

Treasury Report: Conflict in Iraq: Economic Implications for New Zealand

Date:	21 February 2003	Treasury Priority:	Low
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Action Sought

	Action Sought	Deadline
Minister of Finance	a note the contents of this report; b note that we will be providing an oral briefing at a forthcoming fiscal issues meeting; and c note that there has been media interest in this report and we are working with your Office on its release.	None
Associate Minister of Finance (Hon Trevor Mallard)	Note contents	None
Associate Minister of Finance (Hon Paul Swain)	Note contents	None

Enclosure: No

21 February 2003

BM-3-10

Treasury Report: Conflict in Iraq: Economic Implications for New Zealand

Executive Summary

Any impact on the New Zealand economy from a conflict in Iraq depends on how the United States and the global economy develop generally. It is difficult to predict how events will unfold. However, the key transmission channels in which any conflict could possibly have an impact on the New Zealand economy remain the same. They are:

- Lower demand for New Zealand exports of goods and services (largely tourism).
- Lower export prices, compounded by higher import prices due to high oil prices.
- Confidence is negatively affected, leading to a pullback on domestic consumption and investment.
- Equity markets and exchange rates. Financial markets to become more volatile, with equity markets retreating and leading to flow-on impacts from wealth loss.

The impacts on the New Zealand economy from a conflict in Iraq are likely to be negative. Exporters and farmers face a fall in incomes through lower global demand and lower prices, compounded by higher input costs (largely due to higher oil prices). The favourable commodity prices and competitive exchange rate that helped insulate the New Zealand economy from the impact of the September 11 terrorist attacks have largely unwound. However, the New Zealand economy is still well placed to absorb some of the initial impact of a conflict in Iraq. Firms' balance sheets are in good shape, and apart from petrol companies, most other firms should be able to absorb rising input costs within their margins. Momentum in the domestic sector, which has been a key driver of economic growth in the past year, is still strong. There should be enough internal demand to see out any further short-term weakness in the external sector.

Resolution of the conflict and the removal of the geopolitical uncertainty should see global growth rebound. This should help to push up growth in the New Zealand economy. However, a quick United States and global economic recovery following the conflict is by no means guaranteed. Imbalances in the United States economy may mean that economic growth remains subdued, even once the current uncertainties around the impact of war are removed.

Although there is scope for the Reserve Bank of New Zealand to move on interest rates, it is not a forgone conclusion that the Reserve Bank will ease monetary policy in response to a conflict in Iraq. The Reserve Bank would need to balance the impact of higher prices feeding through from higher oil prices against aggregate demand impacts that may lead to weakening growth.

The Government's current fiscal position is strong with low debt levels. In the event of conflict it would be appropriate to let automatic fiscal stabilisers operate until better information comes to hand and a more thorough assessment can be made as to whether additional policy responses would be necessary.

Recommended Action

We recommend that you:

- a **note** the contents of this report;
- b **note** that we will be providing an oral briefing at a forthcoming fiscal issues meeting;
and
- c **note** that there has been media interest in this report and we are working with your Office on its release.

for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: **Conflict in Iraq: Economic Implications for New Zealand**

Purpose of Report

1. This note provides an assessment of the likely impacts on the New Zealand economy from a military conflict in Iraq. This note is prepared during a time of great geopolitical uncertainty in the Middle East, with growing speculation that the United States will launch an attack on Iraq.

Analysis

Conflict Scenarios

2. It is difficult to be definitive on what the impact of such a conflict would be, due to the myriad of possible scenarios and outcomes. Analysts have narrowed the scenarios down to four key ones:
 - No conflict: Iraq fully complies with UN Resolution 1441, and the United Nations Security Council concludes that Iraq has disarmed.
 - Short Conflict: The United States and its allies (with or without UN sanction) disarm Iraq by force. Conflict is quick and decisive, similar to the 1991 Gulf War where fighting was over within six weeks. A new regime is installed in Iraq.
 - Prolonged Conflict: A variety of scenarios have been suggested within a prolonged conflict.¹ Included amongst these possibilities is a drawn out conflict, perhaps with unconventional warfare and/or hostilities spreading beyond Iraq. Terrorist attacks hit the United States/Europe in retaliation, claiming both military and civilian casualties.
 - Intermediate Conflict: This scenario covers any outcome between the short and prolonged conflict. Hostilities last longer than six weeks but fighting is over within a year with a decisive victory to the United States and its allies.
3. Scenarios two and three can be seen as the two ends of the spectrum. It is also worth noting that not all scenarios are equally likely. Much international commentary has focussed on a short conflict scenario. A short conflict is likely to have modest impact on global growth, and therefore a modest impact on the New Zealand economy.

Global Economy Analysis

4. A war premium has already largely been factored into oil prices, and financial markets have largely priced in a short conflict. However, at the outbreak of conflict, oil prices are likely to spike higher and financial markets are likely to fall. In the short conflict scenario, once the outcome of the conflict is apparent the war-related risk premia should be removed and oil prices should retreat to their long-term historical average of around US\$20 per barrel. Any negative impact on the real global economy will be

¹ Nordhaus summarises a variety of situations that could eventuate leading to a prolonged war in *"The Economic Consequences of a War with Iraq"* in *"War with Iraq: Costs, Consequences and Alternatives"*, American Academy of Arts and Science, 2002.

limited to one or two quarters, with inflation likely to briefly move higher around the world and international tourism fall for a time, but a recovery should follow once the conflict is resolved. Most international analysts expect a recovery in the United States economy following a short conflict.

5. It is possible that some geopolitical risk could remain even after a short conflict if there is still an element of uncertainty in the region, but less than the current risk built into asset markets. In addition, it is possible that the United States economy may not recover quickly following the completion of war. While uncertainty over war and rising oil prices do appear to be having a negative impact on the United States economy, economic fundamentals, such as the large current account deficit, are also playing a role. Even upon the completion of war, some of the fundamental imbalances in the United States economy are likely to remain. Regardless of the precise impact on the United States economy of a short conflict, it is likely that the recovery in the United States and world economy will be delayed somewhat relative to our expectations at the time of the *2002 December Economic and Fiscal Update (DEFU)*. Already Consensus forecasts of world activity are weakening slightly and even a short conflict would be likely to delay recovery.
6. A prolonged conflict could have larger consequences for the global economy. The exact magnitudes depend on the duration of the conflict. Nordhaus and the Centre for Strategic Studies consider that in a prolonged conflict scenario with some of the elements described above, oil prices could reach as high as US\$80 per barrel for a period of time.² However, there is a sizable degree of uncertainty around such estimates of oil price increases. A sustained increase in oil prices, even if not to the extent of US\$80 per barrel, could be expected to have a sizable impact on global economic conditions with firms facing a large rise in input costs, inflation rising and households effectively facing a real wage cut. Business investment and consumption would slow markedly and unemployment rises rapidly, with a global recession a distinct possibility.³ However, such an impact would be likely to be met with policy responses, particularly reduced interest rates, which may offset some of the impact. Once the end of the conflict was apparent oil prices would return to their long-term average of around US\$20 per barrel.

New Zealand Economy Analysis

7. Any impact on the New Zealand economy from a conflict in Iraq is largely dependent on how events develop in the United States and the global economy generally. There is a great deal of uncertainty around the likely scenarios that could exist and even within the four scenarios described in the introduction to this note, events could develop in a number of different ways. However, the key transmission mechanisms that will impact the New Zealand economy remain the same in any scenario. The channels described below will need to be watched closely to assess the likely impacts on New Zealand:
 - Lower demand for New Zealand exports of goods and services (largely tourism).
 - Lower export prices, compounded by higher import prices due to high oil prices.

² The Centre of Strategic Studies created a number of scenarios for Goldman Sachs, described in the Goldman Sachs *Global Economics Weekly 27 November 2002*.

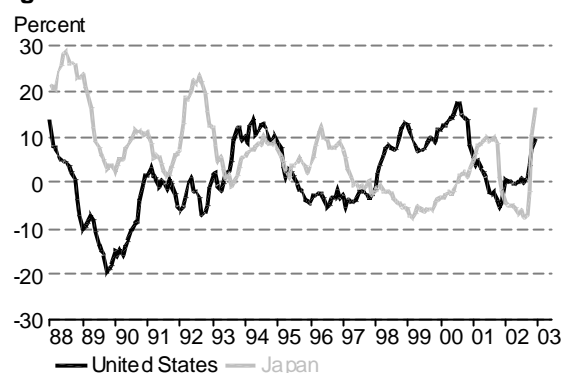
³ As an example of the possible magnitude of the impact in the United States, Nordhaus suggests that as much as US\$390 billion of output could be lost over a 10 year period. However, Nordhaus also notes large error bounds around these types of estimates in the order of 50%.

- Confidence is negatively affected, leading to a pullback on domestic consumption and investment.
 - Equity markets and exchange rates. Financial markets to become more volatile, with equity markets retreating and leading to flow-on impacts from wealth loss.
8. In the event of a short conflict with a small impact on the global economy, the impact on New Zealand is likely to be small with tourism and confidence the only of the channels described above that are likely to be important and the effect is likely to be short-lived. If conflict is prolonged, all the channels above will come into play.

Export Volumes Impact

9. Weak global growth will result in weaker demand for exports. The strongest impact would be on demand sensitive exports such as: non-commodity manufacturing; crude materials; forestry exports; and services (tourism and international students). The most immediate visual impact once the conflict begins is likely to be a drop off in visitor arrivals due to aversion to long-distance travel, especially from the United States and Japan. Such an impact is likely, even in the short conflict scenario, as was the case during the Gulf War. However, New Zealand's geographical isolation away from the Middle East and its reputation as a safe destination may provide some insulation. Upon resolution of the conflict, visitor arrivals should bounce back quickly based on the experience post the September 11, 2001 terrorist attacks.
10. The more prolonged the conflict, the more the impact on world income growth. Added to that the impact of higher oil prices on long-distance air travel, making it more expensive and less attractive, and the prospect is for a more prolonged drop in visitor numbers than is the case in the short conflict scenario. If there is a similar impact on New Zealand's growing international education market, services exports would fall for the duration of the conflict, and possibly a short time after that.
11. Because agricultural export volumes are largely driven by supply-side factors, such as the weather, we do not expect much impact on the volumes side. Other exports are also unlikely to be affected in the short conflict scenario. However, if the conflict is prolonged and the world economy is hit hard, demand for non-commodity manufactured exports will be hit as export orders get cancelled or deferred. With Australia being our largest export destination, the magnitude of any impact would largely depend on the robustness of the Australian economy. Disruptions to the transport and distribution channels of New Zealand's exports to major markets due to the conflict is a further factor that could exacerbate the negative impact on export volumes.

Figure 1 – Visitor Arrivals

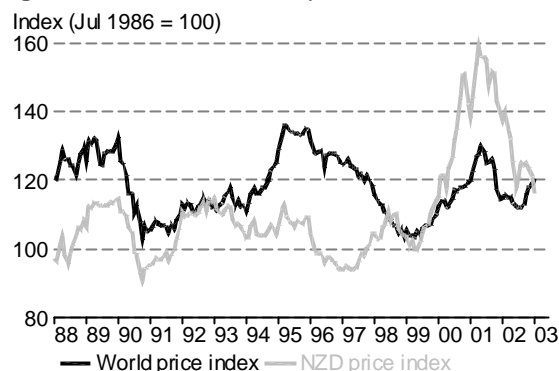


Source: Statistics New Zealand

Prices Impact

12. Prices for New Zealand exports typically follow global economic growth. Due to market specific factors in 2000 and 2001, commodity prices held up even though global growth slowed. Those factors have unwound, and further deterioration in global growth prospects will negatively impact on export prices. However, in the short conflict scenario, the impact on prices is likely to be small or zero unless world growth slows. Prices would be more likely to be negatively impacted in a prolonged conflict. Export earnings will be hit by a double whammy of lower volumes as well as lower prices.

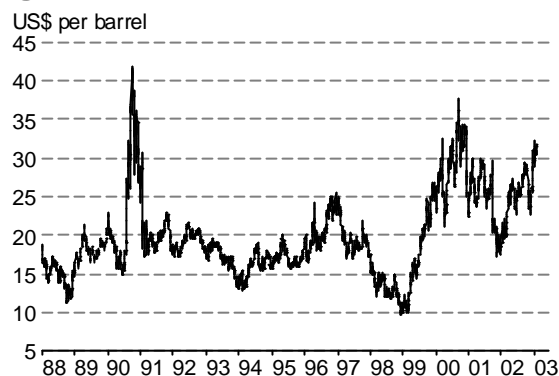
Figure 2 – ANZ Commodity Price Index



Source: ANZ

13. A brief spike in oil prices, as is likely in the short conflict scenario, will have only a small impact on the New Zealand economy. Even if producers pass on higher costs to consumers the impact should only be short-lived and would be expected to reverse quickly following the conclusion of war. However, a sustained rise in oil prices during a prolonged conflict could drive global inflation up, further deteriorating the situation for exporters who face lower output prices and higher input costs. In previous global downturns, weak global demand resulted in lower import prices, which provided an important offset to export price falls. The prospect of sustained higher prices for oil would exacerbate the impact of falling export prices and see a sizable fall in the terms of trade.

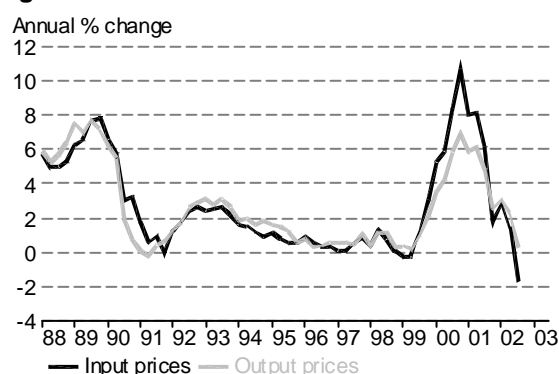
Figure 3 – Brent Oil Price



Source: Datastream

14. Although some of the impact of higher oil prices has already occurred, a price increase to the US\$40 per barrel mark seen during the Gulf War would have further negative effects on the New Zealand economy, via lower domestic consumption and higher inflation. Higher petrol prices can be viewed as a tax on consumers as they reduce household discretionary income and result in lower expenditure on other goods and services. As current petrol margins are already tight, petrol prices will react instantaneously to changes in oil prices. Our estimate is that for every US\$1 increase in international oil prices, all else constant, retail petrol prices (for regular unleaded petrol) would rise by around 1.3 cents per litre. At US\$40 per barrel, petrol prices would go up by around 8.8 cents per litre. This would add ¼% to headline inflation, and reduce household discretionary income by some 0.3%.

Figure 4 – Producer Prices



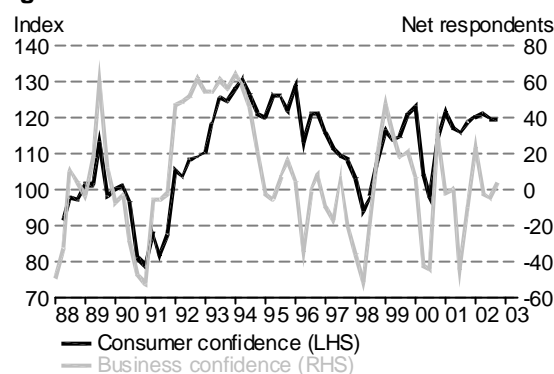
Source: Statistics New Zealand

15. The extent of any further inflationary pressures (apart from directly via petrol prices) would depend on whether producers pass on the cost of higher input costs onto consumers, or whether they absorb it within their margins. For a short period during the Gulf War, and over the two year period from 2000-2001 when oil prices rose (and the NZD depreciated), firms absorbed the higher input costs in their margins, limiting any inflationary impact. When fighting erupts and oil prices spike up, firms might be willing to allow their margins to erode for a short period of time. But eventually, sustained increases in input costs will be passed on to consumers, which may then feed into inflation expectations. Security or border control costs could also be directly impacted by war. For example, insurance premiums may increase and/or exporters may be faced with stricter security measures for their goods, which would increase costs faced by producers.

Confidence Impact

16. Once conflict starts, confidence will decline as households and businesses worry about the duration of the conflict and any potential retaliation. During the conflict, the willingness of households to spend, and firms to employ and invest, will be negatively affected. There is a further risk that firms and households become overly cautious, resulting in a self-fulfilling prophesy of declining domestic activity. In a short conflict this impact would be short-lived and likely to have a small impact on the economy with the current momentum in the domestic economy likely to offset the impact somewhat.

Figure 5 – Confidence



Source: Westpac McDermott Miller, NZIER QSBO

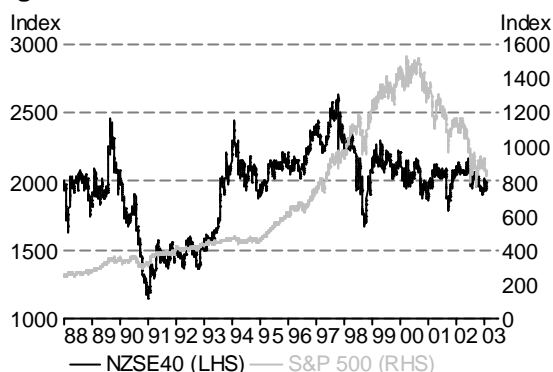
17. Firms will be nervous about taking on additional labour, and with their margins eroding will minimise any wage increases. A halt in hiring, compounded by downsizing in firms impacted by weak global demand, will lead to slowing or even declining employment growth if conflict is prolonged, with the unemployment rate likely to rise. For households, the decline in real wages, a drop in farm incomes, and uncertainty about their jobs will lead to sluggish consumption and residential investment growth.

Financial Markets Impact

18. Financial markets dislike uncertainty, and although the prospect of war has already been partly priced into the equity markets, the start of a conflict in Iraq will almost certainly see a sell-off in global equity markets, including New Zealand. The impact on the real economy from increased volatility in equity markets is uncertain, but is likely to be minimal if there are early signs of an imminent victory by the United States and its allies. However, the longer the conflict drags on, the higher the chances of equity markets staying at low levels. This could result in a further slowdown in global economic activity via the negative wealth effect, which further reduces the demand for New Zealand exports and puts more downward pressure on New Zealand's export prices.
19. Any sharp movements in the exchange rate during war would have impacts on the New Zealand economy, via the prices of tradable goods within the economy and via the prices received by New Zealand export companies. However, which way the NZD will

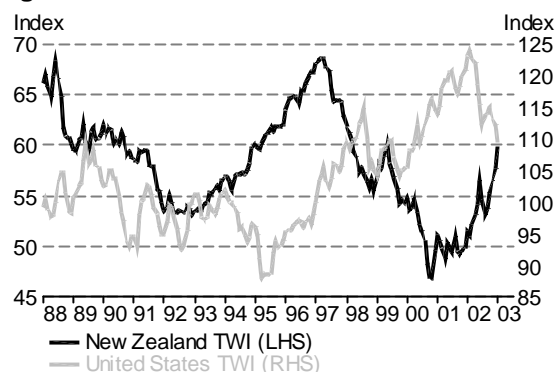
move is less clear-cut. During periods of uncertainty, investors tend to flock into US bonds, and peripheral currencies like the NZD tend to get sold down. Such an impact would make imports more expensive and add to inflationary pressure but would increase the returns to New Zealand exporters.

Figure 6 – NZSE40 and S&P 500



Source: Datastream

Figure 7 – NZD and USD Index



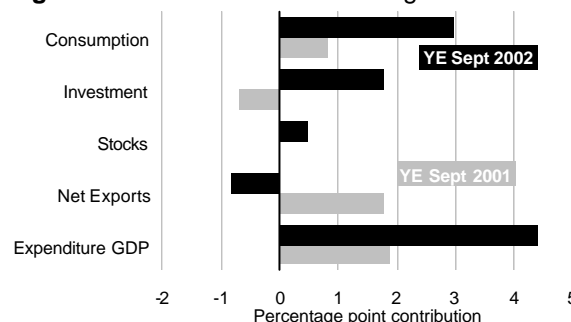
Source: Datastream

Overall Assessment

20. The impacts on the New Zealand economy from a conflict in Iraq are likely to be negative. In a short conflict the impact on New Zealand would be small with tourism likely to see the largest impact. However, even the impact on tourism is likely to be short-lived and reversed at the conclusion of war. The favourable commodity prices and competitive exchange rate that helped insulate the New Zealand economy from the impact of the September 11 terrorist attacks have largely unwound. However, the New Zealand economy is still well placed to absorb some of the initial impact of a conflict in Iraq. Firms' balance sheets are in good shape, and apart from petrol companies, most other firms should be able to absorb rising input costs within their margins.

21. There is still momentum in the domestic sector, which has been a key driver of economic growth in the past year. Strong consumption and investment growth has more than compensated for the weak external sector, which has subtracted from growth. Residential investment is still strong, and so long as net migration does not slump when conflict erupts, there should be enough internal demand to see out any further short-term weakness in the external sector.

Figure 8 – Contributions to GDP growth



Source: Statistics New Zealand, The Treasury

22. The risk of a conflict in Iraq is one of a number of negative risks facing the New Zealand economy as it heads towards 2003/04. Lower commodity prices, a sluggish world economy and an easing in net migration inflows were some of the factors we highlighted in the DEFU. The impact on New Zealand's GDP growth from a conflict in Iraq is difficult to quantify at this stage, but together with the above factors and a higher exchange rate than we had factored in DEFU, poses downside risks to our DEFU forecast of GDP growth of 2.5% for 2003/04. The deterioration in New Zealand's terms of trade as a result of the conflict will lead to a larger current account deficit, and the oil price impact will lead to higher inflation.

23. Resolution of the conflict and the removal of the geopolitical uncertainty should see global growth rebound, helping to push up growth in the New Zealand economy. However, a quick United States and global economic recovery following the conflict is by no means guaranteed. Imbalances in the United States economy may mean that economic growth remains subdued, even once the current uncertainties around the impact of war are removed.

Policy Responses

24. If there is evidence of reduced pressures on domestic resources and medium-term inflation from a conflict in Iraq, then there may be scope for a cut in the Official Cash Rate (OCR).⁴ However, it is not a foregone conclusion that interest rates will be cut. The Reserve Bank of New Zealand would need to balance the impact of higher prices feeding through from higher oil prices against aggregate demand impacts that may lead to weakening growth. If oil prices appeared likely to push inflation outside of the 1-3% range in the short term, the key uncertainty would be to assess whether such an increase in oil prices was likely to be enduring or transitory. If the shock is transitory then any impact on inflation is likely to be transitory, allowing the Reserve Bank to look through this impact on prices. If the oil price shock is long lasting there is more likely to be a large degree of spill-over into other prices, and potentially into inflation expectations. If this were to occur, the Reserve Bank may raise interest rates instead.
25. The Government's current fiscal position is strong with low debt levels. In the event of conflict it would be appropriate to let automatic fiscal stabilisers operate until better information comes to hand and a more thorough assessment can be made as to whether additional policy responses would be necessary. The Government's new fiscal management approach should help this assessment process as it allows for more regular fiscal reviews. Automatic fiscal stabilisers are the changes in tax revenue and unemployment spending that tend to occur directly in response to economic fluctuations, without any government decision to alter revenue or spending. Letting the stabilisers operate in a downturn would generally see slower growth in tax revenues and higher unemployment spending, and so a reduced fiscal balance. The Government's spending plans would be maintained in the first instance. This approach means that fiscal policy is looser in a downturn.

Risks

26. There is media interest in this report, and its release may attract public comment. We are working with your Office on the public release of this report.

⁴ A week after the September 11, 2001 terrorist attacks, the Reserve Bank made an unscheduled cut to the OCR by 50 basis points. This was followed by another 50 basis points cut two months later.