Strategic Insight

Financing Wars on Terrorism and Iraq

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Introduction

One of the key questions about the current U.S. war against terrorism and rogue states remains largely unanswered: The extent to which defense/security expenditures will have to expand to meet the threat. Clearly, the ultimate cost will depend upon events that are still unfolding: Will the United States be able to maintain the peace in Afghanistan with the current level of effort? Will the remaining terrorist cells engage in further major acts of violence? Will the United States attack Iraq? If the attack occurs, how is that conflict likely to develop in terms of the intensity and duration? The time and resources required for reconstruction and nation building? The added amount of foreign aid to affected countries?

At this point, it is unrealistic to attempt even a rough estimate of the financial burden imposed by terrorism and rogue states. Instead, this essay looks at rough magnitudes of added security expenditures in the short-run—over the next year or so, and the role of the international monetary system in facilitating their financing. A future essay will examine the possible longer run financial costs of these conflicts and their implications for a necessary restructuring of the international monetary system to enable it to better meet the financing requirements dictated by world security needs.

Costs Associated With Terrorism and Homeland Security

The War on Terrorism clearly differs from past wars in a number of important respects. Economically a much larger share of the burden is falling directly on the private sector rather than just the government. Higher insurance rates are clearly one of several new costs falling upon corporations (Looney, August 2002). In the year following 9/11, American firms have hired over 300,000 new security guards as well as spending heavily on new forms of metal detection and other security equipment. While there is little precise data available about these expenditures it would not be unreasonable to estimate that rising insurance prices and increased spending on security will probably cost American businesses about $100 billion per annum, or nearly as much as the national defense budget will increase during 2002-2003.

One might think, therefore, that the added costs of homeland security would place considerable budgetary stress on both the private and public sectors. However, a recent Federal Reserve study (Hobijn, 2002) suggests that:

- Public and private sector outlays for increased security will be relatively small—roughly $472 billion per year or 0.66 percent of the U.S. Gross Domestic Product (GDP) in 2003.

- Fears that private sector productivity will decline significantly as firms shift resources to protection appear ill founded. Firms' security initiatives will lower labor productivity levels by no more than an estimated 1.12 percent.

- Indirect costs of homeland security—notably the delays related to tightened airport security and the diversion of research and development funds from productivity—enhancing technologies are also likely to prove modest.

For the near future, as firms gain experience in managing security more effectively, they will no doubt find ways to reduce costs and improve productivity of their new security employees. Still, it is likely these costs will have a depressing impact on corporate earnings at a point in the business cycle when higher profits are needed to revive capital spending. As a result, the short run economic implications of 9/11 will probably be a more subdued upturn in the global economy during late 2002 and 2003 than would have occurred otherwise. In turn, lower growth in the domestic economy is likely to result in larger budget deficits, while a slowdown in the world economy may further increase the current account deficit of the balance of payments.

On the other hand, the reallocation of resources to homeland security is unlikely to have any large and long-lasting effect on the economy. In addition, spending on homeland security should not in and of itself push defense expenditures back to their Cold War levels and force the federal government to run large budget deficits (Mandell et al., 2002).

With regard to the foreign aid component of the War on Terrorism (Looney, July 2002) the Bush Administration's post 9/11 foreign aid initiatives came from the $40 billion supplemental appropriations bill Congress passed on September 18. The administration constructed a $1.06 million assistance package covering Afghanistan, Pakistan, Turkmenistan, Uzbekistan, Kyrgyzstan, and Tajikistan. No doubt, the Afghanistan reconstruction efforts will go on for a number of years, as will stepped up assistance for Pakistan. Nonetheless the magnitudes while large in absolute terms, do not fundamentally change the conclusionthat the war on terrorism can be financed without incurring greatly expanded budget deficits and rising interest rates.

Costs of a War Against Iraq

The traditional textbook view is that war stimulates an economy, at least in the short term. However, that simple view of wartime economics is too narrow to describe the possible effects of an Iraq war. At stake are the financial limitation in terms of larger budgetary deficits and their impact on interest rates, the value of the dollar and inflation (Ford, 2002). Also, even a limited war could profoundly disrupt the international flow of goods, services, and investments upon which our global economy now rests (McTeague, 2002).

Numerous experts before key Congressional committees have presented their estimates of the financial implications of a war with Iraq. As might be expected, these estimates vary considerably depending on assumptions as to the intensityand duration of the war and post-war reconstruction. Based on the hearings before his committee, Senator Joseph Biden, former Chairman of the Senate Committee on Foreign Relations, feels that a realistic estimate of war costs may be much as $80-$100 billion. As a frame of reference, the 1990-91 Gulf War cost $61 billion. That is almost $80 billion in today's dollars.

Testifying at the Senate hearings on Iraq, Samuel Berger, Senior Foreign Policy Advisor during the Clinton Administration, suggested that the costs for rebuilding the Iraqi economy will range from $50 to $150 billion. Scott Feil, a retired colonel and expert on post conflict reconstruction, noted that significant material and personnel resources would be required for reconstruction. By his account, security forces alone would entail 75,000 personnel in the first year, amounting to $16.5 billion. At least 5000 troops would have to remain in place over 5-10 years costing over $1 billion a year. Beyond security, the U.S. would be expected to make a significant contribution for humanitarian and emergency aid, a transitional administration, civil service and other components for reconstruction. Feil estimated that these non-security costs would amount to $15-$25 billion over the next decade.

In addition to the often impressionistic testimony noted above, several major studies have been undertaken to assess the financial implications of a future war with Iraq. Under the assumptions

incorporated in its examples, the Congressional Budget Office (CBO, September 2002) estimates that the incremental costs of deploying a force to the Persian gulf would be between $9 billion and $13 billion. Prosecuting a war would cost between $6 billion and $9 billion a month. After hostilities end, the costs to return U.S. forces to their home bases would range between $5 billion and $7 billion, CBO estimates. Further, the incremental cost of an occupation following combat operations would vary from about $1billion to $4 billion a month. The estimates of monthly costs incorporate no assumptions about the duration of the conflict or the occupation. Also the CBO felt it had no basis for estimating any costs for reconstruction or for foreign aid that the United States might choose to extend after a conflict ends.

At a recent conference, Laurence Meyer (2002) and Anthony Cordesman of the Center for Strategic and International Studies provided three war scenarios, each of which entailed a certain cost. The "benign case" anticipates rapid victory. Much of Saddam's Army surrenders or defects. Because uncertainly lifts, the economy fares better than under a "no war" scenario. The temporary loss of Iraqi oil is not a big deal. Iraq's production now represents about 2 to 2.5 percent of world oil use. Saudi Arabia and other Persian Gulf suppliers offset the loss. Their surplus capacity is about 6 percent of global consumption. The United States might also release oil from strategic reserves.

By contrast, Meyer and Cordesman's other scenarios—though deemed less probable—are of much greater concern (Wolf, 2002). In the "intermediate case," fighting lasts up to three months. Iraqi attacks slightly damage other gulf oilfields. Oil prices, now about $25 dollars a barrel, hit $42 by early 2003. In the worst case, Iraq badly damages other oilfields. Production drops by at least 5 million barrels a day, out of a total global consumption of 77 million barrels a day. Oil prices hit $80 a barrel. Intense urban fighting incites the U.S. antiwar movement. Social unrest spreads in the Middle East. In the intermediate case, unemployment (now 5.7 percent) reaches almost 6.6 percent by late 2003. In the worst case, it goes to 7.5 percent. Table 1 Summarizes the CSIS/Meyer/Cordesman estimates.

Table 1 CSIS Forecasts of the Cost to the U.S. of a War with Iraq ($billion)

	Low*	**High**
Direct military spending	50	140
Follow on costs		
Occupation & peacekeeping	75	500
Reconstruction & nation-building	25	100
Humanitarian assistance	1	10
Impact on oil markets	-30	500
Macroeconomic impact	0	345
Total**	**121**	**1595**

**Low = Short and favorable scenario*
High = Protracted and unfavorable
***Total for the decade following the conflict (in 2002$)*

Finally, an extensive analysis by William Nordhaus of Yale University (2002) focused on the long term costs to America from an Iraq war. He points to the high costs likely to be incurred after a military victory is secured e.g., in peacekeeping, reconstruction, and nation building. By examining international experience in post-war Kosovo, East Timor, Haiti and other recent cases, he estimated that such non-military costs could reach $600 billion if a liberated Iraq turns out to be more like the West Bank than Kosovo.

Nordhaus also worries that an Arab boycott or some other political factor could keep a significant share of OPEC off the market for many months. And that of course would mean higher oil prices, higher inflation,

lost economic output and so on. All told Mr. Nordhaus thinks that even an Iraqi invasion that went well would probably cost around $120 billion in today's money over the next decade-and one that went horribly wrong could end up costing in the range of $1.6 trillion.

While it has been suggested that the United States could tap some of Iraq's oil as sort of a reparation scheme to cover some of the costs of reconstruction/humanitarian assistance, this is not very likely. Many experts feel that it may take up to six months and possibly more than a year to expand oil production. McNulty (2002) notes that "it would take Iraq between one and three years to return to the production level of 3.5 million barrels per day it had reached in 1990". Iraq's production capacity is now at 2.6 to 2.8 million barrels per day, and obviously this could decline drastically in a protracted conflict.

In sum, while the war cost estimates vary widely, they suggest that potentially the United States might find itself incurring staggering costs (Dobbs, 2002). The United States had much international support during the Gulf War. Coalition members contributed about 90% of the costs. However, unless things change drastically, a war with Iraq would not have this sort of support. Many allies have made it clear that they are not in favor of a preemptive strike. Germany and Saudi Arabia, among the largest cash and in-kind contributors to the Gulf War, have indicated their opposition to an invasion. Unless the situation changes drastically, the United States can expect in addition to the costs of homeland security and terrorism-related foreign aid, to pay for most of the Iraq war as well as reconstruction. As noted, at best Iraqi oil might cover some of the post-war humanitarian assistance.

Budgetary Strategies

The increased government outlays associated with wars can be financed in four ways: through higher taxes, reductions in other government spending, increased public borrowing (both domestic and international) and monetary creation (Labonte, 2001). The first two methods are unlikely to have an effect on aggregate demand in the short run—the expansion in aggregate demand caused by greater military outlays is offset by the contraction in aggregate demand caused by higher taxes and/or lower non-military government spending. The latter two methods increase aggregate demand.

During World War II, government expenditures were financed primarily by issuing debt (Tobin, 2002). During the Korean War, expenditures came almost exclusively by higher taxes, reflecting President Truman's preference for balanced budgets. Recent work by Ohanian (1997) indicates that the economic impacts of debt financing are much less severe than those imposed by tax increases. Specifically he finds that using a Korean War policy during World War II would have resulted in much lower output and welfare relative to the actual policy.

The beginning of the Vietnam conflict coincided with a large tax cut, but this actually resulted in increased government revenues and a budgetary surplus the following year. However, after that, non-military government spending rose throughout the Vietnam era. Budget deficits were used for most of the financing, although tax increases occurred at the peak of the conflict. Inflation rose throughout the period and President Nixon turned to price controls in August 1971. The stresses caused by this policy in conjunction with deficit induced excess demand are often blamed for destroying the international monetary system of the time, the Bretton Woods dollar exchange system established after World War II.

The Reagan military buildup in the 1980s followed a different pattern. Both taxes and inflation were lowered during this period for reasons unrelated to the military buildup. Tax cuts and their supply-side effects on economic growth were one of the major themes of the Reagan era, while the main goal of the Federal Reserve under Chairman Paul Volcker was to reduce inflation from the double-digit rates prevailing in the late 1970s. The Federal Reserve Bank accomplished this through tight monetary policy, which unfortunately also set off the deepest recession since the 1930s, derailing the investment surge counted on by the supply-siders (Looney 2001). As theory suggests, the combination of loose fiscal policy and tight monetary policy in the 1980s led to the highest real interest rates in recent history. Since the United States operated a floating exchange rate in the 1980s, as it does at present, some economists

believe that one result of the large budget deficits were the excessive trade deficits of the mid-1980s. Looked at from a different angle, the trade deficits were simply a refledtion of foreign capital being attracted to the United States by the high interest rates stemming from the budget deficits. A contrary view holds that the high interest rates were largely related to the tight monetary policy of the Fed and that the budget deficits while contributing to this increase played only a minor role. This view stresses that the deficits were financed in large part by foreign capital inflows, relieving stress on the domestic capital markets.

To date, the current military buildup resembles the Vietnam and Reagan eras, with neither shared economic sacrifice nor war focused prioritizing. Monetary policy is harder to characterize. The Fed has been cutting interest rates, but given a growth of only 4% in the money supply from the autumn of 2001 to the summer of 2002 some economists contend that it was relatively tight (Kudlow 2002). This view is reinforced by the current fear in some circles (Krugman 2002) that the country may experience a period of deflation similar to that occurring in Japan. That country's money supply growth also decelerated in the early 1990s.

So far, with just the war on terrorism and homeland security allocations the increase in military/security related expenditures has been manageable. Defense costs have risen from 3% of GDP in FY2001 to 3.4% in FY2002, much less than in the last decade of the cold war (The Economist, 2002). However, the cost of fighting terrorism in coming years, plus a likely war in Iraq followed by a long military presence, not to mention deployments elsewhere, could increase the figure considerably.

In short, this year's fiscal deficit does not present any particular problems (Wolf 2002). A struggling economy makes that necessary. It also makes tax increases this year inappropriate; indeed, if the economy weakens further, income tax cuts scheduled for 2004 might have to be moved up to 2003. However, assuming the economy regains strength in coming years, large future deficits resulting from recent and prospective spending and tax legislation would without resort to increased foreign borrowing sharply increase interest rates, crowd out private investment and increase the difficulty of funding Social Security and Medicare.

Constraints Placed by the International Monetary System-The Trilemma Problem

The real question then is how to pay for growing military and homeland security needs? Even before 9/11 increasing demands on the military were becoming a growing area of concern (Danoon, 2001). Can we do so while also addressing such other bipartisan goals as improving education, providing prescription drug benefits and strengthening Social Security? Based on the current mix of relatively tight monetary policy and loose fiscal policy, a logical solution would be to relax monetary policy. This is consistent with Ohanian's analysis noted above of the impact of alternative financing models (deficit over taxes) for World War II and Korea.

However, in today's world, the extent to which growing budget and current account deficits are desirable as well as feasible revolves around a series of choices that have to be made in the context of the international monetary system. As with most policy problems in economics, one is faced with a number of tradeoffs. In the current situation, funding of increased defense/security expenditures will depend in large part on trade-offs between our standard of living, increased indebtedness to foreign governments and individuals, and our willingness to shift from a largely unilateral to a multilateral approach to the war on terrorism/rogue states.

This can be illustrated by building upon the so-called international monetary system trilemma problem (Rodrik, 2000, 2002). The trilemma problem states that the international monetary order is influenced by the pursuit of three goals, of which only two can be reached simultaneously in a satisfactory manner. Thus policymakers have to decide which two goals they prefer. This largely determines the resulting international monetary system.

To examine the broader aspects of international integration, Summers proposed what he calls the economic integration trilemma. According to Summers (1999), the three main goals of international economic integration are:

- Monetary autonomy or economic national sovereignty.
- Stable exchange rates or proper public economic management. Summers associates with this objective the creation of institutions and the implementation of regulations that aim at reducing or eliminating market failure and market imperfections.
- Free capital flows or greater international economic integration.

Summers suggests that the three goals of the integration trilemma involve trade-offs where in essence only two goals are achievable at any one time. For example, if a country pursues greater international integration and appropriate public policies, which also focus on a more global environment, independent national goals can not be reached.

Figure 1

The logic of the integration trilemma leads in analogy to the analysis of the three policy solutions which reflect clear preferences regarding the three competing goals based largely on one's view of the viability and desirability of relying on free market forces, The Market Centric Trilemma. Here three logical groups can be identified: (1) Multilateral Market Interventionists, (2) Unilateral, Free Market Conservatives, and (3) Multilateral Managed Market Internationalists.

Figure 2

Market oriented conservatives such as the Bush Administrations and many Republicans typically stress the importance of free markets and sovereign governments. As this position is often accompanied by strong beliefs in the efficiency of markets and by a deep mistrust of the motives and capabilities of state agencies, public management is not seen as a major loss. For them, exchange markets while clearly more complex than commodity markets are best left to themselves to equilibrate forces of supply and demand. These traits usually lead them to prefer unilateral solutions to problems, both economic and non-economic (Fukuyama, 2002). In the case of the wars on terrorism and Iraq, the military/security strategy at current levels of funding is consistent with the current structure of the international monetary system.

Multilateral Market Interventionist liberals prefer a different solution to the trilemma, which is indicated by their position on such things as exchange rates where it is felt that currency markets are often highly unstable, requiring Federal Reserve/Treasury intervention and/or increased coordination with foreign monetary authorities and the International Monetary Fund to achieve stable rates. While stable rates may not reflect free market forces this group, including many Democrats, believes free market forces as affected by volatile capital flows are not an efficient solution. They would also be more inclined toward a multilateral approach to the wars on terrorism and Iraq. Again an approach where security strategy is consistent with the workings of an international monetary system relying heavily on market intervention.

Internationalists typically differentiate themselves from the other two positions in their less pronounced stance on national sovereignty. If there are forces that lead to increasing world integration and if public management is beneficial, then national sovereignty is less important relative to the other two goals. Their position on markets is not as well developed as that of the other two groups, but would probably prefer an international currency created by an organization such as a restructured IMF or World Bank to the current system of national currencies plus the euro—this would eliminate exchange rates and thus the need for national intervention.

Figure 3

Conclusions

As the Washington Post recently editorialized "The historical judgment on all these conflicts (World War II, Korea, Vietnam) depends, rightly, on whether they increased the security on which liberty and economic progress depend. The same is true of an Iraq war. If you think Saddam Hussein poses no threat, it would be crazy to wage war against him no matter what the price tag. But if you think he may one day use weapons of mass destruction to blackmail his oil producing neighbors and threaten American security—and if you think crucially that the [Bush] Administration will be committed to the long task of creating a better regime after the war's done - then $200 billion or even $400 billion would be worthwhile" (Washington Post 2002).

On the assumption that Saddam Hussein poses a serious threat, a question quickly arises as to the financial implications of his removal. In this regard, the international monetary trilemmas may play a critical role. As noted, the United States is currently pursuing the unilateral free market option with very limited economic cooperation. This strategy relies on maintaining a relatively strong dollar (Makin, 2000), facilitating large capital inflows that can be used to fight the wars on terrorism and Iraq, while sustaining a higher standard of living than one reflecting on domestic resource availability.

In the short run, current account deficits in the range of 4-5% of GDP are probably sustainable (Mann, 2000). If these are adequate for our defense security needs then the international monetary system is consistent with maintaining a satisfactory expansion of the domestic economy. On the other hand if defense/security needs force the current account deficit to 6-7% of GDP then higher interest rates through tighter monetary policy and a restructuring of the tax system spreading out burdens over time (Cecchetti, 2002) would be required to maintain a strong dollar consistent with this size deficit. Under these circumstances, the domestic economy might be thrown back into a recession and the wars on terrorism and Iraq scaled down, domestic taxes increased significantly or another international monetary arrangement put in place, most likely one flowing out of the multilateral market interventionist portion of the trilemma depicted in Figure 3.

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