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***EIAS Round Table
on
Economic and Political Impact of the Iraq War on Asia***

With the kind collaboration of Mr. John Cushman MEP

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**The Economic Impact of the Iraq war
on Japan, China and India**

Dr Sushanta Mallick
International Economics Programme, Royal Institute of International Affairs

Contact Information:
European Institute for Asian Studies (EIAS) Ms Roberta Zavoretti,
Rue des Deux Eglises 35, B-1000 Brussels
Tel.: 0032-(0) 2-2308122 **Fax: 0032-(0) 2-230 5402** Email: r.zavoretti@eias.org

The Economic Impact of the Iraq war on Japan, China and India

*Dr Sushanta Mallick**

The war in Iraq would impact the key players in Asia as much as any other major economy. Asian economies account for about 25% of US\$31.5 trillion World GDP and clearly they are one of the major players in the global market place. Prior to the war, the uncertainty was when the war was going to start, and that was being factored into the markets including the oil market. Now the market sentiment is centred on when the war is going to end. This kind of uncertainty continues to discourage consumers and investors to undertake their planned expenditure at this time.

What are the channels of transmission of this kind of shock to the economy? Essentially there are two kinds of impacts. The direct or first order impacts of this shock will be the same as what happened in the last Gulf war. In the last Gulf war, oil prices increased sharply – a concern to all the oil-importing countries, equity prices fell sharply, both business- and consumer-confidence were hit as a result of the uncertainty, that in turn depressed capital markets and slowed down economic growth. Besides, certain sectors also suffered particularly badly including tourism and aviation industry.

The combination of higher oil-prices, weaker confidence and lower equity prices therefore contributed to slower growth, in the aftermath of the last Gulf War. We have already seen the similar kind of impact so far in this Gulf War: the oil price has jumped to its highest level since the last Gulf War. New records could be broken in the course of this war, if oil supplies are substantially reduced into the medium or long term. Besides, there is one direct positive impact that could come from higher defence spending which can offset a part of the negative knock-on effects and stimulate economic growth. But that cannot be significant relative to the negative effects.

The second order impact would depend on the outcome of the war and whether the war achieves its objective of getting rid of weapons of mass destruction and regime change in Iraq. There are obviously negative impacts of any war. If the war escalates into a large-scale prolonged conflict, it carries the risk of putting the global economy in depression. For example, prior to the last Gulf War, the US and other economies were already weak but the war pushed these economies into recession. This time since the global economy is already weak, a long-term uncertainty as a consequence of a prolonged conflict could create a similar recession.

How the policy makers should respond to this kind of negative shock? In terms of monetary policy, there is little room for additional easing in the US, as the Fed funds rate is already at its record low level. Japan being in a deflation trap has little scope for additional monetary and fiscal stimulus to offset any negative economic impact of the war. But in the Euro zone given the currency appreciation, and in the UK, there is some room for further policy easing to counteract any negative shock coming out of the war.

* International Economics Programme, Royal Institute of International Affairs, 10 St James's Square, SW1Y 4LE, London, UK.

War is usually understood to be a temporary phenomenon, but the efforts to deal with terrorism has been more of a long-term one since the 9/11 event erupted. This long-term nature of this war adds huge amount of uncertainty into economic behaviour that suggests a more faltering global economy. Even before 9/11, the global economy was slowing down since the technology bubble burst in March 2000. Now it is already in recession, although not in a technical sense, with highly volatile consumer and business confidence.

Higher oil prices will certainly intensify the problem. Japan, China and India are no exception, since all the three countries are oil importing-countries and they are mainly dependent on the Middle East for their oil supply. China is the world's third-largest consumer of crude, after the US and Japan. It imports one-third of its oil requirements, 60 percent of which comes from the Middle East. With regard to the long-term impact on oil prices, it would depend on how badly the oil infrastructure gets damaged in any kind of extended war and to what extent the oil supply gets squeezed.

In the short term, this uncertainty in the Middle East will make the oil prices volatile, but a long-term rise in oil prices is more likely to cut global economic growth. So the long-term strategy then should be to diversify the source of oil supply rather than relying heavily on the Middle East. For example, China is already looking to diversify including Russia as a source of its supply. It is always a good strategy to diversify, no matter whether it is with regard to the export markets or the sources of foreign investment or the foreign exchange earnings such as tourism. Over-dependence on any one source is risky.

In terms of growth effects, despite this negative shock, China and India are more likely to outperform all of their neighbours. Both are very different economies in the world. One common characteristic of those two economies is their strong domestic demand. Although China has been relying on an export-led development strategy recently, still domestic demand remains quite robust supporting growth.

For India, one major source of foreign exchange comes from non-resident deposits and, private transfers by Indian residents working abroad, particularly in the Middle East. If the war spreads beyond Iraq, it is possible that this source of inflows could dry up as it happened in the last Gulf war that aggravated India's balance of payments problem giving rise to a crisis in July 1991, although severe fiscal and external imbalances were the main reason. At that time India just had under US\$4 billion, which is currently over US\$74 billion. So India is not likely to encounter such a crisis this time.

Outside investor confidence is crucial for the capital flow to both China and India, given the economic arbitrage. For example, although in general China could be a risky market, the reality is that foreign direct investments have increased over 50% year-on-year in the first two months of this year at a time when there was a huge risk of war. This could partly suggest China as a safe heaven at a time of uncertainty.

In terms of exchange rate effects, China actually benefits from this war uncertainty in the sense that Chinese Yuan being pegged to the US dollar becomes more competitive in line with the falling dollar, while Japan is being hit hard by the dollar weakness that makes the Yen less competitive.

To sum up, there can be three scenarios. **Pessimistic** (war goes badly): if the cost of war turns out to be much greater than anticipated and if the West does not find weapons of mass destruction. This would suggest that there could be continuing

global instability with regional consequences and the recession could get deeper. The longer the war goes, the more destructive it becomes. In addition, Saddam Hussein's best chance of survival is to escalate the conflict beyond Iraq, possibly by attacking Israel or by portraying the war as an attack on Islam rather than on his regime.

Intermediate: if war goes well (victory but with significant cost), which means that the extent of disruption to oil-supply stays within control, and the global economy gets a boost. Money in the frozen accounts and annual oil revenues of US\$20 billion can be used to rebuild Iraq.

Optimistic: if war goes very well (victory with a contained war). This scenario suggests that the West finds weapons of mass destruction, reinforcing their rationale for the war. There is a perception that the next move could be after Iran or North Korea. If something like that happens, we would continue to live in a world of long-term uncertainty and that in turn would keep the markets range-bound. Settlement of the Iraq crisis could, by removing 'geopolitical uncertainties', give the global economy time to recover.

The idea that poverty breeds terrorism has been thrown up in academic and policy debates. In fact, there is no simple and straightforward relationship between the two. However, such statements do contain some truth. There seems to be a trade-off between global poverty and international security. Poverty may not cause terrorism, but terrorists might manipulate poverty and income inequality between the rich and poor nations to their advantage. Thus, any viable strategy to prevent terrorism must address core issues of economic development in the third world.

Many G8 countries including the US have pledged to increase their development aid to poor nations, in their attempt to curb poverty. But foreign aid is no answer to raising living standards in poorest nations. It can be an important instrument to reduce poverty marginally, if it is used in a productive manner. But large part of the foreign aid, given to low and middle income countries goes to meeting the government's current expenditure rather than being spent on capital expenditure to create productive employment that can provide a sustainable solution.