Economic Policy Recommendations in the Baker Report

Clark Johnson
February 8, 2007

The recommendations of the bipartisan Iraq Study Group (also called the Baker-Hamilton Commission), issued in early December 2006, have been eclipsed in public attention. Yet, the Bush Administration's intended "surge" of 21,500 additional troops to stabilize Baghdad was not rejected as an option by the ISG Report. The appointment of General Petraeus and his embrace of a clear-hold-build counterinsurgency strategy reverses the US Army's heretofore over-inclination toward offensive operations. The US Army's former dissidents are now making and implementing policy.

From the ISG Report, in the meantime, we can identify at least three policy foundations that should be in place for any counterinsurgency strategy to succeed. One is coordination with an Iraqi government that shares Coalition end goals. Based on its own public statements, and on testimony that its "benchmarks" have not been met, the current Shia sectarian-linked administration no more than partially shares these objectives. Baghdad is rife with rumors of a possible successor administration, perhaps introduced through parliamentary recombination.

A second ISG requirement is regional diplomacy. US absence from widely-rumored Syria-Israel negotiations could result in a deal for the Golan Heights that increases Syrian latitude for intervention in Iraq. US policy not to negotiate with the anti-Taliban Iranian government strengthens the position of those in Pakistan's security apparatus who have long provided tactical support to the Taliban, while denying the US the ability to offer incentives for cooperation inside Iraq. Inside Iraq, any Shiite-led government will maintain dialog with Teheran – hence US non-participation increases odds that US interests will be short-changed.

Economic Strategy

A third requirement covers economic policy, which must be undertaken with security and diplomatic objectives in mind. In some areas the Baker Report recommendations reinforce what appeared already to be new directions in US and Coalition policy. Ministerial "capacity building" and job creation top the Report's list. The first may help to demonstrate that the Iraqi federal government is functional and efficient – thereby reinforcing military and political efforts.

Some civilians in the US Embassy have questioned the importance of job creation by citing anecdotal evidence of job-holding Iraqis who have assisted the insurgency. This unlikely conclusion is supported by the economic argument that private sector development produces wealth, which, in turn, generates demand for products and services, thereby creating employment and income. The weakness of that argument in the present context is, of course, that private sector development is now greatly constrained by a deteriorating security situation and by middle class flight. Also, security aside, private sector expansion in Iraq is hampered by inadequate development of finance, commercial law, and property rights, much more than by any potential diversion of government revenues into public jobs schemes.

The Report notes that deBaathification, as implemented, forced politically neutral "technocrats" out of the government, and should be reversed It adds that an oil law should ensure population-adjusted distribution of oil export revenues. The ISG recommends that US outlays for economic assistance to Iraq should be increased to USD 5 B annually, rather than allowed to diminish. It also notes that reconstruction efforts have been badly managed, and that coordination among US departments and agencies has been ineffective. These observations are not original, but are surely accurate – in any event, a new person (Ambassador Tim Carney) has since been put in charge of the overall reconstruction in Iraq, which will perhaps bring some improvement.

The Baker Report is wide of the mark with other recommendations. These bear note because they offer prestigious support in favor of policies on fuel price decontrol and monetary policy that are at best not very relevant, and at worst are likely to be damaging. The Commission also neglects items that should be included in an economic agenda for Iraq.

Fuel Price Adjustments

Iraq's refineries are antiquated and have been poorly maintained, hence a third or more of domestic fuel consumption must be imported. At present, fuel importation is a state monopoly. Fuel prices have long been controlled – for both domestic and imported product – and direct or indirect subsidies for fuel consumption comprise from 15 to 25 percent of Iraq's GDP. The Baker Report joins the IMF in arguing for gradually raising official prices for domestically refined fuel, while granting licenses to private firms to import fuel, which they would be authorized to sell at market prices.

A budget-driven decision in late 2005 to reduce official importation of refined fuel led immediately to shortages and to a burgeoning black market distribution. Black market prices by mid-2006 were often higher than world market price levels, and obtaining fuel required often dangerous waits in hours-long queues. An Iraq Central Statistics study showed that typical Iraqi families were spending more than 40 percent of income on fuel. As crude oil prices were by then in the USD 70/ barrel range, the Ministry of Finance became flush with revenues. It soon after elected to resume official fuel imports, thereby alleviating market distress, but at per month budget costs of several hundred million dollars.

As the Baker Report notes, to attract private sector fuel imports would require authorization to sell them in Iraq at market prices. Even if the IMF price increases are implemented in full, however, prices for domestically produced fuel will remain below world market levels. Hence, the Report implicitly endorses a dual price structure, one for domestic produce and a second for imports. Yet introducing a separate price structure will mean uncertainty, black market competition, and the need to set up separate distribution stations. In Iraq's current market, imports-only service stations would be easy to identify, and might become targets for violent attack. Also, pricing at or near world market levels for imports would introduce politically sensitive distribution questions, and would cause hardship for many Iraqis.

What is just as clear, but not emphasized in the Baker Report, is that private enterprises will not build domestic refineries where end-prices for fuel are well below prices for imported fuel. Under such conditions, it would be more profitable for them to import. Also, it would not be effective to privatize state-owned refineries as long as a two-tier price structure prevents market level pricing of output.

In part because of the complications that would result from introducing a two-tier market, Iraqi officials have hesitated to open the domestic fuel markets to private sector imports.
In concept, fuel price reform thus requires both a unified price, close to the world level, and a mechanism for moderating the impact of higher prices on users. Iraqis might accomplish both by

1. setting an administered price for all fuel products, high enough to attract imports and encourage domestic production; and
2. then introducing an expanded coupon system to provide discounts on fuel purchases to all families, and to enterprises on a size-linked basis.

All Iraqi families would obtain discount coupons; those consuming relatively little fuel could sell unused coupons to families consuming more, thereby providing a subsidy offsetting much of the costs resulting from the higher unified fuel price.

The budget cost of providing the coupons would be more than offset by revenues obtained from higher consumer prices on domestically produced fuel. Government fuel imports would be eliminated as private firms might then import to a more stable domestic market. Following this model, fuel markets could be allowed to work, while equity concerns could be addressed. Foreign advisors have been slow to advise Iraqis to create a unified price structure – but without it we are unlikely to see many imports, or many privately built refineries. The Baker Report misses a good opportunity to endorse a unified fuel price and a coupon system.

The ISG also leaves the impression that the Iraqi government lacks capacity to implement or manage a nationwide coupon system (the Report argues that “there is no institution in Iraq at present that could implement an [oil dividend] distribution system,” which would involve similar scope.) This is misleading -- Iraq has provided monthly food rations to most of its population since the United Nations Oil for Food program was established in 1995. Since April 2003, the Ministry of Trade has used the food ration distribution system to distribute checks, in one instance for Eid bonuses, in another as compensation for undelivered food. Government checks were delivered through food agents, which were then cashed by designated branches of state-owned banks. Similar mechanisms could be used to distribute fuel coupons.

Monetary issues

Dinar prices have risen sharply during the past year – at an average rate of over 60 percent from December 2005 to December 2006, according to a source at the Central Bank (CBI). Core inflation, which does not include food and fuel prices, is estimated to have risen a less alarming 31 percent. The ISG Report urges that bank rate and exchange rate policy be deployed to suppress inflation.

CBI is not able to respond to inflationary pressures the way central banks typically do. Neither bank rate, nor discount facilities, nor open market operations are likely to be effective in Iraq’s market. Iraq’s commercial banks are now highly liquid, with only slightly more than 10 percent of the sectoral balance sheet loaned to the private sector – hence, they do not need to borrow to meet reserve requirements. Selling government securities to the banking sector would drain some of the latter's cash; but that would affect little, as much of the loose cash now sits in CBI deposit facilities. Moving the bank balances from deposit at CBI to placement in government securities would have almost no impact on lending to the private sector, or on price pressures.

The only effective policy instrument CBI now has is control of the dinar exchange rate. A higher dinar exchange tends to lower dinar prices, while a lower dinar exchange does the reverse. Until November 2006, however, CBI's approximate dollar peg in its daily foreign exchange "auctions" meant that it acted much like a currency board, and did not manage the exchange rate to counter higher prices. It bought any dinars offered to it at a set price. Under a currency board, the quantity of domestic money rises only as it is backed by growing international reserves. When the currency-holding public sells dinars to purchase dollars, CBI lacks capacity to offset such transactions through expansionary bank rate or open market policies.

The Baker Commission, following earlier advice from the IMF, recommended raising overnight bank rate to 20 percent and revaluing the dinar by 10 percent. CBI implemented both prior to issue of the ISG Report in early December 2006, and both have done damage.

A higher CBI borrowing rate counters inflation through the mechanism of slowing the pace of commercial bank lending. As explained above, however, commercial banks are not constrained by the need to borrow to meet reserve requirements. Total bank lending to the Iraqi private sector is now around ID 1 T, or about USD 800 million, a rather small amount in an economy with a GDP in 2006 projected at USD 47 B.[1] The source of the current inflation in Iraq has little to do with over-heated bank lending, hence the IMF-Baker Commission advice misses the point. But raising the overnight bank rate to 20 percent has shifted large amounts of commercial bank cash to the CBI deposit facility.

Consistent with the IMF/ Baker Commission advice, by January 2007, the dinar was revalued by more than 10 percent, from about 1470 to the dollar to about 1250. But exchange rate appreciation seeks a monetary solution to a problem with non-monetary roots. Cheaper imports will tend to discourage domestic production of food and non-food items. Also, we do not really know what the price structure inside Iraq will be as price decontrol moves forward. Higher internal prices may at some point be too high to sustain in any event – hence a deliberate revaluation might have to be reversed later.

Even more serious, currency appreciation (or even public discussion of appreciation) creates uncertainty about the future international value of the dinar, which obstructs development of the financial system. The Ministry of Finance and CBI now issue bills with maturities ranging from three months to one year toward the goal of creating short-term debt markets. Secondary markets hardly exist. Neither domestic nor foreign investors have any confidence that exchange value will be maintained, or that markets will be liquid.

---

[1] IMF, *First and Second Reviews Under the Stand-By Arrangement*, IMF Country Report 06/301, August 2006, Table 1, p. 16.

In mid-2006, CBI bills yielded about 7 ½ percent, that is, they were priced off parallel dollar treasury bills, but with a risk premium of something over 2 percent. They did not reflect inflation expectations in Iraq. This implicit integration into regional and dollar-area debt markets was a large, usually un-remarked advance for a country that had been isolated for decades, and should have been encouraged. By January of 2007, however, CBI bills were no longer priced off US treasuries, but instead off CBI deposit rates in the vicinity of 20 percent. Whatever integration into world financial markets during more than two years of a dollar peg was rapidly lost as the dinar was de-coupled from the dollar.

It would be better to address Iraq's inflation through different measures – more cogent price decontrol strategy; restraining increases in public salaries and pensions; addressing specific areas of shortage, including fuel and cement. Building deeper debt markets would enable the CBI to deploy other policy instruments, hence to behave more like other central banks. It would enable Iraqi policy to target domestic price stability without abandoning the external stability that was achieved earlier.

A final thought here is that the Iraqis would do well to join the Gulf Council Countries (GCC) effort to reach currency union by 2010. All six GCC currencies are now fixed to the dollar – although they have recently considered a joint revaluation. Most GCC countries are large exporters of oil or natural gas, hence they tend to experience common inflationary or deflationary pressures. Were Iraq, against the analysis offered here, to revalue the dinar, its financial isolation would be less were appreciation to take place in step with other GCC countries, rather than alone.

Neglected Reforms

The Coalition's reconstruction agenda has in some cases been driven by maximalist goals that parallel the Bush Administration's intention to use the invasion and occupation of Iraq as a lever to achieve political and diplomatic transformation of the Middle East. The military outcome of the 2003 invasion was taken for granted, hence, it was assumed, economic reconstruction would not have to support military operations. Privatization of state owned enterprises (SOE's), monetization of food ration entitlements, and reduction of fuel subsidies were front and center in Coalition planning. And with one administrative order, the Coalition moved Iraq from being a protected, semi-autarchic economy to one where goods could be imported with near-zero tariffs and little control of standards. All of these initiatives were understood as essential to the long-term market-based development of Iraq – but they were not the kinds of things that would generate public approval for the occupiers, or support a counterinsurgency strategy in the short-term. As the Baker Commission calls for scaling back of political and diplomatic objectives, it is surprising that it says nothing about adjusting any of these rather maximal economic policy goals.

The Report might have suggested guidance on how best to sequence reforms. Privatization of SOE's is pointless without prior imposition of hard budget constraints and decontrol of energy and other input prices. Absent such preconditions, privatized companies behave much the way state-owned companies do. Further, arguments for privatization depend on having a business environment in which enterprise assets can be bought, sold, and recombined – in other words, they assume fairly robust finance and commercial law. In the meantime, efforts should be made to improve bookkeeping and accounting, which will facilitate the transition to operating under hard budget constraints, and finally to privatization. Also, SOE's should be encouraged to bid for government contracts.

Turning to trade policy, the ISG might have noted that simply opening borders will not give impetus to economic development. Details of how business is done inside Iraq are crucial. Where market signals inside the borders are muffled by subsidies, price controls, or distorted financial systems, then domestic industry will find it difficult to adjust to challenges from foreign competitors. Also, where the financial system is as weak as it now is in Iraq, enterprises are highly dependent on self-finance through retained earnings – and cutting tariffs to close to zero reduces income, compounding the blockage to private sector adjustment. Better policy would propose a WTO-compatible bargain: gain support for internal liberalization in exchange for temporary imposition of border tariffs.

The Baker Report might have embraced use of development zones to jump-start commercial activities. Areas where the Iraq business environment is weakest include the regulatory burden, corruption, rule of law, and physical infrastructure. All of these are easier to address inside defined areas than for the country at large. For example, a zone operator will have an incentive to address regulatory and legal enforcement issues in order to attract foreign or domestic investors. Electricity can be provided through dedicated generators long before the national grid is restored to capacity.

Ironically, given its focus on privatization of enterprises, the US Embassy has had almost nothing to say about legal extension of property rights that would increase private sector ownership of land. (I am aware of two contractor studies that draw attention to the matter.) Most agricultural land is owned by government, hence few farmers have other than some variety of use right. Further complicating matters is that titles are typically held jointly, involving dozens or hundred of heirs. In urban areas, outright ownership of land and buildings is more common, but such freehold title also is often held jointly. Such property is difficult to mortgage, because there is no straightforward legal procedure for obligating joint title holders who might be recalcitrant or hard to locate.

Nearly every discussion about industrial, commercial, or agricultural expansion in Iraq stumbles over the hard constraint of inadequate finance. Part of the problem, of course, is that ongoing war and security concerns raise the risks of lending. Advisors at the US Embassy have focused on training commercial bankers in cash-flow based lending to boost industrial finance, and on farmer cooperatives and government lending arrangements to boost agricultural finance. The limitation of these approaches is that they do not make use of property systems that can convert work and savings into potentially enormous amounts of capital. In an oil-based economy like Iraq's, asset-based lending is the only source of capital that can offer more than small-scale alternatives to government controlled finance drawing on oil revenues.

Expanding property rights automatically decentralizes economic control and decision making – without which private sector development is nearly certain to be stunted. In private discussions, a number of senior or former senior Iraqi officials have expressed interest in extending legal property rights, and they hoped Coalition advisors would offer some support. Such reforms could provide both for combination of joint title possession into corporation forms and for conversion of use or lease rights into outright ownership.

One senses that ISG members got most of their input about reconstruction from those now involved directly or indirectly in setting economic policy in Iraq. This would explain why the Report neglects any mention of creating a legal property system – yet here is an area where empowerment of new property holders could come fairly quickly, thereby boosting economic performance and demonstrating that the government could institute substantial change.

Conclusions

The Baker Commission recommendations for economic policy -- just as their proposals for political, diplomatic and military policy -- intend to focus on basics, and draw back from the Bush Administration's earlier maximalist goals.

The Report is right to make fuel price reform a priority, but does not explain that adequate reform requires a unified price system, and that the Iraqi government is unlikely to implement it without a mechanism to address hardship.

The Report repeats an IMF recommendation that bank rate be used to combat inflation – but this misses the point, as inflation in Iraq has very little to do with excessive bank lending.

The Report also reiterates an IMF recommendation that the dinar be revalued to combat inflation. Revaluation might in fact reduce inflation, but at a cost of de-linking the dinar's value from regional currencies and from the dollar, and thereby deferring development of Iraq's debt markets.

Maximalist goals for economic development might be best scaled-back through considering the appropriate sequence of reforms, particularly regarding privatization of state enterprises and of trade.

The Baker Report neglects any mention of property rights, which might play a large role in boosting access to finance, and in enhancing government legitimacy.

Clark Johnson has been an economic advisor in Iraq.