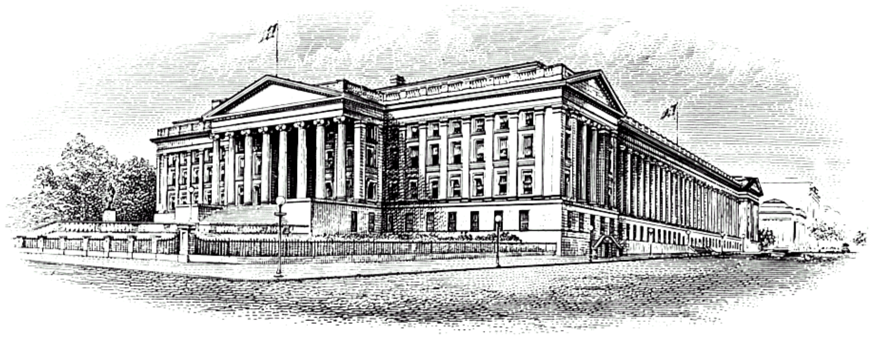

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“Financial Reconstruction in Iraq”

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Under Secretary of the Treasury for International Affairs

before the

Senate Banking, Housing, and Urban Affairs Committee

Subcommittee on International Trade and Finance

Introduction

Chairman Hagel, Ranking Member Bayh and other members of the Subcommittee, thank you for inviting me back to testify on the financial reconstruction of Iraq. There have been many significant, positive developments since I last testified in September, and I welcome the opportunity to discuss them with you today.

Just this weekend, during the G-7 finance ministers’ meeting in Boca Raton, we had an opportunity to hear from Iraq’s Central Bank Governor, Sinan Shabibi, and Finance Minister, Kamel Gailani, about their reform priorities. Both officials participated in a session with the G-7 Ministers, and took the opportunity to underscore their commitment to moving ahead with sound, market-oriented reforms that will underpin private sector-led growth.

They also stressed that their vision of a new Iraqi economy shares the following key principles: 1) openness and transparency of Iraq’s institutions; 2) the creation of strong incentives for private sector development; 3) close economic and financial integration with the international community; 4) implementation of international standards and best practices; and 5) a social safety net that addresses the needs of all Iraqis.

These officials are already taking meaningful actions to back up their statements. For example, Iraq's Central Bank Governor recently announced three major actions that will have far- reaching consequences for the development of Iraq's financial sector: 1) the selection of three foreign banks to receive a license to operate in Iraq; 2) a plan to liberalize interest rates by March 1; and 3) passage, soon, of a new Central Bank law.

Today, I would like to tell you more about these developments, as well as update you on the progress that has been made on currency reform, reducing Iraq's international debt burden, and mobilizing international support to meet Iraq's reconstruction needs.

Currency Reform

I would like to begin by highlighting one of the most important accomplishments in the financial sector – the successful introduction of a new currency in Iraq. When I last spoke before this committee, I laid out our strategy for replacing the old national currencies – the Swiss dinar and the Saddam dinar – with a new, unified national currency. I am happy to report that this plan was successfully implemented as scheduled between October 15 and January 15.

Printing and delivering this currency on time was an enormous feat -- the equivalent of twenty-seven 747 plane loads of currency were delivered to Iraq and distributed to the public through approximately 240 exchange sites, mostly bank branches, under a significant security threat.

By all accounts, the Iraqis have wholeheartedly embraced their new dinars. Not only are the new notes much more difficult to counterfeit -- a chronic problem under the old currency regime -- the Iraqis now have six denominations available, up from only two. And the value of the currency has steadily increased since its introduction. Now the challenge is to manage this new currency in such a way as to provide a stable monetary foundation for a healthy financial system and vigorous reconstruction.

Restoring and Revitalizing the Banking Sector

Another area where meaningful progress has been made is in the banking sector. In my last testimony, I reported that Treasury advisors were assessing the conditions of Iraqi's state-owned and private banks. Since then, we have learned that Rasheed and Rafidain banks – the two large state-owned banks which controlled over 85% of banking assets -- are at best marginally capitalized, and have loan portfolios with a high concentration of non-performing loans. Compounding these problems is the lack of comprehensive, modern accounting standards and systems. We also discovered that although these two banks have an extensive network of more than 360 branches throughout the country, each branch has operated largely as an independent unit. As a result, Iraq lacks centralized management and an integrated system for making and clearing payments.

An evaluation of the private banks uncovered significant problems as well. It turns out the 17 private banks in Iraq served predominantly to take deposits rather than finance investments, and that the largest of these private banks had only $1 million in capital. Finally, our evaluation of Iraq's legal regime showed that Iraq lacked a competent supervisory or effective regulatory structure to oversee the financial sector.

Despite this bleak assessment, the Iraqi bankers we engaged with from the private and public sectors – as well as key finance officials – shared an eagerness to adopt the reforms necessary to develop a modern, efficient financial sector. Though they lack technology, resources and experience, after only a few months, significant progress has already been made toward this goal.

First, the Iraqis are moving towards the establishment of a modern legal and regulatory framework for the financial sector. For example, working with experts from central banks and other governments and the International Monetary Fund, we helped Iraq to prepare a modern Banking Law and a new Central Bank Law, both based on international best practices. The Banking Law was enacted in late September and contains many provisions designed to support the development of a strong, robust banking sector, including higher minimum capital requirements (10 billion dinars, or more than $6 million), and more rigorous standards for bank licensing and for bank governance.

We expect the Central Bank Law to be adopted soon by the Iraqi Governing Council. It will not only confirm the independence of the Central Bank established by a July 7 CPA order, but will also prevent the Central Bank from engaging in inflationary financing of the government. Indeed, it establishes price stability as the primary macroeconomic objective of monetary policy.

Second, the Central Bank Governor announced that interest rates on all domestic financial instruments – loans, deposits and securities – will be fully liberalized by March 1. This measure is an important step in the direction of creating a modern, efficient financial sector, because it will enable lenders and borrowers to make their own decisions rather than having them determined by fiat and top-down directives issued by the Central Bank.

And third, the Iraqis have taken significant steps to reinvigorate private banks in Iraq. Under Saddam's regime, private banks fared poorly – they controlled less than 8% of total banking assets, used antiquated technology, and offered very limited services. Despite their weaknesses, Iraq's private bank mangers have been eager to develop their capacity to operate as modern, commercial bankers. As provided under the new Banking Law, these banks can now provide new services to their clients. Already, ten banks are receiving international payments and remittances, and issuing letters of credit. With 143 functioning branches, international payments and remittances are now estimated at more than $5 million per day into Iraq. This influx of funds will play a major role in financing investment and consumption.

While some of the existing private banks are expected to develop into fully functioning financial institutions, Iraqi authorities decided that it would be important for foreign banks to operate in Iraq because of the experience, technology and resources they can offer. The new bank law permits up to six foreign banks to enter the Iraqi market over the next four years. This is in sharp contract to the previous regime, which permitted only Arab banks to enter Iraq's market.

Following a request for applications issued in November, Iraq received fifteen applications for a foreign bank license. On January 31, the Central Bank Governor announced the three finalists for the first set of licenses to be awarded – Hong Kong Shanghai Banking Corporation, the National Bank of Kuwait, and Standard Chartered Bank from the U.K. The Central Bank anticipates that all three will be granted a license by mid-March. Already, the National Bank of Kuwait has announced its intent to purchase 85% of one of the existing private banks.

Next on the agenda is reform of the state-owned banks. Substantial and sustained restructuring of management, organization, personnel and systems is needed to make these banks competitive. The Iraqi authorities are now working with Treasury advisors to develop a strategy for dealing with the state-owned banks so they can operate profitably and provide a wide array of financial services to the Iraqi economy. In the meantime, we are working with the Iraqis to ensure that the state-owned banks can provide basic services, such as taking deposits, clearing checks and making loans to support business activity. For the quarter ending November 30, 2003, Iraq's two large state-owned commercial banks, Rafidain and Rasheed, extended loans totaling about $6 million, primarily to small and medium enterprises.

Trade Bank of Iraq

Given the limited capacity of the Iraqi banking system, we also went forward with a plan to open a Trade Bank in order to facilitate the imports and exports urgently needed to support Iraq's reconstruction and the transition from the UN's oil for food program. When I reported on this initiative last September, the CPA had completed a competitive bidding process for management of the Bank, and negotiations for its establishment were underway. The Bank opened on December 4, 2003, and is now fully operational. To date, the Trade Bank of Iraq has issued over 200 Letters of Credit worth $190 million for most Ministries and several state-owned enterprises.

In addition, sixteen export credit agencies have signed an agreement with the CPA and the Trade Bank under which they will provide guarantees and short-term credit lines valued at $2.4 billion.

Iraq's International Debt

I want to turn now to the issue of Iraq's substantial foreign debt problem. Last September, the G-7 Finance Ministers committed to making their best efforts to resolve this issue by the end of 2004. We have made significant progress towards this goal.

As an indication of the priority we place on this issue, the President asked former Secretary of the Treasury and of State James Baker to serve as his Special Presidential Envoy to work with the world's governments at the highest levels in seeking to restructure Iraq's official debt burden. Over the past two months, Secretary Baker successfully secured commitments from leaders throughout Western Europe, Asia, and the Gulf States to provide at least substantial debt reduction for Iraq in 2004. Final agreement on the amount and terms of this reduction will be negotiated between Iraq and its creditors, including through the Paris Club.

We are also continuing our efforts to obtain the best possible data on how much debt Iraq owes. Current estimates put Iraq's external debt burden around $120 billion. Paris Club members are owed roughly $40 billion -- $21 billion in principal and roughly an equivalent amount in late interest. Non-Paris Club governments, chiefly the Gulf States, and private creditors hold the rest.

To further the data gathering effort, the Iraqi government recently issued a request for proposals from accounting firms and financial organizations to assist in the process of gathering and reconciling data on Iraq's external debt. With this data in hand, all parties will be better able to reach a resolution on reducing Iraq's unsustainable debt burden.

Assessment of Reconstruction Costs and International Fundraising Efforts

Before concluding, I would like to update you on our efforts to mobilize international financial support for the reconstruction and recovery of Iraq. In October, Secretaries Snow and Powell led the U.S. delegation to the Iraq donors' conference in Madrid. Seventy-three countries participated in this conference, which succeeded in raising over $32 billion, including the $18.4 billion commitment from the United States.

Donors also called on the World Bank and United Nations to establish a vehicle to channel their resources and help coordinate assistance for reconstruction and development activities. Working with key donors, CPA and the Iraqi authorities, the World Bank and the United Nations established two trust funds within an International Reconstruction Facility for Iraq (IRFF). We plan to contribute $10 million to the Facility, which will be equally divided between the World Bank and UNDP trust funds. The World Bank has met several times with Iraqi authorities to identify priority programs and projects under this Facility, and hopes to begin disbursements by July 2004.

In addition, the World Bank has pledged to provide between $3 and $5 billion of its own resources over a four-year period. In consultation with Iraqi authorities, the World Bank will prepare a lending program in support of Iraq's economic development with particular attention to health, education and the creation of a strong social safety-net.

The World Bank's sister agency, the IFC, has already approved the establishment of a Small Business Finance Facility in Iraq. This Facility will be funded by resources from the IFC, as well as bilateral donors, the Overseas Private Investment Corporation, and private banks, to provide credit to micro and small businesses on a transparent, commercial and sustainable basis. We are hopeful that this facility will be operational by mid-year.

The International Monetary Fund (IMF) is also laying the groundwork to provide financial support for Iraq. At the Madrid donor conference, the IMF announced that total assistance could range from $2.5 billion to $4.25 billion over a three-year period. Iraqi finance officials met with Managing Director Kohler in Boca Raton over the weekend before traveling to Washington for additional meetings with IMF staff. The purpose of these meetings was to initiate discussions on a policy framework that could become the basis for a funded program later this year.

Frozen Assets

Finally, I am pleased to report that our efforts to persuade governments to transfer assets of the former Iraqi regime back to Iraq have yielded results. To date, more than ten countries have transferred approximately $650 million in such assets to the Development Fund for Iraq. We are continuing to press other governments – especially Iraq's neighbors – to move quickly to find, freeze, and transfer Iraqi assets so they can be put to use for the benefit of the Iraqi people.

Conclusion

In closing, I would like to stress that despite a difficult security situation, challenging working conditions and limited capacity, the Iraqis are beginning to overcome the grim legacy of Saddam Hussein's regime. With the strong support of the international community, Iraq is making tangible progress towards the establishment of an open, robust market economy that will offer its citizens a promising and prosperous future.