Financial markets seem to be assuming a short, sharp US assault on Iraq with finite post-war costs. But there's well-documented evidence that Iraq is only the first step in a strategy of total war that could undermine both the US and global economy. • ***Antony Currie*** *reports*

What price glory?

THERE WAS NO doubt in the investment banker's voice as he gave his take on his most recent visit to Washington DC. "We're going to war. This administration wants to take us to war."

It wasn't last month, it wasn't even in the week after the September 11 terrorist attacks on New York and Washington DC. It was spring 2001 while the US was dealing with the Chinese government over an incident involving a US surveillance aircraft and a couple of Chinese fighters.

Euromoney scoffed at the idea. Okay, the administration has its hawks, but war? Surely that's just bluster? Patiently the banker replied that he'd been at an event hosted by Empower America, a right-wing Republican think-tank set up by Jack Kemp, formerly a senior Republican member of the House of Representatives. US vice-president Dick Cheney was the keynote speaker. "He adopted that avuncular manner of his, with one arm leaning on the podium, and basically stated that the administration was going to war."

It was no isolated incident. He'd heard similar words the year before from Condoleezza Rice. Now national security adviser, at the time she was one of George W Bush's senior foreign policy advisers. She was speaking at a post-session meeting at the August 2000 Republican National Convention in Philadelphia, at which Bush and Cheney were formally adopted as the party ticket for the November presidential elections.

This particular meeting had senator John McCain as keynote speaker. Rice followed, and what she said, recalls the banker, "made the hairs on the back of my neck stand up".

As with Cheney several months later, says the banker, "she made it pretty clear what the agenda would be were they to be elected. 'We're going to take an eraser and get rid of Saddam Hussein and any others in the Middle East who cause us problems.'"

These are not two one-off events; rather they are some of the few semi-public utterances by senior members of president Bush's teams of a foreign policy strategy that has been under development since the latter half of Bush senior's presidential stint. It is a strategy of active American military dominance around the world. It is, in effect, total war.

The administration would never couch it in such terms, but its advisers do. Michael Leedon is one of them. He's a scholar at the American Enterprise Institute, a right-wing think-tank that is an incubator for Republican policy and leaders. After George W Bush was declared the winner of the 2000 presidential election, 20 of the AEI's 50 or so scholars left to take up posts in the new administration. In November 2001 Leedon, who stayed on, proclaimed at an AEI panel that the response to the terrorist attacks would have "no stages. This is total war. We are fighting a variety of enemies. There are lots of them out there.

"All this talk about first we are going to do Afghanistan, then we will do Iraq, then we will take a look around and see how things stand. That is entirely the wrong way to go about it ... If we just try to let our vision of the world go forth, and we embrace it entirely, and we don't try to ... piece together clever diplomatic solutions ... but just wage a total war against these tyrants, I think we will do very well. Our children will sing great songs about us years from now."

This is something that the financial markets prefer to ignore: maybe the costs of total war are too frightening to think about. Most are still grappling with the financial and economic effects of a war directed solely against Iraq. How much it costs the US to pursue the war and then rebuild Iraq will have a large impact on economic matters back home.

But most investors and analysts operate under the possibly misguided impression that once it's done, it's done. That view was best summed up last month by the man often regarded as the sage of the US economy, Federal Reserve chairman Alan Greenspan, in his testimony to Congress: "The intensification of geopolitical risks makes discerning the economic path ahead especially difficult," he said. "If these uncertainties diminish considerably in the near term, we should be able to tell far better whether we are dealing with a business sector and an economy poised to grow more rapidly – our more probable expectation – or one that is still labouring under persistent strains and imbalances that have been misidentified as transitory."

That near-term view can only be a reference to the hope for an invasion of Iraq sooner rather than later, and one that is followed by a quick military victory. That's a big hope: a military victory might not come quickly, the war could spread, Hussein might escape just as Osama bin Laden has, oil production could be affected. There are any number of outcomes, many of which have been examined by economists such as William Nordhaus at Yale University.

These detailed studies refer just to Iraq. But there are a few who have started to question whether it would end there. Certainly there's no guarantee that the economy would turn around quickly after a military victory in Iraq.

"Greenspan and co believe that once the Iraq issue is resolved, oil prices will fall and the economy will be back on track," says David Rosenberg, chief US economist at Merrill Lynch. "We're not that optimistic. Corporate and household balance sheets are not yet fully repaired and the latest Fed survey of lending standards has them tighter than they were at this stage of the early-1990s post-recession cycle."

And then there is the danger of more conflict, says his colleague Gerald Lucas, Merrill's government bonds analyst: "Although our concerns may be temporarily alleviated through a successful war with Iraq, a similar problem may still arise again at another date with another country. These concerns should lead to an overall long-term increased level of uncertainty and volatility in the market. Greater post-war uncertainties may lead to an uneven recovery and choppy markets."

It's a wise way to think. Iraq, according to the diktats of the Bush foreign policy that has been 10 years in the making, is just the second stage in a process, starting with Afghanistan, that many administration officials all the way up to the president himself have stated could take years.

The consequences for the economy and financial markets are huge, yet few are talking about them. By how much will the defence budget be increased? How often does the administration plan to start a war? How much will they cost? How does it aim to organize and pay for the process of cleaning up and rebuilding after the wars, especially given its ideological aversion to anything to do with nation-building and its inherent distrust of long-term cooperation with precisely those international bodies that would have to run such operations? Can it expand the military, wage wars, and rebuild those countries it attacks at the same time as cutting taxes, running an expanding deficit and presiding over a weakening dollar, and still expect the economy to pull itself out of the mire?

War spending as % of US GDP

**Both Union and Confederate*
Source: Nordhaus/US Department of Commerce

Fiscal deterioration

George Magnus, chief economist at UBS Warburg, and his team of Andrew Cates and Paul Donovan, wrote in a recent report: "Higher defence and security outlays won't be the only source of fiscal deterioration. We would judge that while the budget deficit on current accepted assumptions looks likely to rise to 3% to 4% of GDP in the next one or two years, there is every likelihood that it could regain the depths to which it sank under president Reagan, who added more public debt to the US than all the presidents from George Washington to Jimmy Carter put together."

And there is lurking around the corner the ever so large issue of non-discretionary federal expenditure, continued Magnus. Such items as "underfunded social security and medicare programmes will need to be addressed without the additional burden of tax cuts for the rich".

Is there a credible financial and economic plan here?

The administration already appears to be deceiving itself, and others, about the deficit. Budget chief Mitch Daniels stated on a financial news TV show at the start of February that deficits would improve by 2005. But, says Lehman Brothers Washington DC analyst Kim Wallace, "neither war nor the cost of tax cuts is in the deficit estimates. The likelihood of war spending seems high, as do the prospects for looser fiscal policy this year. If either or both events occur, deficits and debt will grow this year and over the intermediate term, at minimum. Washington would be imprudent to plan with its eyes focused only on potential upsides."

>

Magnus, Cates and Donovan put all this in the context of the "challenge to, even decline in, American hegemony". It's a theme that has been around before: in the early 1990s the tiger economies of Asia were widely assumed to be gearing up to take over from the US as the drivers of the world economy, with the 21st century set to become the Pacific Century. The collapse first of the Japanese economy and then of most other economies in Asia appeared to put paid to that. But China could be starting to change that again. According to the Warburg team, industrial production was up 15% in China last year. "Put another way, about 40% of the increase in world output was attributable to China," writes Magnus.

The Warburg team isn't alone in questioning the sustainability of US economic hegemony if the heavy financial burden of total war is added to existing weaknesses. Bill Gross, Pimco's chief bond investor, was also writing about it last month.

While accepting that the US was, militarily, the hegemonic power, Gross writes that "I'm not so sure that we are, or perhaps will be the economic powerhouse we once were. Three years of stock market declines, a 20% devaluation of the dollar over 10 months, and an inability to serve as the global economy's locomotive despite massive monetary and fiscal stimulation suggests America's 'shining city on a hill' may have lost some of its sheen of late ... Economically, we may have begun a process of hegemonic decay of late."

Unlike many of his peers in the financial markets, Gross appears to understand why. "Bush has in no uncertain terms said that our future struggle [against terrorism] will be a never-ending story, as opposed to a single-shot kill. If so, investors must know that perpetual containment entails costs, not just monetary but those involving potential policy reversals that have formed the backbone of America's economic hegemony for nearly seven decades."

Free markets are first casualty

The promotion of free trade is one such policy that has been called into question, by last year's steel and lumber tariffs. The increasing use of global capital controls in the fight against terrorism is another retreat from free markets. Gross continues: "We will experience a somewhat vicious cycle of policy reversal instead of the virtuous circle of recent decades, which led to higher profits and lower inflation. In the reversal's wake will come subdued profits, higher inflation, a lower dollar and anaemic financial returns."

These aren't questions the administration sacrifices much time to discussing. For many of the senior members of the Bush team the focus is on the foreign policy agenda that they have been brewing since Bush senior was in the White House.

Total war is hardly a new idea. But it's one that has never got far in the US; there have always been elements within US administrations in the past advocating such a stance, especially aimed at the Soviet Union at various points during the Cold War. But they were always a minority, and often dismissed as zealots, or worse. Now, under George W Bush, they're in control.

Paul Wolfowitz, now deputy secretary of defence, was one of the first to formulate the modern version of this strategy. Back in 1992, when he was undersecretary for policy at the Department of Defense in Bush senior's administration, Wolfowitz was responsible for a 46-page document detailing how the US, as the only remaining superpower, ought to be more proactive in using its military power to defend and expand the strategic interests of the US. It became known as the Wolfowitz Memorandum, and posited that the US should do all it could to prevent the rise of any superpower to replace the Soviet Union, "establish and protect a new order" under unchallenged American dominance, consider the pre-emptive use of nuclear biological and chemical weapons, and maintain US forces at then-current levels and resist expenditure cutbacks.


AFP

Wolfowitz, Cheney, a US tank in Kuwait, Bush Jr and Rumsfeld: *The military might to build the new American century will prove costly*

The document was leaked to the *New York Times*, and was later revised to sound less aggressive, less arrogant and more supportive of multilateral approaches and institutions. Opposition to budget cuts was also toned down. It was those cuts, of course, that formed most of the reduction in federal discretionary spending [which excludes spending on social security and medicare] during the 1990s, which acted as the so-called peace dividend for the US economy, helping to eliminate the federal deficit and arguably contributing greatly to US economic growth in the 1990s.

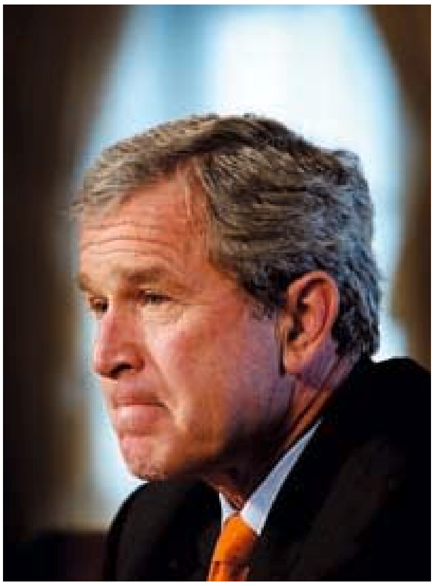
The military, meanwhile, extended its technological superiority over allies and enemies alike. Although that might not have made it structurally well positioned for the wars that Wolfowitz and his Pentagon boss, secretary of defence Donald Rumsfeld, now envisage fighting, that wasn't for lack of money.

Five years after he was forced to tone down his report, Wolfowitz, by then dean of the Nitze School of Advanced International Studies of The Johns Hopkins University, banded together with like-minded individuals to set up a think-tank called the Project for the New American Century. Solely focused on international affairs, it took the Wolfowitz Memorandum as its starting point, adopted Clinton's defence and international affairs policies – or lack of them – as its bêtes noires, and called for the US to reassert its influence and power around the world, foster closer ties with democratic allies, and promote economic and political freedom abroad.

Among those joining Wolfowitz were Rumsfeld; Bush senior's vice-president, Dan Quayle, and his defence secretary, Dick Cheney (now vice-president); and Jeb Bush, the current president's brother.

Project for the new American century

One of the group's first significant acts came in January 1998 when some members wrote an open letter to president Bill Clinton advising him to adopt a policy of regime change in Iraq. Adding their names to the letter alongside the PNAC clan were Richard Armitage, now deputy to Colin Powell at the Department of State; Robert Zoellick, now the US trade representative; John Bolton, now undersecretary for arms control and international security; and Richard Perle, who runs the defence advisory board advising Rumsfeld.



Perle is the man who told the Pentagon last year that they should be going after Saudi Arabia. He's also the man who was adviser to Israeli prime minister Binyamin Netanyahu between 1996 and 1999. In 1996 he co-wrote a paper entitled "A Clean Break", referring to the Oslo peace process, stating that Israel's "claim to the land (including the West Bank) is legitimate and noble". What's more, it asserted, "only the unconditional acceptance by Arabs of our rights is a solid basis for the future". His co-author was Douglas Feith, now an undersecretary at the Department of Defense.

It's no wonder Arab governments and civilians have little faith that US foreign policy takes account of their views.

Two years later the PNAC produced its seminal defence document, entitled "Rebuilding America's defences: strategy, forces and resources for a new century". It was prepared, in September 2000, for consideration by Bush junior's senior advisers and potential cabinet members. Little was known about it until last year when Australia's *Sunday Herald* got hold of a copy. It's now prominently displayed on PNAC's website.

It relies heavily on, and refers to, the original Wolfowitz Memorandum. Referring to the US/UK no-fly zones over Iraq, it states that "though the immediate mission of those forces is to enforce the no-fly zones over northern and southern Iraq, they represent the long-term commitment of the US and its major allies to a region of vital importance. Indeed, the United States has for decades sought to play a more permanent role in Gulf regional security. While the unresolved conflict with Iraq provides the immediate justification, the need for a substantial American force presence in the Gulf transcends the issue of the regime of Saddam Hussein."

As to the future of the bases in Saudi Arabia and Kuwait hosting the aircraft and crew: "from an American perspective, the value of such bases would endure even should Saddam pass from the scene. Over the long term, Iran may well prove as large a threat to US interests in the Gulf as Iraq has. And even should US-Iranian relations improve, retaining forward bases in the region would still be an essential element in US security strategy given the longstanding American interests in the region."

Saddam's chief role in the security planning of PNAC, and by extension much of the Bush administration, is not to get rid of him because he is a tyrant, nor necessarily to get rid of him to stop him getting weapons of mass destruction. It is to act as a means of providing a rationale for getting US troops stationed in the region, and keeping them there.

Some financial analysts are already questioning, albeit obliquely, the reasoning behind some of the administration's decisions. Wallace at Lehman Brothers notes that Bush often talks about how he relies on faith to guide his actions.

Wallace might also have mentioned that Bush regards Jesus Christ as the most important political philosopher, and has now taken to finishing presidential addresses not with the usual "God bless

Costs of projected Persian Gulf war II ($bn)

Source of cost	*Low (short and favourable)*	*High (long and unfavourable)*
Direct military spending	$50	$140
Follow-on costs		
Occupation and peacekeeping	$75	$500
Reconstruction and nation-building	$30	$105
Humanitarian assistance	$1	$10
Impact on oil markets	$–40	$778
Macroeconomic impact	$–17	$391
Total	**$99**	**$1,924**

Source: Nordhaus

America", but, adopting a degree of presumption, with "May God continue to bless the United States of America".

Usually religious beliefs wouldn't be an issue for a financial markets analyst at a Wall Street firm such as Wallace. But, he says, "to the extent people believe that war is predicated on anyone's sense of destiny, the credibility of policy comes into question in the minds of several people, including supporters as well as detractors of Bush's foreign policies.

"When those views happen to coincide with the known strategic perspectives of vice-president Cheney and defence secretary Rumsfeld, one gets a glimpse into the concerns of many who believe that war to disarm Iraq may not be grounded in rigorous, dispassionate analysis."

Bypassing Congress

Central to the pursuit of the Bush administration's war aims is its ability effectively to neuter Congress. It might not yet have achieved that completely, but it's doing a pretty good job.

After the terrorist attacks of September 11 2001, the Bush administration sought from Congress, and got, a wide-ranging resolution granting the administration seemingly unlimited powers to pursue those behind the attacks. Its most important section reads: "The president is authorized to use all necessary and appropriate force against those nations, organizations, or persons he determines planned, authorized, committed or aided the terrorist attacks that occurred on September 11th 2001, or harboured such organizations or persons, in order to prevent any future acts of international terrorism against the United States by such nations, organizations or persons."

In the aftermath of the attacks it seemed to be an appropriate response, a sign of solidarity and resolve. But it's now one of the administration's chief political and legal weapons: Bush can now claim that this grants him the requisite legislative authority to wage war without much recourse to Congress.

It undermines one of the most effective checks included in the US constitution – that neither the executive branch nor the legislature should have the sole authority to exercise war powers. The president is commander-in-chief with the right to control forces as he sees fit. To avoid the holder of that office wielding too much power, though, Congress was given sole right to declare war. That distinction was lost for much of the 20th century as successive administrations chose simply not to seek a declaration of war; the last time the US declared war, in fact, was in 1941.

Congress, meanwhile, acquiesced, largely trusting presidents to wage undeclared wars as they saw fit. The Vietnam war changed all that. The result was the War Powers Act of 1973, which no president has ever acknowledged as law, even thought president Richard Nixon's veto at the time was overturned by Congress mustering the requisite two-thirds majority. It required that the president "consult" with members of Congress before sending troops abroad, and would have to withdraw them after 60 days (90 if an extension was granted), or else return to Congress to seek broader authority.

In practice, presidents have limited consultation largely to informing senior congressional members of impending action, and the time limits have become irrelevant. Standing up to an administration is tough; most of the US's military exploits abroad since 1973 have been against very much weaker states, such as Grenada or Panama. Or they have not involved the deployment of troops, for example the Clinton administration's reliance on cruise missiles. Few senators or congressmen worth their salt who have any pretensions to higher office have found it to be in their political interest to challenge any administration on military action under those circumstances. The September 14 2001 resolution was the first step in Congress's abrogation of its constitutional responsibilities to provide a workable check to the power of the executive branch.

The pro-administration hawks point out that Congress has other powers to influence and curtail any excesses of the executive branch, not least the ability to pull the plug on the finances. That's true, but it's no quick fix. It took three years to get most US troops out of Vietnam, another two before they all left.

The cost of post-war action

Let's assume that the invasion of Iraq produces the desired outcome: the overthrow of Saddam Hussein. Let's assume it happens quickly, say within a month or two. Let's assume that there's no retaliation from within Iraq, that no other countries in the region become involved (with Israel and Iran being the main candidates). And let's assume that it's relatively easy to maintain Iraq's territorial integrity and impose orderly rule, whether democratic or of another form.

Assuming all that, we can now start thinking about how to reconstruct Iraq. After the overthrow of Saddam, the country is in even more of a mess than before. Let's assume the Pentagon has followed through on its promise to deliver what it calls "shock and awe" to Iraq on the first two days of the attack: 800 missiles, most aimed at Baghdad, more than twice the number used in the whole of the last Gulf War. And this just adds to the mess the country's been in: US and UK forces continued regularly to bomb the country after the devastation of the 1991 Desert Storm campaign, destroying oil, water, electricity and transportation facilities. According to Yale University's Nordhaus, the last Gulf war "destroyed about $230 billion of infrastructure". Citing a 1991 UN report, he says that it would have cost $22 billion then, $30 billion in today's money, to pay for basic rebuilding of Iraq's infrastructure.

Many of the country's citizens are malnourished, as Iraq used to import many of its products before 1991, and much of that has been banned or held up by the UN Sanctions Committee. Depleted uranium shells used by the US in 1991 have not been cleaned up, because of lack of equipment; they have contaminated the environment and are probably responsible for the huge increase in cancer in southern areas of the country. Meanwhile, domestic farming has been hampered not just by the after-effects of the war and bombing but also by the diversion by Turkey for its own use of some of the waters of the Tigris and Euphrates further upstream.

Assuming reconstruction does not suffer from any further attacks or major setbacks, the country faces a long, hard and exceptionally costly slog.

Nordhaus offers the only study on how much all elements of the war and reconstruction could cost. Assuming that between 1 million and 5 million of Iraq's 24 million people need humanitarian aid for between two and four years, that will cost between $1 billion and $10 billion. At least $30 billion is needed for basic reconstruction, and between $75 billion and $500 billion on peacekeeping.

"It is difficult to see how a successful occupation of Iraq could be less than five years and it might easily extend for two decades," writes Nordhaus. There are still outstanding reparations claims from Kuwait, $100 billion in foreign debts and $78 billion in business claims. And that's without going into the effects, positive or negative, of oil prices. In sum, says Nordhaus, the very best all-inclusive stab-in-the dark figure is $99 billion. The worst is $1.9 trillion.

Late last year Larry Lindsey, who at the time was still Bush's chief economic adviser, told the *Wall Street Journal* that at most the war would cost $100 billion to $200 billion, just 1% or 2% of US GDP. But then he also claimed that a free Iraq would quickly be able to increase oil production by 3 million to 5 million barrels a day from current levels of 2.5 million. It was a terrible example of spin getting out of control. The oil figure was just plain wrong: Iraq has never sustainably produced more than 3 million barrels a day. The other figures look like wish-fulfilment. It didn't help Lindsey, who was already the subject of rumours about his impending removal from his post. He was gone by the end of the year.

Let's assume the overall cost is more than Lindsey's estimate, more than the $95 billion the administration indicated at the end of last month it would ask for. Does the US have the stamina for that? Can it persuade enough other states to help, given that it has derided many of those that it would need for this less glamorous phase of regime change in Iraq? Would the administration be willing to forgo tax cuts or dampen the economic recovery at home to help pay for the reconstruction?

It certainly cannot rely on Iraqi oil to pay for US involvement. Assuming production could rise to 3 million barrels a day, receipts would be about $25 billion a year. "Given all these claims, to divert funds from vital necessities to pay for the expenses of the US occupation forces would be economic and political folly," says Nordhaus. The administration has also, by default, pledged itself to allowing Iraq to use its oil resources as it sees fit: in the recent tussles with France, administration officials and their allies have stated that French company TotalFinaElf had negotiated an oil contract with Iraq that was detrimental to the needs of the Iraqis.

There is the very obvious question of how long current administration officials could cope with constant distractions of nation-building, peace-keeping and humanitarian aid. There's also the question of whether the US public, primed for wars of liberation and wars to destroy terrorism, would withstand having their economic wellbeing remaining under threat so that its government can put other countries back together again.

For now, financial markets participants appear to have adopted a wait-and-see approach. It's not that the potential risks and costs of total war aren't fully priced into markets: oil aside, they're not priced in at all. "The war premium has been talked about a lot more than it has been traded," says Raja Visweswaren, European credit strategist at Bank of America Securities. "The white noise in the markets reflects the simple lack of a unified market perception on the effects of any war. The low levels of observed, as well as option-implied volatility in major markets are simply not consistent with the notion that a war-risk premium is at work."

But that hasn't stopped some from trying to blame the nation's economic ills on the looming attack on Iraq, explains Bill Dudley, chief US economist at Goldman Sachs: "Many economists have been surprised by the apparent slowdown in the GDP growth pace that began after the inventory bounce of early 2002 began to subside," says Dudley. "Instead of concluding that they may have overestimated the economy's inherent strength, many in effect labelled the error term in their GDP forecast as the "Iraq impact". We think the ongoing balance sheet adjustments among households, corporations and state and local governments following the equity bubble's demise are much more important."

And that's just purely domestic economic concerns; there's also the issue of the US's current account deficit and the collapse in the value of the dollar. Henry Willmore, chief US economist at Barclays Capital, says: "During the previous Gulf crisis, the dollar was in the middle of a long period of relative stability. It depreciated in the initial weeks of the Gulf War, but recovered shortly thereafter. Currently the dollar is in the middle of a significant decline."

According to the Fed's trade-weighted index against other major currencies, he adds, "the US dollar has declined 13% during the last year, with the decline accelerating in recent weeks. The dollar's vulnerability to geopolitical uncertainty appears to have increased with the size of the current account deficit. It currently stands at almost 5% of GDP, compared with less than 2% of GDP in 1990."

> "Given the US's appetite for foreign capital, how and with whom it wins the war matters much for the dollar and US asset prices"

The administration can talk tough on this as much as it wants. But the way it will have to handle trade, the trade deficit and the value of the dollar will have to be in marked contrast to the unilateralist instincts of its senior leaders.

The global distribution of economic power is much more evenly spread than that of military power. And that demands a more inclusive, multilateral approach be taken. "Given the size of the current account deficit and the US's appetite for foreign capital, how and with whom the US wins the war matters much for the dollar and US asset prices," says Gemma Wright, market strategist for Barclays Capital in New York. "If the US takes a unilateralist approach the dollar will come under pressure and rates will need to be higher and the curve steeper than otherwise; spreads and volatility are likely to be higher too."

Imperial overstretch, like total war, is not a new concept either. ■