Banking on Baghdad: Financial Change in Postwar Iraq

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"There is a direct link between the Iraqi economy's capacity to recover its health and natural dynamism and the political and security situation in the country." - Mehdi al-Hafez Iraqi Minister for Planning and Development[1]

"It is most important to first build a sound economic infrastructure and legal system…But the U.S. has to do it right. The best thing is to overhaul the whole financial system. It's like when you have a house infested with termites. It's much easier to knock it down and rebuild than to keep spraying for termites and fixing the holes ." - Rubar S.Sandi, head of the U.S.-Iraq Business Council.[2]

Introduction

April 2004 represents an important milestone in Iraqi history—the one year mark after the overthrow of Saddam Hussein's Ba'athist regime. Assuming the insurrection and increased hostilities surrounding this date will abate, this represents a fitting time to assess the Iraqi government's likely strategy for restoring the country's economic health. That strategy was outlined in January 2004 by central bank governor Sinan Shabibi and finance minister Kamel Gailani. Their vision for Iraq is in accordance with the Bush Administration's neoliberal model and provides substance to some of the vague principles laid down by the Administration in the spring and summer of 2003.[3] The strategy encompasses the creation of: (a) openness and transparency of Iraq's institutions; (b) strong incentives for private sector development; (c) close economic and financial integration with the international community, (d) international standards and best practices; and (e) a social safety net that addresses the needs of all Iraqis.[4]

While many factors within this framework will play a key role in the economy's recovery, emphasis on free markets and private sector investment suggest the creation of a viable efficient financial system will be the key to the country's economic recovery. In this regard, a recent United Nations' needs assessment notes that:

With a dysfunctional financial system featuring a poorly organized regulatory framework and ineffective institutions, the task of rebuilding a sound and safe modern financial sector in Iraq is daunting. It should start with the banking sector, which is currently the essential component of the financial system and should cover the sector's legal and regulatory aspects as well as its main institutions. This would be a long term process that will require significant resources, technical as well as financial.[5]

To gauge the progress made to date in laying the foundation for the country's economic recovery, the sections below examine the main developments in the Iraqi financial system in the past year. In particular: (a) What was the condition of the banking system before March 2003? (b) What are the key institutional structures that have been put in place over the last year? and, finally (c) What are the key indicators to watch in assessing progress made at various points in the future? In this regard, because of the financial sector's links to the real economy, its success will stimulate economic growth, while in turn developments while in turn the progress made by the economy will largely determine the sector's viability—monitoring its progress will also provides a glimpse as to the state of the overall economy.

The Banking System

The banking sector in Iraq dates back to the mid-1930s. At that time, branches of foreign banks and private Iraqi banks were opened. Over time these grew as the economy expanded. However, in 1964, Iraq consolidated and nationalized private banks into what is now the Rafidain Bank, the country's largest state-owned bank. In the 1980s, the Rafidain Bank and, later a second state bank, the Rashid Bank, were profitable largely through financing the government's budget deficits. This prosperity ended when UN economic sanctions were imposed in 1990. From then until the ouster of Saddam's regime, most of the state bank's business was directed towards simply underwriting the Iraqi military and then the ruling party. The government opened its banking sector to local private banks in the early 1990s to spur business and help offset the impact of sanctions.[6]

By March 2003, the sanctions, two wars and several decades of Ba'athist rule, had left the Iraqi banking sector in complete decay. Greatly compounding the situation was the devastation inflicted on the system during the immediate post-war period. At that time, the Ministry of Finance, the Central Bank, the Baghdad Stock Exchange, and the two key state banks, Rafidain and Rashid were systematically looted, as were a number of the twenty-one smaller state-owned and private banks. The situation was so serious that even a year later there was no proper banking sector to speak of. At that time Iraq was still almost entirely a cash economy.

In reconstructing the banking system, the Coalition Provisional Authority (CPA) was confronted with a structure unlike that in many neighboring countries. In contrast to most banks in the Gulf Cooperation Council (GCC) states, recovering Iraqi banks could not count on liquidity-driven profits—very little liquidity existed. In addition, Iraqi interest rates were set at a high rate (17%) by the Central Bank. Credit demand was high, and money-lending (as opposed to other diversified non-interest incomes) was the principal source of bank income. Also in contrast with neighboring countries, there was little demand for Islamic Banking. Other than one small private bank, The Iraqi Islamic Bank for Development and Investment, Islamic banking was for all practical purposes non-existent in the country.

In March of 2003 the banking system had some US$2 billion equivalent in assets—of which over 85-90 percent was in the two state banks. These assets represented only around 8 percent of Iraq's GDP, an extremely low ratio by international standards, underscoring the marginal role played by the banking sector both as a provider of resources to the economy and as a store for national savings.[7]

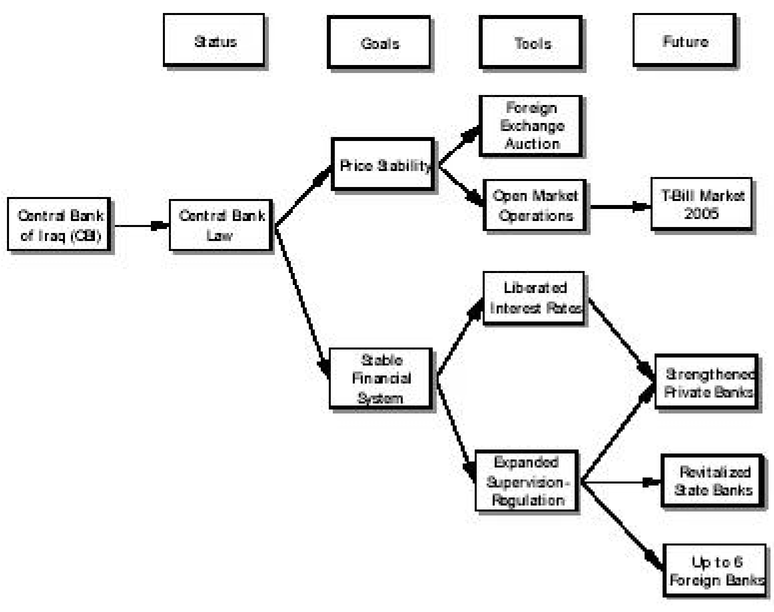
In its efforts to establish a viable banking sector, and after much study, the CPA issued Order Number 40 on September 19, 2003. Order 40, the Bank Law, defined the rules establishing and governing the new Iraqi banking system and in so doing provided a foundation for Iraq's future economic growth and development. The provisions of the Bank Law were modeled significantly after the Western approach to bank regulation. They grant the Central Bank of Iraq (CBI) full legal and operational authority. Most importantly, the Bank Law provides the Iraqi banks with the powers and authorities associated with those of modern banks operating in today's international financial system. Another notable feature of the Banking Law is the absence of any mention of traditional Islamic banking practices or activities.

The Central Bank of Iraq (CBI)

Much of the CPA's focus has been on strengthening the Central Bank of Iraq (CBI). Here, the most significant development has been the issuance of the Law to Govern the Central Bank of Iraq , which went into effect March 7, 2004.[8] In contrast to the past, the CBI is now independent of government coercion and control. Procedures are in place to assure higher levels of transparency and accountability. Most significantly, the CBI will no longer be required to lend to the various Iraqi ministries and has the authority to undertake monetary policy independently of the Finance Ministry. In sum. the Law to Govern the Central Bank of Iraq envisages a modern central bank that will bring greater price stability, foster a market-based financial system and promote sustainable growth, employment and prosperity (Figure 1). In addition, the new law empowers the CBI to:

1. Take charge of the country's monetary policy, including exchange rate policy.
2. Act as a fiscal agent of the government, performing financial operations including the issuing and redeeming of the Ministry of Finance's securities.
3. Grant government-owned commercial banks loans on the same terms as privately-owned commercial banks, and
4. License and supervise both state-owned and private commercial banks, including foreign banks.

Figure 1: Central Bank of Iraq



Consistent with the new economic philosophy of the CPA, interest rates have been liberalized (effective March 1, 2004, allowing their values to be determined by market forces.[9] As part of the September 2003 investment law, the CBI also plans to establish insurance to provide additional protection to small and medium sized depositors.

Monetary Policy

Perhaps the biggest challenge to confront the CBI is its ability to effectively conduct monetary policy. To do this, the CBI must be able to regulate either the interest rate or the quantity of money and credit in the economy. Normally, monetary policy operates through affecting the underlying demand and supply conditions in foreign exchange, money or interbank markets. Unfortunately, at the present time these markets are either non-existent or extremely underdeveloped. In early 2004:

1. There was no primary market in Iraq for government debt. Uncertainty surrounded the small secondary market in debt issued by the Hussein government. That debt may become worthless should a new government decide not to service it.
2. No functioning markets for debt or equity securities offered by the private Iraqi firms existed, although the Baghdad Stock Exchange was expected to open once new reporting and accounting standards were in place.
3. The country had no interbank market, linking banks via a payment and settlement system. The absence of an of this market made it nearly impossible for the CBI to set an effective reference interest rate or adjust the monetary base.
4. The quantity of base money could be affected only altering the amount of currency in circulation, a very inefficient process given uncertainties over the amount of outstanding currency and the demand for currency.[10]

As Steve Hanke, economics professor at Johns Hopkins University, correctly notes, until these key markets are developed, the CBI will be forced to utilize direct instruments that work through involuntary regulations.[11] He sees as likely candidates controls on banks' deposit and lending rates, as well as the use of credit floors and ceilings. Unfortunately, such involuntary restrictions are likely to impose two costs: first they will make it impossible for banks to allocate their portfolios in response to market signals. Second, the restrictions will dampen competition for deposits. The net effect will most likely retard the country's much needed financial development.

Exchange Rate Policy

As noted, without an active bond market, the CBI was forced to control the money supply (and indirectly the exchange rate) through its buying and selling of dollars. This resulted in a fairly volatile dinar/dollar rate. In fact, at one point in late 2003 the currency rallied from 2,000 dinar to the dollar to 1,400 following the phasing out of the old Saddam notes.[12] However the volatility of the exchange rate does not necessarily bode well and may well indicate speculative forces rather than market-based efficiency considerations were driving the rate. Speculation may explain the paradox of a strengthening dinar in December 2003 while prices for basic goods in Iraqi markets remained the same or rose even further.[13]

The uncertainty surrounding the volatility of the exchange rate limited to a certain extent the willingness of Iraqis to trade in their dollars for the new dinars, making CBI control of the money supply all that more difficult.

An alternative to the flexible exchange rate policy[14] might have been the adoption, at least initially, of a fixed exchange rate managed through a currency board. Postwar Bosnia and Montenegro both have stable currencies today, thanks to currency boards linked to the euro.[15] Iraq could have established one with the dinar linked to the dollar, the euro, or an index based on both. This would have required considerable hard currency reserves, perhaps unrealistic amounts under the circumstances.

Whether a fixed or the current flexible exchange rate is best for the country's reconstruction and recovery efforts depends on several factors. The recent theoretical literature has tended to focus on the goal of stabilizing output in the context of responding to shocks to the economy.[16] On the basis of this criterion, if shocks are predominantly external or real (such as terms-of-trade shocks) calling for changes in relative prices, exchange rate flexibility is desirable since it facilitates adjustments in the real exchange rate, buffeting the domestic economy.

On the other hand, if the majority of shocks affecting the economy have predominantly domestic monetary origins, a fixed exchange rate is preferable for output stabilization. Under a fixed rate the money supply becomes endogenous (with capital flowing in and out of the country) adjusting to shocks in money demand with minimal impact on output.

Several considerations determine the effectiveness of the nominal exchange rate in dealing with real shocks. As a general rule, movements in the nominal exchange rate translate into changes in the real exchange rate only if real wages are flexible and if the pass-through of exchange rate movements into domestic prices and wages are low. These are conditions likely to prevail in Iraq as reconstruction proceeds.

If wages have some degree of rigidity, the costs associated with the adoption of a fixed exchange rate are lower the more mobile labor is among regions and sectors. In addition, the cost of exchange rate rigidity is lower if the economy is well diversified, since a shock to a particular industry is less significant for overall output in a diversified economy.

On the issue of diversification, the Iraqi economy appears more suited to a flexible exchange rate. Here, terms of trade related output volatility is of great significance. Oil price increases will likely result in booms of domestic demand, increased capital inflows and investment, and real exchange rate appreciation harmful for the development of non-resource related export sectors—the Dutch disease problem.

Another factor favoring flexible rates in Iraq centers around problems likely to develop if the country pegged to the dollar or euro, currencies of net oil importers. For example, maintaining a fixed peg to the dollar would require Iraq to tie its monetary policy to that of the United States. The likely result would be interest rate movements counter to the country's best interests. During periods of oil price increases, the U.S. would likely pursue an expansionary monetary/low interest rate policy to maintain domestic demand. In this environment, just the opposite, a tight monetary/high interest policy would be best for dampening inflationary pressures in an Iraq awash with dollars.

On the other hand, many of the problems noted above associated with a fixed exchange rate can be significantly reduced by implementing a fiscal policy that smoothes demand over time. This type of fiscal policy could be implemented through the creation of an oil stabilization fund. Also, the likely flows of foreign assistance to Iraq are likely to be countercyclical to oil price movements, increasing during periods of abnormally low oil prices and falling somewhat during periods of high prices. A fixed exchange rate would limit the inflationary impact of the pass-though of exchange rate movements into domestic prices. Finally, a fixed rate might help overcome investor concerns over exchange risk. Such concerns are particularly relevant for today's Iraq. As noted above the country's underdeveloped financial markets offer few if any instruments to hedge exchange risk.

In short, there are distinct advantages to Iraq in adopting a fixed exchange rate at least until monetary institutions and associated markets are developed and efficient. Ultimately the choice of the degree of flexibility of the exchange rate regime depends on the objective function of the authorities, as regards the trade-off between the desire to dampen exchange rate volatility and to control inflation by using the exchange rate as a nominal anchor, and to reduce fluctuations in output by allowing the nominal exchange rate to absorb shocks.

As it stands the decision to proceed with a flexible exchange rate means that monetary policy must be allocated to the task of domestic stabilization with fiscal policy focused on balance of payments stability—in essence the government must rely on its weakest economic tool, monetary policy, to tackle the country's massive unemployment problem. In this environment we are likely to see fairly wide fluctuations in exchange and interest rates; hopefully these rate movements will not discourage significantly much needed private investment and foreign capital inflows.

Main Areas of Concern

Clearly the CBI faces a number of obstacles. The ability of the Bank to meet these challenges will go a long way in setting the tone for the country's financial market development and ultimately the success of reconstruction efforts. In this regard the above considerations suggest that with regard to the CBI the main issues to monitor include:

1. *Inflation rate:* Does the CBI have the tools and expertise to control the money supply? Bank deposits in foreign currencies increased by 26 percent in March 2004 compared with a year before - deposits in Iraqi dinars increased by 63 percent over same period.
2. *Fluctuations in the exchange rate:* Will they be destabilizing/disruptive?
3. *Sudden Capital Inflows:* With its existing tools, can the CBI prevent speculative bubbles? Many of the transition economies of Eastern Europe and the Former Soviet Union have experienced destabilizing surges of financial inflows and outflows . As Iraq opens its economy, will it suffer the same fate?
4. *Exchange Rate Overvaluation:* If the exchange rate becomes overvalued, will the CBI be able correct the situation? Modify the impact on private investment? - Export oriented industries may decline, intense foreign competition for many producers for the local market - the Dutch Disease effect.
5. *Regulation/Supervision:* Will it quickly develop the expertise to effectively regulate and supervise a rapidly expanding and diverse banking system?
6. *Crisis Management:* Will the bank be able to quickly put into place emergency measures for meeting the challenge to the system posed by bank failures?
7. *Capital Market Development:* Will the bank be able to work with the Ministry of Finance to develop and create an efficient bond market?

The State Banks

While Iraq's two state owned banks, Rasheed and Rafidain, control over 85 percent of banking assets (top, Figure 2), they are at best marginally capitalized and have loan portfolios with a high concentration of non-performing loans. Before March 2003, the banks clearly lacked modern comprehensive accounting standards and systems. Despite the fact that they had a large network of more than 360 branches, each branch has operated largely as an independent unit with no real centralized management or an integrated system for making and clearing payments.[18]

Developments prior to March 2003 left the state banks with a unique set of features. In contrast to their counterparts in other developing countries, Rafidain and Rasheed did not lend extensively to the corporate sector, either state owned enterprises (SOEs) or the private sector. Instead state enterprises received most of their funding through government grants and hidden subsidies. The Iraqi government, in turn, would finance itself by issuing debt in the form of Treasury bills subscribed by the banking sector - mostly Rafidain and Rasheed. As a result, Treasury bills account for about two-thirds of Rafidain's assets and fifty percent of Rasheed's portfolio.[19]

At the same time, the SOEs had to place their deposits with Rafidain and Rasheed. In fact, these funds represent about half of Rafidain's toal deposits. Ironically, given the limited amount of financing extended by banks to the SOEs, the state enterprises may be in effect net creditors to Rafidain and Rasheed.[20]

Several factors are severely restraining the activities of the state banks. In particular the debt overhang and the attachment risk on assets by creditors are making it impossible for the public sector banks to perform international banking functions.[21]

Currently, the US Treasury is working with the state banks enabling them to provide better domestic services such and taking deposits, clearing checks and making loans to support business activity. There are some signs of success. For the Quarter ending November 30, 2003. Iraq's two large state-owned commercial banks Rafidain and Rasheed, extended loans totaling about $6 million primarily to small and medium enterprises.[22] This portfolio shift represents a sharp break from past practices.

Clearly, substantial and sustained restructuring of management, organization, personnel and systems is needed to make the state banks competitive, profitable and able to provide a wide array of high-quality financial services. Rafidain for example plans to lay off a third of its 7,300 employees and restructure its debt-burden balance sheet in preparation for privatization. The bank is saddled with over $20 billion of Iraq's debt. The former Iraqi government opened letters of credit through the bank that were never settled with the debt becoming technically classified as the bank's liability.

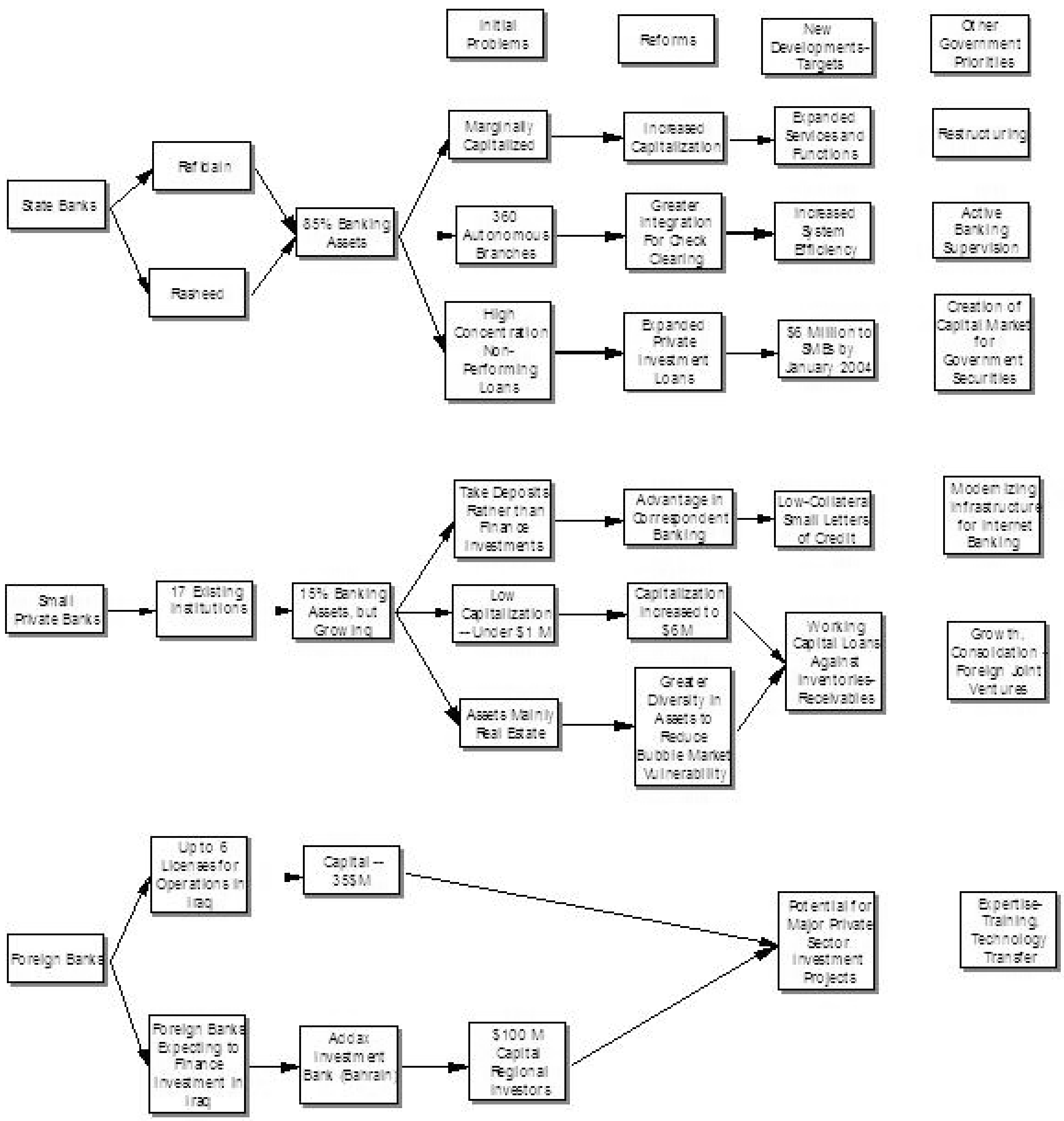
Privatization will probably entail entering into a partnership with foreign banks rather than an outright sale of assets to those institutions. The uncertainty over the future status of the bank is no doubt taking a heavy tool on employee morale and limiting bank functionality in the short-run.[23]

Private Banks

As noted above, the government opened its banking sector to local private banks (middle, Figure 2) in the early 1990s. By the year 2000 these banks had a market share of around 6.6%. Also at that time, private sector banks had a loan market share of 21% , a very high rate in light of their position in the deposit market. The credit deposit ratio for the private banks was around 52%., suggesting that for the most part, private banks were quite profitable.[24]

Still, the overall performance of these banks must be classed as unsatisfactory by just about any standard. In addition to their small share of the deposit market, private banks used antiquated technology, and could provide only very limited services to their customers. Because most Iraqis did not trust the government, they preferred to hold their deposits in banks outside the country, mainly Jordan and Lebanon.

Figure 2: Iraq: Banking System Issues



A year after the overthrow of Saddam, private banks are still suffering from a wide range of problems including the uncertain security situation in Iraq, the instability of the Iraqi dinar, and the lack of adequate capital markets. The situation is made worse by the fact that local banks have limited capital bases, limited customer reach, outdated technologies, and inadequately trained staff.[25]

Banking Law (September 2003)

As noted above, to tackle the problems of the private banks, the CPA has in addition to the Central Bank Law, introduced a new Banking Law in September 2003.[26] The Banking Law contains many provisions designed to support the development of a strong, robust banking sector. Under the Law:

1. Domestic banks are required to increase their capital to 10 billion Iraqi dinars within 18 months. This is expected to encourage consolidation and foreign investment.
2. Banks must maintain long-term capitalization consistent with international standards
3. More rigorous qualifications are set for bank licensing and for bank managers and boards of directors.
4. Foreign banks may enter the market. The legislation allows for 6 foreign banks to enter the market over the next 5 years. The Central Bank of Iraq, with assistance from CPA, will develop procedures for foreign bank licensing and for establishing representative offices.

Central Bank regulations and supervisory capabilities are being developed to support the new banking legislation.

Foreign Banks

While no doubt some of the existing private banks will evolve into fully functioning financial institutions, one of the most important aspects of the Banking Law is the opening up of the Iraqi market to foreign banks. These banks are expected to play an important role in increasing the availability of credit, providing a network of relationships to Iraq that will support economic growth, and in accelerating the process of strengthening the banking sector through competition and the transfer of technology, know-how, and best practices. Eastern European transition economy experiences with financial sector reforms show that one of the most important contributors to modernizing financial sectors is bringing in foreign banks.[27]

In January 2004, Britain's HSBC and Standard Chartered and the National Bank of Kuwait (NBK) were granted licenses and are expected to start up operations by the end of the year. They were selected from fifteen applicants which included banks from across the Middle East. The conditions for selection focused on banks with expertise outside their home country and a commitment to invest in Iraq. The three banks have each pledged to keep a minimum of $25 million in Iraq. Standard Chartered has been expanding in the Middle East, opening branches in Jordan and Lebanon in recent years and focusing on retail. HSBC, the world's second-largest bank by market value, already operates in twelveMiddle East countries. The National Bank of Kuwait is one of the largest Gulf banks. Kuwait hopes to be a base for firms eyeing Iraqi reconstruction but worried over security.

As for the future, no doubt there will be a series of mergers, with foreign banks looking at investing in the sector and financing projects (bottom, Figure 2). Some of the private banks may survive by developing special niches. Many have done well in the year following April 2003. They have made good loans secured by real estate, the price of which in Baghdad has more doubled in the last year.[28]

In spite of their small size, the private banks currently have several advantages over the two large state banks. In particular, they are less incumbered in establishing foreign correspondent banking relationships: as opposed to the state banks, they are not subject to having their foreign assets seized in any future Iraqi government debt resolution scheme. The state banks will face that risk until there is a comprehensive official rescheduling and write-down of Iraq's international debts.[29]

The Trade Bank of Iraq

While some of the private banks are beginning to supply trade financing, given their limited capacity to perform this function, the Governing Council and the CPA decided to establish a bank to facilitate the imports and exports urgently needed to support Iraq's reconstruction and the transition from the UN's Oil for food program. To this end the CPA awarded a consortium led by the US based J. P. Morgan Chase & Co the tender for operating the Trade Bank of Iraq. The Consortium consists of 13 banks representing 14 countries. The trade Bank of Iraq is planned to operate for 12 months, but may continue for another two or three years, especially if the private banks and restructured state banks are still not in a position to effectively assume this business.

Ten Signs of Progress and Concern

In judging progress in the banking area, several key developments will be of particular importance:

1. Extent to which funds are being repatriated into the banking system.
2. Speed and extent of recapitalization of the private banks
3. Progress at restructuring the state banks.
4. Extent to which foreign banks investing in joint ventures with private banks.
5. Response of savers and borrowers to interest rate changes.
6. Extent to which the state banks can expand loans for private sector investment.
7. The speed and extent of diversification of bank assets away from real estate.
8. Extent to which private bank credit fuelling the consumption boom, rather than private investment.
9. The extent to which banks can develop expertise to evaluate private investment projects.
10. Progress made in developing an efficient bond markets.

Developments that may signal the unlikelihood of the financial system evolving along projected lines:

1. A growing reliance by borrowers on microfinance administered by NGOs.
2. A limited number (well below 15) of foreign banks applying for the next round of licenses to operate in Iraq.
3. Increased pressures on the CBI from religious groups opposed to Western style banking.
4. Little or no investment in Iraq originating from foreign financial institutions/funds.
5. Erratic fluctuations in interest rates and/or the exchange rate.
6. Speculative bubbles fuelled by rapid short term capital inflows and outflows.
7. On-going inflation and the inability to develop a viable government bond market.
8. On-going bank failures.
9. Extended reliance on the Trade Bank of Iraq

Assessment

The CPA has lad a solid foundation for the creation of a modern efficient banking system. While one may quibble over such things as the desirability of fixed versus flexible exchange rates and the ability of the CBI to conduct precise monetary policy, it's hard to envision a more comprehensive set of institutional changes to the country's financial system. However, the CPA's efforts may only be a necessary but not sufficient condition for success. It is quite likely development of the banking sector, together with its contribution to investment and economic growth will be largely conditioned by developments in other areas . In particular (a) the security situation, (2) progress made in resolving the country's outstanding foreign debt, and (3) developments in the oil sector. Adverse developments in any one or more of these areas could seriously impede the development of a viable, functional banking system in Iraq.

One also senses that the system laid down by the CPA, while technically correct and efficient by Western standards, was created in something of a vacuum. There does not appear to be much give and take between the CPA and Iraqi representatives in arriving at a consensus likely to be acceptable to large segments of the local population. Islamic banking, one of the most rapid growing areas of finance in the Middle East is not even mentioned in the voluminous documents and directives released by the CPA. As a result, there is great uncertainty over the direction the system will take once an elected Iraqi government is in power. No doubt this uncertainty, in addition to the security situation, is undermining the growth and development of this critical sector. As late as March 2004 a prominent Lebanese official noted, "The country is full of opportunities, but the investment horizon is not clear yet - I don't think Lebanese banks will move to Iraq…. we don't really know what the laws are yet."[30]

In sum, what was created in Iraq is a banking system rather unique to the Middle East and one that eventually may not be accepted by the Iraqis themselves.

What any foreigners write or say is irrelevant unless the people of Iraq are involved. Most importantly, we cannot go in to Iraq and build a set of institutions that reflect American and Western European values. This will not work. The new Central Bank of Iraq will belong to the Iraqis and so they have to set it up..... We can set out a framework of principles that appear to be universal, but the details are up to the people who live there, not us.[31]

In this sense, the Iraqi banking system may be a microcosm reflecting the larger set of issues and problems now facing the United States.

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