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Little Economic Impact From Subcontinent Conflict

The India-Pakistan conflict adds to the cumulative weight of geopolitical risk around the world.

» The economic impact of the latest conflict between India and Pakistan is likely to be muted, and financial markets have held broadly steady.
» An escalation of the conflict could hurt global economic growth given the subcontinent's growing contribution to that growth.
» The India-Pakistan conflict adds to the cumulative weight of geopolitical risk around the world.

The current conflict between India and Pakistan in their northern border area is unlikely to have a significant economic impact within the region or more broadly. This is the message from financial markets in the region, which have held broadly steady since the February 14 car bomb attack on Indian paramilitary police that was the spark for the current conflict. This also was the case during similar events in the past, when admittedly the two economies were smaller than they are today, and the conflicts were of limited duration.

RISING CONTRIBUTION TO GLOBAL GROWTH

The Indian subcontinent generates an outsize proportion of global GDP growth because of its size and its leading growth rate. India accounted for 3.3% of the global economy in 2017, according to the International Monetary Fund; Pakistan, on the other hand, is much smaller, equal to only about 0.3% of the global economy. Together they added 0.13 percentage point to global growth of 3.1% in 2017.

This may not sound significant, but India's contribution to global growth has grown significantly since the global financial crisis in 2008 for two reasons. First, its growth rate has accelerated. Second, the rate of growth of the rest of the world has slowed, largely because of slower growth among developed economies. This, however, is not the case for Pakistan. While its growth does outpace the global growth rate, Pakistan's annualized growth rate from 2009 to 2017 of 4.1% was slower than its rate of 4.7% from 1985 to 2007.

Table 1: Real GDP Growth

	% change annualized rate	
	1985 to 2007	2009 to 2017
India	6.3	7.3
Pakistan	4.7	4.1
World	3.2	3.0

Sources: IMF, Moody's Analytics

Prior to the financial crisis, the contribution of India and Pakistan to global growth was barely measurable. But it has increased gradually over the past more than 30 years.

Table 2: Contributions to Global Growth

	% change annualized rate		
	1961 to 1985	1985 to 2007	2009 to 2017
Total global growth	4.0	3.2	3.0
Global growth excluding India and Pakistan	4.0	3.1	2.9
Difference, percentage point	0.0	0.1	0.1

Sources: IMF, Moody's Analytics

Thus, the region's growth is an increasingly significant factor driving the global economy. It is reasonable, therefore, to ask whether the recently reignited conflict between Pakistan and India in and around the line of control in Kashmir will cause any damage to either of these economies, or to the global economy.

LINK BETWEEN CONFLICT AND THE ECONOMY

Since independence from Britain, India and Pakistan have fought four brief wars over this border area. The longest was in 1947-1949; the shortest, lasting just two weeks, was in 1971.

Table 3: India-Pakistan Conflicts

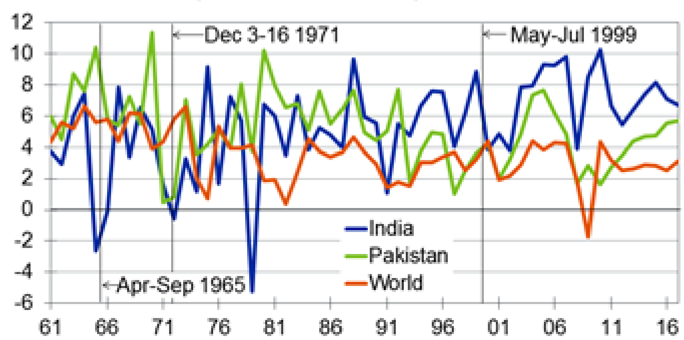
Start	End	Duration
October 1947	January 1949	14 months
April 1965	September 1965	Six months
December 3, 1971	December 16, 1971	Two weeks
May 1999	July 1999	Three months

Sources: BBC, Moody's Analytics

Linkages between conflicts and economic conditions are difficult to determine for several reasons. First, the GDP data for India and Pakistan are volatile. Second, the causes of conflict are varied and complex and may promote or detract from economic growth. Third, the three past conflicts on the subcontinent (the data do not go back beyond 1960) seem to have been at turning points for the economy of one or the other or both countries, but not always in the same or uniform direction.

Previous Wars at Turning Points

Real GDP, % change, annual data through 2017



Sources: IMF, Moody's Analytics

The 1965 and 1971 conflicts occurred when India was in or near a recession. On the other hand, the 1999 conflict occurred when India's economy was growing at a rapid 8% rate, although it slowed to about 4% in each of the subsequent years. The pattern was similar for Pakistan, except in 1965 when its economy was on a tear while India was in recession.

Thus, these conflicts do not seem to be tied directly to economic conditions, and the limited duration of at least the prior three conflicts makes it hard to tie subsequent economic growth to the preceding conflict. And given the weak link between the subcontinent's growth and global growth during the decades leading up to 2000, there was little consequence to the global economy from these regional conflicts.

Individual trading partners with India, however, would have a higher exposure to economic disruptions on the subcontinent. China is the largest point of origin for imports into both India and Pakistan. The Middle East is the next largest source (see Table 4). Thus, if there were a significant economic slowdown on the subcontinent that reduced demand for imports, it might be felt most in China and the Middle East. But as shown above, there is little evidence that past conflicts directly caused slower growth, and both the Middle East and China export to a broad array of global markets.

Table 4: Largest Trading Partners With India and Pakistan, 2017

	India				Pakistan			
	Export destinations	Share of total	Import origins	Share of total	Export destinations	Share of total	Import origins	Share of total
1	United States	15.0%	China	16.0%	United States	14.0%	China	27.0%
2	United Arab Emirates	9.6%	United States	5.5%	Germany	7.7%	United Arab Emirates	12.0%
3	China	5.1%	United Arab Emirates	5.3%	China	7.5%	Saudi Arabia	4.5%
4	Hong Kong	4.4%	Switzerland	5.0%	United Kingdom	5.9%	Indonesia	4.4%
5	Germany	3.4%	Saudi Arabia	4.6%	Afghanistan	5.6%	Japan	4.3%

Sources: https://atlas.media.mit.edu/en/, Moody's Analytics

Since 2000 the volatility of growth in both India and Pakistan has been reduced; the one exception to this was during the global financial crisis when both economies took a hit. Since then they have gradually improved and the spread between their growth rates and the global rate has widened. And as the data show, the global economy is slightly more dependent upon the subcontinent's performance.

So if the current conflict were to last longer and it worked to slow investment spending or consumer spending in the region, one might see a small impact on the global economy. The Indian economy, for which there are quarterly estimates of GDP through the end of 2018, has already slowed from a recent peak in the second quarter of 2018 because of a number of domestic factors, as well as through links to the rest of the global economy, but this began well before the recent conflict.

WHAT COULD GO WRONG?

While the impact of the current conflict should mimic those of the past and remain small, what could go wrong? How could this time be different? A more significant and prolonged crisis, perhaps caused by allies and adversaries in the region joining the fray, could lead to global disruptions. Tensions could rise if Middle East countries supported one side or the other, which could add volatility to the price of crude oil. Investors might fret further if the conflict extended to disputed borders with China, with the potential to destabilize the broader South and Southeast Asia region.

At the very least, this conflict adds to the geopolitical uncertainties shaking global confidence. These include Brexit uncertainty; policy conflicts within the EU; Iran oil sanctions; negotiations with Korea; the trade war between the U.S. and China; and a myriad of elections being held this year, including within Asia, and in India, Indonesia, the Philippines and Thailand. The India-Pakistan conflict won't nudge the global economy into recession, but it adds to the cumulative weight of geopolitical risk around the world.