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Fortune

July 7, 2003

SECTION: FEATURES; Pg. 64

LENGTH: 2797 words

HEADLINE: Making Iraq Safe For Capitalism;
Can a U.S. Treasury team build a free-market economy in a war-torn
land?

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BODY:

The bank manager in the backseat of the SUV nervously toys with his prayer beads. Eminem is blaring on the stereo. The captain climbs in and lowers the volume. "Hey, media's choice, sir," the corporal at the wheel protests. Ahead the Humvees are purring, their roof-mounted M-249 machine guns locked and loaded. Behind us are four white armored trucks holding \$ 23 million in cold, hard cash. It's 10 A.M. in Baghdad, and Iraq's equivalent of the money train is ready to roll.

It has taken almost two hours to load the money from the vaults of a bank in the affluent neighborhood of al-Mansur. The cash is stuffed in canvas bags and wrapped in plastic bricks--\$ 12 million in small U.S. bills, mostly from the Federal Reserve Bank of New York, and \$ 11 million in Iraqi dinars. An Englishman, thin and pale and wearing a white straw hat, monitors the workers hauling the sacks on their backs. "They have a tendency to talk if you leave them," he says.

That's Jacob Nell, an Oxford-educated expert in budget forecasting. A former advisor to British Prime Minister Tony Blair, he was sent to Iraq to help formulate economic policy, but there's no data available to crunch. So he's figuring out how to best stack money inside a truck. Nell has been in Baghdad only six days, but he is already a grizzled veteran of currency transfers. He frets about the time. The cash has a long way to travel. From the bank, the convoy will escort the money to Baghdad International Airport, a perilous 40-minute drive along a road notorious for attacks against American troops. There it will be placed aboard Army helicopters, which will fly the money to Mosul and Kirkuk, where it will be used to pay government workers their April salaries, already two months late, along with a \$ 30 emergency payment.

Such a transfer might be accomplished with a few deft keystrokes in the U.S. Here the process is a logistical nightmare--slow, cumbersome, and fraught with danger. In short, it's a perfect metaphor for the challenges facing America's grand project to rebuild Iraq's moribund economy. At the center of the effort is a small team of officials from the U.S. Treasury Department. Their mission is not only to reverse the damage from three weeks of war and the month of looting that followed but also to erase the effects of 12 years of economic sanctions and 30 years of inefficient state planning and chronic underinvestment.

As with most other aspects of America's postwar governance of Iraq, inadequate security, nonexistent telecommunications, and abysmal working conditions have hamstrung economic reconstruction. The Treasury team has struggled to perform basic steps, such as finding new office space for the Ministry of Finance and meeting government payrolls. At the same time, it is advancing an ambitious political agenda that envisions Iraq as a capitalist phoenix, emerging from the ashes of war with a fully formed free-market economy in 18 months. Given the slow pace of progress so far, that timetable looks increasingly unrealistic.

The stakes are enormous: It's not just the fate of Iraq's 23 million people but the stability of the entire region that's in play. Blessed with the world's second-largest proven oil reserves and equipped with a skilled workforce, Iraq could become an economic dynamo. But first the U.S. must figure out how to get Iraq's anarchic banking system on its feet and stabilize its currency. Then it must revamp the legal system, decontrol prices without causing inflation, and figure out the best way to privatize Iraq's state-owned enterprises—everything from banks to cigarette factories.

Trying to do too much too quickly could be disastrous. The unemployment rate is a staggering 38%, yet efficiency measures might put more people out of work. Some Iraqis say they need protection from foreign competition in order to catch up, yet moving too slowly could lead to economic stagnation. It's a political tightrope, and the U.S. hasn't yet found its balance.

Iraq's economy was once a model for developing nations in the Middle East. Buoyed by oil revenue, per capita income doubled during the 1970s. But the Stalinist system imposed by Saddam Hussein, along with spending for a nine-year war with Iran, sent the country into a tailspin. The 1991 Gulf war and more than a decade of economic sanctions further depressed growth. Last year Iraq's GDP was \$25 billion, according to estimates made by a Treasury team economist, one-fifth of what it was in 1979. This year it is expected to fall to about \$15 billion. And while Iraq may soon be generating \$ 18 billion in annual oil revenues, rebuilding its infrastructure is expected to cost three times that amount. What's more, Iraq is burdened by debt and war-reparations bills that could total as much as \$380 billion.

Those figures weigh heavily on Peter McPherson, the White House's economic point man in Iraq. A former deputy Treasury secretary, a former head of the U.S. Agency for International Development, and a former Bank of America executive, McPherson, 62, is on leave from his current job as president of Michigan State University. He's due back in East Lansing in September, so he's pushing hard to make the most of his summer abroad. He sees his mission as essential to Iraq's political as well as financial future. "There is a close relationship," he says, "between economic freedom and political freedom."

The 17 members of the Treasury team work out of a suite of tiny offices in one of Hussein's former palaces, now the seat of American power in Iraq. Despite temperatures that routinely exceed 110 degrees, only a few of the rooms have air conditioning. For weeks the crew's workspace consisted of a half-dozen laptops set up in a corner dubbed "the sweatbox." Team members slept nearby, six to a room, on cots covered

with mosquito netting. Most have since moved to air-conditioned trailers behind the palace.

Until recently the team had just three working phone lines, and they were useful only for communicating with Washington or other coalition offices. The U.S. bombed Baghdad's main telephone exchange during the war, and citywide phone service has yet to be restored. That means all contact with Iraqis must be done face to face. Treasury officials tell of exhausting mornings spent making trips across the traffic-snarled city to deliver simple messages. Just leaving the palace grounds can be complicated: American officials aren't allowed into the city without a military escort, and there haven't been enough troops to cover travel needs.

While the team is under pressure from the Bush administration to begin tackling complicated policy issues, most of its time has been spent trying to jump-start Iraq's financial system. The U.S. bombed the Ministry of Planning, and looting and arson badly damaged the Ministry of Finance and the Central Bank. One ten-story Central Bank building has been reduced to a shell of twisted metal and shattered glass. Thousands of charred dinar notes litter the main floor. Robbers attempted to break into the subterranean vaults, firing rocket-propelled grenades. They failed to blow open the safes, but a burst sewer pipe flooded the area.

Outside the Central Bank on al-Rasheed Street, Baghdad's Wall Street, the directors of a government-owned bank attempt to hold a board meeting at a long table placed in the middle of the road. Forty of the bank's branches have been looted or damaged, and only three are open for business. A crowd gathers around the table, interrupting the meeting to get forms signed and hectoring the directors with complaints. Disgusted, an Iraqi woman approaches Rex Pendleton, the bank's Treasury advisor, and tells him that the street isn't a suitable place for a board meeting. "I know," Pendleton says, "but it's the best we can do right now."

The scene at the temporary Ministry of Finance is even more bizarre. The ministry is being run out of a house that once served as the administrative offices for Iraq's duty-free zones. Upstairs, a narrow corridor is jammed with workers looking to get paid. Newspaper vendors and a man hawking rolls from a tray balanced on his head wend their way through the throng. The interim minister, Muhana Jassim al-Batat, huddles with his advisors in a windowless room. Some of those gathered outside his door loudly denounce him as a member of Saddam's Baath Party and an embezzler, charges he denies. One day officials from a local branch of the Hawza, a Shiite religious order, burst into his office and threaten to take over the building.

In order to build a free-market economy, McPherson must unravel what he calls Hussein's "pathological" economic system. In most Western economies prices float freely and wages are subsidized if necessary through welfare or tax programs. In Iraq the opposite is true. Wages are extremely low compared with other nations, but prices are subsidized by the state. You can't remove price controls in one sector without also increasing wages, raising the specter of an inflationary spiral.

During the embargo years, Iraq's inflation rate sometimes hit 1,000% annually, as Hussein simply printed more money to meet expenses. No one expects a return to that kind of hyperinflation, and McPherson thinks inflation can be limited to a one-time spike if Iraq's budget remains balanced. But the Treasury team doesn't have a firm read on the inflation rate, making baseline comparisons difficult.

The team isn't only short on data. It can't focus on long-term planning because more immediate problems keep cropping up. Consider the volatile behavior of Iraq's currency. Since the war, the dinar-dollar exchange rate has been swinging wildly, bouncing as much as 40% in a single day. That means workers' purchasing power is in flux. Because the Central Bank isn't operating, the exchange rate has been set by street-corner moneychangers, some of whom the U.S. suspects are linked to organized-crime groups. What is clear is that the market lacks depth and can easily be manipulated by small groups of traders. "Let's just say Jay Gould would do well here," McPherson says.

Stabilizing the currency won't be easy. Saddam's son Qusay removed about \$1 billion from the Central Bank's vault. (American forces have since recovered \$950 million, but the money has yet to be returned to the bank.) Another \$1.1 billion in Central Bank deposits were frozen in the U.S. during the sanctions regime and are now being used to pay for Iraq's reconstruction. That leaves the Central Bank with only \$ 350 million in reserves, far short of the \$2 billion or more it needs. "You can't support the currency with \$350 million," says Leonard Lapidus, the Treasury official advising Iraq's Central Bank.

Another unexpected speed bump: the loss of confidence in the 10,000-dinar note. The purple and yellow bills, worth about \$ 7 each, are the main denomination used to pay Iraqi civil servants. But they are considered easy to counterfeit, and few merchants will accept them. Moneychangers are happy to take them--in exchange for 7,000 dinars. The coalition has attempted to reassure Iraqis that the notes will be honored as legal tender, but the message hasn't gotten through. So the Treasury team came up with a plan to print more 250-dinar notes--even though they bear Hussein's picture--and offer them in exchange for the larger bills.

Ultimately the U.S. would like to see Iraq adopt a new currency--one without Hussein's mug on it. One team member says Washington has made new money such a high priority it has begun leaning on Treasury economists to produce data that exaggerates the danger of hyperinflation. That's because under the laws governing its occupation, the U.S. is only supposed to take steps necessary for the welfare of the Iraqi people. McPherson says no one is being pressured to manipulate data. But he says the volatile currency is hurting Iraqi businesses and "people's energies have become disproportionately focused" on the exchange rate as a sign of economic and political health.

Another pressing concern is unemployment. Disbanding the military and the Ministry of Information put tens of thousands of Iraqis out of work. McPherson hopes some of them will be able to find temporary jobs rebuilding Iraq's infrastructure. But longer term he has to find ways to stimulate Iraq's private sector. To that end, the Treasury team is contacting banks willing to set up a trade-credit facility with Iraq's

Central Bank. It has also suspended tariffs and customs duties on most items until at least January.

With help from the Treasury team, ministries have begun paying back wages to public employees. They have also started drafting budgets. Gone are programs like those that bought fleets of new cars each year to reward employees. But it's not clear how Iraq will generate enough revenue to support itself during the next six months. "It's a flat EKG at the moment," says Ralph Laws, a Treasury budget advisor. "There is no normal activity. Taxes are not being collected. Companies are not operating."

As if performing open-heart surgery on Iraq's economy is not enough, McPherson also wants to give the country's financial system a radical face-lift. His makeover list: revamp the banking system, modernize the stock exchange, privatize industries, and open the country to foreign investment. But he is well aware that many Iraqis are fearful of such changes. Auctioning state-owned industries now would amount to selling at a market bottom, as Iraqi assets are unlikely to ever be worth less than they are today. At the same time, Iraqis are unlikely to ever be as poor as they are now, so unless restrictions are put in place, state-owned companies will likely end up in foreign hands.

McPherson argues that if privatization doesn't occur soon state-owned entities will form a powerful lobby against ever doing it. "If you don't do enough to create a political constituency for privatization now," he says, "then it will get killed in the cradle." But many, including some of McPherson's own team, worry that talk of free-market reform is premature. "These discussions are about ten to 12 months too early," says one team member. "You have to focus on the plumbing--the basic infrastructure--first." Another accuses McPherson of believing in an "ideological nirvana." He says key decisions, such as the governance of the Central Bank, should be left to a future Iraqi government.

McPherson bristles at those criticisms. Basic reconstruction and longer-term planning must proceed simultaneously, he says. Some decisions will be deferred until a new government is formed, but "the reality is that we are here and we have the responsibility to make this work for the betterment of the Iraqi people."

There's something else going on here. In its efforts to rebuild Iraq, the Bush administration wants to see points on the board. And right now there's nothing up there. There's no government. There's precious little economic activity. And every day resentment toward America grows. If things don't change fast, the White House's Iraq strategy will be in jeopardy. "There's a political environment in which we have to operate here," says George Wolfe, the U.S. Treasury's deputy general counsel who is helping supervise the team. "We need to move faster than would normally be the case."

So far, through Herculean efforts, the team has made some small improvements. The salary structure is fairer, and banking is more transparent. But the distance between this and McPherson's vision of a thriving, Western-style market system seems almost as great as it was the day the war ended. Bridging that gap will take patience, perhaps more than Bush administration has. It took eight years to rebuild the

economies of Germany and Japan after World War II—far longer than a summer sabbatical.

Sitting alone at his desk, one of the few pieces of furniture that wasn't looted from Baghdad University's department of business administration, Thamar al-Bakri, the department chairman, expresses the sentiments of many Iraqis. "We are a rich country," he says. "We have oil. We have an educated workforce. We are capable of innovation. Right now the situation is very dark. But if the Americans give us security and stability, then I think I can start to see light ahead."

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GRAPHIC: COLOR PHOTO: PHOTOGRAPHS BY TERU KUWAYAMA--CORBIS, A U.S. soldier patrols the looted lobby of a Central Bank building in Baghdad.; THREE COLOR PHOTOS: PHOTOGRAPHS BY TERU KUWAYAMA--CORBIS, Clockwise from top: Iraqi pensioners wait for \$40 payouts in Baghdad; a burned-out Central Bank building; Treasury team leader Peter McPherson works in his makeshift office in a former presidential palace.

LOAD-DATE: June 23, 2003