

**Remarks by Mr. Adil Abdul Mahdi
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It is an honor and a pleasure to address the American Enterprise Institute.

Today marks nearly the endpoint of a very busy and fruitful week for Iraq's delegation to the annual meetings of the World Bank and International Monetary Fund. This week has afforded to me and other members of the Iraqi delegation the opportunity to renew contacts with old friends, both individual and institutional, and to make new ones.

It was my privilege this week to take up the role of Iraq's Governor to the World Bank and participate in the deliberations of that institution. And I was pleased when my colleague, Central Bank Governor Sinan al-Shabibi, assumed the role of Iraq's Governor to the International Monetary Fund. As you know, official relations between Iraq and the international financial institutions were interrupted for more than two decades -- so I was proud for my country that, this week, Iraq took additional and important steps towards full re-integration in the international financial community.

Such re-integration takes many dimensions. One of the most important dimensions occurred on Wednesday, September 29, when the IMF Executive Board approved Emergency Post-Conflict Assistance (EPCA) for Iraq. At one level, that approval re-confirmed and deepened Iraq's relations with the IMF. But in a broader sense, the decision of the Executive Board, representing the IMF's 184 member

countries, marked an endorsement of the economic and financial path that Iraq has charted for itself.

Today I would like to talk to you about the specific economic initiatives and developments in Iraq that made it possible to conclude an assistance package with the IMF and, more broadly, are transforming my country. Taken together, the initiatives and reforms that make up Iraq's economic program constitute one of the main pillars of the new life and institutions that we are building in Iraq.

I would also like to talk to you today about another crucial dimension to Iraq's full re-integration in the international financial community -- the conclusion of an international agreement on the reduction of Iraq's external debt. In particular, I would like to discuss why deep debt reduction is essential to achieving both the economic and broader political and security objectives to which Iraq and its partners are committed.

Current Economic Picture

The main features of Iraq's current economic picture include, you may be surprised to hear, a number of positive elements: a sound macroeconomic framework; robust economic activity; and a good start on a broad range of structural and legal reforms that are critical to making the transition from a centralized economy to an economy based on private ownership, open markets, transparency, and the rule of law.

There are, of course, a number of very real economic problems and challenges. Chief among them are high unemployment, a large number of state-owned enterprises, an infrastructure that, despite improvements, is in need of further repair, and, as I will discuss later, a very large overhang of foreign debt. These economic issues are, in turn,

part of a broader picture that includes political and security challenges. We are in the midst of preparing for elections, which can be a contentious process. And we are fighting, every day, against insurgents and foreign terrorists who seek to undermine everything we are trying to achieve.

These challenges have not deterred us, however, from moving forward with our economic reform program. Let me describe the main elements of that program – noting what we have achieved thus far and what remains to be done.

Macroeconomy

One of the most important accomplishments in Iraq since the end of the conflict – and one you do not read about in the papers -- is the stabilization of the economy inherited from the Saddam regime and the establishment of a sound macro-economic framework. Given the economic mismanagement of the Saddam era, Iraq's post-war economy could have been characterized by a collapse of the currency, by hyper-inflation and by widespread tensions, if not chaos, borne of fears of an economic meltdown. Instead, Iraq enjoys overall macro-economic stability, which is the basis on which all else having to do with the economy rests. Consumer prices have been broadly stable this year, and the exchange rate has remained largely unchanged in active trading. Thanks in part to this stable macroeconomic environment, growth is expected to be about 50 percent in 2004, despite the difficult security environment.

The sound macro environment is the result of a number of crucial reforms and initiatives. In the monetary area, the introduction of a new currency has brought confidence and facilitated the day-to-day transactions of Iraq's 25 million citizens. A new central bank law provides for the independence and accountability of the Central

Bank of Iraq and prohibits the Central Bank from extending credit to the government. I am happy to report that the Central Bank, which was once a part of the Finance Ministry, is no longer the lender of first resort.

Monetary policy has focused on maintaining price stability in the context of a stable exchange rate. The Central Bank conducts daily foreign exchange auctions to limit the impact on money growth from oil export earnings. New monetary policy tools are being created to give us more and better-tailored options for managing liquidity, including a lender-of-last resort and overnight facilities, adjustments to reserve requirements, and a T-bill market. The Ministry of Finance recently introduced regular treasury bill auctions, and we intend to develop a secondary market that will facilitate open market operations by the Central Bank. This demonstrates that there is extensive domestic savings in Iraq, a factor fundamental to growth and investment. The T-bill market will also help banks manage their liquidity, which in turn will support much needed intermediation.

Economic Activity

The main driver of Iraq's economy is, of course, oil production, which constitutes more than 75 percent of total economic activity. By September of this year, oil production had risen to 2.4 million barrels per day (mbpd) and exports were up to 1.7 mbpd, although production and export levels continue to fluctuate due to sabotage and deteriorated infrastructure. Oil production is expected to average slightly more than 2 mbpd in 2004, and exports about 1.5 mbpd.

Non-oil economic activity has been recovering, driven mainly by commercial and reconstruction activities. Despite the security environment, retail commercial activity

continues to be brisk, and there appears to be a revival in the agriculture sector. The streets and bazaars are filled with all kinds of goods. Many of those goods are imported, reflecting robust trade relations with Iraq's immediate neighbors and other members of the international community. Trade has been facilitated by a sweeping reform of Iraq's trade regime. Imports are subject to a single, flat import duty of five percent. And the creation of institutions such as the Trade Bank of Iraq has spurred trade and helped support reconstruction efforts. To date the Trade Bank of Iraq, which involves the participation of a consortium of international banks, has issued letters of credit with a total value of well over \$1 billion. To strengthen Iraq's integration in the international trade community, Iraq is actively pursuing membership in the World Trade Organization and recently achieved observer status.

Structural Reforms

Iraq has taken some important steps to emerge from a legacy of statist controls, price distortions, and government ownership. Interest rates have been fully liberalized. A new foreign direct investment law provides national treatment for foreign investors and allows foreign ownership in all sectors of the economy except natural resources, real estate and insurance. The banking sector has been the focus of much investor interest, both domestic and foreign, thanks in part to the passage of modern commercial banking law in October of last year and the opening of the financial sector to foreign banks. Four foreign banks have been licensed to operate in Iraq, and domestic entities have shown strong interest in applying for banking licenses. With the increase in banking activity, the Central Bank has taken steps to strengthen its ability to evaluate applications, and to

monitor and regulate banking operations. We have also taken steps to require commercial banks to strengthen their capital base.

A Look Ahead

The steps I have just described helped make it possible for the IMF's membership to provide emergency post-conflict assistance. The IMF's support, as well as other assistance we are receiving from the international community, will, in turn, help us to deepen and strengthen the economic reform program we have undertaken. Let me describe the main things on the horizon, particularly in the areas of fiscal policy, further structural reform, and debt relief.

Fiscal Policy

Achieving a sustainable fiscal position is one of my top priorities. High costs for reconstruction and security, combined with fluctuating revenues from the oil sector, make this a challenging task. Among my chief concerns is the heavy dependence of the economy, and in turn the budget, on the oil sector. Iraq must avoid falling into the trap of oil dependency and instead create conditions in which a diverse and vibrant economy can flourish. We have already implemented reforms to the tax code and to customs policy that will help make Iraq a more hospitable environment for trade and business activity. Specifically, we have simplified and liberalized the trade regime – as I noted earlier there is now a flat five percent duty on imports -- and capped individual and corporate income taxes at fifteen percent.

Our efforts to create conditions for growth have been matched by steps to keep expenditures at a level that Iraq, with assistance from the international community, can

afford. We are making a special effort to keep recurrent expenditures in check in order to ensure fiscal balance in the coming years. In this regard, we are committed to limiting the wage and pension bill and eliminating off-budget expenditures.

We are also taking steps to strengthen the infrastructure of sound fiscal policy – the laws and management systems that underpin the budget. Increasing transparency is a crucial part of our effort. This year, for the first time in decades, the Ministry of Finance published its federal budget. This is a practice I intend to keep. We have also adopted a Financial Management Law that establishes a framework, based on international best practice, for developing, executing, and reporting the annual budget. As part of our IMF program, we are implementing throughout the country a financial management information system, and taking steps to ensure effective metering of oil production.

Changing outdated systems and practices of budget formulation and execution, as well as economic policy management more broadly, will take time, but we are committed to this.

Further Structural Reforms

Creating the conditions that support job creation, private-sector led growth, and fiscal soundness requires that Iraq push ahead with structural reforms. Two of the most important and politically difficult challenges are to unwind Iraq's energy and food subsidies, while ensuring support for the most needy, and to reduce the presence of state-owned enterprises. Domestic prices for oil products are well below international and regional standards. Our goal is to bring domestic energy prices up to a level where costs

are recovered. Towards that goal, by the end of this year Iraq will reduce subsidies on a range of oil products, including gasoline.

Regarding food subsidies, Iraq continues to operate a food rationing system as part of the social safety net. We intend to move from a food-based system to a cash distribution system that is targeted at the poor. Monetizing the ration system will support the revitalization of the agricultural sector and open new opportunities for the private sector while continuing to provide for the needs of the poorest sectors of society.

We will also be analyzing the viability of state-owned enterprises to determine how to deal with each entity. In the financial sector, we are focusing our efforts on adopting a plan for restructuring and streamlining Iraq's state-owned banks. Iraq's two state-owned commercial banks – Rafidain and Rasheed bank – currently account for nearly 90 percent of total banking assets, and their extensive network of branches constitutes the main banking presence throughout the country. At the same time, Iraq's private banking sector is enjoying a renaissance. As I noted earlier, both foreign and domestic entities have shown keen interest in obtaining licenses to operate in Iraq. It will be important to restructure the state-owned banks in a way that supports the continued development of a robust private banking sector.

Debt Relief

I would like to conclude with some remarks on one of the most pressing issues facing Iraq -- its staggering external debt burden. Deep reduction of Iraq's external debt is essential. Iraq's economy has great potential if it can be unchained from the constraints that hold it back. Some of those constraints are internal and, to a greater or

lesser extent, within Iraq's control. The economic reforms that I have described will go a long way towards removing the burdens imposed by poor policies, outdated institutional practices, structural rigidities, and other legacies of Iraq's statist past.

But these reforms will not suffice. In order for Iraq's economy to attract the kind of investment needed for sustained growth, in order for Iraq's authorities to maintain a fiscal regime conducive to private sector activity and investment in human capital, in order for the Iraqi people to achieve living standards that support political stability, virtually all of Iraq's debt overhang needs to be eliminated.

I do not want to dwell on numbers or percentages, but the basic numbers tell a compelling story. Iraq's external debt, \$125 billion, much of which was accumulated during the period of sanctions, represents almost six times Iraq's GDP. *Six times*. Some have spoken of eliminating half or two-thirds of Iraq's external debt. That would leave a debt burden that is still multiples of our GDP. To service such a debt burden, Iraq's financial authorities would be forced to divert funding that is desperately needed for investments in infrastructure, education, health care, and other reconstruction priorities, and would be obliged to institute a tax regime that stifles private sector activity.

I believe that part of the reason that some may be reluctant to provide deep debt reduction for Iraq is because of a misunderstanding about real living conditions in Iraq today. Some, perhaps remembering that Iraq was once one of the more prosperous countries in the Gulf, simply do not realize that Iraq's GDP per capita has fallen from \$3,200 in 1980 to less than \$1,000 today. Iraq's human indicators are on a par with some of the poorest countries in the world. In 2000, the infant mortality rate was estimated at 121 per 1,000 births and adult illiteracy at approximately 60 percent. Housing standards

are extremely poor. Providing Iraq with a “traditional” debt treatment would be tantamount to condemning Iraq to years of poverty.

Some find it hard to believe that a country with vast oil reserves could be impoverished, under any circumstances. Iraq does enjoy very significant oil reserves, but if Iraq cannot attract the investment capital needed to repair and upgrade its oil industry, then its reserves stay in the ground. Investors, especially those that need to commit capital for a significant period of time in order to see a real return on their investment, will not come to Iraq if there is a major debt overhang. These are the kinds of investors Iraq must attract if it is to transform its oil reserves into real economic assets, and to restructure and privatize its state-owned enterprises.

In closing, let me emphasize that deep debt reduction is not only very important for Iraq but will also pay returns many times over to the region and the world. An Iraq that enjoys robust and sustained economic growth, political stability, and greater integration with the international community is in everyone’s interest. I look forward to continue working towards that goal, and retain hope that the international community will continue to support Iraq in its efforts.