



## **BUILDING A MARKET ECONOMY IN IRAQ**

[Paper for CASE seminar on October 17, 2003]

The purpose of this paper is to discuss basic preconditions of market-oriented reforms in Iraq related to liberalization of domestic market and freeing prices. This is a modified fragment of a larger memo prepared under the World Bank sponsored project on 'Iraq - Price Liberalization and Transition from the Oil for Food Program'. The content of this note reflects Author's personal knowledge and opinions and not necessarily those of the World Bank, CASE and other institutions, which Author is associated with.

In Section 1 I will give a general characteristics of Iraqi economic system and address the issue of relevance of post-communist transition experience to economic and political challenges faced by today's Iraq. Section 2 contains an analysis of the existing system of price control, its subsidization, administrative rationing of goods, and their economic, social and political consequences. In Section 3 I discuss importance of early comprehensive price liberalization, its possible scenarios and timetable. As price liberalization may have substantial consequences for inflation, budget, population's living standard and financial sustainability of enterprise sector and cannot be isolated from other policy reforms, Section 3 analyzes the directions of accompanying measures in the sphere of trade, social, fiscal and monetary policies.

The findings and proposals presented in this note have a preliminary character and will be subject of further discussion and verification. In particular, they may suffer from a very limited factual and statistical information on Iraqi economy, non-transparent fiscal accounts and dynamically changing current political and economic situation.

### **1. The economic legacy of Saddam regime: how much Iraq is different from Eastern Europe after collapse of communism?**

Decades of 'socialist' and etatist experiments of the Baath Party regime together with subsequent wars and consequences of UN sanctions left Iraqi economy heavily damaged, distorted and exposed to administrative and political interference. As the complex characteristics of the economic system, which Iraq has inherited from the Saddam era goes obviously beyond the agenda of this short paper I will concentrate on domestic market mechanism distortions caused by a far-going interventionism and protectionism.

The highly authoritarian and repressive character of the Saddam regime, dominant 'socialist' ideology, and a large role of state-owned sector, central planning and

administrative intervention into economic life suggests analogy with the historic experience of the Soviet/ communist system. And indeed such a comparison has become a quite popular intellectual exercise recently. It has a certain rationale: in both cases the reform agenda involves a double fundamental transition from a long-lasting authoritarian regime and centrally planned economy to democracy and market. It is worth to remember, however, that past experience of any single country or group of countries has only a limited relevance in preparing a new diagnosis and policy recommendations in other country, particularly located in another region and representing another historical and economic background. Such an experience may serve as the helpful benchmark for comparison but cannot be automatically transferred without taking into consideration the local specific.

Coming back to comparison of post-Saddam Iraq with post-communist counties in the beginning of 1990s one should notice two important differences. On the one hand, the internal political and public security situation of today Iraq seems to be much more complicated than that of most of the former communist countries with few exceptions such as the former Yugoslavia (apart from Slovenia), Transcaucasus or Tajikistan. On the positive side, in spite of far-going state interventionism and etatism Iraqi economy under Saddam regime remained privately owned and privately run to extent, which could not be observed in any former communist country. Most of small and medium sized enterprises have been remained privately owned, market-determined prices have played a bigger role and memory of less distorted market economy has remained in people's minds. There is also a considerable number of Western-trained people among civil servants, top management and university lecturers.

The above means that carrying out purely economic reforms should be much easier in Iraq than it was in Eastern Europe and former USSR in 1990s unless political and security situation in Iraq will go completely out of control (Although one should remember that there is two-side dependence here: the political stability also depends strongly on results of economic reforms). The key sector of Iraqi economy (oil production and processing) is internationally competitive and can provide budget with substantial revenues in the near future. Although some structural adjustment following price and trade liberalization can be economically and socially painful (especially in non-oil and non-energy SOE sector), Iraq does not face the danger of deep and prolonged output decline experienced, for example, in Albania, Bulgaria, Ukraine, Russia or other ex-USSR countries unless military conflict will physically disrupt production capacities.

There is no problem of creating a basic market infrastructure of small and medium size private firms, their expected market reactions, market incentives and behavior of most of population. Its adaptation capacities, economic flexibility and market-oriented culture seems to be much greater than in the case of *homo sovieticus*.

In spite of the above differences Iraq face a similar reform agenda to that experienced in Eastern Europe and former Soviet Union. The basic reform package should include liberalization of prices and markets, opening up the economy to external competition, privatization of SOEs, guaranteeing a stable currency, balancing a budget, and deep reform of state institutions and legal system. And all these reforms should be launched quickly, in a complex, comprehensive and consequent way. Otherwise, a reform momentum can be lost for many years and special interest groups built around intermediate (palliative) solutions and source of rent created by them can block and distort effectively further reform attempts.

One also should remember about very limited institutional capacity of the state undergoing a difficult transition process. Thus, a simple solutions limiting government intervention rather than sophisticated fine-tuning arrangements requiring stable, well-controlled and efficient administrative apparatus have chance to work in such an environment.

## 2. Price control and price distortions

Contrary to most of the former communist countries at the beginning of their transition to market economy the role of free prices and market mechanism in Iraq seems to be bigger. However, a substantial part of market transactions is carried out at administratively determined and heavily distorted prices. This relates to at least five groups of goods and services: (1) the basket of basic food and cosmetic products, (2) oil products, (3) electricity tariffs, (4) tariffs on services of some other utilities, and (5) some input prices in state owned enterprises (SOE).

### 2.1. Basket of basic food and cosmetic products

Administratively set prices relate only to the part of consumer goods and to the extent they are quantitatively rationed. Beyond the strictly defined quantity norm per capita (being the subject of coupon rationing) the same products are traded freely at market-determined prices. Of course, prices on parallel market can serve as the only very rough estimation of price-equilibrium level because the large quantities of rationed distribution at the artificially low prices distort both demand and supply functions.

The rationing system was established on September 1, 1990, just after Iraqi invasion of Kuwait and imposition the UN sanctions against Iraq. The basic basket of rationed goods currently includes: 9 kg of wheat flour, 3 kg of rice, 2 kg of sugar, 0.2 kg of tea, 1.5 liter of vegetable oil, 1 kg of dried whole milk, 1.5 kg of dried beans, 0.15 kg of iodized salt, 0.25 kg of soap and 0.5 kg of detergents (all quantities relate to a monthly norm per capita). Children below 1 year age get cosmetics and baby food. The price of the monthly ration is 250 Iraqi dinars (ID) per one person (of which ID 50 is the price of flour and ID 200 of remaining products) while its 'parallel market' value amounts to ca. ID 6,000 (estimation of July 2003 for one adult person)<sup>1</sup>. The difference is equal to the equivalent of roughly US\$3.5 at the current free-market exchange rate (ca. 1,700 ID per 1 US\$).

Most of deliveries comes from the import organized under the UN Oil for Food Program (OFP). So the cost of subsidization of the basic basket of rationed goods is not reflected directly in the state budget.

As any rationing system also the Iraqi system involves a lot of waste and inefficiencies. Although advocates of this system claim that it guarantees a basic food security of the country and allows for wholesale import of cheaper food (than in the case of decentralized private import)<sup>2</sup> this should be put against huge administrative costs of operating this systems both international (3 percent operating costs collected by the UN agencies) and domestic. The latter consists of thousands of employees of Ministry of Trade involved in distributing individual food coupons<sup>3</sup> plus some thousands private retail shops around the country being in charge of registering coupons and selling rationed products.

In addition, consumer choice has become limited. In spite of different consumer needs and tastes people have been forced to buy the same quantities of low-quality products. Many of them cash these products immediately, selling them on parallel market, or use them for feeding animals.

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<sup>1</sup> See Faik Ali Abdul-Rasool 'Iraq: Transition to Market Economy from Low Cost, Subsidies, Food, Oil Products, Electricity', mimeo, October 2003.

<sup>2</sup> This not necessarily must be true. There are anecdotal stories about over-invoicing import contracts under OFP due to corruption, incompetence, or in order to facilitate capital flight.

<sup>3</sup> In Northern provinces the UN World Food Program and regional authorities are directly in charge of operating this system.

## 2.2. Oil products

Price control covers all major oil products such as gasoline, diesel fuel, kerosene, heating oil, and cooking gas (propane). All these items are heavily underpriced, comparing to other countries in the region. For example, the official price of standard gasoline is 20 ID (ca. US\$ 0.01) per 1 liter while in Qatar it amounts to US\$ 0.16, in Kuwait – US\$ 0.20, in Bahrain – US\$ 0.21, UAE – US\$ 0.22, Libya – US\$ 0.23, Saudi Arabia – US\$ 0.24, Algeria – 0.26, Egypt – US\$ 0.27 and Syria – US\$ 0.40<sup>4</sup>, not saying about the US or Europe. Other oil products are subject of similar differences.

The above comparison illustrates not only a scale of relative underpricing (even comparing to oil-producing neighboring countries) but also room for a cross-border price arbitrage. This is exactly what has happened after collapse of the Saddam regime. When Iraqi border became open for ordinary people a massive outflow of oil products has started<sup>5</sup>. Consequently, it damaged domestic market equilibrium: shortages, long lines in front of gasoline stations and parallel black market (with prices exceeding at least ten times the official ones) became widespread<sup>6</sup>. Gasoline shortages and black market provoked, in turn, social unrest in many Iraqi cities and deteriorated country's security situation.

On the paper, production of oil refineries remains profitable. However, they are supplied with a crude oil at the price of 40 ID (ca. US cents 2) for one barrel, i.e. almost for free. They used heavily underpriced electricity (see below). One can also doubt if other costs are really included and correctly accounted. This relates, for example, to costs of using natural resources, environmental costs, depreciation of fixed assets, artificially overvalued exchange rate (100 ID per 1 US\$) used in the case of oil equipment and spare parts import under the OFP. In addition, excise tax on oil products is rather symbolic and does not constitute a significant source of budget revenues. Again, these indirect subsidies are not reflected in the state budget.

As result of absence of proper cost accounting and UN, subsequent military conflicts and UN sanctions the whole oil sector has been heavily decapitalized and its production capacity has gradually decreased over the decade of 1990s.

## 2.3. Electricity tariffs

Electricity tariffs do not guarantee even formal profitability of a power industry in spite of extremely low fuel prices (oil and natural gas), low or zero effective depreciation rates of machine and equipment, symbolic prices for use of land, water and other resources, and overvalued exchange rate used for import of spare parts under the OFP. The officially-recorded average costs of production of 1 kwh increased from 1.408 in 1999 to 2.457 ID in 2001 while the average weighted price of 1 kwh amounts to 2.422 ID<sup>7</sup>. As the state budget did not provide explicit subsidies to electricity industry one can say about various forms of implicit subsidies (through underpriced inputs, OFP transactions and multiple exchange rate system), cross-subsidization (between various groups of consumers) and technical degradation of production capacities.

As in the case of oil products the average price of 1 kwh in Iraq (equivalent of some 0.14 US cent) is many times lower than in other Arab countries: 2.3 cents in Egypt, 3.2. in Sudan, 3.5 in Jordan, 5.3 cents in Lebanon, 6.1 in Libya, and 6.7 in Tunisia.

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<sup>4</sup> Abdul-Rasool, p.37, Table 5.

<sup>5</sup> According to anecdotal evidence cross-border smuggling of oil products took place also under the Saddam dictatorship. However, it had probably a more 'organized' character in the sense that it was controlled by regime's political structures and served going around UN sanctions.

<sup>6</sup> It is fair to admit that shortages on an oil-products market have been observed in the past either.

<sup>7</sup> Abdul-Rasool, p. 24, table 4.

In addition, electricity tariffs are internally heavily distorted in a way typical for many command economies what means that they involve a lot of cross-subsidization. First, households pay relatively much less than the commercial users in industry, agriculture and service sectors. Second, the tariff for households has a strongly progressive construction what reflects a desire to subsidize poorer groups of population on the one hand, and limit a consumer demand for electricity on the other (or extract revenues from the most wealthy group of population). Third, a similar progression relates to the so-called commercial users, i.e. enterprises in service sector and small or medium-size firms in manufacturing industry. Historically, it probably reflected the regime's attempt to provide small business with certain economic preferences for political reason.

At least from the time of 1991 Gulf War, country has experienced acute shortages of electricity supply. In summer 2003 the deficit of power generating capacity has been estimated of at least 3,000 MW, i.e. approximately half of the peak demand<sup>8</sup>. As reconstruction of the Iraqi economy will progress, this gap can increase even further. Thus, the power industry needs a huge reconstruction and investment effort and prices guaranteeing at least a cost-recovery level.

#### **2.4. Other tariffs**

The fourth group contains housing rents, transportation, telecommunication, water supply and other similar tariffs. The lack of detail information about costs structure of these industries does not allow making any deeper diagnosis at the moment. However, it seems obvious that at least telecommunication and water supply tariffs are heavily underpriced and need a serious correction, particularly in the situation when both sector are heavily damaged and needs huge investments.

#### **2.5. Producer prices**

According to anecdotal evidence prices in SOE sector are set on a cost-plus basis, thus guaranteeing its formal profitability. However, many important inputs (oil products, electricity, water, transportation, raw material and spare parts imported under the OFP) are artificially underpriced and probably cost accounting rules differ significantly from international standards. It is unclear to what extent pricing decisions in SOE sector remain under administrative control and which concrete forms of this control are used in practice.

#### **2.6. Multiple exchange rates**

In addition, similarly to other centrally-planned and closed economies Iraq used a system of multiple exchange rates, mostly to subsidize indirectly the preferred import. The full historical record of this practices is not known at the moment. Anecdotal evidence tells about exchange rate varying between 3.2 US\$ per 1 ID (financing costs of official trips abroad and some import transactions) to ca. 2,000-3,000 ID per 1 US\$ (black-market exchange rate in years 2000-2002). Most of these artificial exchange rates is already gone at least regarding the current foreign exchange transactions. The artificially overvalued exchange rates (like 100 or 75 ID per 1 US\$) are probably still used for accounting purposes in the case of centralized import conducted under the OFP.

#### **2.7. Summary**

Summing up, the scope of direct price interference on food and other consumer goods market in Iraq seems to be a bit smaller comparing to former communist countries and has character of social benefit in-kind package rather than price control per se.

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<sup>8</sup> See "United Nations / World Bank Joint Iraq Needs Assessment", October 2003, p. 28-29, [http://Inweb18.worldbank.org/mna/mena.nsf/Attachments/Iraq+Joint+Needs+Assessment/\\$File/Joint+Needs+Assessment.pdf](http://Inweb18.worldbank.org/mna/mena.nsf/Attachments/Iraq+Joint+Needs+Assessment/$File/Joint+Needs+Assessment.pdf)

However, an important role played in Iraqi economy by oil products and electricity means that the overall structure of prices is heavily distorted.

Most of subsidization has not been explicitly reflected in a budget. Instead, subsidies were provided in various indirect ways: through a multiple exchange rate system, transactions under the OFP, underpricing basic resources (oil industry, water supply), cross-subsidization inside individual industries (the case of electricity tariffs), and government investment programs.

### **3. How to liberalize/ adjust prices in Iraq?**

#### **3.1. Arguments in favor of price liberalization**

Free prices reflecting relative scarcity of goods and services and their full production costs constitute a basic precondition of a normally functioning market economy. Continuing a status quo for a longer period of time involves a lot of economic and non-economic risk. At least four of them should be mentioned:

1. Large-scale price control and food rationing requires a tough enforcement mechanism and effective administrative apparatus. It is why such a system can work quite well in totalitarian states where all levels and branches of government are expected to follow closely instructions of a central authority. In the case of Iraq the rationing system was administered by the Ministry of Trade territorial offices and backed by the Baath Party and large-scale security and repression apparatus. In addition, Iraqi people could not travel freely abroad and numerous restrictions on economic and trade activities were in place. All these factors limited opportunity of system erosion and undesired market arbitrage. Now the totalitarian system is gone and people get back their basic freedoms. Iraqi borders are open. In addition, central government has become seriously weakened. It is very unlikely that it will regain its position until the new constitution will be adopted and free democratic election to national parliament will be organized. In the meantime, one can expect a fast erosion of the existing food distribution system and administrative capacity to control effectively prices in other spheres (for example, on the oil product market).
2. It is unlikely that the current system can be continued without increasing pressure on consolidated budget as keeping artificially low prices/ tariffs will hamper prospects of rehabilitation of the key Iraqi industries such as oil sector, energy generation and distribution, water supply and telecommunication. Inflation even if stays at low two-digit level will contribute to further erosion of the current administrative prices. Consequently, sectors affected by low administrative prices will not have room to self-finance its reconstruction and development and private investors will not be interested to engage their resources. Scarce budget resources and foreign official aid will remain the only potential sources. In addition, public investment projects in these sectors will involve serious microeconomic flaws: (i) they will be probably less efficient than their private alternatives; (ii) they will contribute to expansion of public ownership and SOE sector instead of promoting private sector development.
3. Continuing the current system of price control and administrative rationing will create serious obstacles to private sector development. This will work through various channels. First, any private entrepreneur prefers to work in sector or industry where she/he is free to negotiate prices of her/his products/ services with purchasers. Second, food rationing at the artificially low prices dampens agriculture production, food industry and development of trade and services related to agriculture/ food sector. Third, low administrative prices on oil products

and low electricity tariffs will discourage foreign investors from putting their money into these important sectors of the Iraqi economy. Fourth, retaining current price distortions (particularly underpriced energy) will issue a wrong signal to potential investors exposing them to a risk of miscalculations of future profits and losses. Fifth, fiscal or quasi-fiscal consequences of continuing status quo will contribute *ceteris paribus* to either higher taxation or crowding out expenditures important for private sector development (for example, infrastructure rehabilitation projects).

4. Limited consumer choice, low quality of distributed goods, market shortages, lines in front of shops/ gasoline stations, spontaneous market arbitrage (speculation), corruption and other abuses are unavoidably connected with any system of price control and administrative rationing, particularly in the environment of a weak state. These phenomena must lead to an increasing social unrest and political instability eroding the credibility of CPA and its ability to control economic and political developments in Iraq.

Thus, price liberalization should be considered as one of the most urgent tasks in programming economic reforms in Iraq.

### **3.2. Fast versus slow liberalization**

Any price liberalization or administrative price adjustment is socially unpopular and politically costly. Even if goods/ services priced administratively are not available to ordinary citizen and, therefore, social benefits of price control are fictitious, many people, and certainly politicians, prefer to keep these illusions. A wide-scale price liberalization itself also involves significant risks, especially if taken in soft macroeconomic environment characterized, for example, by a large fiscal imbalance, accommodative monetary policy, accumulated monetary overhang, and automatic wage/income indexation. Looking historically, large-scale price liberalization in former communist countries always caused at least a substantial 'corrective' inflation. If economic policy did not manage to provide sufficiently hard macroeconomic constraints at the onset of price liberalization, country usually entered a period of high inflation or even hyperinflation (Poland in 1989, Bulgaria and Romania in 1990, Russia and other CIS countries in 1992-1994). In addition, removing price distortions may change significantly income distribution and put a pressure on the potentially loss-making enterprises, subsidized so far by the underpriced inputs.

All these risks make politicians and policymakers reluctant to undertake price liberalization at all or think about dividing this operation into several stages in order to minimize social costs and economic and political risks. However, the belief that 'cutting cat's tie step-by-step instead of one-off move' minimizes various costs and risks is wrong for many reasons. At least some of them require a closer attention:

1. Liberalizing prices step-by-step increases very often at least temporarily price distortions instead of mitigating them. In particular, it relates to situation when prices for some goods and services are liberalized and others are not. If prices of basic inputs are liberalized and prices of final goods are still kept under control it increases subsidization needs of the latter. If the opposite happens producer of final goods/ services enjoys windfall profits which can be considered by them as the permanent ones. In turn, this can create a powerful constituency against next stages of liberalization of prices of the primary or intermediary goods/ services.
2. Gradual price liberalization leads to higher inflationary expectations, higher money velocity and danger of chronic inflationary inertia. It also provokes excessive demand for certain products, sometimes market panics, speculative storage of goods, etc. The same happens when plans of price liberalization become a subject

of public debate or consultation (examples of Poland in 1981, 1987 and 1989, and the former Soviet Union in 1989-1990).

3. Macroeconomic and social consequences of price liberalization are generally very difficult to be simulated because of unknown supply and demand function for individual goods and services, potential substitution effect, direct and indirect costs of administrative distribution, and various consumption models. Such an exercise is even more difficult in the case of Iraqi economy, lacking in elementary statistical data and research, for example, household survey (the recent one done in 1980s). However, this kind of exercise will not be necessarily easier in the case of gradual liberalization. One may expect that some contradicting effects of a one big operation will neutralize each other. Paradoxically, estimation of social compensations needed in the case of a one-off operation can be easier than when dividing such an operation into several smaller steps.
4. From a political economy point of view gradual liberalization does not minimize its unpopularity. On the contrary, political pain must be repeated several times and positive economic and social effects of liberalization (non-distorted prices, better consumer market, better incentives to private sector) will be certainly delayed and somehow diluted. Each subsequent step will become a subject of new social complains and political bargaining, leading very often to an even slower pace of liberalization than originally planned as well as to overcompensation of its expected income consequences what, in turn, will increase probability of its inflationary effect. Sometimes it can lead to losing the existing political window of opportunity to carry out a comprehensive reform.

The experience of transition countries generally confirms advantage of one-off liberalization (or at least of series of liberalization steps concentrated in the relatively short period) over 'gradualism'. In fact, only two countries, former GDR (in July 1990) and former Czechoslovakia (in January 1991) avoided large-scale inflationary shocks while both conducted a comprehensive price liberalization<sup>9</sup> virtually overnight but in a very tight monetary environment. Most of countries where price liberalization was conducted gradually (apart from Hungary) experienced substantial and long-lasting inflationary effects, price and income distortions, and significant fiscal losses. This was in line with more general observation that fast, radical and comprehensive reforms in economic and institutional sphere helped to achieve better transition results than gradual and compromise ones<sup>10</sup>.

### 3.3. Possible scenarios of price liberalization in Iraq

Taking into consideration the advantages of fast and complex price liberalization discussed in the previous subsection, it makes sense to think about one operation involving:

- elimination of price control and rationing of food and other products constituting a basic consumer basket;
- liberalization of prices of oil products;
- adjustment of electricity tariffs to the level guaranteeing at least full cost recovery in this industry and changes in their internal structure according to its microeconomic logic;

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<sup>9</sup> In addition, the initial scope of price control and scale of price distortions in both countries was much bigger than in the case of Iraq.

<sup>10</sup> For deeper empirical evidence see, for example, *Transition. The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union*, The World Bank, 2002.

- adjustment of other tariffs (like transport, telecommunication, water supply) in the same way as electricity; and
- abandoning of all remaining multiple exchange rate practices and legalizing convertibility of the Iraqi dinar at least for the purpose of current account transactions.

The above package should not wait too long to be implemented for the reasons described in subsections 3.1. and 3.2. Furthermore, termination of OFP in November 2003 according to Resolution No. 1483 of the UN Security Council will create another good reason to change radically the existing pricing and distribution system.

According to the available information and consumer market evidence Iraq does not face the danger of food shortage or food crisis. One can expect that basic food prices will not increase above the current free (parallel) market level unless some additional money supply or income policy impulse will push aggregate demand up. Moreover, taking into consideration the logic of rationing system (forced substitution) its abandoning and freeing prices may even cause a some decrease in free-market prices as result of modifying the demand function.

Nevertheless, in order to be sure that nothing unexpected will happen the remaining OFP import contracts of food supply (which probably will be delivered at least until mid-2004) should serve as the kind of 'strategic reserve' guaranteeing food-market stability. This means, however, that internal distribution system of centrally imported food will have to be changed radically. Instead of distributing food through a coupon rationing, Ministry of Trade should organize regional food auctions for private food traders, smoothing potential price fluctuation in a transition period (until deliveries under OFP will be terminated completely).

What concerns oil products the existence of several refineries should give an opportunity to create a competitive market relatively quickly. The after-liberalization market equilibrium prices will be probably a bit lower than in neighboring countries taking into consideration abundant domestic supply and limited technical export opportunities. The part of additional revenues of oil companies and refineries should be extracted for budget purposes in the form of increased excise tax (or rent tax on natural resources).

The scale of necessary tariff adjustment in electricity, telecommunication and other utilities sectors will depend on independent assessment of their actual costs of production and reconstruction needs, including a second-round effect coming from liberalization of oil prices.

While there is no big sense to divide food price liberalization into stages (it will only make this operation technically and politically much more complicated – see above) one can think about certain 'gradualism' related to oil products, electricity and other basic services. Going in this direction, a few stages of administrative price adjustment would replace one-off liberalization of oil-product market with price deregulation coming only at the very end of this process. However, one must keep in mind possible negative consequences of gradual adjustment elaborated in the previous subsection.

#### **4. Accompanying measures**

As it was said before, any price liberalization cannot be isolated from other policies that will eventually determine either success or failure of price deregulation itself. For purpose of this memo I will mention shortly about three of them: income compensation and its fiscal consequences, monetary policy, and trade policy.

#### 4.1. Income compensations

At first glance, cash compensation seems to be the most natural way of neutralizing social pain and political risk connected with negative income consequences of price liberalization and price adjustment. In the case of currently rationed food basket estimating such compensation would be technically relatively easy. It would not be so easy, however, to assess social consequences of increased oil, electricity and other utilities prices as consumption of these products and services is strongly differentiated and there are various second- or third-round effects in other sectors. Making everybody happy would need a huge aggregate overcompensation with its obvious negative fiscal and inflationary effects.

However, even an (only) 100% compensation is not desirable. In macroeconomic terms, the full compensation means no positive fiscal effect (while any projection of current and future consolidated budget shows a serious deficit<sup>11</sup>) and significant increase of aggregate demand leading to a risk of a second-round inflationary effect. In terms of expenditure allocation it is probably more desirable to redirect part of saved money for rehabilitation/ investment projects or for increasing salaries of public employees (and improving their structure) than organize a full-scale compensation system. In addition, such a system would be technically very difficult to operate (and, therefore, very costly), especially taking into account the lack of the banking payment system in Iraq and necessity to carry out all operations in cash.

In this situation cash compensations could be limited only to pensioners and other existing beneficiaries of social transfers in the form of higher pensions/ benefits. In the medium-to-long-term perspective there is necessary to think about creating a system of more targeted social assistance addressed to the most vulnerable groups of Iraqi population.

Private and public enterprise sector and self-employed people should absorb income effects of price liberalization by adjusting a market-determined wages, salaries or individual income. Salary reform accepted in September 2003 and coming into force on October 1, 2003<sup>12</sup> provides a significant increase in remuneration of many categories of public employees. If necessary, a further wage adjustment should be granted them in this way rather than through building any extra compensation system.

#### 4.2. Monetary policy

Any price liberalization must be secured by a tight monetary policy in order to keep aggregate demand under control and avoid a second-round inflationary effect. The problem with Iraq is that this country does not have any clear concept of monetary policy yet. The so-called 'monetary reform', which starts on October 15, 2003<sup>13</sup> does not reserve this term because it is a purely technical operation of exchanging banknotes conducted for both political (removing from them the face of Saddam Hussein) and operational reasons (introducing banknotes with higher nominal value and better protection against counterfeiting). It does not address a more fundamental problems such as high inflation memory, lack credibility of national currency and extensive spontaneous dollarization. In fact, this operation can have a negative impact on inflationary expectations in the Northern part of Iraq, which has had so far its own, less inflated currency (the so-called 'Swiss' dinar). The exchange of banknotes in all the

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<sup>11</sup> See Ministry of Finance, Ministry of Planning, Coalition Provisional Authority "Republic of Iraq. Budget Revenues and Expenses. 2003 July-December", <http://www.cpa-iraq.org/budget/budget2003.html>; "UN/World Bank Present Iraq Reconstruction Needs To Core Group", World Bank News Release No: 2004/103/S.

<sup>12</sup> CPA Order No. 30 „Reform of Salaries and Employment Conditions of State Employees“, [http://www.cpa-iraq.org/regulations/20030909\\_CPAORD30.pdf](http://www.cpa-iraq.org/regulations/20030909_CPAORD30.pdf)

<sup>13</sup> See 'Iraqi Currency Exchange', <http://www.cpa-iraq.org/budget/IraqCurrencyExchange.html>

country will mean multiplying 150 times all prices, wages and other nominal values in Northern Iraq.

The conceptual framework of future monetary policy requires an urgent and complex discussion as this is extremely important issue not only from the point of view of successful price liberalization. Generally speaking, it is very unlikely to have good chances of successful sovereign monetary policy in a heavily dollarized country, which suffers a lot of political instability and uncertainty, and faces perspective of a series of very fundamental structural breaks such as price liberalization, rehabilitation of the banking system, creating a non-cash payment system. Forecasting demand for money (including its domestic currency component) in such an environment will be almost impossible. It means that much easier and safe (from the point of view of price stability) would be to think about automatic exchange-rate 'stabilizer' in the form of 'hard peg' (official dollarization or currency board) than to try manage domestic liquidity in a discretionary way.

### 4.3. Trade policy

Free import and export will help to eliminate price distortions and adjust domestic prices of tradables to their international level. In addition, duty-free import means the additional competition on a domestic market of tradable goods and services. Thus, continuing the tariff-free trade regime introduced by CPA Order 12 of June 8, 2003<sup>14</sup> until the end of 2003 would provide the additional safeguards for price liberalization, through minimizing risk of any unexpected monopolistic practices on the domestic market<sup>15</sup>. The 5% reconstruction levy introduced from January 1, 2004 by the CPA Order No. 38 of September 21, 2003<sup>16</sup> on all import other than food, medicines and medical equipment, clothing, goods imported for humanitarian, reconstruction and diplomatic purposes, coalition forces needs, and similar categories should not change dramatically the required competitive environment securing future price liberalization unless other protectionist measures will be adopted.

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<sup>14</sup> CPA Order No. 12 „Trade Liberalization Policy”, <http://www.cpa-iraq.org/regulations/CPAORD12.pdf>

<sup>15</sup> Liberal trade policy can be also beneficial for fast restructuring of the Iraqi economy and enhancing economic growth in medium- and long-term perspective – see Bartłomiej Kaminski 'Liberal Economic Regime is the Best Option for Iraq: The Foreign Trade Perspective', mimeo, October 14, 2003.

<sup>16</sup> CPA Order No. 38 „Reconstruction Levy”, [http://www.cpa-iraq.org/regulations/20030921\\_CPAORD38.pdf](http://www.cpa-iraq.org/regulations/20030921_CPAORD38.pdf)