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How Much Does the War Matter for the Global Economy?

We pull together our views on a number of key questions about the war and its consequences. A 'successful' outcome to the war will not resolve underlying challenges to the global economy

It now seems very likely that the US will lead some form of military attack on Iraq, possibly by the end of this week. As we have stated before, we believe it is important to avoid overemphasising the importance of war to the longer-term outlook for the world economy. We see four reasons why a successful outcome to the war may not resolve underlying challenges:

- geopolitical risks, including the Korean peninsula, and risks of terrorism will remain**;**
- poor supply fundamentals mean that oil prices will not ease significantly;
- the market is too optimistic about growth prospects in 2004; and
- global financial conditions remain too tight.

In the following pages, we pull together our views on a number of key questions surrounding the war and its consequences.

1. Where are oil prices headed?

Although the market is pricing in some risk premium for an Iraq war, we believe the sharp rise in oil prices over the past few months is mainly due to tight supply/demand dynamics of the oil market. In addition to a very cold winter in the Northern Hemisphere, the oil market faces severe supply constraints and limited demand flexibility. Global inventories of crude and petroleum products are at or near minimum operating levels, nearly every producer in the world is currently producing at capacity, and demand is less elastic than in the past.

With little fundamental flexibility anywhere in the supply chain, we expect to see significant volatility around our 2003Q1 WTI oil price forecast of $36/bbl, with the potential for upward and downward spikes in the current environment. Assuming no war-related disruption in supply, our Commodity Research Team continues to expect oil prices to average around $31-32/bbl in 2003.

2. How sensitive is global economic growth to oil prices?

Our models suggest that a sustained 50% rise in oil prices would reduce G7 GDP growth by nearly 1% after 12 months (this is relative to a baseline oil price of $25/bbl. A sustained 50% rise from the current oil price would obviously have a larger impact). Higher prices accordingly threaten to offset any positive impact of the renewed policy stimulus we hope to see in the G3 economies.

Our model also suggests that a short, sharp spike could have equally serious economic impacts. If oil prices were to spike by 50% (say to around $45/bbl) for only one quarter, we estimate that G7 growth would be around 0.5% lower within 12 months. A two-quarter shock would have a larger impact (roughly 0.7% over 12 months). More sustained or sharper oil price rises would cause even greater damage, but that might ultimately bring prices down again.

We also looked at three alternative price paths and the impact on GDP relative to our existing forecasts.

Swift collapse. If oil prices followed a similar path to what was seen at the start of military operations in 1991 (a swift price decline of around 30%) global GDP growth 12 months out could be boosted by 0.9%.

Spike and decline. If we were to get a sharp price spike followed by a much more substantial price decline, GDP growth price 12 months out might be boosted as much as 0.4%.

A repeat of 'Gulf I.' Supply disruptions in the first Gulf war began in August 1990. If oil prices mirror that path for six months *starting today*, the outlook is even more negative than what we have assumed. This pattern would take 0.4% off even our current forecasts.

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3. How do we think the major central banks will react to sharply higher oil prices?

Policy responses from central banks and governments will affect the shorter-term economic outcomes of potential spikes in oil prices. The Fed would tend to 'look through' adverse inflation developments and ease policy if activity and confidence indicators showed meaningful weakness in the face of military conflict and supply disruptions. We expect the ECB to act in a similar fashion, especially as it now seems willing to live with inflation close to 2%.

Meanwhile, for the Bank of Japan, the direct impact of higher oil price rises would scarcely alter the country's recessionary and deflationary environment, and we believe the existing policy of zero rates and quantitative easing would continue.

4. What would be the cost of the war?

The Congressional Budget Office (CBO) has estimated that the cost of a military attack on Iraq would be up to $10 billion during the first month of combat, subsequently falling to $8bn per month, on top of an initial outlay of up to $14 billion for the deployment of troops to the Persian Gulf region. After hostilities end, the cost of repatriation of US forces would approximately be $9 billion. Further, the incremental cost of an occupation following combat operations could vary from about $1 billion to $4 billion a month.

A quick war—one that lasts less than four weeks—could therefore cost up to $57 billion. A more prolonged conflict could cost up to $65 billion. In real terms, this is broadly the cost of the 1991 Gulf war, which was fought with a larger force but lasted only a few days.

We have penciled in about $50bn for the cost of the war during fiscal 2003,and a further $30bn in fiscal 2004. These figures would be consistent with CBO estimates for the cost of a quick war followed by an extended period of occupation.

5. Who is going to foot the bill?

It seems likely that American taxpayers will find themselves footing most of the bill for the war in Iraq, unlike in the Gulf war ten years ago. On that occasion, the U.S. Department of Defense estimated the cost of the Gulf War at $61 billion, of which about $53 billion was later offset by other allied nations. Two-thirds of the $53 billion was provided by the Gulf States ($36 billion), with the remaining one third mostly provided by Germany and Japan ($16 billion). This time, the coalition will likely consist of only the US and the UK.

There has been some talk in the US of using proceeds from 'new Iraq's' oil reserves to fund the costs of the war. We currently do not see this as a viable option. It will be difficult to return Iraqi production capacity to the 3.0 million b/d levels seen in the late 1990s. We estimate that current production capacity is only 2.6 million b/d and rapidly declining, as a result of chronic underinvestment. Restarting the Iraqi oil industry, should a war cause large-scale production shut-ins for two months or more, would be a considerable challenge.

Assuming no other infrastructure is damaged, production would likely ramp-up to 1.5 million b/d, but it would probably take another several months to surpass 2.0 million b/d. Again,the situation would be worse if the conflict caused additional supply disruptions outside Iraq.

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Updating Our ERP Estimates

The table below shows our updated estimates of global ERP from an economics perspective.

Our European strategist, Peter Oppenheimer, calculates that the current ERP is currently around 4.5% in Europe and around 5% in the UK—similar to our own estimates. Our strategists assume that the sustainable ERP is around 3.5%. This would suggest that there is room for around a 100bp compression in the ERP in Europe as current geopolitical fears fade. On their calculations, that would boost the equity market by around 15%, largely unwinding the current valuation overshoot.

Given the difficult pricing environment and low nominal GDP, our strategists expect profits to grow this year but in both Europe and the US, the annualised growth is likely to be 7%-10% over the next three years. This is a reasonable proxy for the kind of rise in equity markets after a rally that reverses the current valuation overshoot. ■

	Real GDP Growth	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	3.0	3.0		2.0		5.0		1.8		3.2	2.0	6.4
Japan	1.0	2.0		1.2		3.2		0.4		2.8	0.3	3.3
UK	2.5	2.5		4.0		6.5		2.0		4.5	2.0	7.6
Germany	2.2	2.2		3.1		5.3		3.0		2.3	1.8	7.1
France	2.2	2.2		2.9		5.1		3.0		2.1	1.8	6.9
Europe ex UK	2.25	2.25		3.6		5.9		2.0		3.9	2.0	7.0
MSCI World	2.5	2.5		2.5		5.0		1.7		3.3	1.7	6.3

*Calculated as of 13 March 2003. Real GDP grow th and expected inflation are GS Economics Research forecasts.

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6. What does this mean for the US budget?

Although the estimated cost of the war can be easily financed without a major economic impact, the budget outlook was already deteriorating on the back of the economic slowdown. Assuming the proposed $674bn fiscal package, which includes the abolition of the taxes of dividends, will add more than $100bn to the deficit this fiscal year alone, we recently boosted our fiscal 2003 budget deficit estimate to $375 billion, and still regard the risks as tilted to the high side. In fiscal 2004, we expect a $425-billion shortfall.

What does this mean for US bonds? In the near term, we expect that war uncertainties and weak economic data will keep the yield on benchmark 10-year Treasury notes in the vicinity of 4%. However, as growth picks up later in the year and the full dimensions of budget deterioration become more apparent, yields should begin to rise. By year-end, we would expect 10-year Treasury notes to be trading around 4½%.

7. How will the war impact the US$?

Looking back to 1991, the Gulf War did not appear to have a significant and long-lasting effect on currency markets, particularly on the US dollar. We believe this will be the case again.

There may be a temporary relief rally in US assets and the dollar once it becomes clear that the US is heading for victory, but we do not believe that current dollar weakness is due to concerns about war. Indeed, we think dollar weakness reflects more the persistence of financial imbalances in the US and deteriorating trade and current account deficits (during 2002Q4 the US ran a Broad Balance of Payment (BBoP) deficit of 3.4% of GDP). Our ongoing concern about the ability of the US to fund the growing current account deficit has prompted us to revise down our dollar forecasts recently. Our new forecasts for Euro/$ are 1.12, 1.12, and 1.18 in the next 3, 6 and 12 months.

8. How serious is the risk of trade wars between the US and Europe?

US politicians are threatening to take retaliatory action against France, Belgium and Germany for failing to support US policy on Iraq. Indeed, some have called for a trade ban on French imports and the withdrawal of some US troops from Germany.

In our view, the risk, at least in the near term, that political tension between the US and Europe affects bilateral trade relations is sizeable. However, we would not overplay the risks for a number of reasons:

- Trade relations between the two blocs have often been tense. Indeed, the US is already involved in several trade disputes with the European Union, over the tariffs on steel and the EU's ban on US exports of genetically modified food.
- Any backlash from the US is more than likely to be focused on France, and possibly Germany, who are perceived to be the "leaders of the opposition" to US policy on Iraq. US Secretary of State Colin Powell stated that there would be no repercussions for US relations with Russia, even in the short term.
- Both EU trade commissioner Pascal Lamy and his counterpart, US trade representative Robert Zoellick, have recently stressed the two sides' mutual commitment for free trade, particularly at a multinational level through the World Trade Organization. Indeed, they both recognize that an escalation of trade disputes would not be beneficial for anyone. ■

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The World Economy Needs Looser Financial Conditions, Not a Dividing War

Driven by weak equity markets, global financial conditions have moved close to their tightest levels since 1999. More policy response is needed to make G7 financial conditions more accommodative

As the world sits glued to TV screens, policymakers are less able to focus on the growing need for more effective economic stimulus. We have discussed the need for world policymakers, either separately or collectively, to undertake measures to stimulate the global economy. Specifically, we have called for significant monetary and fiscal easing in the US and Eurozone; specific stimulative measures in Japan; a decline in the dollar; and a revaluation of the Chinese renminbi.

Although the world economy has seen some movement on these fronts, it has not been enough. Driven by weak equity markets, global financial conditions have moved close to their tightest levels since 1999. More policy response is needed.

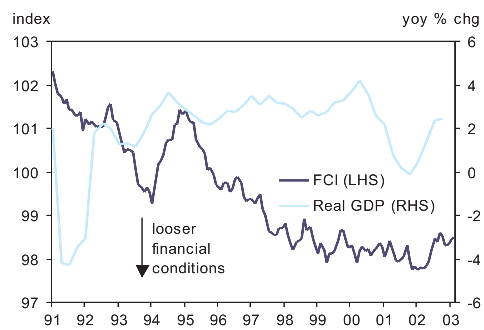
To help improve the global economic outlook, G7 financial conditions need to become more accommodative. The quickest way this could happen would be through a large and sustained recovery in equity markets. In the absence of such a development, the US and Europe need to get together to further lower the dollar and offer an aggregate net monetary stimulus, and to facilitate better integration of Asian economic powers into the world economy. A stronger Chinese renminbi is still a necessary ingredient.

G7 Financial Conditions Are Still Tight

The chart on this page shows the performance of combined G7 financial conditions since the start of the 1990s, as well as the performance of G7 real GDP. A loose inverse correlation can be seen. As financial conditions improved throughout most of the 1990s, real GDP expanded at a healthy clip. As the decade drew to a close, financial conditions stopped improving, and real GDP growth lost its momentum. G7 financial conditions have recently approached the levels last seen in late 1999.

What Should Be Done?

G7 Financial Conditions Index vs GDP



Equities. If the clouds of geopolitical uncertainty would result in a **permanent** rally in the major equity markets of as much as 30%-40%, then the war would be helpful. A 40% rally in equities would boost financial conditions in the US by 200 basis points, in the Eurozone and Japan by between 80 to 100 basis points, and in the G7 collectively by around 130 basis points.

US. The US needs easier financial conditions and has the most scope to achieve them easily.

To achieve financial easing, in the absence of a major (30%) rally in equities, the US could either slash short-term interest rates another 125bp (44bp worth of FCI stimulus), force a 100bp or more drop in triple-B rated corporate bond yields though Fed purchases (55bp worth of FCI) and/or encourage a further 10% drop in the trade weighted dollar (50bp worth of easing). All three options together would achieve the same as a permanent 30% rally in equities.

Euroland. Financial conditions in the Eurozone are also tightening, although not as much as in the US. On the other hand, Euroland's fragile economy can perhaps less afford to see conditions tighten. If our prescription for the US includes a further 10% dollar decline, the Eurozone would need to more than offset this.

To ease the Euroland FCI by 150bp with some appreciation of the euro and no change in equities, a 165bp decline in interest rates would be necessary.

Japan. Short-term interest rates are already zero and long-term rates are around 75bp. Consequently, Japan can only achieve easier financial conditions if the yen weakens sharply and/or the Nikkei rallies significantly.

Easier financial conditions would best be achieved through improved financial conditions outside Japan. If not, Japan's domestic choices would seem to either involve stronger efforts to deliberately strengthen equity prices or policies outside an FCI framework.

China Needs to Play a Role

A stronger Chinese renminbi is needed to ease financial conditions globally. This idea has gained ground since last summer, but the currency remains stable. Recent trade data actually suggests that Chinese import growth is now outpacing export growth (57% versus 33% in 2003 to date) reducing the current account surplus. To some, this undercuts our argument, as China is clearly contributing positively to global trade and the current account surplus is slowing. However, China continues to enjoy significant FDI inflows and therefore a large and growing Broad Balance of Payments surplus.

A significant rise in the renminbi, rather than a free float, would help to maintain China's contribution to world trade without significantly damaging China's growth outlook. At the same time, it would help to achieve easier financial conditions in the US, Euroland and Japan.

Whatever the military developments in the next few days, policymakers should turn their attention to economic policies again very soon—unless they believe a quick resolution in Iraq can deliver a large rally in equity prices. ■