The War in Iraq and the Global Economy

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Overview

- The global economy is fundamentally weak, suffering from insufficient aggregate demand.

- The war in Iraq is unlikely to stimulate economic growth in the U.S. or in the global economy.

- The war in Iraq creates many risks for the global economy, which could translate into slower growth for some time.
Fundamental Weaknesses

- Industrialized countries are weak for idiosyncratic reasons, with feasible policy options for recovery remaining unutilized.

- Many emerging economies remain vulnerable to financial instability. Avoiding financial crises has forced many of these nations to adopt restrictive macro policies.
The United States

- The IMF has revised down projections for U.S. growth in 2003 in the past two World Economic Outlooks by a combined 1.4%. Their latest projection is 2.2% growth for 2003.

- The Blue Chips forecasters (traditionally a pretty bullish group) has revised down their forecast from 3.5% to 2.4% over the past year.

- Growth this low, combined with the productivity increases averaging about 2.5% for the past two years, implies rising unemployment throughout the year and into 2004.
The IMF has lowered its forecasts for EU growth by a combined 1.8% over the past year. Its most recent forecast is for growth of 1.1% in 2003.

This growth rate is too slow to lower unemployment in the EU.

There is room for the ECB to lower rates, as they remain higher than the benchmark rates in the US and Japan.
Japan

- The IMF, in its Fall 2002 report, raised its forecast for Japanese growth by .3%, but, took this raise back in its Spring 2003 report. They now expect growth to run at .8% for 2003.

- It appears that the debt overhang of Japanese banks, which was worsened in the Asian financial crisis, is reducing the available amount of credit for investment (classic New Keynesian credit rationing).

- Also, the end of lifetime employment, and rising unemployment, resulted in low demand growth. Real private consumption expenditures are expected to grow at only 0.5% in 2003.
Developing Nations

- Many emerging economies have emerged from the late 1990s still feeling the effects of severe financial crises.

- Latin American nations and Turkey remain vulnerable to financial conditions. It seems that the international financial markets are going to demand severe austerity from Brazil in return for holding onto its foreign debt. Currently interest rates are over 20% and primary surpluses of over 4% of total GDP are being recommended.

- In parts of Asia, substantially more room to for policy maneuver.
Some analysts argue that a quick war will lead to an economic boom:

- Increased military spending and the rebuilding of Iraq will increase demand for products in the U.S. and other allied countries.

- A quick end to the war will reduce the uncertainty and free pent-up demand.

- We see this scenario as very unlikely: the quick war should not be expected to spur a strong recovery.
The problems in the U.S. economy are *not* driven by uncertainty.

Consumption growth is weak, not because consumers are indecisive, but because their incomes are growing slowly and their debt service burdens near an all-time high, even with nominal interest rates exceptionally low.

Investment growth is weak because of chronic over-capacity.

Government spending will fall in the coming year as the effects of the state fiscal crisis start to bite.
**Wages and other Contributions to Income Growth**

<table>
<thead>
<tr>
<th>Share of DPI Growth</th>
<th>Income</th>
<th>Labor Income</th>
<th>Capital Income</th>
<th>Transfers</th>
<th>Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969:4-1971:3</td>
<td>100%</td>
<td>57%</td>
<td>20%</td>
<td>24%</td>
<td>0%</td>
</tr>
<tr>
<td>1973:4-1975:3</td>
<td>100%</td>
<td>64%</td>
<td>14%</td>
<td>33%</td>
<td>-12%</td>
</tr>
<tr>
<td>1981:3-1983:2</td>
<td>100%</td>
<td>62%</td>
<td>21%</td>
<td>23%</td>
<td>-7%</td>
</tr>
<tr>
<td>1990:3-1992:2</td>
<td>100%</td>
<td>57%</td>
<td>12%</td>
<td>39%</td>
<td>-8%</td>
</tr>
<tr>
<td>2001:1-2002:4</td>
<td>100%</td>
<td>25%</td>
<td>9%</td>
<td>29%</td>
<td>36%</td>
</tr>
<tr>
<td>Average, Prior 4</td>
<td>0%</td>
<td>60%</td>
<td>17%</td>
<td>30%</td>
<td>-6%</td>
</tr>
<tr>
<td>1995:4-2000:4</td>
<td>100%</td>
<td>85%</td>
<td>10%</td>
<td>11%</td>
<td>-35%</td>
</tr>
</tbody>
</table>
• While the amount of total household debt and consumer debt have increased greatly, the cost of debt service (principle and interest) as a percentage of disposable household income has NOT. In fact current ratios are lower than in the mid-1980s and no more than 2% points higher than the beginning of the decade. This cannot explain much of the slower pace of consumer spending.
## Capacity Utilization Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Man</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>78.77</td>
<td>78.57</td>
</tr>
<tr>
<td>1987</td>
<td>81.20</td>
<td>81.10</td>
</tr>
<tr>
<td>1988</td>
<td>84.17</td>
<td>84.10</td>
</tr>
<tr>
<td>1989</td>
<td>83.63</td>
<td>83.20</td>
</tr>
<tr>
<td>1990</td>
<td>82.46</td>
<td>81.65</td>
</tr>
<tr>
<td>1991</td>
<td>79.56</td>
<td>78.26</td>
</tr>
<tr>
<td>1992</td>
<td>80.15</td>
<td>79.31</td>
</tr>
<tr>
<td>1993</td>
<td>81.09</td>
<td>80.04</td>
</tr>
<tr>
<td>1994</td>
<td>83.27</td>
<td>82.45</td>
</tr>
<tr>
<td>1995</td>
<td>83.62</td>
<td>82.76</td>
</tr>
<tr>
<td>1996</td>
<td>82.53</td>
<td>81.23</td>
</tr>
<tr>
<td>1997</td>
<td>83.70</td>
<td>82.70</td>
</tr>
<tr>
<td>1998</td>
<td>82.88</td>
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<tr>
<td>2001</td>
<td>77.30</td>
<td>75.55</td>
</tr>
<tr>
<td>2002</td>
<td>75.60</td>
<td>73.76</td>
</tr>
<tr>
<td>2003</td>
<td>75.56</td>
<td>72.94</td>
</tr>
</tbody>
</table>

**Average** 81.14 80.13
Military Spending Increases, % of GDP

Increase in Military Spending as % of US GDP

- WWII
- Korean War
- Vietnam War
- 2001/2003
Defense Spending vs. State and Local Government Outlays

- In 2002, defense spending and state and local government spending increases each accounted for around 15 percent of total GDP growth that year.

- If state and local spending stayed constant in real terms, its contribution to GDP growth would be zero.

- The consensus forecast is a reduction of state and local spending by up to $100 billion, reducing GDP growth by a percentage point.
The Economic Risks from a War with Iraq

- Much about the economics of the war in Iraq is not known. But a few risks should be considered – given that the war was short and will be limited to Iraq:
  - The war in Iraq may hamper global economic growth due to higher oil prices.
  - The war in Iraq may result in disruptions of international trade.
  - *The war in Iraq may impede international coordination in fighting the global recession*
Spot Price for Oil

Crude Oil Spot
WTI Cushing

$38
$36
$34
$32
$30
$28
$26
$24
$22


April 1, 2002 - April 16, 2003

$29.18

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## US/EU Trade

<table>
<thead>
<tr>
<th>Category</th>
<th>Imports</th>
<th>Pct</th>
<th>Exports</th>
<th>Pct</th>
</tr>
</thead>
<tbody>
<tr>
<td>autos</td>
<td>28510</td>
<td>0.13</td>
<td>6744</td>
<td>0.05</td>
</tr>
<tr>
<td>other transport</td>
<td>19000</td>
<td>0.09</td>
<td>22100</td>
<td>0.15</td>
</tr>
<tr>
<td>industrial machinery</td>
<td>29208</td>
<td>0.13</td>
<td>28100</td>
<td>0.19</td>
</tr>
<tr>
<td>chemicals</td>
<td>39656</td>
<td>0.18</td>
<td>21877</td>
<td>0.15</td>
</tr>
<tr>
<td>electrical machinery</td>
<td>14913</td>
<td>0.07</td>
<td>17013</td>
<td>0.12</td>
</tr>
<tr>
<td>scientific instruments</td>
<td>12465</td>
<td>0.06</td>
<td>15686</td>
<td>0.11</td>
</tr>
<tr>
<td>food</td>
<td>8661</td>
<td>0.04</td>
<td>3253</td>
<td>0.02</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>219000</td>
<td>0.70</td>
<td>147327</td>
<td>0.78</td>
</tr>
</tbody>
</table>

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**EU**

- 20 percent US imports
- 20 percent US exports
- 17.5 percent of total trade deficit
Risks to EU from Conflict

- The E.U. depends on petroleum for 41% of domestic energy needs, slightly more than the U.S.

- The bulk of E.U. trade occurs internally, risks of trade disruptions are small. Most U.S. exports are capital goods, hence unlikely to be affected by boycotts.

- Rising oil prices could lead to more inflation, making the ECB reluctant to engage in monetary easing necessary for an economic recovery.
Risks to Japan

- Japan relies on petroleum for 51% of all energy needs.

- Rising oil prices may nudge inflation up, but, since Japan imports essentially 100% of its petroleum, this is almost exactly equivalent to a tax increase, and will do nothing to ameliorate the negatives associated with deflation.

- Japanese PM Kozui recently expressed a view that 1-2% inflation could be good for Japan. Again, as with E.U., it would not be good if this inflation was driven by oil price spikes.
Summary: Risks to Industrial Nations from the Conflict

- The greatest risk to individual nations is that fallout from the conflict will prevent policymakers in the EU and Japan from undertaking aggressive expansionary policies.

- For the U.S., the risk is over the medium-term, as rising fiscal deficits work themselves out on interest rates. Of course, the cost of the conflict is small compared to the size of the Bush Administration tax cuts.
Risks to Developing Nations

- The primary risk to developing nations is their increasing exposure to risks of the advanced economies. China’s exports to the U.S. constitute 10% of their total GDP.

- Danger that Iraq reconstruction may squeeze international funds for very poor nations.

- Financial vulnerabilities in a number of economies remain high (Brazil, Turkey). Given the monetary easing in the past couple of years in the industrial nations, there is little room for maneuver on this front to combat those financial crises that occur.
Global Policy Coordination Necessary

- In a world of globally deregulated trade and capital flows, individual countries are often not well equipped to design policies to revive their economies.

- Globalization creates a ‘leaky’ macroeconomic environment: Fiscal stimuli will be less effective due to increased imports and monetary policy decisions are bound by the interest rate decisions of the leading markets, sometimes reducing individual nations’ ability to lower interest rates.

- A solution would be the coordination of fiscal and monetary policy between the major industrialized economies. However, this global policy coordination is less likely due to the transatlantic rift over the war in Iraq.
The goals of global economic policy should be two-fold:

- Build political foundation for economic coordination

- Take the domestic steps that are possible to spur demand and stability
Coordinated Economic Policies

- Ideally, global growth could be supported through coordinated economic policies between the major industrialized economies:
  - Coordinated fiscal stimuli and coordinated interest rate policies.
  - A coordinated effort to stabilize exchange rates, particularly to lower the value of the dollar.

- Coordination, though, is less likely in the current political climate.
Coordinated Policies(2)

- Emerging economies need to develop domestic sources of demand-growth and reduce their dependence on export-led strategies.

- Given the current account balance of the U.S., prospects for exports to the U.S. market providing an engine of growth seem limited.

- A broad effort on this front will also lead to a more stable global economy in years to come.
Countries could pursue individual economic policies. But fiscal policy is hampered by international trade, and monetary policy is impeded by capital mobility.

Trade and capital liberalization is unlikely to be reversed.

Consequently, domestic policies should focus more on institutional development:

- Redistributive policies.
- Indigenous banking sector development.
- Improved labor rights.
Redistributive Policies

- Higher income earners are less likely to spend money than lower income earners.

- Consequently, redistributing funds from high income earners to low income earners could spur domestic demand.

- One example is the expansion of the E.U.’s practice of redistributing funds towards the lower income regions of Central and Eastern Europe.
Indigenous Banking Systems

- A crucial ingredient to growth is the development of sound finance that will provide funds for consumption, housing, and investment.

- However, in many countries the trend has been towards concentration of banking in the hands of multinational banks. Often, this results in less credit for many borrowers.

- Instead, public support for indigenous banking systems could help to boost local demand. Support for credit unions, credit cooperatives, postal savings unions, or savings banks can help to support growth.
Improved Labor Rights

- Better labor rights can help to strengthen growth.

- Labor rights are associated with faster productivity growth and more equal income distribution.

- As a result, growth will be stronger and more sustainable, and external shocks will be less costly and more easily recovered from.
Now vs. Early 1990s

- Last time there was call for international coordination of macroeconomic policies was the early 1990s. Strong U.S. boom lifted global economy. Can this be repeated?

- No: current account deficit too large to export demand abroad. Also, U.S. economy far from booming.

- May need further fiscal stimulus, front-loaded and targeted. In 2003, the fiscal impulse is projected to be less than the last two years.
Conclusion

- The global economy is fundamentally weak.
- The war in Iraq bears a number of risks that could further dampen global economic growth.
- There are no offsetting economic benefits from the war in Iraq for the global economy.
- The economic problems need to be addressed sooner rather than later since the problem has become more urgent with the war in Iraq.