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Assessing pacification policy in Iraq: Evidence from Iraqi financial markets

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At the end of January, 2006 the Iraqi government issued roughly $2.7 billion of debt in exchange for over $20 billion of Saddam-era commercial claims. This paper uses variation in the yield spread of this sovereign debt to evaluate pacification policy in Iraq. Structural change models are run in conjunction with conventional event study analysis. Results detail a mixed market reaction towards pacification policies implemented through August, 2006. While the market seems wary of coalition troop withdrawals, events denoted military and political breakthroughs by the United States seldom coincide with decreases in the yield spread. However, the market responds to news of negotiations with Iran positively. The analysis underscores the potential benefits of using market variation to inform policy in regions where data collection is difficult and policies are time sensitive. *Journal of Comparative Economics* **36** (1) (2008) 1–16. Department of Economics, University of California, Berkeley, CA 94720-3880, USA.

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1. Introduction

On January 23, 2006 Iraqi sovereign debt began trading on world markets. Variation in this bond's yield spread provides an additional vehicle to inform policy in Iraq. This market-based metric is particularly informative in situations where conventional data collection is difficult or impossible. Since efficient markets aggregate available information rapidly, market analysis has the potential to provide unbiased policy analysis within a short time frame. In addition to rapidly and efficiently processing information, markets provide incentives to reveal private information. If investors have access to information not available to policy makers, market variation contains an additional source of intelligence.

Despite the potential benefits to policy makers in Iraq and in other distressed environments, economists have rarely used event studies to analyze non-economic events and policies. Prominent exceptions include Willard et al. (1996) and Frey and Kucher (2000) who use market variation to identify structural breaks in the American Civil War and

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World War II. While pioneering in their use of markets to determine important political and historical events, these studies were not intended to provide policy evaluations. Recently, economists have shown increased interest in using markets to provide "real-time" policy evaluations. Leigh et al. (2003) use international financial markets to forecast the outcome of the coalition invasion of Iraq. Zussman and Zussman (2006) use Israeli and Palestinian stock market data to investigate the effectiveness of ongoing anti-terrorism measures in Israel.

This paper examines the Iraqi bond market's reaction to political and military events from January through August, 2006. Events are then used to evaluate three pacification strategies considered by policy makers during this period of increasing violence. The first of these strategies was aimed at encouraging political reconciliation between Iraqis, the second called for engaging Iran and the third suggested increased military action against insurgents and militias.

The paper highlights the potential benefits of using financial markets to inform policy in areas where conventional data collection is problematic and where policies are time sensitive. I use a list of country-specific headlines provided by Bloomberg to run conventional event study analysis on the Iraqi bond market. I combine these results with those provided by structural change models to provide a robustness check. The use of both techniques arguably provides an unbiased analysis of market variation.

In broad terms, the analysis shows that events labeled by United States officials as military and political breakthroughs seldom coincided with significant decreases in the yield spread. I find evidence that the market viewed sectarian violence (i.e. violence directed at a specific religious or ethnic group) as more worrisome than random acts of insurgent violence. The market responded favorably to news of political reconciliation among the involved parties (including Iran), yet remained flat following the killing of al-Zarqawi and other insurgents. In sum, results suggest that the market viewed political reconciliation between Iraqi parties and negotiations with Iran as the most promising avenues to low-risk Iraqi debt during the period analyzed.

The paper proceeds as follows: Section 2 provides an overview of the Iraqi financial markets used in the analysis. Section 3 provides a broad overview of coalition pacification policies in Iraq and argues for the use of markets to help inform policy. Section 4 details the empirical strategy and the results. Section 5 uses the results to investigate policy implications. Section 6 concludes.

2. Iraqi financial markets

2.1. History of Iraqi public debt

On the eve of coalition military action against the Republic of Iraq, bilateral and commercial creditors held approximately \$130 billion in Iraqi debt. The Paris Club held claims to roughly \$40 billion, Persian Gulf creditors \$65 billion and commercial creditors \$22 billion. Iraq incurred this debt prior to the 1990 invasion of Kuwait, after which Iraq defaulted on its international obligations.[1]

Following the end of major combat operations in May 2003, the UN Security Council issued resolution 1483 effectively prohibiting creditors from recouping their claims through the proceeds of Iraq's petroleum industry until January 1, 2008. In December 2003, President Bush appointed James A. Baker III as his personal envoy in negotiations regarding the reduction of Iraqi sovereign debt. The Bush Administration and Congress considered Iraqi debt relief a high priority, and on November 21, 2004, Paris Club members agreed to reduce Iraqi sovereign debt by 80%. The Paris Club agreement set the framework for the reduction and restructuring of Iraq's \$22 billion of commercial debt.

On November 16, 2005 the Republic of Iraq sent invitations to holders of Saddam-era commercial debt to exchange their notes. Only creditors owed more than \$35 million were given the option of receiving the new notes.[2] Each old \$1000 note was exchanged for a new \$200 note with a maturity of January 15, 2028 and an annual fixed coupon of 5.80%. The interim president, Ayad Allawi, stated that,

> by making debt-for-debt offers to our larger commercial creditors on terms comparable (in present value terms) to those agreed with the Paris Club last fall, Iraq is demonstrating its commitment to treating all creditors in a fair, transparent and even-handed way.[3]

1 Congressional Research Service (2005).

2 Creditors having claims totaling less than \$35 million were eligible for a cash buyback at the rate of 10.25% of principal plus accrued interest.

3 Iraq Ministry of Finance (2005, p. 3).