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The Neoliberal Model's Planned Role in Iraq's Economic Transition, Strategic Insights

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Strategic Insights, v.2, issue 8 (August 2003)

<http://hdl.handle.net/10945/29627>

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Strategic Insight

The Neoliberal Model's Planned Role in Iraq's Economic Transition

by [Robert Looney](#)

Strategic Insights are published monthly by the Center for Contemporary Conflict (CCC). The CCC is the research arm of the [National Security Affairs Department](#) at the [Naval Postgraduate School](#) in Monterey, California. The views expressed here are those of the author and do not necessarily represent the views of the Naval Postgraduate School, the Department of Defense, or the U.S. Government.

August 1, 2003

Introduction

Iraq has been blessed with abundant economic and human resources. It has the second highest proven oil reserves in the world at around 112 billion barrels, after Saudi Arabia with 262 billion barrels. However, despite its wealth, Iraq has experienced continuous economic deterioration since 1980 and has become one of the region's least developed economies. A country that could have been a model of development for the Arab world turned out to be a devastated case of economic decline, mismanagement and massive corruption (Azzam, 2003).

In addition to the obvious factors such as three major wars and a decade of crippling sanctions, what factors accounted for Iraq's economic disaster? In a seminal paper on Middle Eastern economies, Jahangir Amuzegar (1974) examined what he termed "the growth-through-ideology thesis" in an attempt to determine if one economic system produced consistently better (or worse) economic performance in the Middle East context. Acknowledging variations by country, Amuzegar classified the region's countries into three major economic systems: Arab Socialism, comprised by Egypt, Syria and Iraq; capitalist Lebanon and Saudi Arabia; and an in-between group including Turkey's "etatist" regime leaning toward free enterprise and Iran's positive nationalism or private enterprise assisted by the state.

From the vantage point of 2003, it's clear that the Arab Socialist model was a major failure not just in Iraq, but also in Egypt and Syria. State companies tended to be less efficient than their private sector counterparts. Lacking market motivation, state companies were less productive and innovative and therefore registered low returns or losses. They were often launched in sectors in which the country had no comparative advantage and thus required subsidies explicit or implicit. Fiscal deficits resulting from losses or subsidies led to underinvestment; any investment that did take place was often misallocated and driven largely by non-economic criteria (Bennett 2003). No doubt, Arab Socialism would have severely retarded Iraqi growth even in the absence of Saddam Hussein.

On the other hand Lebanese and Saudi Arabian capitalism while faring a bit better have not, for differing reasons, produced the results hoped for. In Lebanon's case the civil war took a crushing toll on the economy. In Saudi Arabia's case the economy has had difficulty evolving from a rentier economy (Looney 2001). Iran's revolution ended state assisted private enterprise, while Turkey's economy, despite having more success, has also not lived up to expectations. Due to intermittent political instability and poor economic management, the country has experienced severe macro economic imbalances at times, together with periods of stalled economic reforms.

Nobel Prize winner Gary Becker (2003) takes this one step further by contending that:

The main obstacle to modern economic development for Middle Eastern nations has been bad policy, often inspired by the teachings of Karl Marx and other Western intellectuals. State enterprises and government regulations still dominate the economies of Egypt, Iran (under both the Shah and the mullahs), Iraq, Saudi Arabia, and Syria. Important industries including oil production and refining are controlled directly by the government or by private monopolies that depend on the state.

While the Bush administration would like to use Iraq as a beacon of democracy in the Arab world, a potentially greater impact on the region might come through demonstrating in Iraq how a new economic approach could quickly revitalize even the most moribund economy. In fact, even before hostilities had broken out, interest was growing in Washington and in Arab capitals to find a way to spur growth in a region that over the past quarter century has lagged well behind other developing areas (LaFranchi, 2003). In short, the United States is hoping to combine political reform and economic development in a way that could improve endemic problems in the region, such as youth unemployment, which Washington believes underlies terrorism (LaFranchi 2003).

Academic institutes (Svejnar 2003), private research organizations (Maracel and Mitchell, 2003; Barton and Crocker, 2003; Kurland, 2003), and consulting companies (Global Investment House, 2003) have come forth with sound proposals and plans for reviving and invigorating the Iraqi economy. However, a Heritage Foundation paper titled, "The Road to Economic Prosperity for a Post-Saddam Iraq" most caught the attention of top Washington circles (Cohen and O'Driscoll, 2003). In essence, this study lays out an argument for the complete neoliberalization of Iraq's internal markets and trade relations, and for the privatization of its industries, including oil.

In fact, the neoliberal view appears to have won sufficient supporters in Washington for it to become the framework within which Iraq's economy will be structured over the next several years. The actual roadmap for the country's economic reforms is apparently laid out in a classified document titled "Moving the Iraqi Economy from Recovery to Sustainable Growth," (King, 2003). Created by the Treasury Department and the U.S. Agency for International Development (USAID) as a blueprint for prospective contractors it outlines a series of steps the Bush Administration wants to achieve over the next year in Iraq, steps that will launch the country as a test case for exporting the neoliberal economic model to the Middle East (Lursen, 2003).

In sum, for many in the Bush Administration Iraq is now the test case for whether the United States can create, within the Arab world, a system of American style free market capitalism. In a February address, President Bush spoke of "a new Arab charter that champions internal reform, greater political participation, economic openness and free trade." A new regime in Iraq, he said, "would serve as a dramatic and inspiring example of freedom for other nations in the region" (King, 2003).

This *Strategic Insight* examines the neoliberal model's approach to restructuring Iraq's economy. What are the model's main assumptions and components? How would it be applied to the Iraqi economy? Are the conditions in Iraq such that it has a good chance of success?

The Neoliberal Model

As it has evolved over time, the term "Neoliberalism" is usually used by economists to refer to the economic policies pioneered by Chile in the 1970s. Subsequently, these reforms spread throughout most of Latin America in the 1980s and to other parts of the developing world in the late 1980s and early 1990s. In this sense, neoliberalism emphasizes a policy mix stressing a greater role for the market in the allocation of resources, a much-reduced role for the state, and increasing integration into the world economy. Unfortunately, in Latin America and many other nations, neoliberalism has come to represent the "evil of all evils" and to be held responsible for all sorts of problems by people who have no clear notion of what neoliberalism really is.

The literature reflects these two differing views towards the neoliberal reforms. The first view considers the structural reforms inspired by neoliberalism to be the quintessence of good economic policy, while the other considers this model a disaster, involving excessively high costs, especially measured in terms of the suffering imposed on groups unable to protect themselves from market forces.

The intellectual foundations of modern neoliberalism stem largely from the writings of Friedrich Hayek and Milton Friedman during the 1950s and 1960s. In large part, Hayek and Friedman were responding to the emergence, and subsequent predominance, of Keynesianism in Western capitalist societies and to the socialism that evolved in the former Soviet Union, China, and many other nations following World War II.

In the eyes of the neoliberals the triumph of democracy and markets over authoritarianism and statist economies was combined with efforts to promote open economies and open policies stressing export-led industrialization.

For development economists, the rise of the East Asian economies vindicated the liberal prescriptions of market-oriented policies and participation in the world economy and made obsolete policies drawn from state-interventionist theories and protectionism. New growth trajectories stressing the importance of export-led development became widely accepted as an integral part of the neoliberal ideas inspiring economic and political changes in the world. Moreover, the downfall of communism in Eastern Europe and the collapse of the apartheid regime in South Africa were depicted as supreme examples of ill-fated attempts to sustain economic growth within a closed economy.

The neoliberal core is based on three important concepts: imperfect information, individual freedom, and the market.

- **Imperfect Information.** Neoliberals contend that because individuals in general and society as a whole have imperfect information about past and present developments and events, any strategy of attempting to centrally plan and control economies is irrational and doomed to fail (Hayek). Moreover, neoliberalism contends that any attempt to plan or construct a society that goes beyond these natural restrictions is dangerous for the existing social order.
- **Individual Freedom.** Neoliberalism is based on the freedom of, and private ownership by, individuals seeking to maximize their well-being. This apparently natural behavior is particularly important from an economic viewpoint because it leads to political freedom. Thus, individual economic freedom is the basis for any civilized society and is antithetical to totalitarianism or to any form of economic planning.
- **The Market.** The market is the principal economic and social institution within which individuals adjust their preferences according to price signals, in spite of restriction in the available information. Hayek and Friedman are aware of the market's limitations, since perfect competition, individual freedom, and private ownership, as well as instantaneous price adjustments, depend on perfect information. The concept of "market" thus becomes utopian and yet is dogmatically defended by neoliberals against any form of planning or state intervention.

Braer and Maloney (1997) note that while numerous economic policies have been encompassed under the rubric of neoliberalism, in practice it is often difficult to separate macroeconomic adjustment policies from liberalization measures.

With this caveat in mind, they list the main components of neoliberalism as: (a) fiscal adjustment; (b) privatization; (c) decontrolling and/or adjusting prices; (d) decontrol of the financial sector; (e) trade liberalization; (f) incentives to foreign investments; (g) social security reform; and (h) labor market reform.

- **Fiscal Adjustment.** In most countries this has been achieved largely through tax reforms and reductions in subsidies.
- **Privatization.** Since the world depression of the 1930s, many developing country governments had increased their presence in their economies through the founding of state enterprises in

heavy industries, in the expansion of petroleum and other mineral resources, in public utilities, in banking and even in some consumer goods industries. Although this presence might have contributed to the industrialization and growth of some of these economies, by the 1970s and 1980s many state enterprises had become loss-making operations due largely to inefficiency. Beginning at the end of the 1980s, many governments were convinced or persuaded by their creditors that in order to achieve a fiscal adjustment and to improve the efficiency of the economy a substantial portion of public sector enterprises should be privatized. With neoliberal reforms, privatization is usually accompanied by an increased emphasis on private property rights.

- **Decontrolling and/or adjusting prices.** Many developing country governments have controlled prices across a wide variety of products—public utilities, basic food products, some industrial products—as instruments of income distribution or as a way to decrease inflationary pressures. The net effect of these controls was to distort the allocation of resources, turn many firms in the affected sectors into loss-makers requiring government subsidies, and in some sectors, to discourage investments. The neoliberal agenda was to either free prices totally or to readjust prices of the controlled sectors to provide firms with a positive rate of return. In a similar spirit, the vast overvaluations of the exchange rate were to be avoided in favor of rates that would encourage integration with the rest of the world.
- **Decontrol of the Financial Sector.** Controlled interest rates (often negative in real terms), allocative quotas for bank loans and forced bank holdings of government debt discouraged savings and distorted the allocation of scarce capital resources. Ending "financial repression" implied greater market allocation of investment resources, and often the liberalization of controls on external capital flows.
- **Trade Liberalization.** Many governments had retained the high levels of protection that were instituted as part of the promotion of their import substitution (ISI) programs of the 1950s and 1960s. In addition to the standard inefficiencies arising from tariffs and quotas, these regimes pushed countries away from developing in line with innate comparative advantage, shielded industries from healthy external competitive forces, and gave rise to "rent seeking" opportunities—corruption.
- **Incentives to Foreign Investments.** After the 1982 Mexican debt default, most countries of the region experienced a drastic decline in private investment, a shortage of fiscal resources for the expansion of state enterprises, and the increased obsolescence of their industrial technology. Following Chile's lead many opened their entire economy to foreign investment, including such formerly closed sectors as telecommunications, petroleum expansion, power generation and distribution, etc., frequently through debt-equity swaps
- **Social Security Reform.** The traditional pay-as-you-go social security systems in Latin America were generally vastly underfunded and constituted a major, although hidden, component of government debt. Again, in 1980 Chile led the way to establishing private, competitive pension funds where workers held individualized accounts that reflected their accumulated contributions.
- **Labor Market Reform.** The labor protection system embodied in many Latin American constitutions is thought to have led to excessively rigid labor markets, ill-adapted to competition in a global economy. Under neoliberal reforms, Chile's military government disbanded unions, and repealed minimum wage laws.

Neoliberals are firmly convinced that, with few exceptions, the set of measures described above is both a necessary and sufficient condition for growth and also for equity. These views can be easily seen in the recent statements of Paul Bremer, the chief U.S. administrator in Iraq:

- "A free economy and a free people go hand in hand. History tells us that substantial and broadly held resources, protected by private property rights, are the best protection of political freedom. Building such prosperity in Iraq will be a key measure of our success here." (Wilson 2003)
- "In the long term we would like to see market prices brought into the economy...At this point it would be premature for me to lay down specific guidelines (for foreign investment) and it's a matter that, in the end, an Iraqi government would want to make a contribution to discussing." (Agence-France Presse, May 26, 2003)

- "Privatization is obviously something we have been giving a lot of thought to. When we sit down with the governing council... it is going to be on the table. The governing council will be able to make statements that could be seen as more binding and the trick will be to figure out how we do this. Everybody knows we cannot wait until there is an elected government to start economic reform." (Reuters July 8, 2003)
- "A fundamental component of this process will be to force state-owned enterprises to face hard budget constraints by reducing subsidies and special deals....Iraq will no doubt find that opening its borders to trade and investment will increase competitive pressure on its domestic firms and thereby raise productivity." (Andrews, June 23, 2003)

In contrast, neo-structuralists, institutionalists, and other critics of the neoliberal agenda attribute poor economic performance to flaws in key markets—i.e. rigidities, segmentation and gaps in those same factor markets, so that they question whether that set of measures will automatically result in growth and especially equity. They therefore call for state intervention to correct these critical flaws and claim that the notable success of the newly-industrialized Asian countries, in terms of both growth and equity, is due precisely to such interventions.

Ramos (1997) suggests that another way of looking at the neoliberal reforms is to note that although in general terms the reforms make sense in the long run, there have been serious technical errors in their application. This has occurred because more often than not neoliberals assume markets have the capacity to adjust rapidly, automatically and effectively to any kind of disturbance or policy change. If this flexibility is not present, many of the problems noted in the previous paragraph occur to an extent that often results in a dismantling of the neoliberal reforms. The other is that while recognizing there have often been costs in terms of deterioration in the distribution of income (and/or increase in poverty) stemming from neoliberal policies, advocates contend the reforms could be effected without regressive costs if applied judiciously and accompanied by additional measures to avoid or relieve distributive problems.

Summing up, neoliberalism is essentially about making trade easier. It is about freer movement of goods, resources, and enterprises in a bid to always find cheaper resources, to maximize profits and efficiency. The risks associated with this strategy are mainly short-term: increased unemployment, bankruptcies, increased concentration of income— all elements that can lead to political instability and backlash from groups who stand to lose from the introduction of neoliberal reforms.

Neoliberal Economic Policies Considered for Implementation in Iraq

As noted above, U.S. postwar neoliberal strategy is apparently laid out in a USAID/US Treasury document, "Moving the Iraqi Economy From Recovery to Sustainable Growth." While the document is classified, many of its key components have been leaked to the press. According to King (2003) the main elements of the strategy include:

- **Privatize Iraq's Industries.** Here the United States will attempt to build a consensus for industry privatization during the first year, after which the assets of the Iraqi public sector would be transferred to private ownership over a period of three years. The country did have some limited attempts at privatization in the 1980s, so the concept is not completely foreign to the population at large. The main controversy here is obviously the proposed privatization of the oil industry.
- **Modernize the Baghdad Stock Exchange.** Here the goal is to convert Iraq's rudimentary prewar stock market within a year into a world class exchange for trading the shares of newly privatized companies. Tasks would entail developing a centralized share registry as well as a new clearing and settlement system (Krebsbach, 2003). Presumably, U.S. officials working with AID contractors would write rules for membership in the exchange.
- **Reform the Central Bank.** A new charter will be drafted to give the bank independence in pursuing monetary policy—as opposed to the policy of underwriting government deficits under the Saddam regime. According to Faleh Daud Salman Governor of the Iraqi Central Bank (Agence

France Presse July 9, 2003), "Independence will help us formulate economic policies that will contribute to encouraging activity in the country and making better use of its resources and revenue, as well as promoting growth." Contractors would help revamp the country's battered banking system by working out problem loans. The traditional Islamic money transfer system, Hawala (Looney, 2003), would be incorporated into the banking system.

- **Establish a New Currency.** Beginning October 15 Iraqis will begin exchanging notes bearing the image of Saddam Hussein for new bills denominated between 50 and 25,000 dinars. This will end the dual currency system that has separated the Kurdish north from the rest of the country (Oppel, 2003). It is not clear at this point, however, what type of exchange regime the country will adopt. Since exchange rate stability is a key element in the neoliberal model, some type of fixed exchange rate is likely (Looney 2003).
- **Provide Iraqi businesses with fresh credit.** Initial plans are for extending as much as \$8 million in loans to small and medium sized Iraqi businesses within the first year.
- **Create a legal framework compatible with private ownership, production and distribution.** This essentially involves creating a system of laws protecting private property contracts and all of the supporting infrastructure that is required by a modern market economy.
- **Rewrite the tax and tariff system.** Here contractors would be designing a comprehensive income tax system and preparing regulations to impose a consumption tax. Presumably the tariff structure would be set quite low or there may even be a tariff holiday for six months or so (Andrews June 1, 2003), preparing the country for a free trade agreement with the United States and eventual membership in the World Trade Organization.

Implementation of many of the neoliberal reforms is to be undertaken by BearingPoint of McLean Virginia. Under the contract (Cox, 2003), BearingPoint will be responsible for creating Iraq's budget, writing business laws, setting up tax collection, and laying out trade and customs rules. It will also:

- Privatize state-owned enterprises by auctioning them off or issuing Iraqis shares in the enterprises.
- Reopen banks and jump-start the private sector by making small loans of \$100 to \$10,000.
- Wean Iraqis from the U.N. oil-for-food program, the main source of food for 60% of the population.
- Issue a new currency and set exchange rates.

The components noted above provide, at least in theory, a mutually complementary system that should be capable of providing the basis for rapid recovery and growth. One sequence might involve state owned enterprises being sold or their shares distributed to the public. This would provide capital to be sold on the Baghdad Stock Exchange. The consumption-based rather than income-based tax system is supposed to encourage workers to spend less and save more, further expanding the capital markets. The stable currency reduces exchange rate risk, stimulating increased inflows of foreign direct and portfolio capital (Lursen, 2003). Ideally, a virtuous cycle will be created in which a large financial burden is removed from the state, with the private sector playing a key role in the nation's capital formation.

In short, one of the main advantages of the neoliberal model is that it shifts a good deal of the costs for reconstruction and development to the private sector, thus reducing the direct burden placed on the United States and its coalition partners. Advocates contend that given the unlikelihood of Iraqi oil revenues being sufficient to cover these costs, there are no real alternatives to the neoliberal approach (Looney, 2003).

Factors Affecting the Success of the Neoliberal Model in Iraq

In evaluating the likelihood of success of the neoliberal model in Iraq, several issues arise. Will the model still provide the needed investment and efficiency gains if some of its main components are missing or are not fully implemented? Do the proper environmental conditions for success exist in Iraq?

Since the neoliberal model relies primarily on functioning markets and private sector initiative to shift resources where they are most profitable, it is essential that a stable environment exists within which realistic estimates of future prices, costs, and rates of return can be made. An institutional infrastructure defined by supportive government institutions, laws, and regulations is also a key complementary component.

General Environmental Factors

In terms of the post war reconstruction, U.S. planners made two key assumptions that were not borne out. One was that the coalition authorities would find a fully functioning modern state, with government ministries, police forces and public utilities in working order (Fineman 2003). The second was that the resistance would end quickly. The absence of both of these elements has undermined a key requirement of the neoliberal model—an environment that is conducive to private sector investment and risk taking.

There is no surprise that the biggest problem in post-war Iraq is a disastrous collapse in the moral order and a free-for-all of scavenging that can easily degenerate into looting and sheer banditry. A country once famous for its discipline has been converted by a generation of war and sanctions into a nation living in the shadows of criminality and despair (MEED June 20, 2003).

On a more general level, a true market economy would be a big change for Iraq. In addition to state-run companies dominating the economy, a culture of entitlements pervades the country. Everyone is entitled to food rations. Gasoline prices are kept artificially low. Iraqis often offer fond memories of the generous cradle-to-grave welfare state provided before the economy was drained by three successive wars beginning with the Iran-Iraq conflict of the 1980s (Dunning, 2003). In short there is no culture of competition and free markets. This factor is quite relevant for Iraq because of the pattern of recovery of the transition economies of Central and Eastern Europe—those with the longest isolation from capitalist markets have been the slowest in revitalizing their economies.

Implementation Factors

A critical factor in market liberalization programs is the proper sequencing of reforms. Given the reality that everything cannot be done at once, which reforms are initially best, and what should follow for maximum effectiveness?

- **Tariff Reductions.** Because it was probably the easiest to implement one of the first neoliberal reforms undertaken in Iraq was to reduce tariffs, allowing imports to come into the country at low world prices. Normally this action is beneficial, because it helps dampen inflationary pressures. The risk is that it may undermine the viability of existing private and state companies. Andrews (June 1, 2003) finds this phenomena in Iraq resulting in the country being:

transformed from one of the world's most isolated economies into a huge new free-trade zone. While goods simply unavailable or unaffordable before are flowing into the country there is a downside. Iraqi manufacturers, which employed more than one tenth of all workers before the war, are almost powerless to match the new competition. Their equipment is badly outdated and they lack marketing skills to compete with foreign goods. The free-market shocks are even bigger for the country's state owned industrial companies, which produce everything from packaged goods to electrical equipment and employ more than 100,000 people.

- **Privatization.** Auctioning state-owned industries early—say late 2003—would amount to selling at a market bottom, as Iraqi assets are unlikely to ever be worth less than at that time. At the same time, Iraqis are unlikely to ever be as poor. So unless restrictions are put in place (reducing the revenues from privatization), state owned companies will likely end up in foreign hands (Kahn 2003).

- **Social Security-Pensions.** Social security and pension reform is usually a key element in neoliberal programs, yet there is not much mention of it in the Iraqi context. The usual case is for state-sponsored retirement programs to be converted into individual accounts in a way similar to U.S. citizens' 401(k) plans to which workers contribute to fund their retirements. In addition to providing for retirement, these programs are intended to increase savings and provide a stimulus for shares on local stock markets. It's unclear how the absence of these plans will retard the growth in private savings and the development of the Baghdad Stock Exchange.

Political Factors

The neoliberal reforms are a rather extreme solution to the country's problems. The neoliberal model is a distinctly Western approach to organizing economic activity. While many, but certainly not all economists applaud the approach, those in other disciplines (and politicians) are extremely skeptical of its merits. It is a fairly high risk strategy in the sense that most of the costs of implementation are borne up front in the form of lost output and jobs as the restructuring and transformation process occurs. The benefits of the reforms usually do not begin to be significant for several years.

The model has also fallen somewhat into disrepute in the last several years, especially after the crisis in a number of Latin American countries that had adopted them in the late 1980s and early 1990s. The literature is replete with examples attributing (rightly or wrongly) a whole set of problems to the model's implementation: (1) increased concentration of wealth in the hands of the very rich; (2) increased unemployment and underemployment; (3) wages that remain low for those who still have jobs even as workforce productivity increases; (4) decreased power of trade unions under the pressure of economic globalization; (5) increased crime as more people become economically marginalized; (6) increased numbers of police and prisons to combat the increase in crime; (7) an erosion of civil liberties; (8) increased homelessness and street begging; (9) rural depopulation as small farmers are put out of business by corporate agribusiness which, with free trade can take full advantage of its economies of scale; (10) armed resistance by traditional cultures put under economic siege; (11) increased immigration to more economically developed countries by those who no longer have land to work and/or cannot find work in the cities; (12) an increasingly irrelevant political system that is unable and/or unwilling to start a genuine, democratic debate because it is controlled by interlocking corporate interests that have the most to gain from the status quo; (13) an alarming decrease in social solidarity.

Given the neoliberal model's likely criticism by many Iraqi groups, its implementation will require broad based popular consensus and a leadership that is able to articulate the longer term benefits of the program. This does not appear to be occurring in Iraq. As bin Talal (2003) notes: "Iraqis are rightly cautious of accepting solutions imposed on them by third parties that have their own economic or regional interests." It does not bode well for the successful introduction of neoliberal reforms into Iraq.

Conclusions

"There is no alternative" (TINA) was an oft-repeated expression of Margaret Thatcher's, used to dismiss any plausible alternatives to her brand of hard-nosed neoliberalism (Munkc, 2003). As the British economy has subsequently proved, things are never this black and white.

The big debates will be between those in Washington who want to press ahead with a dogmatic neoliberal approach and those in the field who see the necessity, often for political reasons, to go step-by-step, acknowledging a large amount of uncertainty about what institutional changes are necessary or even desired by the Iraqis (Dionne, 2003). On the Iraqi side, advocates for the adoption of an Islamic economic system (Brown 2003) will be more and more vocal if the neoliberal reforms do not show quick dividends. Groups that are more moderate no doubt will push for various "Third Way" systems, revolving around retaining state ownership of the oil sector, and the disbursement of its revenues to the population at large (Kurland 2003).

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For Further Reading

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