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Driving a Dangerous Course: Economic Obstacles for Iraq's Macroeconomic Health

By the end of the year he made four times the salary I did, and it was paid for with Iraq's future. It doesn't matter if "he" is the actual contractor I spoke with. He made the typical wage for an American contractor in Iraq during 2005: over $500 a day (Murphy). These high wages are a symptom of a reconstruction that has gone off course, dangerously swerving towards mistakes the industrialized world last made nearly ninety years ago.

After the second Gulf War the Bush administration invoked the spirit of the Marshall Plan to describe the reconstruction of Iraq, however there are significant differences between the two. These differences could steer Iraq's economy close to disaster. While we've traveled a long way down this road, it's not too late to map out the obstacles ahead and plot a solid course towards a stable and reconstructed Iraq. I will look at two of the major obstacles laying in Iraq's economic path, compare them to historical situations, and offer possible routes around these dangers.

The reconstruction of Iraq is far from complete. While the Bush administration touts specific successes, bringing the entire infrastructure of the country up to speed proves to be more elusive. To complete the reconstruction of Iraq will take tens of billions of dollars. Yet Iraq's lack of basic infrastructure is holding its economy back (Daragahi, Richter, and Smith; Dreazen). Across the nation, the electricity is on for half the day or less; Baghdad has electricity for less than six hours a day (Knickmeyer). Estimates of unemployment range from 25 to 40 percent (The Brookings Institute). It's true that Iraq's revenue from oil exports was greater than the Iraqi budget predicted for 2005 (CBO; The Brookings Institute). Unfortunately, both output

and revenue from the oil industry have declined to their lowest levels since the war began (Hernandez). This shortfall is crucial; the money from the oil industry was expected to largely pay for reconstruction (Regan).

At the beginning of 2006, the Bush administration indicated that the funds pledged to rebuild Iraq would not fully materialize. As of the beginning of 2006, U.S. allies had only contributed 23% of the monies they pledged (Dreazen). Additionally, the Bush administration will not seek American funds to continue rebuilding Iraq at the end of 2006 (Goldenberg). Despite what success it's had so far, Iraq will have little choice but to turn to foreign loans from agencies like the IMF. The first loans have already been approved, and this brings us to the most obvious of our two obstacles.

At the end of World War I, the Allies had won a decisive victory over an aggressive Germany. Germany was compelled to pay massive reparations as part of the peace agreement. Observers, including the economist John Maynard Keynes could see that the debts of war and demand for reparations created their own problems. Keynes wrote that they created such a burden that events would "grow into a conflagration that may destroy much else as well" (ch. 7). This observation seems to have been fulfilled with the horrors of World War II. The sequence of events Keynes observed is not unique; there appears to be a strong link between economic and political strife (Morrison and Stevenson).

The second time that the Allies defeated Germany they did not make the same mistake. The Marshall Plan, while not consisting of grants, allowed for the "repayments" to largely be reinvested in the aided country. By helping to restore financial stability and creating an environment favorable to market forces, the Marshall Plan allowed for the GDPs of Western Europe to nearly reach 5% per annum (DeLong and Eichengreen).

In contrast, the IMF has a documented history of overstating projected growth in Latin America and elsewhere. These projections, serving as the basis for loans, had disastrous results to local economies via unbalanced debt-to-GDP ratios (Baker and Rosnick). Nicaragua provides a specific example: The economic reforms suggested by the IMF, combined with the massive burden of debt servicing, led to massively reduced social spending for education and healthcare (Casciani). By not investing in human capital, Nicaragua reduced its ability to maintain economic growth. By concentrating on short-term growth, the IMF's policies also encouraged unsustainable exploitation of natural timber resources (Montanye and Welch). These policies and their effects have led to severe economic hardship for many of Nicaragua's citizens. The IMF currently urges Nicaragua to continue focusing on good governance and reducing corruption. They state that focus "is essential to achieving strong and lasting growth and poverty alleviation" (Green). That statement seems misguided, for though reducing corruption is a worthwhile goal, there appears to be no correlation between corruption and economic growth (Sachs 191). This seems to indicate a disturbing disconnection between the IMF's recommendations and real-world results.

Iraq has already acted on the first of the IMF policy requirements, raising the internal price of oil by reducing subsidies (Zarocostas). This appears to be a policy similar to that successfully used to halt hyperinflation in Bolivia in 1985. Bolivia's hyperinflation was caused by purely monetary causes; Bolivia's central bank was literally printing money to keep the government solvent (Sachs 92). The rising gas prices increased governmental receipts, reducing the need to print money, and stabilized the hyperinflation within a week. Stopping Bolivia's hyperinflation benefited firms far more than they were hurt by the rise in oil prices. In modern Iraq, this price increase is also supposed to reduce government deficits (Zarocostas). Unlike in

Bolivia, the new Iraqi *dinar* has held relatively stable since its inception in 2004 (FXHistory). This increase in fuel prices has already begun to make business more expensive for Iraqis (Enders). Unlike Bolivia, there is not the benefit of a lower inflationary rate to offset higher fuel prices for the private sector. Iraqi businesses will certainly experience reduced productivity and run a greater risk of failing from the increased cost of doing business. This IMF-decreed policy runs a strong risk of creating a net reduction of government receipts and potentially creating inflation.

The Paris Club – a consortium of Western creditor countries – has arranged for a great deal of debt cancellation and restructuring. This step alone greatly reduces the burden on Iraq's economy. It seems paradoxical, then to put Iraq in a position where it must borrow more money to continue reconstruction. Initiating new loans will simply recreate the forgiven debt, and once again will serve as a drag on Iraq's struggling economy.

Despite the security difficulties that have slowed reconstruction to date, there are exceptionally high – and disagreeing – predictions for Iraq's growth. In 2005, Iraq's real GDP grew between 3.7% and 4%. Predictions for real GDP growth for Iraq in 2006 range from 11% by the IMF to a staggering 16.8% from officials at the U.S. Treasury (The Brookings Institute, Zarocostas).

Iraq's growth is harder to predict than most. The economic environment under Saddam was extremely different than the economic environment in 2006. Of the last four years, the GDP of two are decidedly skewed due to the effects of the war and a return to relative peacetime. Given the remainder of Iraq's recent GDPs and historical examples of other developing nations, it appears that Iraq's 4% real GDP growth of 2005 is far more likely to continue than the official projections' estimates.

These high numbers speak either of a naive optimism, or something more sinister. John Perkins asserts in his memoir that intentionally projecting unrealistically high growth was an accepted and encouraged practice for economic advisors (25-31). These inflated projections led to larger loans to developing nations. The nations would then hire the consulting and contracting firms Perkins worked for. With billions of dollars in reconstruction funds at stake in Iraq, the similarities to Perkins' memoir are impossible to ignore. Yet without a modern whistleblower, this can only be conjecture.

Even if these projections are entirely accurate, our own recent history provides a cautionary tale. In 1999 the Congressional Budget Office predicted the 2006 budget would have a US$300 billion surplus. Tax breaks aside; we are now expecting a deficit of almost US$400 billion for fiscal year 2006. If such uncertainty can strike the United States, projecting extremely high growth for Iraq is extremely risky. Iraq's future is certainly less secure than our own.

If Iraq borrows as much as it can "afford" based on these high growth rates, it runs the risk of finding itself unable to support its people due to crushing debt. This situation – referred to as "fiscal trap" by Jeffrey Sachs – can reduce an entire country to poverty in short order (59). When debt-to-GDP ratio becomes too extreme, simply servicing existing debt is enough to trap the country in poverty with no way to pull themselves out. Much like a household borrowing against a predicted raise, Iraq is borrowing against a rosy future that may never come.

Yet this is only the most obvious obstacle ahead. The second major obstacle to Iraq's macroeconomic success is created within the reconstruction effort itself. Much of the reconstruction effort has been contracted to companies based in the United States and its allies. One prior contractor spoke to me about his experiences in Iraq. He told me that while these companies do employ Iraqi nationals, they are almost always hired as unskilled labor.

Supervisory positions and jobs requiring technical skills are reserved for Americans or American expatriates. These skilled positions command a disproportionately high pay; his paycheck for a month would pay the yearly salary for 100 of his Iraqi subordinates (Anonymous Source). The BBC corroborates their experience, reporting that the average wage for jobs such as his is $550 a day (Murphy). The BBC also reports that many of the low-paying jobs also send money back out of the country, as third world workers are imported for miniscule wages (Hess). Therefore, a large amount of the money meant to be injected into Iraq's economy is instead returning to donor countries in the form of the contractors' wages.

The true danger to Iraq's economy is subtler. The contractors are neither training Iraqi nationals nor giving locals practical experience in skilled or managerial positions. This lack of investment in human capital, combined with skilled workers fleeing the violence, will leave Iraq in a precarious position (Struck). Even if the funds remain available, the local expertise to continue reconstruction – or maintain the work already done – does not exist or is rapidly leaving the country. For reconstruction to continue, further loans will have to be used to hire the same foreign companies that are currently working in Iraq. This will multiply the burden on Iraq's economy. Not only will the debt-to-GDP ratio increase, but also large amounts of that debt will not be invested in Iraq's economy, in contrast to the reinvestment of the Marshall Plan.

This kind of situation has taken place once before – during the British Raj in India. While technological advances occurred, they were for the benefit of British companies, not India. Also like American contractors today, British corporations were hesitant to train Indians or place them in management positions. The results were devastating to India's economic growth; it remained below 0.3 percent until Indian independence in 1947. The legacy of these policies haunted India's economy for decades, with per capita growth under two percent until its green

revolution in the late 1960s. It was the investment in human capital by the Indian Institutes of Technology that allowed India to leap towards sustained high economic growth in the last quarter century (Sachs 173-176).

Much as with the British Raj, American contractor's policies provide an immediate profit for themselves – and their stockholders – at the expense of the long-term stability of Iraq and all nations that rely on Middle Eastern oil. Reconstruction's current policies – though arguably for security and fiscal reasons – are ultimately adding to Iraq's problems, not solving them.

This prediction is bearish, but again the forecast of America's growth in 1999 serves as a warning. All economic predictions – including this one – are based on assumptions about trends we cannot fully model or understand. When dealing with events at the microeconomic scale, that risk is more acceptable. Any ill effects are easily mitigated and absorbed by the community at large. At a macroeconomic scale, the consequences of an overly rosy projection could be disastrous for millions – and with already promised aid not materializing, there is little hope of the international community lessening the blow of any further shocks to Iraq's economy.

The problems noted above – the methods of financing the reconstruction, and the lack of Iraqi training – will cause large difficulties for Iraq's economy unless two things happen. The expansion created by reconstruction's capital investment will need to outpace the contraction incurred by debt – a debt compounded by the need to pay foreign contractors. Secondly, Iraq will need to retain enough funds to adequately educate its citizenry or provides attractive enough options for emigration to be both desirable and safe for those emigrating.

The course of Iraq's economy can be steered away from the brink. While much of the fate of any economy rests with those who are within it, there are several concrete steps that are in the hands of the wealthy countries of the world. We can maximize the cost-to-output ratio of

contractors working in Iraq by eliminating no-bid contracts and aggressively eliminating corruption and “overcharges” by American contractors. We can reduce the drag on Iraq’s GDP by completing current plans for debt cancellation and restructuring. We can provide a true Marshall Plan to Iraq – where “repayment” is funneled back into the Iraqi infrastructure – instead of simply offering more loans. Finally, we can remember that human capital is an intrinsic part of Iraq’s infrastructure. By training Iraqi nationals and bringing them into well-paying management and skilled labor positions, they can truly take “ownership” of the reconstruction of their country.

It is in the best long-run interests of the United States for Iraq to have a healthy, self-sustaining economy. As shown with the beneficial trade with Marshall Plan recipients, helping countries make their own way up the ladder of economic development helps our own economy in the long run. As Energy Secretary Samuel Bodman made clear the day after President Bush’s 2006 State of the Union address, the United States will continue importing oil from the Middle East for the indefinite future (Hall). Given the strong correlation between ailing economies and political instabilities like civil war, strengthening Iraq’s economy is wise from both an economic and security standpoint (Collier and Hoeffler).

Ultimately, the greatest consequence of the second Gulf War will not be in how it was promoted or waged. America will not be judged by the promises of WMD, “Mission Accomplished” photo-ops, yellowcake, or intelligence failures. Above all these, our nation will be judged on how well we are able rebuild Iraq.

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