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After an Attack on Iraq: The Economic Consequences

Review and Update

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On November 12, 2002, CSIS held a conference on the economic consequences of an attack on Iraq. A team of a dozen experts—political and military specialists, oil market analysts, macro modelers, and financial market specialists—worked together for about two months to develop the military and political scenarios and then simulate the effect of the war on the U.S and global economy in each of three war scenarios. A summary and full transcript of the conference are available on the CSIS web site.

In this briefing, I will first review the methodology and the conclusions reached at the conference, then consider developments since the time of the conference that may have altered the likely effects in the event of war, and provide a brief discussion of some of the implications of the recent developments. While I have had discussions with some of the other participants in the CSIS study, I have not asked the group to formally reassess their input and conclusions. I am therefore offering this afternoon my own assessment, though one that has been informed by discussion with some of the participants. I will circulate this update to the participants and revise it based on the comments I receive. The revised update will then be posted on the CSIS web site.

Methodology and Conclusions of the November 12 Conference

Tony Cordesman, the Arleigh A. Burke Chair in Strategy at CSIS, developed the three war scenarios that served as the foundation for the CSIS study: the benign, the intermediate and the worse case. In the benign case, there is a quick and decisive victory, limited casualties and collateral damage, no damage to oil facilities in Iraq or elsewhere in the region, no use of weapons of mass destruction, no attack on Israel or Israeli retaliation, no political destabilization in the region, and no dramatic terrorist events. In the intermediate case, there are a number of more adverse outcomes, possibly including modest damage to Iraqi oil fields, greater political destabilization in the region, resulting in some reluctance of Saudi Arabia to completely offset the loss of Iraqi oil, a limited attack on Israel with limited response, and some terrorist incidents, but without major damage. In the worse case, there is some combination of still more adverse outcomes, possibly including extensive damage to oil facilities in Iraq and elsewhere in the region, use of weapons of mass destruction, a massive attack on Israel and significant Israeli retaliation, and significant and successful terrorist attacks.

The oil panel concluded there would be a spike in oil prices in the quarter following the outbreak of war in all three scenarios, followed by declines though 2004, the end of the simulation period. The oil price spike would be progressively greater in the intermediate and worse case scenarios, and oil prices, while declining, would remain elevated relative to the no-war and benign scenarios in the intermediate and worse case scenarios through 2004.

The economic simulations took into account the increase in oil prices, the effect on government spending associated with the cost of the war, the international feedbacks from the effect of the war on other countries, the response of monetary policy in the U.S. and elsewhere, and the psychological effects of the war on financial markets and consumer confidence.

In the benign scenario, the macro modelers concluded that war would result in stronger growth this year than in the no-war case. That conclusion reflects the interpretation of the no-war case. In the no-war case we assumed that uncertainty about whether or not there would be a war would linger for a period and then gradually dissipate. A quick and decisive victory in a war with Iraq more quickly removes the uncertainty that has been weighing on the economy. Equity prices rebound and consumer confidence improves quickly in the benign case, resulting in about ½ percentage point faster growth than in the no-war case.

The economy grows more slowly in the no-war case and in the intermediate case and the U.S. and global economies are thrown into recessions in the worse case scenario. In the intermediate case, economic growth slows by 1¾ percentage points over 2003, compared to the no-war case; and in the worse case scenario economic growth slows by 4½ percentage points, with the unemployment rate rising to 7% - 7½% in the U.S.

In both the intermediate and worse case scenarios the Fed is assumed to ease interest rates to cushion the effect on growth and the associated rise in the unemployment rate.

Developments since the Conference

Oil markets

There have been a number of important developments in oil markets, reflected in a rise in crude oil prices by about $12 since the time of the conference. While I take responsibility for the analysis of oil markets below, it has, fortunately, been informed by my discussion with Larry Goldstein, President of the Petroleum Industry Research Association, who chaired the oil panel at the CSIS conference.

First, global oil inventories are significantly lower than at the time of the conference. This is due principally to the strike in Venezuela. Venezuelan oil production was about 3.1 million barrels a day (MBD) before the strike. It fell to a low of 0.6 mbd in January and has now rebounded to about 1.6 mbd. The oil markets have cumulatively lost more than 100 million barrels of oil as a result of the strike in Venezuela, contributing to the further depletion of oil inventories. In addition, it is expected that there will be a permanent loss of Venezuelan productive capacity, as a result of the strike, of about 500,000 barrels a day.

Second, Saudi Arabia increased its oil production to offset the loss of Venezuelan output, resulting in a decline in the amount of excess capacity among oil producing countries, compared to the situation at the time of the CSIS conference. Excess capacity (principally located in Saudi Arabia) has declined from about 2½ - 3 mbd at the time of the conference to as little as 1 mbd or even less today.

Third, while the panel believed that there was no-war premium at the time of the conference, there is likely a small war premium today. The premium, while highly volatile, depending on perceptions about the imminent risk of war, may have averaged recently in the range of $2 - $3 per barrel.

Fourth, seasonal factors first increased the demand for crude through January and February and now have eased the demand.

Fifth, the increase in Saudi production earlier in the year, intended to offset the decline in Venezuelan production, should be arriving at consumer countries, including the U.S., within one to three weeks.

<u>Vulnerability of the U.S. and global economy</u>
The U.S. and global economies are weaker today than we expected at the time of the conference. In general, an economy is more vulnerable to a recession (defined as an outright decline in output) when there is a smaller cushion of growth. In addition, the lower inventories and more limited excess capacity among oil producers means that oil markets are more vulnerable to a spike in oil prices if Iraqi oil is removed from the market for a period, or if there is damage to other oil facilities in the region, but this is offset by the seasonal easing in demand for crude and the step-up in Saudi production.

<u>Fiscal "Insurance"</u>
The Bush administration, since the conference, has proposed a package of tax cuts that could provide incremental stimulus for the economy, if approved. This could provide some protection for the economy in the event of an adverse outcome to the war. This does not alter the incremental effects in the war scenarios, but it would result in stronger growth in both the war and no-war scenarios.

<u>Timing of the war</u>
At the time of the conference, we assumed the war would begin on January 1, 2003. It now appears that the war may begin within days, even by tonight, March 17.

<u>Geopolitical uncertainty and escalating war anxieties</u>
At the conference, we assumed that there would be some adverse effects in advance of the war. We also assumed that there would be some additional adverse effects on the economy at the outset of the war, including a further decline in equity prices, erosion of consumer confidence, and higher risk spreads in the capital markets. Still, we did not, at least in my view, anticipate the degree to which war anxieties would escalate and weigh importantly in the economy in the period leading up to the war. There is some disagreement about the degree to which the soft spot that emerged in the second half of 2002 and the apparent further weakening in the expansion reflected in the February employment report are in fact due to escalating war anxieties. But it is reasonable to conclude that geopolitical uncertainty related to the possibility of a war with Iraq has played a significant role in the persistence and intensification of the soft spot.

The fact that some of the adverse effects of a possible war have already occurred could diminish any incremental adverse effects that accompany the onset of the war, or even result in rallies in financial markets and declines in oil prices, especially if it appears that the benign scenario is playing out. Interestingly, the financial markets are rallying as we approach the brink of war. This situation is reminiscent of the Gulf War. The adverse effects related to the war — the rise in oil prices and decline in consumer confidence — occurred immediately following the invasion of Kuwait. At the onset of the shooting war itself, there was a quick reversal of at least some of the earlier negative impacts. In the current crisis it is possible that we have already experienced the adverse economic "shocks" associated with the lead up to war, and there remains the possibility that the onset of the war, at least in the benign scenario, will lead to a quick reversal of the earlier declines in consumer confidence and erosion in equity prices. Keep in mind that, even if the benign scenario is unfolding, there will likely be "bad" days along the way, unexpected adverse events, and corresponding setbacks in the market. And we should not lose sight of the potential for outcomes less benign than the "benign" scenario.

Implications of the developments since the conference

I believe the qualitative stories associated with the three war scenarios continue to provide a plausible picture of the range of possible outcomes associated with a war with Iraq. The key conclusions we reached remain, in my view, intact. First, the benign war outcome could allow the economy to quickly accelerate as uncertainty is removed and confidence rebounds. Second, there are non-trivial probabilities associated with more adverse outcomes, with the intermediate and worse case providing useful benchmarks. Nevertheless, the developments since the conference do have some implications for the economic consequences of an attack on Iraq.

First, while lower crude oil inventories and diminished excess capacity point to the possibility of a sharper initial spike in oil prices, this is significantly offset by the seasonal easing of the demand for crude. Oil prices, which peaked at $38 per barrel (WTI) in the benign scenario in the conference study, reached those levels earlier this month, though they have now backed off to around $35. There will likely be a short-lived spike once war begins, even in the benign case, but it now appears unlikely that oil prices in the benign scenario would increase $8 as a quarterly average, as assumed in the CSIS study. The speed with which oil prices decline will likely be affected by the actions of Saudi Arabia, the U.S. government in relation to the SPR, and of the IEA in relation to oil reserves outside the U.S, in addition, of course, to the military outcomes and extent of damage to oil fields and/or distribution facilities. At the conference, we assumed there would be an immediate announcement that the SPR would be tapped, but that, in the benign case, no drawdown would actually be made. It is difficult to read the intentions with respect to the use of the SPR and related international reserves, but announcements that they would be used would obviously contribute to a quicker decline in oil prices.

Second, oil prices in the no-war scenario have been marked up from $20 a barrel in 2004 to $25 a barrel, as a result of the permanent decline in Venezuelan production and the elevated demand expected for a period as oil inventories are rebuilt. This does not affect the incremental effect on oil prices associated with the three war scenarios, but it does mean that the path of oil prices in absolute terms is higher in all the war scenarios. This contributes to weaker demand in the U.S. and global economy over the forecast period in the war and no-war scenarios.

Third, the fact that war anxieties have already depressed equity prices and consumer confidence by more than we anticipated at the time of the conference suggests that the effects of the outbreak of the war may be smaller than otherwise would have been the case. Indeed, financial markets are rallying as we move to the brink of war.

Fourth, the fact that the war is likely to begin later means that war anxieties leading up to the war have weighed on the economy longer in 2003 than earlier expected and that there will be less time for the rebound from the war in the benign case to be reflected in stronger growth this calendar year. The later start to the war therefore probably means a weaker economy over 2003, but a slightly stronger economy over 2004.