Economic effects of war start to mount

By Sid Marris
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AS more detailed work is done on the possible economic effects of a Middle East conflict, the outlook becomes grimmer.

Getting a grip on those effects has proved difficult so far.

This is understandable, given the wide variety of scenarios.

Most research has concentrated on the costs to the US government of military action.

Estimates have varied from $US50 billion ($83 billion) to $US140 billion for the immediate costs of a short campaign, according to the Centre for Strategic and International Studies.

Initial work from market analysts has concentrated on oil price effects.

Many believe there will be a large spike in the oil price which will drive up prices generally and suppress demand.

This would slice a "manageable" 0.5 per cent off US growth, says one analyst.

Most, too, including the Bank of England, believe any war will be short, and that oil prices will then return to more reasonable levels of under $US30 a barrel by year's end.

But then there is this sombre warning of "recession vulnerability" from Morgan Stanley's Stephen Roach last week.

The world economy has changed significantly in the past decade, he says, with the emergence of a "lopsided US-centric global growth dynamic".

Over the past seven years the US has accounted for 64 per cent of the cumulative increase in the world's gross domestic product.

"Consequently, I am left with the uncomfortable conclusion that the world is in a far more precarious state than it was some 12 years ago," he says.

Economists are still grappling with estimates but markets, of necessity, are having to draw their own immediate conclusions.

Expatriate Australians Andrew Leigh at Harvard University and Justin Wolfers at Stanford University and American colleague Eric Zitzewitz have tried to tap these market decisions and form some analysis.

The basis of the work is an unusual online betting service operating out of

Ireland.

Www.tradesports.com runs a $US10 wager - nicknamed Saddam securities - on when Iraqi President Saddam Hussein will be deposed.

The service's operators say a high proportion of clients comes from Wall Street.

The researchers have found correlations between movements in the Saddam securities and real life events - speeches, UN reports, news items - and, using all of these, have made some predictions about effects based on these betting decisions.

The spot price of oil moves closely with the Saddam security, so that a 10 per cent rise in the probability of war saw oil prices rise $US1 a barrel.

The effects in equity markets are larger.

The bad effects are concentrated in the consumer and discretionary sectors, airlines and information technology but gold and energy get a boost.

Given markets are already responding to these trends, including guesses about the effect of the war on prices, the researchers conclude there is a 50 per cent chance the stock market will range between a 10 per cent fall and a 5 per cent rise.

At the extreme, there is a 10 per cent chance the market will fall by 25 per cent.

A much more in-depth attempt is the work of ANU professor and Reserve Bank board member Warwick McKibbin and Centre for International Economics director Andrew Stoeckel.

Their modelling attempts to put a solid base on the economic costs of war, as mapped out in theory by William Nordaus of Yale University.

They find a $US2 billion drop in the level of Australia's GDP and a $US34 billion fall for the US in the event of a short war.

World economic growth would be cut by 0.7 percentage points.

The flow-on costs, from the costs of peacekeeping to dislocation of markets, is as much as $US18 billion for Australia by 2010 and $US491 billion for the US, again for a short war.

Like Federal Reserve chairman Alan Greenspan, who warned earlier this month that the US government deficit would put pressure on interest rates, McKibbin subscribes to the orthodox view that government deficits "crowd out" private sector investment.

This means that any short-term expansionary effects from government spending on defence will be overrun.

This conclusion should make Treasurer Peter Costello even more keen to ensure there is no dip into a cash deficit here.

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