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THE INTERNATIONAL DEBT CRISIS OF IRAQ

I. Introduction

Over the last seventeen years and primarily because of the two devastating wars Iraq fought first with Iran, and then, ten years later, with the invasion of Kuwait, the situation in Iraq has become critical. As a consequence, life in that country has deteriorated at such an incredibly rapid pace that the country as a whole is on the verge of total economic and social collapse. At the same time, Iraq faces a crippling debt burden without the prospect of any new capital inflows due to the UN sanctions. ([1])

A recent report by the New York-based Center for Economic and Social Rights (CESR) reveals that Iraq's GDP has shrunk to below 10% of its pre-1990 level. ([2]) Iraq's currency, the dinar, which was worth about US$3 before the 1991 Gulf War, plunged to its lowest level in the early days of January 1996 when it traded as low as ID3,000:US$1 on the flourishing parallel market. The implementation of the UN oil-for-food resolution, although in the short-term, may stabilize the dinar and possibly even result in some short-term appreciation; a depreciation against the US dollar is expected over 1997-98 as a whole. ([3])

The UN Food and Agriculture Organization (FAO) says that Iraqi food prices have risen more than 4,000 fold since the early 1990's.

([1]) The UN strictly enforced severe economic sanctions on Iraq when its troops invaded Kuwait in August 1990. These are still in effect in 1997. For a detailed coverage about the economic and social devastation and hardship that these sanctions have inflicted upon Iraq, see A. Alnasrawi, *The Economy of Iraq: Oil, Wars, Destruction of Development and Prospects (1950-2010)*, Westport: Greenwood Press, 1994; A. Al-Roubaie and W. Elali, "The Financial Implications of Economic Sanctions Against Iraq", *Arab Studies Quarterly*, Summer 1995, pp. 53-68; J. Dreze and H. Gazdar, "Hunger and Poverty in Iraq, 1991", *World Development*, Vol. 20, No. 7, 1992, pp. 921-945; and J. Battersby, "Saddam, Sanctions Plunge Iraq Into Irreversible Ruin", *The Christian Science Monitor*, October 30, 1995, pp. 1 & 8.

([2]) See EIU, *Country Report: Iraq*, 3rd Quarter 1996, London: The Economist Intelligence Unit Ltd., 1996, p.16.

([3]) It should be noted that the announcement of the Iraqi government on the 19th of January 1996 to consider the UN Security Council Resolution 986 (which permits the sale of US$2 billion worth of oil every six months to purchase food and medicine for Iraqi civilians) instantly raised hopes and expectations within Iraq and caused a dramatic rise in the dinar. When the two parties finally reached and signed an accord on May 20, 1996, the dinar jumped to an all new level, trading at ID450:US$1, but it subsequently had slipped back to around ID940:$1 by the end of June 1996. Since then it has even fallen further because the oil-for-food deal does not provide enough foreign currency to meet the demand driven by the increase in trading opportunities. For more details, see *ibid.*; and EIU, *Country Report: Iraq*, 1st Quarter 1997, London: The Economist Intelligence Unit Ltd., 1997.

Moreover, EIU in its latest report forecasts that Iraq's consumer price inflation will remain at around 200% throughout 1997 and 1998, as shortages in food, medicine, equipment, spare parts, and other basic supplies persist. [4]

The country's reputation as having the maximum risk rating in the world remains unchallenged. It is also experiencing nearly total political and economic isolation since its invasion of Kuwait in 1990. Living and health standards for the average Iraqi household have fallen drastically with hundreds of thousands of Iraqis malnourished, ill, or even dying from the lack of medical supplies. The education sector is also in crisis and social and family values have been greatly undermined by a wave of lawlessness, poverty, and corruption.

The unemployment rate has soared to unprecedented levels and it is not uncommon to find academics, accountants, and engineers driving cabs or selling powdered milk in the Shorje market in downtown Baghdad, having given up on their own chosen careers. Meanwhile, to make matters worse, a whole generation of professional men and women, intellectuals, artists, and writers have admitted defeat and left the country. Government corruption and bribery has almost become institutionalized from top to bottom and crime has never been so widespread. Furthermore, because of the UN oil and trade embargo, export and domestic production has collapsed and the country has lost approximately US$110 billion worth of oil revenues since its imposition in 1990. [5] This is all a clear reflection of the sad state of Iraq's economy and of the adverse impact it has had on the vast majority of the population.

The plight of Iraq has not been widely discussed or analyzed at the international level. During the 1980s until now, the World Bank, the IMF, and other multilateral institutions have produced almost no reports that diagnose Iraq's financial and economic crisis in great detail. These

(4) This is primarily because of the limited scope of the oil-for-food agreement, which will fail to solve the fundamental problems of a devastated economy and of a population impoverished by two successive wars and seven years of economic sanctions. For more details, see *ibid*.

(5) Oil is the mainstay of Iraq's economy and today only limited sales are carried out to Jordan, Turkey, and Iran through smuggling. This is a very small amount compared to the country's huge oil export capacity of more than 3 million barrels per day worth more than US$ 15 billion per annum at a modest price of US$14 per barrel. Nevertheless, Iraq's acceptance of the UNSC Resolution 986 which allows oil to be swapped for food and medical supplies marks Baghdad's first step away from nearly total political and economic isolation since its invasion of Kuwait in August 1990. Under a memorandum of understanding signed May 20, 1996, Iraq is permitted to sell about 700,000 barrels of oil a day, well short of its pre-war production level of some 3 million barrels a day.

institutions also haven't made any serious attempts to outline or suggest any policy measures that could restore growth in Iraq and aid in its long-term development. Iraq, as well, has not mounted any serious studies or adopted any comprehensive programs to help alleviate the severity of this problem or to help it achieve any specific domestic goals and objectives associated with it. (6)

Furthermore, the limited amount of available data regarding Iraq's economic and financial position does not mean that one should minimize the seriousness of the country's present dire crisis. As a matter of fact, recent reports reveal that Iraq has definitely suffered an unprecedented and unparalleled economic and social collapse. Besides the huge economic and human losses it incurred during the two wars, Iraq also carries a debt burden of no less international significance than that of other so-called Severely Indebted Countries (SICs). (7) However, it is the latter which have consistently dominated international headlines, with little or no consideration given to Iraq.

Not only is there a great shortage of official statistics about Iraq's financial and economic problems; but, to make matters worse, opinions also differ sharply as to the cause and what should be done to help Iraq accelerate its return to a normal situation; that is, to regain normal access to the international capital markets as well as to restore growth and promote sustainable development. The United Nations Security Council (UNSC) and the international community, for example, blame Saddam Hussein's government as well as other internal factors for Iraq's poor economic performance and indebtedness. Iraq, on the other hand, regards external factors as being largely responsible for its problems.

Whatever the cause, it is generally agreed that:

(a) Iraq is experiencing a severe external debt crisis, which it cannot resolve on its own. Therefore, intensive international as well as regional efforts must be exerted in order to help get Iraq out of this crisis;

(b) Traditional methods and techniques of debt consolidation such as rescheduling, refinancing, and debt cancellation are inappropriate and of limited use in Iraq's case; and

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(6) It is interesting to note that the only official proposal about Iraq's financial difficulties was the one submitted by the Iraqi government to the UNSC on April 29,1991. This report outlined the dire financial and economic situation facing it and asked for a moratorium of at least five years on war reparation payments under the UNSC Resolution 687 (1991). See MEES, 13 May 1991, p.D6.

(7) Severely Indebted Countries (SICs) or Highly Indebted Countries (HICs) are defined as countries in which either of two key ratios are above critical levels: the present value of debt-to-GNP (80 percent), and the present value of debt-to-exports (220 percent). See World Bank, *World Debt Tables 1994-1995,* Vol. I, Washington, DC: 1994, p.46.

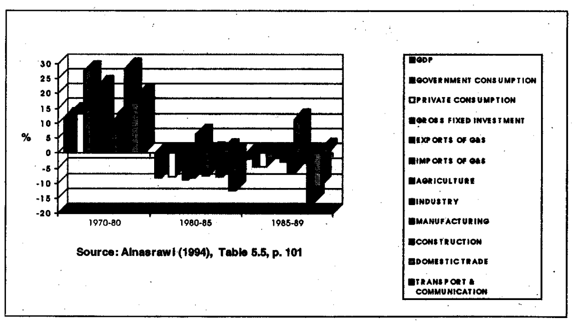
(c) Iraq needs to undertake fundamental political, social, and economic reforms, if it is to get out of debt and achieve economic recovery, stability, and long-term sustainable growth.

This paper accepts these premises and argues, first, that Iraq has to develop and implement a cohesive debt management strategy in order to get out of its present financial and economic chaos. Obviously, the absence of such a strategy prevents the country from being able to effectively control the external indebtedness and keep it at an acceptable level. The paper also affirms that a debt-equity swap program has to become an integral part of any debt management and negotiation strategy. Although not seen as a panacea for Iraq's external debt crisis, it should be considered a welcome instrument to the solution of Iraq's foreign debt problem as it would not only reduce the debt volume, but it would also enhance Iraq's creditworthiness and revitalize its economic environment at a fairly low cost.

II. The roots of the crisis

For Iraq, the 1970s can best be described as a decade of economic growth; although, it was not without serious problems. ([8]) During that decade, especially in the second half of it, almost all major economic activities and indicators witnessed a rapid and an unprecedented growth rate (see Figure 1).

FIGURE 1 - *Average Growth Rates of Selected Economic Indicators*



([8]) For an excellent analysis of these problems, see A. ALNASRAWI, *op. cit.*

Moreover, during the same period, the per capita GDP continuously improved, reaching its peak in 1979, when it was at US$4,219 at constant 1980 prices (see Figure 2). Iraq also had a balance of payments surplus that resulted in the accumulation of nearly US$40 billion of foreign exchange on the eve of the decision of the Iraqi government to invade Iran.

The boom of the 1970s may be credited to the sharp rise in the world price of oil, which boosted Iraq's oil revenue from ID 214 million in 1970 to its peak of ID 8.9 billion in 1980. (9) However, the war with Iran in the 1980s completely reversed Iraq's state of the balance of payments, plunging the country into a huge deficit; thus making it impossible for the country to sustain its economic development. Furthermore, as the war with Iran continued, the Iraqi government found itself with no other option but to seek regional and international loans to finance its ever growing internal and external obligations.

When the war between the two countries finally ended in August 1988, Iraq's foreign debt had reached US$82 billion, and its foreign reserves, which had been estimated at US$40 billion, were completely exhausted. In addition to this, the war with Iran left Iraq politically shaken; its economy in ruins; its infrastructure severely damaged; its resources depleted, and its people impoverished and demoralized. Furthermore, the massive capital outflows spent on the imprudent financing of such things as spectacular megaprojects coupled with the decline in the world price of oil in the 1980s, not only unleashed overwhelming inflationary pressures and seriously reduced Iraq's foreign exchange earnings, but also imposed greater financial constraints on its balance of payments.

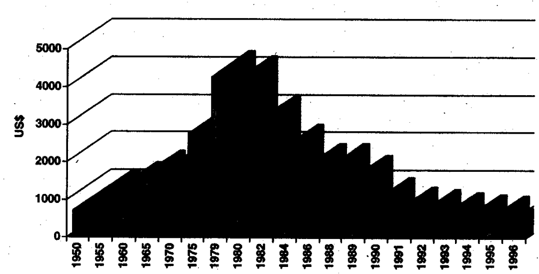
The decision to invade and annex a tiny, but rich and defenceless country such as Kuwait in August 1990 was driven primarily by the Iraqi government's desire to find a quick fix to its deepening economic and financial crisis. The takeover, in the mind of the invader, would not only pay the bill for Iraq's losses and misconduct, but it would also rekindle Saddam Hussein's chimerical national and regional political ambitions. However, these economic and political dreams turned to dust when Operation Desert Storm took place in January 1991.

By the end of the first quarter of 1991, the Gulf War had completely destroyed Iraq's basic economic infrastructure and devastated its ability to produce and export oil, which was necessary to finance any post-war reconstruction. At the same time, the UNSC had strictly enforced severe

(9) *Ibid.*, p.11. Also note that the Iraqi Dinar was equal to US$2.80 between 1950 and 1968; US$2.78 in 1970; and US$3.38 in 1973-1981.

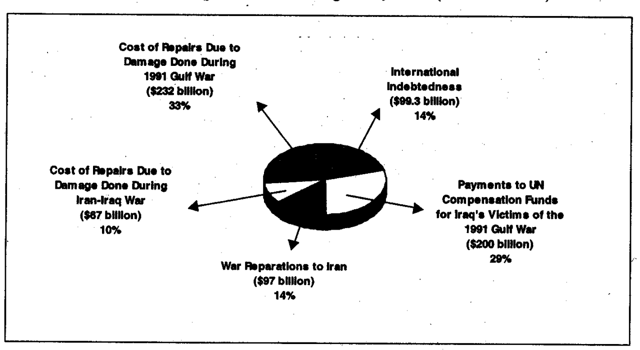
economic sanctions on Iraq which forced the country to be put in a strait-jacket. As a result, Iraq's GDP sank lower than what it was in the 1950s, when its population, now over 22 million, was barely 7 million. This left 1996 GDP per capita (at constant prices of 1980) at about $374, which corresponded to the level of the 1940s (see Figure 2). Also, the country, already drowning in foreign debt, now faced additional staggering

FIGURE 2 - *GDP Per Capita in Constant 1980 Prices, 1950-1996*



Source: ALNASRAVI (1994), Table 8.1, p. 152.
Note: Data for 1994, 1995, and 1996 are author's estimates.

FIGURE 3 - *Iraq's Financial Obligations, 1996* (in US dollars)



bills for reconstruction, damage repairs, and war reparations under the UNSC resolutions, which all together were estimated at approximately US$700 billion (see Figure 3). ([10])

III. THE MAGNITUDE OF EXTERNAL INDEBTEDNESS

Although it is hard to get precise figures on Iraq's foreign indebtedness or to know in detail what actually constitutes Iraq's debt, there are still some reliable estimates of the magnitude of the debt burden. ([11]) The Export-Import Bank of the United States, for example, reported in early 1989 that Iraq was facing a severe debt crisis that oil revenues could not rectify. ([12]) According to that report, in 1989, Iraq owed nearly US$27 billion to Western creditors. In addition, it owed another US$50 billion to the Gulf States including US$10 billion to Kuwait. Furthermore, as of 1992, the World Bank, in its World Debt Tables, listed Iraq among the Severely Indebted Countries (SICs) such as Argentina, Brazil, Poland, Cuba, Sudan, Morocco, Ethiopia, Peru, Zaire, and others. ([13]) Then again, the most recent data released by the Economist Intelligence Unit (EIU) portrays another rather depressing picture. According to this source, Iraq's total external indebtedness has almost reached the shocking level of 100 billion US dollars. ([14])

While the case of Iraq may not be typical, its misadventures and indulgences are highly illustrative of the way in which a country may become rapidly bankrupt and experience the ensuing serious economic and social implications. In Table 1, it can be seen how Iraq's major economic indicators continued to deteriorate sharply during the 1980s and the 1990s; thus imposing greater hardship on all, but a small number of Iraqi people. It can also be noted that Iraq's indebtedness increased dramatically between 1980 and 1996. During this period, its total external debt soared from $2.5 billion to $99.3 billion – an increase of almost

([10]) The data in Figure 3 are compiled from ALNASRAWI (1994), *op. cit.*, pp. 152-153; *The Economist* (April 8th 1995), p. 22; EIU, *World Outlook 1996, Country Annual*, p.220; and *The Wall Street Journal* (October 3, 1996), p.A8.

([11]) See ALNASRAWI, *op. cit.*, pp. 157-158.

([12]) See Z. KARABELL, "Backfire: US Policy Toward Iraq, 1988-2 August 1990", *The Middle East Journal*, Winter 1995, p. 32,

([13]) See World Bank, *World Debt Tables 1992-1993*, Vol.I, Washington, DC: World Bank, 1992, p.130.

([14]) Cited by A. REIFENBERG, "How Iraq, Defying the West, Keeps Its Economy Ticking", *The Wall Street Journal,* October 3, 1996, p. A8.

thirty-nine fold. (15) The worldwide oil glut from 1981 onward; the imprudent lending activities of some western creditors and some Arab

TABLE 1 - *Major Economic and Debt Indicators, (1975-1996)*

YEAR	POP (m)	GDP[a] ($bn)	DEBT[b] ($bn)	EXPORT ($bn)	D/GDP (%)	D/XGS (%)	DEBT PER CAPITA
1975	11.1	13.85	1.2	8.30	8.66	14.5	108.11
1980	13.2	53.90	2.5	26.50	4.64	9.43	189.39
1981	13.7	19.85	10.3	11.83	51.89	87.07	751.82
1982	14.1	19.33	19.9	11.62	102.95	171.26	1,411.35
1983	14.7	18.00	26.4	11.41	146.67	231.38	1,795.92
1984	15.4	47.58	55.0	12.25	115.59	448.98	3,571.43
1985	15.9	46.80	65.0	11.64	138.89	558.42	4,088.05
1986	16.5	49.42	75.0	6.96	151.76	1077.59	4,545.45
1987	17.0	59.86	80.0	11.64	133.65	687.29	4,705.88
1988	17.6	57.36	82.0	13.50	142.96	607.41	4,659.09
1989	18.3	75.50	85.0	14.60	112.58	582.19	4,644.81
1990	18.8	60.50	75.6	10.60	124.96	713.21	4,021.28
1991	19.5	10.10	79.9	0.14	791.09	57071.43	4,097.44
1992	20.2	16.80	82.9	0.50	493.45	16580.00	4,103.96
1993	20.9	17.98	85.9	0.75	477.75	11453.33	4,110.05
1994	21.4	17.97	89.7	0.77	499.17	11649.35	4,191.59
1995	21.9	16.78	93.7	0.90	558.40	10411.11	4,278.54
1996	22.4	17.81	99.3	0.90	557.55	11033.33	4,433.04

[a] GDP at current market prices.
[b] These estimates include debts to Arab states in the form of both direct loans and counterpart oil sales.
Source: Based on data derived from the UN, *Handbook of International Trade and Development Statistics* (New York, various years); EIU, *Country Profile, Iraq* (London, various years); (MEES), 13 May 1991; EIU, *World Outlook, Country Annual* (London, various years); *The Wall Street Journal*, October 3, 1996, p. A8; and author's computations.

(15) This figure includes grants from the Gulf Arab countries. However, it should be noted that the Iraqi government has adopted the position that the funds it received from the Gulf States during the war with Iran were a grant. This position

states, in particular Saudi Arabia and Kuwait; the inefficient macro-economic policies; as well as Iraq's explosive military expenditures – all these fuelled Iraq's borrowing, especially, during its later war years with Iran.

The magnitude of Iraq's debt problem can also be explained in terms of its relation to Gross Domestic Product (GDP) and export earnings (XGS). Relating external debt (D) to GDP gives an indication of the relative burden of debt, in terms of output forgone. As shown in Table 1, Iraq's total external debt-to-GDP increased almost continuously from 4.6% in 1980 to 142% in 1988; then, to 791% in 1991, when it peaked before falling to 557% in 1996. Likewise, the debt-export ratio (which indicates how close a debtor country is to bankruptcy) rose from 9.4% in 1980 to 1077% in 1986. It then declined to 582% by 1989, before jumping in the 1990s to a horrendous five digit figure, a percentage value that, even among SICs, is hard to find. (16)

Obviously, what can be concluded from the above figures is that Iraq's debt situation has significantly worsened over the last decade. Furthermore, the seriousness of Iraq's foreign debt situation is so alarming that, if it is not fully acknowledged and a fast workable strategy found to alleviate it, the living conditions and the overall outlook of the country will only become more and more bleak. This huge external debt burden is not only hampering Iraq's economic development, but it is also threatening its future ability to prosper and have a sustainable growth in the years to come. As yet, however, there has been no instant rescue operation from this financial adversity. Ironically, the Iraqi government has even refused to take advantage of several plans such as the most recent one proposed by the UNSC Resolution 986 in April 1995, which would allow the country to sell billions worth of oil every year to fund the purchase of humanitarian items needed by the Iraqi people, as well as pay for reparations of war damages. Iraq, however, chose to delay the obvious choice. After months of combative negotiations with the UN, it finally accepted the resolution in May 20, 1996. The question is why didn't Iraq accept it before?

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was made clear to the United Nations when the government stated that "Iraq's total external debt obligations" amounted, as of December 31, 1990, to ID 13.1 billion, the equivalent of US$42.1 billion, excluding interest payments due and grants from the Arab States. See MEES, 13 May 1991, p.D8.

(16) As a rule of thumb, any country with outstanding debt worth more than 200% of its exports on a present value basis is in trouble. See World Bank, *World Debt Tables 1994-1995*, Vol. I, Washington, DC: World Bank, 1994, p. 40.

IV. International indebtedness and methods of relief

Since the outset of the international debt crisis in 1982, bankers, academics, and policy-makers have developed literally dozens of methods to deal with such a multi-faceted problem. (17) These methods can be grouped into two fundamental categories:

(1) methods for refinancing the debt, and

(2) methods for converting the debt into other forms of obligation.

(A) Debt refinancing

Debt refinancing was the first approach to be proposed to alleviate the problem of foreign indebtedness. Initially, lending banks and others mistakenly diagnosed that debtor countries were merely experiencing a short-term liquidity problem due to unfavorable export prices. Therefore, the immediate strategy devised to resolve such an impasse was to offer a financial package that allowed the debtor country to satisfy its contractual obligations. This package consisted of a number of options such as: lending new money, capitalizing interest payments, repricing loans by reducing the spread, as well as restructuring entire loan maturities and interest rates. Most of these mechanisms have been used repeatedly by a number of Less Developed Countries (LDCs), including major debtors in Africa, Asia, and Latin American countries.

(B) Debt conversion

Debt conversion is the second broad approach that has been proposed and implemented to reduce the debt stock as well as the associated debt service. This approach calls for a voluntary conversion of debt into new securities or other debt instruments, whose face value or respective cash flow would be reduced in loose accordance with the discount on the secondary market. It includes a variety of mechanisms, most notably: debt-for-equity swaps, debt-for-debt swaps, debt-for-local currency swaps, and debt-for-export swaps, to mention just a few. The most widely used mechanism to date to carry out loan conversion has been the debt-equity swap, although the usage of other arrangements is gaining acceptability as well (See Table 2).

(17) For a more detailed description of these proposals, see for example H. Askari, *Third World Debt and Financial Innovation: The Experiences of Chile and Mexico*, Paris: OECD, 1991; R. Grosse (ed), *Private Sector Solutions to the Latin American Debt Problem*, New Brunswick: Transaction Publishers, 1992; and T. M. Klein (ed), *Managing External Debt in Developing Countries*, Washington, D.C.: The World Bank, 1992.

Today, as the debt overhang is so pervasive in many indebted countries, there is a great deal of emphasis on debt reduction as it is seen as an important element of any successful strategy for debt management and the resumption of economic growth. (18) Experience with debt relief

TABLE 2 - *Debt Converted, by Type of Program, 1985-93*
(in US$ billions)

TYPE OF PROGRAM	TOTAL (1985-93)	SHARE OF TOTAL (%)
Debt Equity Swaps	35.17	39.05
Local Currency Payments	11.18	12.41
Debt buyback/exchange	33.93	37.67
Local Currency Conversions	8.64	9.59
Private sector restructuring	12.45	13.82
Total Debt Conversions	90.08	100.00

Source: World Bank, *World Debt Tables 1994-1995*, Vol. I, p.32.

programs has also shown, however, that there is a worrisome aspect to this emphasis on debt reduction, as many analysts now recognize the fact that LDCs face more than just a simple liquidity problem. Most academics and policy makers in the debtor countries argue that LDCs are economically insolvent; that is, their debts exceed what they will ever be able to repay. This means that fundamental reforms are required either within the macro-economic policies and in the management practices of the debtor countries or in the nominal value and terms of their external debts, or in both. (19)

(C) The case of Iraq

In the case of Iraq, one could argue that debt reduction is probably an important prerequisite, but it is certainly not sufficient to bring about the eventual return of the country to a normal situation (i.e., to regain

(18) See J. D. SACHS, "A Strategy for Efficient Debt Reduction", *Journal of Economic Perspectives*, Winter 1990, pp. 19-29; W. CLINE, "Managing International Debt", *The Economist*, February 18th 1995, pp. 17-19; H. ASKARI, *op. cit.*; I. HUSAIN, "External Debt and the Development Process", in *Managing External Debt in Developing Countries*, T. M. KLEIN (ed), Washington, D.C.: The World Bank, 1992; and P. R. KRUGMAN, "Debt Relief is Cheap", in *Current Issues in the International Economy: A Reader*, L. S. GOLDBERG and M. W. KLEIN (eds), New York: Harper Collins College Publishers, 1992, pp.213-218.

(19) See E. BOEHMER and W. L. MEGGINSON, "Determinants of Secondary Market Prices for Developing Country Syndicated Loans", *The Journal of Finance*, December 1990, pp. 1517-1540.

normal access to the international capital markets as well as to restore growth and promote sustainable development). If Iraq, for instance, does achieve a write-off or a reduction in its debt volume, but the underlying economic policies and management practices remain unchanged, then the reduction of the debt alone would be unlikely to benefit Iraq's prospects for economic recovery and prosperity. Sooner or later, Iraq, with its government's long standing reputation of irrationality and imprudence, would find itself in the midst of another debt crisis, despite any reduction of its debt. It is for this reason that the viable and more realistic strategy for resolving Iraq's external indebtedness must be more than the combination of debt rescheduling and cancellation. It must be rather a combination of four complementary elements:

i. Debt reduction,
ii. New financing,
iii. Structural reforms, and
iv. Peace, stability, and regional cooperation.

(i) *Debt Reduction:*

Reducing Iraq's debt volume probably is the most direct means of eliminating its debt overhang. Without such a reduction, Iraq's debt overhang would not only be perpetuated, but it would also discourage domestic and foreign investment, and invite capital flight. Reducing or eliminating foreign debt could be achieved through several vehicles such as debt buybacks, restructuring packages, debt cancellation or forgiveness, and debt-equity swaps just to mention a few.

(ii) *New Financing:*

Ensuring adequate new external financing is the second element in this strategy. An injection of fresh money would provide immediate liquidity relief and could be linked directly to the support of policy reforms. This new financing would have to be offered on highly concessional or grant terms so that the new money would not add to Iraq's debt overhang problem, but would help resolve it.

(iii) *Structural Reforms:*

Implementing major political, social, legal, and economic reforms is the central element of this debt strategy as it would reduce macroeconomic imbalances, promote stability, facilitate long-term growth, and reduce poverty. Policy reforms should include, among other things: adopting open-market policies; diverting resources from defence to education, health care, social welfare, and agriculture; rebuilding civil society, within which human and property rights could clearly be defined and protected; doing away with administrative corruption and the further abuse and misallocation of resources; as well as promoting and creating a responsible and accountable government.

(iv) *Peace, Stability, and Regional Cooperation:*

Wars, hostilities, political instability, anti-market policies, and excessive red tape all constitute obstacles for any rational investor. Without being able to have a reasonable confidence in the country's long-term stability and economic viability, no one would consider investing in Iraq. Thanks to Saddam Hussein, Iraq has distinguished itself for its aggressive behaviour, not only towards its neighbours, but also towards its own people. This must be changed. Iraq needs to get back to its normal position as a civilized and effective member in the region. To achieve this, Iraq must make and maintain a comprehensive peace settlement, building bridges of trust and mutual respect with all of its neighbours. This would involve not only Iraq's recognizing each country's right to existence, but also it would have to cease from all forms of terrorism, war, and violence. It would also have to remove trade barriers, ease government regulations, continue the privatization process and investment openings, encourage regional joint projects and production partnerships, as well as accelerate the process of regional economic cooperation and integration (the proposed Middle East Common Market). Last, but not least, it also would have to adopt more civilized approaches to solving its domestic and regional problems and disputes. All these have to be the new ingredients that would constitute the 'new' Iraq within the 'new' Middle East and should be a sign of potential political and economic stability in the whole region.

V. Debt-equity swaps as a solution

(A) *The concept of a debt-equity swap*

The term debt-equity swap (DES) refers to a process by which a debtor country may convert its external debt into equity rights in a domestic firm. These new equity rights can in turn be sold to an interested foreign or national investor, who might be residing in both countries. Therefore, DES can be a useful tool to stimulate foreign direct investment (FDI) as well as repatriate flight capital. The basic debt-equity swap, as illustrated in Figure 4, involves an original creditor bank (which would generally be an international bank), a debtor country, a firm interested in foreign direct investment (which would usually, but not exclusively, be a large transnational corporation), and an intermediary (usually a bank or an investment firm) that arranges the various parts of the deal.

In a typical DES deal, an investor wishing to invest in a particular debtor country through a swap presents an investment proposal to the appropriate government authorities. On approval, the investor purchases the debt of that country at something less than its full face value in the secondary market. This implies that the loan is value-impaired and that the creditor bank does not expect to receive full value for it in the future. The debt is then presented for redemption at the Central Bank of the host country, which provides local currency equivalent to somewhere between the face value of the paper and its secondary market value. The investor can then use this local currency to make the approved investment, either through the purchase of existing stock or by a completely new infusion of capital.

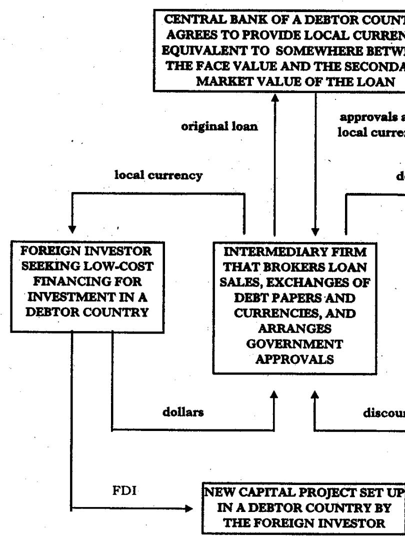
At the end of all these transactions, the parties involved seem to have gained something. The creditor sold a risky asset, even if, at a discount; and by it, was able to unload a non-performing asset from its portfolio. The investor has received domestic currency at a substantial discount from market rates and now is able to diversify by expanding its activities in the designated country or region. The debtor country has managed to retire some of its outstanding external debt without much sacrifice, but, more importantly, the swap has increased its investment activity, which allows for new jobs to be created and for new technology and skills to be brought into the country.

In spite of all the benefits for the debtor country, DES programs, as a debt reduction scheme, are largely viewed undesirable. A good number of indebted countries do not relish the idea of opening up the economy to foreign investment. Nevertheless, things are changing. The recent wave of economic reconstruction and openness, the rapid globalization of production, and the increasing integration of developing countries in world trade have all improved the overall climate for FDI within the developing economies. ([20]) As a consequence of all these new developments, the loss-of-control argument, which was the main drawback from implementing DES, is getting weaker.

([20]) Interestingly enough, in 1990, only a total of $31 billion of FDI went to developing countries. This was less than 20% of the $176 billion flowing within developed economies. Since then, flows to industrialized countries have decreased, while those to developing countries have risen sharply. In 1993, for example, FDI in developing economies amounted to nearly 80 percent of that in industrialized ones: poor countries received $80 billion, while $109 billion went to richer ones.

For many indebted countries, DESs are now regarded as a promising instrument for the alleviation of economic, financial, political, and social problems arising from a high level of international debt and debt service. ([21])

FIGURE 4 - *A swap of foreign debt for equity in a new capital project:* [A schematic presentation]



In Latin American countries, for example, despite their slow acceptance, DESs have become symbolic of the process of economic opening, especially, when they are used to facilitate the privatization of public-

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Likewise, in 1995 the developing world attracted $90 billion in FDI, or 38 percent of all FDI flows. East Asia and the Pacific was the largest recipient, with an estimated $54 billion, up 25 percent from 1994. Nearly all the increases in FDI in recent years have gone to East Asia, with China, Indonesia, and Thailand experiencing significant increases. For more details, see World Bank, *World Debt Tables*, Vol. I, Washington, DC: World Bank, 1996, p. 18; and *The Economist*, September 10th, 1994, p. 124.

([21]) For more details, see ACMS, *Debt-Conversion Schemes in Africa*, London: AACB, 1992; and TCMD, *Debt-Equity Swaps and Development*, New York: UN, 1993.

owned enterprises. (22) Moreover, analysts such as Alan Shapiro (23) and Manuel Lasaga (24), predict that there will be even stronger growth in the DESs market as economic reforms in indebted countries continue to provide new investment opportunities.

(B) *The pros and cons of debt-equity swaps*

For all participants involved, DESs have a number of distinct advantages and disadvantages, which must be carefully analyzed and taken into account. (25) A debtor country, such as Iraq, must keep in perspective the impact of the DES program on its social, economic, and political realities, as well as consider the possibility of obtaining debt reduction by some other means. Likewise, a creditor must evaluate the effect of participating in this program on its after-tax profit, its balance sheet, its credit exposure in LDCs; and, most importantly, it must study the impact on the market price of its shares if the creditor is a bank or a company. In the final analysis, however, the question of whether the benefits of a DES program can outweigh the costs varies with each individual case.

Potential Benefits:

For a country with an excessive amount of external debt, such as Iraq, the direct advantage stemming from the implementation of a successful DES program would be the reduction of its outstanding external obligations. (26) Besides this primary benefit, there are a host of other secondary benefits, which should not be ignored:

1. DESs can attract FDI which are badly needed in order for Iraq to rebuild its damaged infrastructure as well as to sustain its economic growth.

(22) R. GROSSE, "Financial Responses to the Latin American Debt Problem", in *Private Sector Solutions to the Latin American Debt Problem*, R. GROSSE (ed), *op. cit.*, pp. 65-89.

(23) A. SHAPIRO, *Foundations of Multinational Financial Management*, Englewood Cliffs, NJ: Prentice Hall, 1994, pp. 555-559.

(24) M. LASAGA, "The Road Back to the Marketplace: How Banks Have Managed the LDC Debt-Restructuring Process", in R. GROSSE, (ed), *Private Sector Solutions to the Latin American Debt Problem, op. cit.*, pp. 13-34.

(25) For more details, see UNCTC, *Debt Equity Conversions: A Guide for Decision-makers*, New York: UN, 1990.

(26) One of the most frequently cited cases in this respect is that of Chile: a country which, between 1985 and 1989, was able to reduce its external debt by almost US$10 billion, a large part of which was contributed by debt-equity conversion. See TCMD, *op. cit.*, p. 5.

2. DES programs, if they were open to the participation of Iraqi nationals, can encourage the return of the massive capital that they hold abroad- and thus reverse capital flight. ([27])
3. As DES programs attract additional foreign investment, they can provide valuable resources to Iraq's private sector in the form of new technologies, management expertise, patents, trade marks, training, access to foreign markets and so on.
4. The adoption of DES programs could become (as they did for a number of other developing countries) a benchmark in the process of economic reconstruction and openness in Iraq. In this regard, DES programs can support the liberalization and privatization efforts in Iraq where state-run enterprises, mostly loss-making, have a significant presence. ([28])
5. DES programs could act as a catalyst to create an environment conducive to investment activity, which would thus promote jobs and so reduce the unemployment rate which has soared to unprecedented levels. Moreover, the adoption of DES policies could also lead to a better utilization of existing resources and opportunities and so improve the efficiency of Iraq's securities markets.
6. By significantly reducing foreign debt-service obligations, a successful DES leaves a larger share of national income for domestic investment and consumption; hence, the growth prospects of the Iraqi economy would be considerably improved.
7. A DES program could channel investment into priority sectors or regions, which would not occur without the program (e.g. infrastructure projects, export and tourism activities, war torn districts, etc.).
8. The conversion of debt into equity allows for the reasonable settlement of Iraq's foreign indebtedness with little pressure on its limited foreign reserves, and without adverse effects on its balance-of-payments position (because dividends or profit remittances are likely to occur only when both the firm and the country are economically healthy).
9. Last, but not least, a DES program allows for the capture of a part of the discount at which Iraq's debt instruments are traded in the secondary market.

([27]) It is very hard to find any reliable estimates about Iraq's capital flight; however, it has been privately estimated that, over the last three decades, about US$40 billion left the country.

([28]) It is important to point out that, in the aftermath of the war with Iran, the Iraqi government announced an ambitious program of economic openness (*infitah*) and privatization in both the agriculture and light manufacturing sectors; but it has been reluctant to take a major step in this direction.

Potential Costs:

DES programs are inherently controversial because they are not without cost and limitation. The actual practice of using DESs, in the relatively few countries that have implemented such programs, has demonstrated that there can be serious obstacles and pitfalls. (29) Iraq, as well as any other debtor country, should not presume that DESs are axiomatically a beneficial instrument. As John D. Shilling et al. point out, swaps can turn out to be a two-edged sword, depending on the structure of the deal, as economic as well as political costs may be generated. (30) Therefore, an awareness of the potential obstacles and limitations is of critical importance for countries considering the institution of new-debt-equity conversion programs or the revision of old ones.

The first source of concern for Iraq should be a political one. As for any country, foreign penetration or denationalization of the domestic economy is a touchy political issue. It is definitely problematic, but it can be controlled and somewhat ameliorated. One way for Iraq to mitigate the risks of foreign domination is to allow its resident and non-resident nationals to participate as investors in debt-equity conversion schemes, which is what some countries such as Chile, the Philippines, and Turkey managed to do. (31) This could also encourage the repatriation of billions of dollars of Iraqi flight capital.

A number of observers have also noted that DESs might have an inflationary bias, if the debtor government was unwilling or incapable of sterilizing the monetary impact of foreign debt conversion. (32) Therefore, the potential inflationary impact of DES programs would clearly be a second source of concern for Iraq. If foreign debts were exchanged directly with Iraq's central bank for local currency, Iraqi monetary authorities would have to reduce the money supply to avoid an expansionary impact. If foreign debts were exchanged for local debt instruments (e.g., long-term bonds) and then converted into domestic currency in a secondary market, there would be no impact on the monetary aggregates and so no inflationary bias. The shift in demand for local credit, though, would place upward pressure on local interest rates, all else being equal.

The implementation of a DES program has a few other drawbacks, which are not quite so serious in Iraq's case as the two previous ones

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(29) See for example, ACMS, *op. cit.*, pp. 91-98.

(30) J. D. Shilling et al., *Debt Equity Conversion Analysis: A Case Study of the Philippine Program*, World Bank Discussion Papers, No. 76, Washington, DC.: The World Bank, 1990, p. 1.

(31) See H. Askari, *op. cit.*; and G. Nair and M. Frazier, "Debt-Equity Conversion and Privatization", *Economic Impact*, 4/1987, pp. 12-17.

(32) See UNCTC, *op. cit.*, pp. 42-43.

were, but they are worth noting. The most significant one involves 'additionality', i.e., whether a DES program induces additional investment or simply provides a subsidy to investments that would have been made, anyway. ([33]) In practice, experience has shown that there is a degree of 'additionality' in almost all DES programs adopted by indebted countries. ([34]) Nevertheless, for Iraq, it can be argued that FDI is generally low, if it exists at all; so that any investment through DES could be considered as an 'additional'.

Another important drawback relates to 'round tripping', whereby hard currency is brought in from outside (or purchased from the parallel market) in order to buy back foreign debt obligations at a discount, which are subsequently redeemed in local currency, converted back into hard currency and taken out. Obviously, careful design and implementation of the conversion program could help reduce round-tripping. Nigeria, for example, has been able to resolve this problem quite successfully, by monitoring both the hard currency sources, with which the external debt is acquired as well as by monitoring the utilization of the local currency following the debt conversion. ([35])

VI. Concluding remarks

The combined effect of the two devastating wars fought unnecessarily by Iraq alongwith the UN's ongoing economic sanctions have resulted not only in the destruction of Iraq's economic infrastructure, but have also bankrupted the country. This has culminated in widespread poverty, an undermining of the economy, nearly total political and economic isolation, and a serious deterioration of Iraq's standard of living. Much to Iraq's detriment, its foreign indebtedness has also deepened. In 1980, its external debt was around US$2.5 billion; however, as of December 1996, it had jumped to US$99.3 billion.

This paper has made an attempt to analyze that indebtedness problem and to investigate the applicability of DESs as a means of alleviating the severity of Iraq's external debt and obligations. Despite some drawbacks of DESs, the main conclusion to be drawn is that, with a well thought out scheme, this device could not only prove useful in the alleviation of the

([33]) For more details, see J. Bergsman and W. Edisis, *Debt-Equity Swaps and Foreign Direct Investment in Latin America*, IFC Discussion paper, No. 2, Washington, DC.: The World Bank, 1988.
([34]) See UNCTC, *op. cit.*
([35]) See ACMS, *op. cit.*, p. 95.

debt problem, but it could also have the potential of being able to revitalize Iraq's economy. The paper has also showed that, along with reducing Iraq's absolute amount of external debt to be serviced and increasing its equity participation, DESs could also enhance Iraq's credit-worthiness and so improve its overall business climate. With the help of DESs, Iraq could have the hope of obtaining more and better resources.

At the same time, though, Iraq has to accept the fact that its economic recovery, prosperity, and re-integration into the international community cannot be achieved effectively without implementing fundamental economic, social, and political changes. Furthermore, the 'new' Iraq must be able to demonstrate a commitment to private-sector development and to foreign investment as welcome forms of business in the country. All of these factors could play an important role in re-establishing confidence on the part of both domestic as well as foreign investors. Therefore, at a time when every effort counts, DESs could represent a significant part of Iraq's solution to its economic and financial crisis, as they not only have the potential to alleviate the severity of the problem, but they could also help to overcome this insurmountable dilemma, once and for all.

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ABSTRACT

The two devastating wars fought unnecessarily by Iraq in the past decade, alongwith the UN's ongoing economic sanctions, have ultimately led to the bankruptcy of the country. Iraq has thus moved from a once prosperous situation with estimated foreign reserves of US$35-40 billion and virtually no foreign debt to one with a foreign debt and obligations of almost US$700 billion. Obviously, Iraq's prospects for economic recovery, prosperity, and its re-integration into the international community will depend largely on the kind of political, social, and economic reforms that its government can develop and implement. An attitudinal change on the part of the creditor nations towards Iraq's indebtedness problem would also have a considerable impact on its growth and economic recovery.

This paper analyzes Iraq's external indebtedness problem and evaluates the applicability of the debt-equity swap as a means to relieve the severity of its debt burden. In spite of some drawbacks of debt-equity swaps, this paper demonstrates how a successful debt-equity swap program could not only play an important role in alleviating Iraq's debt problem, but it could also aid in the revitalization of its economy.

JEL Classification: F 34.

RIASSUNTO

La crisi debitoria internazionale dell'Iraq

Le due devastanti guerre combattute senza necessità dall'Iraq negli ultimi dieci anni, congiuntamente alle sanzioni economiche attuate dall'Onu, hanno provocato il dissesto finanziario del paese. L'Iraq è così passato da una situazione di prosperità, con riserve stimate a 35-40 miliardi di dollari ed assenza di debito estero, ad un debito estero pari a 700 miliardi di dollari. Ovviamente le prospettive di ripresa economica, prosperità e reinserimento nella comunità internazionale dipenderanno in larga misura dalle riforme politiche, sociali ed economiche che il governo sarà in grado di formulare e realizzare. Anche un atteggiamento diverso da parte delle nazioni creditrici nei confronti del problema dell'indebitamento iracheno inciderebbe notevolmente sulle possibilità di crescita e ripresa economica del paese.

Questo studio analizza il problema dell'indebitamento estero iracheno e valuta la possibilità di ricorrere al ***debt-equity swap*** (conversione del debito estero in partecipazioni azionarie) per alleviare l'onere del debito. Nonostante alcuni svantaggi connessi al debt-equity swap, lo studio dimostra che la realizzazione di un programma di conversione del debito non solo potrebbe avere un ruolo determinante nel migliorare la situazione debitoria dell'Iraq, ma potrebbe anche favorirne la ripresa economica.

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