution to Iraq's debt problem. We will continue to work with other creditors toward the objective of achieving a substantial restructuring of Iraq's debt that will permit the Iraqi government to channel resources into reconstruction activities.

### **Assessment of Reconstruction Costs and International Fundraising Efforts**

We also knew at the outset that one of the major priorities following the conflict would be to produce a comprehensive assessment of reconstruction costs in Iraq. We recognized that we could not focus solely on the costs of repairing the damage inflicted during the short conflict.

Saddam Hussein's total disregard for the welfare of his population likely meant that the needs of the Iraqi people – and the cost of reversing decades of economic decline – would be substantial.

Because of the extent of Iraq's isolation from the international community, we had little reliable information regarding the extent to which critical investments had been neglected. We were concerned that the absence of economic data and other information would make the job of producing a timely needs assessment especially challenging. We engaged early with our fellow shareholders and with senior officials from the World Bank and the International Monetary Fund to create a process for making a needs assessment as soon as the environment was permissible. As a result of these discussions, these institutions acted quickly to develop the scope of the assessment, divide up responsibility for different sectors, and recruit the necessary staff.

We expect that the cost for reconstruction will be in the range of \$50 to \$75 billion. This estimate covers critical infrastructure needs in electricity, public works, transport, telecommunications, health, education and agricultural sectors, among others. But it excludes the annual expenses that have been identified by the Coalition Provisional Authority to cover the government operating budget.

Clearly, this is a cost that will need to be shared widely, and underscores the importance of a major donor effort for Iraq. In June, we established a "Core Group" of donors, consisting of Japan, the EC and the United Arab Emirates, to consult regularly with the UN, World Bank, IMF and CPA, on the planning and preparation for the donor conference. The members of this group are engaging intensively with other potential donors to urge them to pledge generously at the donor meeting in Madrid on October 24. We believe our own substantial contribution of \$20 billion – as reflected in the President's forthcoming supplemental request – will be critical to leveraging support from other governments.

In addition, we are encouraging the international financial institutions to commit their own resources to the people of Iraq. As you are aware, the IMF and World Bank recalled their staff following the bombing of UN headquarters where they were also housed. However, these institutions remain actively engaged on Iraq, and are continuing to work with CPA and Iraqi officials, providing technical assistance and finalizing the needs assessment. The World Bank – in conjunction with the UN – is also completing the design of a multi-donor trust fund that would pool bilateral donations and make them available for priority needs identified by these agencies in their needs assessments. In addition to these vital contributions, we have made good progress in our discussions with the IMF and the World Bank on identifying the type and amounts of resources that could be made available to the Iraqi people once the conditions for lending are in place.

In a related exercise, we are reaching out to Export Credit Agencies (ECAs) around the world, encouraging them to follow the U.S. Ex-Im Bank's efforts to support investments in Iraq by insuring repayments. Many other governments have responded positively to this effort, including Japan and the United Kingdom. Through credit facilities such as the one proposed by Ex-Im Bank, credit agencies will be able to provide short-term export credits worth several billion dollars. Initiatives like this will be very important for supporting trade, facilitating commercial activity and spurring growth in Iraq.

Countries other than the U.S. have been identifying and freezing assets of the Hussein regime in accordance with UN Security Council Resolution 1483. Over \$1 billion of such assets has been identified and frozen. We are working hard to encourage countries that have frozen assets to transfer those funds to the Development Fund for Iraq (DFI), where they will assist in the reconstruction of the country. We have already had some success in these efforts, including a transfer of approximately \$98 million to the DFI announced by Japan on August 29.

## **Conclusion**

Achieving a stable and productive economy is central to our goal of a unified and prosperous Iraq. We have made considerable progress on financial reconstruction over the last several months, thanks to extensive advance planning and the work of many dedicated professionals from the U.S., Coalition partners, and Iraq. Our activities will only intensify in the coming months. While the challenges are formidable, we are well on the way to establishing a vibrant economy that creates opportunities for all Iraqis to achieve a better future for themselves and their children.