Part of the central bank was looted and burned in the wake of the U.S. invasion

The daily mayhem in Iraq obscures the fact that interim Prime Minister Ayad Allawi may actually be making some progress in reforming and reviving the country's long-suffering economy.

Up from the RUINS

By Donald Kirk

Haydar al-Uzri smiles genially as he tosses his shiny black German MP5K submachine gun onto the beige couch of his office, which overlooks the garden of his villa in Baghdad's well-to-do al-Mansour neighborhood. Behind high walls in the driveway below, his driver and two bodyguards, all wielding AK-47 Kalashnikovs, wait in an armored Toyota SUV. Polite but clearly in a hurry, the tall, black-haired Iraqi ensconces himself behind his desk for a quick chat. He has just a few minutes to spare before he must race off for a rendezvous across town.

Al-Uzri is not a militiaman or a rebel leader. A member of a prominent Shiite family, the 55-year-old returned to Iraq for the first time in 44 years in June 2003, two months after the ouster of Saddam Hussein. He now serves as a senior adviser on banking to the interim Iraqi government: His pressing appointment across town — a nerve-racking 30-minute trip — is with Finance Minister Adil Abdul Mahdi.

"The priority for banks is to bring their balance sheets up to standards, then to restructure them to automate," says al-Uzri affably. "That, and a lot of training." He has an MBA from Indiana University and has worked for international banks in Beirut and Bahrain as well as London.

Al-Uzri is just one of scores of advisers to the interim government of Prime Minister Ayad Allawi who tote guns along with their briefcases. Who can blame them? Attempts to assassinate government officials occur so often in Iraq that they barely make news. On August 23, Iraq's Environment and Education ministers narrowly escaped separate bomb attacks; five bodyguards were killed. All cabinet-level officials and central bank governor Sinan al-Shabibi travel in miniconvoys of armored SUVs.

"It's been getting worse," says al-Uzri, since Izzadine Saleem, president of the U.S.-appointed Iraqi Governing Council, was killed on May 17 in a suicide blast right outside the entrance to the green zone, the heavily protected enclave that encompasses the U.S. embassy, which occupies one of Saddam's opulent former palaces.

The government of Prime Minister Allawi, a 59-year-old neurologist who opposed Saddam from exile in the U.K. and promotes an image of toughness, has vowed a fight to the finish against the disparate rebel bands that are trying to thwart efforts to rebuild Iraq. Confronting unrepentant Saddam loyalists, often spurred on by foreign and local Islamic extremists, Allawi has ordered the newly formed army, the Iraq National Guard, and police forces to show no mercy. Recently, battles with Shiite extremists have raged from the holy city of Najaf to the slums of Sadr City, Baghdad's poor, predominantly Shiite sector.

Despite determined offensives by U.S. forces working close-

Sherrlyn Bjorkgren/Redux Pictures

ly with Iraqis when they can, the rebels have kept up the level of conflict and now maintain effective control of cities like Fallujah in the Sunni Triangle to the west and north of Baghdad. The skirmishing shows no signs of abating in spite of periodic ceasefires and the heartfelt desire of most Iraqis for the war to simply go away. In early September, although Shiite rebel leader Moqtada al-Sadr had called on his followers to lay down their arms, insurgents were continuing an all-too-familiar pattern of ambushes, bombings, executions and kidnappings.

It is all the more remarkable, therefore, that amid such chaos the Allawi government appears to be making fitful but real progress toward resuscitating Iraq's ravaged economy and all-but-moribund political system. Oil is again flowing in substantial volumes. Scores of rebuilding projects are under way, and thousands more have been approved and funded. Iraq's currency is no longer worth less than the paper it's printed on. Strong medicine is be administered to the sickly banking system, including a dose of foreign competition.

The government estimates that GDP will grow more than 10 percent this year, to as much as $25 billion, as the country begins to recover from the Saddam era. Give much of the credit not only to the military protection afforded by the U.S.-led coalition but also to a massive, mostly American, aid program. Don't leave out the efforts of the U.S. advisers to the Coalition Provisional Authority under L. Paul Bremer, who have sought to provide Iraq with a framework of comprehensive rules and regulations. Although Bremer returned to the U.S. on June 28 — the day the CPA turned over power to the interim government — the authority's democratic, free-market imprint is clearly etched on the Allawi government and the economy. The question is: How deep is that imprint? Is it really possible to convert a society so long accustomed to an absolute dictatorship to a democracy? And in such short order?

Iraq remains far from the beacon of democracy in the Middle East once envisioned by the Bush administration. Yet progress — however bloody and halting — is being made day by day. Last month an interim assembly of 100 representatives was chosen in a messy four-day conclave of

Finance Minister Adil Abdul Mahdi: Starting 'from under the ashes of war'

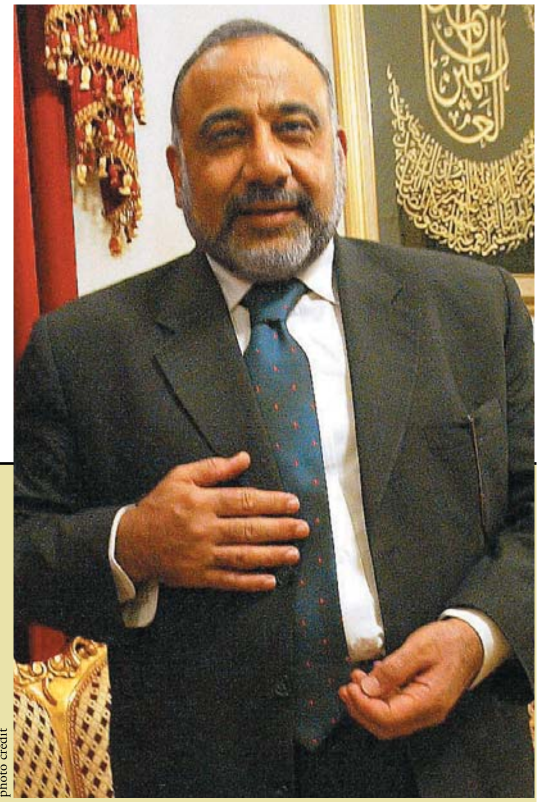


photo credit

Adil: "Our objective is to build a strong market economy"

Several months before the fall of Saddam Hussein, Adil Abdul Mahdi returned to Iraq after 35 years abroad, mostly in France. At first, Adil, 62, the leader of one of two major Shiite Muslim parties, the Supreme Council for Islamic Revolution in Iraq, hid out in the Kurdish north, protected by anti-Saddam forces. Once Saddam was overthrown in April 2003, Adil joined the Iraqi Governing Council, formed by the U.S.-led coalition. When the coalition transferred power to an interim government on June 28, he became its Finance minister.

Adil is responsible for preparing and disbursing Iraq's roughly $15 billion budget, almost all of which is derived from oil revenues. He aims to find new sources of income for Iraqis by diversifying the economy, and he wants to ease Iraq away from its dependence on state subsidies and toward a free-market approach.

Also high on his agenda: negotiating the reduction — if not the elimination — of Iraq's crushing foreign debt, estimated at about $127 billion. "This debt came because of three wars," he points out, contending that creditors eager to see stability in the region should forgive the loans. Two decades of fighting, he notes, have "destroyed our country — all the infrastructure."

Adil holds a master's degree in political science from the International Institute of Public Administration in Paris. While in France he worked for economic think tanks and headed an Islamic studies institute, and he edited both French and Arab magazines.

Institutional Investor Contributor Donald Kirk talked to Adil at his home on a heavily guarded and barricaded Baghdad block.

Institutional Investor: What is your top priority in building a new Iraq?
Adil: To build a strong market economy — this is one of the main objectives. First, we need a healthy Iraqi economy and to correct the erosion of the public sector. Without this, we will have a very centralized and corrupt and unprofitable and unfeasible economy. The economy is now dominated by oil revenues, which come to the state and are consumed by the state budget, mostly by salaries, pensions and subsidies and a little capital investment.

What are you doing to bring about a shift from the state-led economy to a more open economy not so dependent on oil?
We encourage a free-market economy. We are working on tax policies. In Iraq now we don't have any sales tax. That will be one source. Iraq is potentially a rich country, but today it is under debts. We have raised by 20-fold the government salaries of Iraqis. [Nongovernment] Iraqis before the war had salaries of 3,000 to 5,000 dinars a month — $2 or $3. Today we don't have any Iraqi who touches less than $4 or $5 a day. Many workers are paid the equivalent of $5 or $6 a day.

But how will you encourage investment and get away from a state-dominated oil sector?
Once security improves we will have important outside investment in the oil sector. We have natural gas and refineries. We have had certain negotiations with other states and companies. These are projects within the Iraqi Oil Ministry.

Where else do you hope for investment?

more than 1,100 factional leaders. The exercise was all preparation for nationwide elections tentatively set for early next year. (The nonstop conflict may force a postponement.)

Afghanistan, a country in similarly grim straits, is struggling with some success, like Iraq, to salvage its war-devastated economy, making for a case study in comparative economics: see page 80.

To be judged a success, the Allawi government must at a minimum restore war-interrupted basic services, such as power and running water, and ensure day-to-day security. Reviving economic activity could ultimately do more to quell the violence than the presence of an army of foreign troops. The stakes could not be any higher for Allawi.

The prime minister wants to throw off the remaining shackles of Saddam's command-and-control state and build, literally from the rubble, a free-market economy. If Iraqis see good progress, then Allawi may be able to keep his oil-rich country in moderate hands so that it can begin to fulfill its enormous potential and eventually emerge as a model for the region.

If the prime minister's experiment fails, however, Iraq could dissolve into warring religious and ethnic factions. That could be disastrous not only for the country's neighbors but also for the U.S. and other Western nations that dread Iraq's potentially emerging as a hotbed of regional Islamic extremist conflict and an incubator of global terrorism.

"I've been working with Iraqis quite a bit, and I'm very optimistic about their approach," says Faris Hadad-Zervos, the World Bank's country director for Iraq, who had to retreat to Amman, Jordan, after the bomb blast on August 19, 2003, that killed 22 people at the United Nations' Baghdad headquarters. But as for economic reforms, this veteran development official is cautious: "These things don't happen overnight."

Still, the Allawi government can't afford to be too patient — and it has made some remarkable progress. Under British-trained economist al-Shabibi, the central bank has reintroduced and stabilized the Iraqi dinar and reasserted the bank's authority over monetary policy; rather than simply printing more dinar notes, as it once did to finance Saddam's military adventures, the bank is carefully monitoring the money supply. Partly as a result, inflation has dropped from 135 percent five years ago to about 20 percent this year.

Iraq's lifeblood, oil, meanwhile, is again moving to export markets in a volume comparable to that before the U.S. invasion in early March 2003. To be sure, the country's pipelines remain vulnerable to saboteurs, and supply is subject to abrupt halts. Nevertheless, oil is once more bringing in foreign currency and refilling depleted tax coffers — especially with the price of crude at more than $40 a barrel.

We are looking for investment in agriculture, industry, sulfur. We have to strengthen the market economy. This is the way to correct the performance of the public sector so we will have a competitive situation.

Gasoline is provided to all Iraqis almost free of charge. As part of your move from the state-led oil economy, will you raise the price of gasoline?
Raising the price of gasoline is politically unpopular. Certainly, we will raise the price of gasoline. It doesn't affect directly the budget of Iraqis. It's nothing if we double the price from 2 cents a liter. This is nothing. On one side we have raised salaries and wages. On the other side we will stop this policy of subsidies.

Do you have a plan to bring about a serious increase in the price of oil products without causing an adverse popular reaction?
We have another idea: to improve services at the petrol stations. At some stations we can charge people higher prices for oil. On the black market, for instance, they are selling benzene [gasoline] for almost 200 dinars a liter, four times the regular price. People are willing to pay to avoid the lines. If we can provide this in certain stations, people can go there. We don't have to go and brutally say, "Okay, we'll raise the oil like this." The target is achieved without creating a social and political crisis.

The other great subsidy is food, much of which is given away. Will you eliminate the food subsidy?
We are working on that now. We don't want to go quickly for social and political reasons. We are starting. We raised the pensions paid to Iraqis. This will enable us to take certain measures on other issues. For example, for people who receive high wages, we can cancel the food basket. Now every Iraqi has a food basket. For a lot of people, it means nothing. When a person is making $800 to $1,000 a month, it will not be an important issue.

Would you like to have Iraq's entire foreign debt written off?
To be frank, yes, if we can can. This debt came because of three wars. They destroyed our country — all the infrastructure. It put a heavy burden of debt on Iraq. For many years in the 1980s, the military expenditure of Iraq was 160 percent of GDP. The GDP was $28 billion to $30 billion in the '80s, and the military expenditure was $40 billion. We are coming from under the ashes of war.

What is the response from Arab countries?
We have good messages and answers that they will help to the maximum. They know all this debt comes because of war.

What about your Western creditors?
We are trying to see what we can do. It's all linked with Iraq's economic future. They can come and negotiate. Now we are going to the Paris Club of creditors to forgive the debts. Once we have a Paris Club agreement, we can negotiate with all of them.

When do you expect to settle the debt issue?
By the end of this year, we have to settle the question of the foreign debt with the Paris Club. We have prepared a data sustainability analysis for the IMF. The IMF provided it to the Paris Club. That is the basis for all discussion. We start talks in September.

What about all the billions that went out of Iraq with Saddam's relatives and cronies?
No one knows what the real assets of Saddam were. They were talking about $20 billion to $40 billion. There was a 5 percent commission [on oil exports]. When they nationalized the oil industry, 5 percent went to the Baath Party. It never appeared on Iraqi records. So how can you calculate the wealth of Saddam Hussein? The money went to Swiss banks through a Jordanian network, through Europeans, Russians, Asians. We will investigate, but we don't have enough time. We are fully occupied.

How do you feel about Iraq's future?
I am very much optimistic. Finally, we will improve the security situation. The economy is getting much better than before. You go on the streets. We are flourishing commercially. A lot of money is circulating.

The Finance Ministry and the central bank have begun negotiations with international creditors over Iraq's $127 billion of foreign debt, and Iraqi officials express confidence that most of the loans (taken out mainly by Saddam) will be either forgiven or paid off at steep discounts (see box, page 77).

Reconstruction — most of it funded by the U.S. — is getting off the ground. Bechtel Corp. is this month due to finish a water purification project west of Baghdad, with Iraqi subcontractors responsible for most of the work; a nearby power plant is almost done; and labor has just begun on rebuilding Baghdad's historic railroad station. Such endeavors employ thousands of Iraqis who might otherwise fall in with insurgents. And in June, Baghdad opened a new stock exchange, which may someday showcase Iraq's emerging private sector economy (see box, page 74).

"We must go beyond oil," contends Finance Minister Adil, 62, a French-trained economist, in an exclusive interview in July with *Institutional Investor* at his residence in one of Baghdad's central business and shopping districts. "We have to strengthen the market economy. This is the way to correct the performance of the public sector so we will have a competitive situation." The alternative, he warns, is "a very centralized and corrupt and unprofitable and unfeasible economy." (See box, page 70.)

Central banker al-Shabibi, 63, who was the senior economist for the U.N. Conference on Trade and Development for 21 years, offers this upbeat perspective: "There is a great potential in this country. The prospects are very bright. Once security is under control, this country will be very attractive to investors." (An interview with al-Shabibi appears below.)

Assuring security, of course, is the catch. It's still dangerous to travel around much of Iraq. U.S. ambassador to Iraq John Negroponte, who replaced Bremer on the day that the provisional authority headquarters was turned over to the American embassy, has recommended shifting $3.37 billion from aid projects to security,

Central bank chief Sinan al-Shabibi: We "want to enter the rest of the world"

Al-Shabibi: "We want foreign banks to come with policies to manage a market economy"

Sherrlyn Bjorkgren/Redux Pictures

Sinan al-Shabibi became governor of Iraq's central bank a year ago, well before the current interim government was formed. Like many of his colleagues who went back to Iraq after the ouster of Saddam Hussein, al-Shabibi had returned to his homeland after a long absence. He had left the country in 1980 after the outbreak of the Iran-Iraq war and worked for the United Nations Conference on Trade and Development in Geneva for 21 years before retiring three years ago as senior economist. Among the UNCTAD duties that helped to prepare him for the Iraq bank post were monitoring how developing countries pay for OPEC oil and researching Arab countries' debt management.

As governor, his main task is to restore the central bank's traditional functions of making monetary policy and regulating banks. Under Saddam the bank was forced to buy government securities to keep the regime afloat. Meanwhile, most Iraqi banks — state-owned and private alike — suffered terrible losses, making it impossible for them to carry out normal functions. Says al-Shabibi of the Central Bank's mission today: "The overriding objective is not to finance the government. The overriding objective is to maintain price stability."

Al-Shabibi, 63, graduated from Baghdad University in 1966 and received a master's in economics from the University of Manchester in 1971 and a Ph.D. in economics from the University of Bristol in 1975. He worked for Iraq's Oil and Planning ministries before leaving the country.

Institutional Investor Contributor Donald Kirk interviewed al-Shabibi in late July at his large, rather austere office in the central bank.

Institutional Investor: What are the economic and monetary policies of the new Iraq?
Al-Shabibi: We are moving to a market economy. Of course, we should actually use some kind of [statistical] indication and price system to allocate resources. As far as monetary policy is concerned, we are heading toward using competitive procedures [to establish the value of the dinar].

How do you foster competition in banking?
We have done something toward the entry of foreign banks. The idea is to introduce competition among foreign banks and domestic banks. We want the foreign banks to come with technology, with new financial instruments, with policies to manage a market economy. We want some substantial spillover to our private banks.

Your private banks are tiny, and state-owned Rafidain bank is quite small as well. Can you bring about reforms from such a base?
Rafidain is not small. It needs some kind of restructuring. This might include involvement of the private sector in the next few years, and privatization.

What are you doing to increase the size and role of the banking sector?
Under the new banking law, all banks should increase their capital. They should team up with other banks in the region to get bigger. We assume the financial sector depends on investment in the real sector. The most important result from the real sector should be real savings. We want the economy to grow in the real sector. The result will be savings.

One problem for Iraq is huge debts. First, what are you doing about domestic debt?

primarily for the oil industry.

In early September an uneasy calm prevailed in much of Baghdad. Traffic was moving, and shops and offices were open. But ambushes still occur with unnerving regularity, especially in Sadr City. Beyond Baghdad large portions of the country, notably the Sunni Triangle, remain under the sway of forces hostile to Allawi's government, from radical Muslims to Saddam loyalists belonging to the former dictator's Baath Party to al-Qaeda terrorists to murky infiltrators from Iran, Saudi Arabia and Syria.

Equipped with arms and funds from mysterious sources in the Middle East, gangs of terrorists have been kidnapping foreigners and beheading them when the kidnappers' demands are not met. Victims have ranged from a young South Korean working for a company that delivered food to U.S. military bases to two Bulgarian truck drivers to an Italian freelance journalist to a dozen Nepalese working for the Americans as cooks, cleaners and drivers. Their murders were broadcast in gory detail by TV channel Al Jazeera, the Arabic TV channel headquartered in Qatar.

Most foreign investors are understandably more than a little skittish about Iraq, despite its oil and gas riches — second only to those of Saudi Arabia — and its population of 27 million. The country attracted virtually no direct foreign investment in 2003.

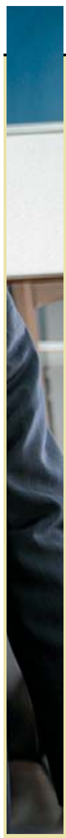
Certainly, Allawi and his colleagues face a Herculean task. The American forces, upon which the interim government depends for its tenuous hold on power, can neither guarantee real security nor easily pull out of Iraq, even if President George W. Bush were to lose his reelection bid. The Allawi regime, moreover, has a problem of credibility, if not legitimacy, as long as it is unable to assert its authority around the country. And the government faces a political test as early as January, when elections for a national assembly are to be held.

That onrushing deadline does not leave Allawi time to carry out his entire agenda, but the government would like to show that it has made a start. It will be up to a duly elected and seated assembly to elect a prime minister — the country's most powerful job. It will also probably select a president, an influential but largely symbolic post.

Sensing that his country's fate — and his own prospects for continuing as Iraq's leader — depend on this strong start, Allawi has been compromising left and right in a balancing act among religious and regional groups. The theory is that by guaranteeing positions of influence to figures representing Shiites, Kurds and others, he will be able to win recognition for his government. Simultaneously, Allawi has sought to demonstrate his authority by confronting uprisings with military force while pushing wholesale economic reforms.

In conjunction with Finance Minister Adil and other top Iraqi policymakers, he is pushing a blueprint — one inspired and largely drafted by Bremer's provisional authority — to replace Saddam's debt-plagued and corrupt state-run economy with a market-driven private sector that promotes entrepreneurship and is wide open to foreign investors. Both U.S. advisers and senior Iraqis play vital roles in this effort. The Americans have been assiduously courting influential Iraqis in hopes of bringing about reforms.

Iraq's dilapidated economy needs urgent repairs. Once one of the most prosperous countries in the Middle East — GDP exceeded $50 billion in the late 1970s — Iraq saw its economy plummet over the course of its eight-year war with Iran, two defeats by U.S.-led military coalitions, stringent U.N. economic sanctions after Saddam's 1991 Kuwait invasion, a U.N.-run food-for-oil program



For the domestic debt, there is a new policy — sale of Treasury bills. Before, because there was no independence for the central bank, the government was able to borrow from it. The government issued T-bills and presented them to the bank.

What's the new T-bill policy?
Now the government is going to auction the T-bills. It is the central bank's choice whether to buy them or not — they will also be offered to commercial banks. The overriding objective is not to finance the government. The overriding objective is to maintain price stability.

What about the foreign debt, which is about 30 times larger than the domestic debt?
The foreign debt is a huge debt of $120 billion. We are going to negotiate with all the creditor countries. We have discussed a program in many meetings with the International Monetary Fund. We are trying to reconcile with the creditors and come up with an agreement.

By how much do you hope to reduce the debt?
All these are agreements and contacts. Iraq is a country that wants to enter the rest of the world. We don't talk about percentages. Ideally, we would like to cancel 100 percent.

Where might you find leniency?
The Gulf states are brother nations. Our debt to them is about $40 billion. We expect a good deal from them. They have an interest in a stable Iraq. Debt reduction would enable an environment for investment and trade. Creditors should think about this.

To go from a centralized command economy to a capitalist economy seems like an overwhelming challenge. Can you do it?
We call it a market economy. We cannot do it in one year. If it takes a long time, this is an argument to start early. We should give priority to private businessmen.

Many of the people who made fortunes under Saddam sent capital abroad — a great deal of it. How can you recover from this loss?
We know there was capital flight. We expect capital flight. We hope that one day this capital will come back. We hope these Iraqis abroad will come back.

Businessmen say Iraqi banks lack the capital to make the loans needed to rebuild the economy. What can banks do that matters?
Even if the banks extend small amounts, we think this is significant. We need investment on a small scale. We have to solve all these problems for Rafidain to work. There needs to be restructuring. We hope the country will have greater capacity to finance from oil revenues. We hope Iraqi private banks will play a major role.

Security concerns discourage potential foreign investors in Iraq — including those foreign banks that you've licensed to enter the country. How do you expect them to respond to the recent violence?
The foreign banks will have to start [operations]. We know security is an issue. It affects both foreign and domestic investment. They have licenses, they are considering coming here. We have a deadline. They should be here by the end of the year.

racked by corruption, and the epic depredations and mismanagement of Saddam and his sons and other relatives and cronies. The country's GDP had plummeted to $6 billion by 1997.

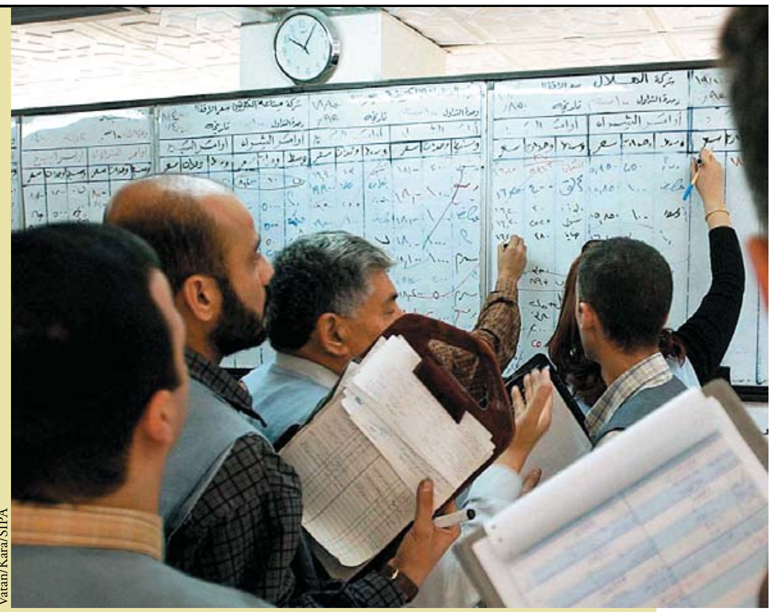
The financial costs of the Saddam era, though, pale beside the human costs. One million Iraqis died in Saddam's war with Iran, and more than 100,000 lost their lives in the 1990–'91 Gulf War. Thousands more Iraqis were executed in Saddam's prisons and death camps and in his assault on the Kurds.

Allawi and Adil, supported by pledges of $33 billion in international aid, including $18.4 billion from the U.S., want Iraq to begin diversifying beyond oil, which currently contributes more than 50 percent of GDP and 95 percent of the budget. They envision a broader industrial and agricultural base and intend to fashion a healthy banking system able to accommodate a broader-gauged economy fueled by chemicals and petroleum products and light manufacturing, among other now-neglected areas. It is Iraq's extraordinary oil reserves, however, that make it a potential powerhouse with the capacity for energy self-sufficiency (a position simply unattainable by Afghanistan, whose main export is opium).

"Iraq is a fortunate country," concedes Faik Ali Abdul-Ra-

Baghdad's borsa Italiana

El Italia was once Baghdad's best Italian restaurant. Now the old tile floor is filled with brokers and investors jawing at each other twice a week over stock quotes that are posted, like menu entrées, in grease pencil on big white boards.



Vatan/Kara/SIPA

Brokers bidding on Iraq's boisterous stock exchange

The onetime pasta place has become the Iraq Stock Exchange. As many as 200 participants cram into what were once the spacious quarters of one of Baghdad's most fashionable Western restaurants for lively two-hour trading sessions on Wednesdays and Sundays. In the adjoining corridors they swap business and political gossip. When a trade is final, a broker draws a circle around the winning bid, jots down the price on a slip of paper and hands it to a nearby clerk who sees to it that the details are entered into a computer.

"The exchange is superb," says its chairman, Talib al-Tabatabaie, after the final bell has rung one day in July. "We are going to automate. We are increasing the number of listed companies week by week. I expect the Iraq exchange to be the best in the Middle East. But give us time."

The bourse has gotten off to a respectable start since it opened in June. Trading doesn't amount to much — turnover in the 26 stocks listed comes to about $2 million per session — but broker Mohammed Ismael is pleased. The former Baghdad Stock Exchange, which closed forever on March 19, 2003, the day the U.S.-led coalition invaded Iraq, averaged between $400,000 and $500,000 per session.

"So we are already doing more business," says Ismael. Although the old bourse listed 114 companies, many would not meet the new exchange's listing standards. Nonetheless, says consultant Bill Gorman, "we're adding more each week."

Gone, along with the Saddam regime, are such limits as a 6 percent lid on daily price changes. These constraints, coupled with an anemic private sector, held the market capitalization of the former Baghdad exchange to $200 million. By contrast, Egypt's Cairo and Alexandria Stock Exchange boasts a $30 billion market cap, while that of the new Iraqi exchange is about $5.5 billion.

Exchange executives work down the hallway in the same one-story building, in a warren of flimsily constructed offices that occupy another former restaurant, El Baghdad. "I think my office was the toilet," laughs Sherwan Mustafa, executive manager of the Iraqi depository center, which holds shares of listed companies.

The whole complex faces a hotel's veranda and swimming pool. There is a sign that says "changing rooms" but none that says "Iraq Stock Exchange."

Although apologetic about the exchange setting, chairman Talib says that it couldn't be helped. "We wanted a safe, secure place in the middle of town," he explains. "We are going to buy a building in the near future."

The bourse depends on the U.S. to provide both technical advice and security. "We don't want the exchange opening and then closing the same day," says U.S. Army Captain Jon Alvarado, who is on leave from his job in the treasury department of Plantronics, a Santa Cruz, California, marketer of telephone headsets. "The exchange is a symbol of Iraq."

American soldiers not only offered security advice but also performed some of the renovations, all in the line of duty. Civilians from the U.S.-led Coalition Provisional Authority, which oversaw Iraq until power was transferred to Iraqis in late June, provided technical expertise.

On trading days American soldiers and private security guards escort U.S. officials in and out of the exchange and wait at the entrance. Other soldiers sit outside in Humvees.

Ismael, however, worries more about the exchange's commercial prospects than its security. Even if a further 30 or so established companies that were listed on the old Baghdad exchange join the new bourse, as expected, "there are no big companies in Iraq" to spark investor interest, he says. But, he adds, "in the future there is a chance. The economy is better. People are feeling good. Salaries are better."

Iraq Stock Exchange officials are even more sanguine. "Of course I am optimistic," says Taha Ahmed Abdul-Salam, the exchange's CEO. "It is a part of capitalism in Iraq. It will be an independent, modern exchange. Give us just six months." **— D.K.**

sool, a central bank and Finance Ministry official under Saddam who is now Allawi's deputy minister of Planning and Development Cooperation. "It can pass through this period with less pain than other countries."

Iraq's 112.5 billion barrels in proven oil reserves (with a further 220 billion barrels categorized as "probable") easily exceed those of Kuwait and the United Arab Emirates (95 billion barrels each) and Iran (92 billion) and lag only Saudi Arabia's 260 billion. Iraq also has the potential to become one of the world's biggest producers of natural gas.

But the very abundance of oil — and Saddam's desire to stave off a revolt — conspired to foster a debilitating culture of dependence in Iraq not unlike that in other Middle Eastern petroleum powers. Saddam underwrote a sizable welfare state, subsidizing basic food needs, gasoline and medicine. Today such subsidies make up 40 percent of Iraq's $15 billion budget (excluding foreign aid). They threaten to impede Allawi's free-market reforms.

Does Baghdad dare to begin dismantling these benefits and antagonizing Iraqis, especially in the run-up to the elections? Kamal al-Basri, an economic consultant who has been a senior adviser to the Trade ministry in Baghdad, says flatly: "It is practically impossible. The nation very much depends on [the food program]." A U.S. adviser to that program concurs, "It's tough politically for Allawi to pull away from free food" — even though Finance Minister Adil espouses weaning Iraqis from what amounts to a mass welfare system.

The issue is extrasensitive at a time of massive unemployment. Mehdi Hafedh, minister of Planning and Development Cooperation, contends that Allawi and whoever succeeds him face four "urgent" tasks. The first priority, he says, not surprisingly, is to "solve security." But right after that — and directly related to security — is job creation. The proportion of Iraqis without work in a labor force of 8 million has dropped from 50 percent after last year's invasion to 27 percent as foreign aid projects have proliferated and oil exports have picked up. But Mehdi says many more jobs are needed. The more people there are working, he points out, the fewer there are for jihadists to recruit. The minister's third challenge is to rapidly restore electricity and basic services, including education and health care. The fourth priority, Mehdi says, is to rebuild and expand Iraq's entire infrastructure, from oil fields to roads and bridges.

As inept as Saddam Hussein was as a military strategist, he was even worse as an economic planner and manager. In 1979, Iraq, enriched by surging oil prices, boasted $40 billion in cash reserves, a GDP of twice that amount and an ambitious development agenda. But in September 1980, Iraq invaded Iran, following years of border clashes, and set off an inconclusive, disastrous, ten-year war that killed a million citizens on each side, diverted tens of billions of dollars from development toward military spending and sent both countries on an overseas borrowing binge, mostly to buy weapons.

By 1982 all of Iraq's reserves were gone. "After the war we were $41.2 billion in debt, plus the destruction of the infrastructure," says deputy Planning minister Faik. "There was no new national or foreign investment in this period. Our investment was less than depreciation." Saddam invaded Kuwait in 1990 and was soundly thrashed in 1991 by a U.S.-led coalition. That costly fiasco, added to the harsh trade sanctions imposed by the U.N., sent Iraq into a downward spiral.

Forbidden to export oil until the U.N. oil-for-food program began in 1997, Iraq had no legal source of export earnings to pay its foreign debt. And even after the oil-for-food program started, the profits largely flowed into the coffers of Saddam and his top aides. The debt ballooned because of accruing interest payments. The current $127 billion total, based on an official Iraqi estimate, includes the amounts owed to other Gulf states as well as to Western nations and to Japan. Iraqi officials privately acknowledge that the real figure may be as high as $140 billion, most of that owed to governments.

During Saddam's reign thousands of educated Iraqis joined in a general exodus, taking billions in cash that they had not already squirreled away in foreign accounts and depriving Iraq of critical expertise. Many of those who returned after Saddam's ouster were shocked by the state of the country and the business community. Ali Shimara, now in his late 40s, left the Baghdad enclave of al-Mansour when he was a child and grew up in nearby Jordan, where many well-to-do Iraqi families fled. Shimara came back to Baghdad last year to take over from relatives what remained of his family-owned construction company, Shimara Group, and discovered that none of his childhood friends or their families — many of them once prominent in business — were left. "They have all gone," he laments. "There are billions of dollars outside Iraq. Iraq needs support from outside. We have nothing now."

For those who stayed behind, doing business was a nightmare. For a start, no one could run any sort enterprise without drawing the attention of the Saddam government. "You had to be in a relation with the regime," says Shimara, who kept in close touch with his relatives in Iraq. "If you wanted to work on a large scale, you had to work in two ways, through the intelligence service or through the two sons of Saddam, Uday and Qusay." The philosophy of Saddam's Baath Party, adds Shimara, was "Don't give anybody the power of money."

The economy continued to deteriorate in the 1990s. Stretched by military spending, Iraq's consumer price index soared from a base of 100 in 1988 to a staggering 80,000 in 2000, reports Mudher Kasim, director-general and senior economist at the central bank. The dinar was devastated.

"The Iraqi economy changed from a fixed exchange rate to a multiple-exchange regime," says Mudher. "The black market worked very well. At the beginning of sanctions, the exchange rate on the black market was $1 to five Iraqi dinar. At the end of 1995, $1 equaled 3,000 dinar." He speaks to a visitor in a central bank building that largely escaped looting in April 2003. Next door vandals — some just plain thieves, others out to destroy an institution that they felt had exploited them under Saddam — set the bank's other building ablaze after ripping out records and stealing computers and other equipment.

To cling to power, Saddam expanded the government subsidies. In the mid-1990s food and gasoline in Iraq were the cheapest in the world, and businessmen with connections to the president and his sons received a special dinar-dollar exchange rate.

Expensive subsidies persist today. Many basic foods are free. A liter of gasoline costs 50 dinar, or about 3 cents — less than a glass of water. As a result, Iraqis sometimes wash their cars with gas, occasionally causing explosions in the desert sun.

The Allawi government wants a free market to replace the welfare state. He and his advisers, ranging from leaders of his own government to experts at the U.S. embassy to trusted friends drawn in from outside, such as well-armed bank adviser al-Uzri, view banks as a prime catalyst for transforming the economy. Toward this end, foreign banks are being allowed to purchase private Iraqi banks or operate in the country under their own brands. "The idea is to introduce competition among foreign and domestic banks" and provide business with much-needed capital, says central banker al-Shabibi.

As it is, Iraq's financial infrastructure is nearly as fragile as its physical infrastructure. Total assets of the country's 25 banks — six state-owned, 19 privately owned — amount to just $2 billion, and those assets are supported by a mere $42 million in equity. This is according to a recent report on Iraq's banking system by Citigroup; the U.S. bank considered opening an Iraqi branch but has rejected the idea for now as too risky.

Only two of Iraq's private banks have more than a few million dollars in assets. That elite pair, Credit Bank of Iraq and Middle East Bank, are thought to have more than $5 million apiece. Bank services in Iraq are next to negligible. Few Iraqis have bank accounts or mortgages; almost none carry credit cards that can be used in Iraq. Private banks' chief customers tend to be relatives or affiliates of the owners, and they usually seek only short-term loans. Some 30 percent of bank deposits go uninvested; the remainder are lodged in government securities, the stock market or affiliated companies, the Citigroup study found. Swift, the bank messaging system that allows global funds transfers, and MICR, the basic check-coding system used worldwide, aren't available in Iraq. Instead, banks clear checks via messengers; the process takes at least a week.

"There's a lot of work to be done," says al-Uzri. The bank adviser's first project is to resuscitate Rafidain Bank, the oldest and largest state-owned bank. One of Saddam's favorite overseas borrowing vehicles during the 1980s, Rafidain fell into default just after Iraq invaded Kuwait. At the time, the bank's foreign debts, which were owed to Paris Club countries and to banks abroad, amounted to $24 billion. (These obligations have since been folded into Iraq's $127 billion national debt.)

Al-Uzri is enthusiastic about Rafidain's prospects but vague about what they are. "The idea is to rehabilitate the state banks," he says, "but it's not decided yet how." One possibility would be to merge the six state-owned banks (four of which were recommended for extinction by U.S. bank advisers in off-the-record interviews) into one. Al-Uzri, however, points out that Rafidain and second-ranked Rasheed Bank are both still able to service normal accounts used by small merchants. "If we exclude the foreign debt, there's a chance for Rafidain to be reestablished," he contends.

Baghdad considers the potential presence of foreign banks as a way not only to promote healthy competition but also to import capital and expertise. Former coalition adviser Kevin Woelflein, a onetime Chicago bank executive with considerable Midle Eastern experience, sees Iraq's private banks being "dramatically changed by the arrival of these banks" and becoming "the core of the Iraq banking structure." Private banks, he says, will introduce new products and use their connections to "their industrialist family owners" and local market knowledge to lead the transformation. Under this scenario the state banks would recede in importance over time.

So far the central bank has awarded three foreign banks — HSBC, National Bank of Kuwait and Standard Chartered Bank — licenses to operate in Iraq. HSBC and NBK would like to buy majority shares in local banks, while Standard Chartered is studying whether and where to set up a branch. The banks have agreed to capitalize their operations with at least $36 million apiece — almost as much as the total equity of all Iraq's private banks.

"The long term is very rosy," says Stuart Horsewood, who heads Standard Chartered Bank Iraq. "It's just a question of security at the moment."

Since April, Horsewood has been working out of Dubai, Standard Chartered's regional headquarters. The bank is evaluating whether to open its Iraq outpost in a new banking district that the Allawi government is contemplating for somewhere south of Baghdad, or possibly in Basra (the southern city defended by British troops) or in a Kurdish city to the north.

Iraq's prospective banking revolution cannot come too soon for businessmen. They complain bitterly that they are unable to get credit from any bank — private or state. Loans for expansion are particularly hard to come by.

One of those affected is repatriate Shimara. "I have a lot of big projects in Iraq," he says, seated behind an ornate antique French desk in his high-ceilinged, chandeliered office near the Tigris River. Like others doing big business in Baghdad, Shimara operates out of what he says is an office building, though it looks more like a residence, albeit one bristling with bodyguards. He commutes from his well-protected home elsewhere.

Using his family wealth, Shimara builds power stations and plants for turning scrap into steel products. He says he doesn't get support from local banks. "The central bank and the other Iraqi banks do activities only for the government," he grumbles. "No one can make loans. We are working on cash." He confides that he personally has "invested a lot of money, but I know it's very high-risk. My family has a lot of money. We bring some from outside Iraq."

Introducing market principles has been easier in some spheres than in others. On July 18, Adil's Finance Ministry auctioned $100 million of Treasury bills, but for the first time in recent memory, it did not set the price and it did not order the central bank to buy the entire issue. Instead, 15 Iraqi banks bid for the T-bills over a two-hour period; the 90-day securities sold at a guaranteed 6.8 percent yield. Although Rafidain and Rasheed bought three quarters of the bills, the participation of other, smaller, Iraqi lenders was an important step in rehabilitating the banking system — and making it clear that the central bank would no longer finance the government.

Last December the provisional authority, with the help of a consortium of 13 foreign banks led by J.P. Morgan Chase & Co., formed the Trade Bank of Iraq to finance imports of badly needed goods such as food, raw materials, construction equipment and machine replacement parts. This ploy sidestepped Rafidain's and Rasheed's foreign credit problems. (Neither bank is capable of operating at full capacity in either the domestic or foreign markets.)

Hussein al-Uzri, Haydar al-Uzri's second cousin, runs the Trade Bank. Raised by his banker father in Beirut, the 41-year-old studied computer engineering at Texas Tech University in Lubbock, Texas, and worked as a financial consultant in both London and Moscow.

"Iraq is a country in default," he says. "People will not extend credit, so the [Trade Bank] consortium is a way for us to open letters of credit. We keep the money on the outside, within the consortium." The bank has opened letters of credit totaling $1.5 billion to date and expects to reach $4 billion by year-end.

Bruce Proctor, head of global trade services for J.P. Morgan Chase in New York, notes that the Iraqi government "wanted a mechanism to finance imports on a normal commercial basis and for getting Iraq onto internationally accepted commercial standards — i.e., letters of credit." For J.P. Morgan Chase and other foreign banks, he says, participation in the Trade Bank offers "experience in a market that could hold a large interest for us."

In Iraq, of course, the ultimate liquidity comes from oil. Financial reforms won't make much difference to the country's economic survival unless it can pump more crude. "This country depends on one sector — the oil sector," acknowledges central bank economist Mudher. Iraq's oil and natural gas fields are entirely government-owned.

The Oil Ministry has managed to raise production from virtually nothing during the U.S. invasion to approximately 3 million barrels a day and plans to raise output by year-end to 3.6 million barrels a day — the average production level before Iraq's invasion of Kuwait. Baghdad's goal is to increase that number to 5.5 million barrels a day by the end of the decade.

Yet getting to even 3.6 million barrels won't happen until sabotage along the country's 4,000 miles of pipelines is brought under control. Several times a week production is slowed or stopped to repair or bypass damage. In August militants at the Shiite stronghold of Najaf, threatening to blow up Iraq's main southern pipeline, attacked ancillary lines and the oil headquarters in Basra. This halved the exports normally flowing from southern Iraq for shipment down the Persian Gulf. The main pipeline was shut down briefly before reopening in late August, but for how long was anyone's guess.

Insurgents have outwitted increasingly large security forces. The militants tend to strike pipelines in remote deserts, setting mines when security guards and U.S. and Iraqi forces are elsewhere. Such disruptions are not necessarily disastrous; crews are expert at fast repair, and pipeline managers can divert oil to other pipelines quite rapidly. Nonetheless, says deputy Planning minister Faik, "the quantity exported fluctuates tremendously because of the destruction of the pipelines."

An Oil Ministry director, who prefers to remain anony-

Rebuilding Iraq: IMF and World Bank move center stage

The International Monetary Fund and the World Bank are about to play a much bigger role in Iraq's reconstruction after having stayed largely in the shadow of the U.S. over the past 18 months. Whether Iraqis will feel the benefits any time soon, however, is questionable.

A debt sustainability analysis prepared by Fund officials over the summer will serve as the basis for negotiations this fall on rescheduling the country's massive $127 billion debt. The IMF analysis indicates that Iraq needs to have between 67 and 95 percent of its debt written off, but the Paris Club of sovereign creditors is far from agreement on a figure, despite the success of President George W. Bush's envoy, James Baker III, earlier this year at getting Paris Club members as well as the Gulf countries and Russia to agree in principle to substantial debt relief. For Washington, that means forgiving 90 to 95 percent of Iraq's debt.

Even if 90 percent were written off, that would still leave Iraq with a debt equal to half of its $25 billion GDP, notes John Taylor, the U.S. Treasury's undersecretary for international affairs. Although such a level would be roughly equal to the debt-GDP ratio of the U.S. and much of Europe, those countries' ability to service debt is far greater than Iraq's, given the latter's war-ravaged economy, he adds. "When people look at the numbers, I think they're recognizing that this has to be very large," Taylor says.

The U.K. also supports a big debt write-off — officials hint at a figure of about 80 percent — but other leading creditors, including France and Germany, are keen to limit relief to no more than 67 percent. These countries believe that because of its vast oil reserves, Iraq should be considered a middle-income country rather than a heavily indebted poor country, and they don't want to set a precedent for big write-offs to other middle-income states. What's more, German officials fear that they will be sued for expropriation by the private sector if they consent to a massive write-off. Germany has the largest exposure to Iraq in the Paris Club — some $5.3 billion — and private companies hold $2.3 billion of that debt.

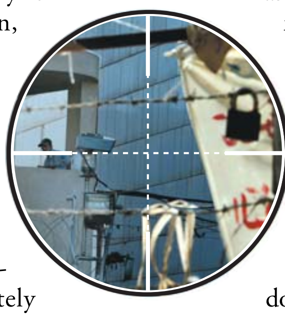
Some European officials also complain that the IMF analysis understates Iraq's revenues because it figures on an average oil price of a little less than $25 a barrel, just slightly more than half the current market price.

Negotiations between Paris Club creditors and Iraq will resume in earnest this month, but before the Paris Club can reach a settlement, the IMF must first agree on an economic program with the interim Iraqi government. The Fund is ready to provide $850 million in immediate postconflict assistance and as much as $3.4 billion in loans under a three-year standby agreement, but reaching a deal is taking longer than expected. The two sides have held several meetings in Amman, Jordan, but IMF officials now say they may not conclude an agreement until early 2005, after the year-end target date for a debt deal set by the Bush administration.

But debt relief, when it occurs, won't be free. The State Department has estimated the cost of forgiving the U.S.'s debt to Iraq at as much as $640 million, and the Bush administration wants that money to come out of the $18.4 billion of reconstruction aid that Congress approved last year.

The World Bank, meanwhile, has committed a modest $156 million so far in Iraq. The Bank plans to provide $3 billion to $5 billion over the next five years, but such a dramatic ramping up of activity "is predicated on an optimistic scenario of improvements in political stability and security," the Bank notes in its interim strategy document. So far signs of such optimism are hard to find on the ground. **— Tom Buerkle** mous, says that the government is trying to build fortified barriers to protect the pipelines. The Oil Ministry is also engaged in what the director calls a "rehabilitation campaign" because so much equipment was looted and so many documents burned after "liberation."

Once the ministry and its foreign advisers manage to eliminate sabotage or at least reduce it to an inconsequential level, they plan to embark on a vast program of building new refineries and turning Iraq from an exporter of ordinary crude into a leading manufacturer of higher-margin petroleum products, ranging from petrochemicals to diesel fuel to highly refined gasoline. Coupled with refinery expansion, Iraq wants to use more sophisticated exploration techniques to find fresh deposits and make more productive use of the country's huge natural-gas resources. The gas is now flared off after providing the pressure for pumping oil out of the ground. With one new pipeline to Kuwait under construction and others to Lebanon, Syria and the Gulf of Aqaba in Jordan under consideration, Faik believes Iraq's oil exports will ultimately reach 10 million barrels a day.



Although the Oil Ministry intends to retain ownership of the reserves, Baghdad plans to invite foreign companies to develop them as partners, perhaps even as owners of Iraqi subsidiaries. "The previous regime wasn't capable of developing oil," says the Oil Ministry's director. "It was investing all its money for weapons. Now the ministry wants to emphasize the Iraqi people's needs for oil and production and go to the upper levels of exports."

First, though, sabotage must abate, if not cease. Iraqi oil officials can hardly contain their frustration. "The silent majority is all against what is going on," says Faik. "Definitely, it will end. People are very optimistic and want it settled."

The oil fields and pipelines are by no means the only form of Iraqi infrastructure that needs an overhaul after three wars and decades of mismanagement. The U.S. Project and Contracting Office has been assigned the chore of overseeing the allocation of the $18.4 billion that the U.S. has committed to rebuilding Iraq from the ground up.

The program covers six major sectors: electricity, public works and water, communications and transportation, education and health, buildings and, of course, oil. Diversifying Iraq's petroleum activities beyond basic crude extraction is one key objective. The PCO expects to spend $12.6 billion on construction and $5.8 billion on everything from computers to vehicles to police uniforms.

The office has so far spent more than $900 million to get nearly 300 projects under way, from schools to clinics to sewage treatment facilities to power plants, and a further 2,000 are in the design phase. Some 24 major construction projects come under the aegis of ten major U.S. contractors, including Lucent Technologies and Kellogg Brown & Root, a unit of Halliburton Co.; each company subcontracts work to Iraqi firms. Iraq's Planning ministry plays a key role in project selection.

"We set up certain criteria," explains Faik. "Projects should be labor-intensive. They should have medium-size investment, should not have large implications for our current budget and should have a gestation period of one year." He adds that the ministry emphasized "basic services, water, electricity, sewage, sanitation, schools, health, infrastructure, bridges" because "a large portion" of U.S. aid was already allocated to oil and gas projects.

Critics, however, contend that the $900 million paid to contractors to date is too little given the magnitude of the rebuilding challenge, the need to demonstrate renewal to Iraqis and also the requirement to generate jobs. The U.S. program is excellent in theory — it is like a Marshall plan," says economic consultant al-Basri. "But it needs to be wisely carried out. At the moment, it does not generate enough jobs." U.S. officials counter that the PCO's contractors and subcontractors, most of them Iraqi, have put more than 110,000 Iraqis on the payroll and that more are being hired every day as the program expands.

Retired rear admiral David Nash, who was in charge of the PCO before rotating out of that post in August after more than a year on the job, was adamant during an interview before he stepped down that his office was moving as fast as it could. "We have committed more than $9 billion in construction and nonconstruction" funds, he noted, relaxing behind his crowded desk on the ground floor of the U.S. embassy in Baghdad. Nash, who made his career as a naval engineer, argued that "the problem was not war but 30 years of neglect, plus looting."

Critics don't understand how ambitious some of these projects are, adds Buddy Allgood, the PCO's director of programs. "They are huge in scale, take a lot of study, design, analysis and engineering before you put a shovel in the ground," he says. "It would have been impossible for anyone in January [when the PCO started] to have understood the situation. There was a shortage of labor, a shortage of trucks. We are not throwing money at these projects to put a Band-Aid on them."

On the ever-present political front, the issue of gasoline prices is so sensitive that senior officials are reluctant to discuss it on the record. "Yes, maybe you can find gasoline is cheaper than water," concedes the Oil Ministry official. "But Iraq has a good treasure of petroleum. All our people are rich people. The ministry of Oil sees we have to be merciful to the Iraqi people." Nevertheless, he concludes, "we have to study the prices."

Food, it seems, can also be hazardous to Iraqi politicians' health. All essential food products, including wheat, rice, beans, ghee for cooking and powdered milk, are imported and distributed without charge to Iraqis. The free lunch even has tea on the menu — much of it grown on a plantation in Vietnam that Baghdad acquired a few years ago in lieu of oil payments. The annual cost of Baghdad's largesse: $3.5 billion.

"One of the things we have to worry about is how you transition away from this welfare economy," says Ross Mountain, the U.N.'s acting special representative for Iraq. "Someone has to have the courage to phase out these subsidies."

Considering that an election looms, however, Allawi is not seriously contemplating doing away with the fuel or food programs. As a senior U.S. adviser says with a shrug, "The food program is going fine, but it's got to go away in the long run. It's not a sustainable program at $3.5 billion a year. But it's feeding everybody, so you can't just stop it overnight." **ii**