Function Summary

Managing Business Risk & the New Threats to Australia's Security
Professor Paul Dibb & Mr Jeff Schubert

Economic Implications of the Iraq War

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There are two notable aspects about the debate on the economic consequences of an invasion of Iraq. One is a likely over-estimation of budgetary expenditures on Iraq, and the other is an under-estimation of the longer-term general economic costs.

The direct budgetary costs of invading, controlling and reconstructing Iraq have been subject to a host of studies. The latest Congressional Budget Office estimate is for around $US50 billion for a "short war". After that there will be around $US225,000 per year for each "peace-keeper" – and, most analysts think there will be more than a 100,000 of these, taking the total cost to about $25bn per year.

A basic reconstruction job for Iraq may cost $US25bn ($US1,000 per Iraqi person).
To do a good job, and get an economy and a "democracy" that was an "example" to the rest of the Middle-East, reconstruction may cost several times this. Indeed, if the example of Kosovo was to be followed in terms of dollar per head of population, the total cost would be about $US12bn in the first year. The US Council for Foreign Relations has noted that "restoring Iraq's electrical-power grid to its pre-1990 level could cost as much as $US20bn".

However, there has to be a very big question mark over whether these amounts for reconstruction will ever be spent. Unlike the 1991 Gulf War, which was largely paid for by US allies, the costs of the Iraq war and its aftermath will almost totally fall on the US taxpayer. It is unlikely that the tax-payers of those rich countries which have been critical of US "unilateralism" will be willing to pay for repairing much of the damage they see the US causing.

US taxpayers are likely to have the opposite view. Having spent so much to "liberate" Iraq, and spending about $US25bn per year (which would amount to about 1% of total annual expenditure by the US federal government on all its activities) on "peacekeeping", they will think that it is time for others to carry a large part of the burden. This sense will be all the stronger if the ousting of Saddam Hussein is accompanied by the significant loss of American lives.

This feeling of US sacrifice may also mean that there will be some unwillingness to give up what has been gained. Before the invasion, the US will have controlled 3% of the world's oil reserves, but consumed 25% of annual world production -- of which half was imported. Having gained control of Iraq's 11% share of world reserves (and it may ultimately be higher than this) the US will be severely tempted to hang on to it – irrespective of whether oil was the original motivating force for the invasion.

This is not to say that that the invasion of Iraq was necessarily a good economic proposition in the first place, as Iraqi oil fields are in need of billions of dollars of investment. The Centre for Global Energy Studies estimates that it would require $US5bn over two to three years just to get Iraqi oil production capacity up from the recent pre-war level of 2.5m barrels per day to 3.5m barrels per day (which is where it was in 1980 before the Iraq-Iran war). Doubling this over the subsequent decade may cost another $US25bn.

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But, as Anthony Cordesman of the Centre for Strategic and International Studies notes, US Department of Energy forecasts "call for US direct imports of oil to increase from roughly 9.2m bpd in 2002 to a best estimate of 26m bpd in 2020". That is, US "imports and true level of oil dependence will increase through 2020" and "barring a technological miracle, that dependence will continue for decades". He says, the US has "one vital strategic interest in the Middle Ease: energy imports".

In these circumstances, having already incurred 'sunk' costs, the marginal costs of staying in Iraq may then seem less to the US than the future returns.

Thus, the US may find itself unwilling to go the final yards to spend the huge sums on building a "new" Iraq, but at the same time be unwilling to walk away from it.

This would boost international political tensions -- between the US and other Arab countries on the one hand, and between the US and much of the rest of the world (including Europe and China) on the other, and also with-in Europe itself.

While there may not be any single large identifiable economic result, there are myriad ways for the world economy to be adversely affected.

The US will be looking to the IMF and World Bank to devote large amounts of funds to Iraq – ie take the burden off the US taxpayer and distribute it to taxpayers in other countries – and this will be resisted if the US remains in control of Iraq.

Economic co-operation within the G7, both formal and informal, will be adversely affected, as will efforts to further free up international trade and investment. There may be some impetus to the rise of new international trading blocks, with the US itself already leading the way in tying trade to security issues.

This is not to say that these developments would cause world recession or totally stunt world economic growth. However, add in the flow-on effects to the private sector (via higher investment risk premiums, less consumer confidence as a result of a tense world) and it is not hard to imagine the world economy looking less than shiny for many years.