



WEB NOTES

SADDAM'S OTHER WEAPON OF MASS DESTRUCTION: THE POTENTIAL ECONOMIC FALLOUT FROM A WAR IN IRAQ

by Vince Cable MP
January 30, 2003

Contents

- | | | |
|---|---|--|
| 1. Introduction | 5. Reserves | Figure 4: Impact of oil price increase |
| 2. Economic impact of war
Figure 1: Economic effects of shocks | 6. Mouthwatering | Figure 5: Oil use per unit GDP |
| 3. Shocking?
Figure 2: Oil reserves & production | 7. Massive disruptions | 10. Recession |
| 4. A fourth oil shock? | 8. Regime change
Figure 3: Oil price scenarios | Figure 6: Saddam's other WMD |
| | 9. The bill | |

1. Introduction

Critics of military intervention in Iraq sometimes allege that the dispute is 'really about oil'. Reaction is usually defensive, along the lines that troops will be sent to risk their lives for more high minded objectives like upholding the authority of the United Nations in relation to weapons of mass destruction or to defend human rights.

Yet the potential conflict must be, in significant part, about oil and economics. It is neither irrational nor unworthy to put them at the centre of the debate. British Foreign Secretary Jack Straw has acknowledged as much. The futures of Iraq and its Gulf neighbours are important, because of oil, in a way that those of Uzbekistan, Zimbabwe and Peru are not.

One does not have to be a conspiracy theorist to note that US net oil imports (around 10.6mn bd) are at their highest level ever, and will grow substantially under projections from the Bush Administration itself and are increasingly from the Gulf.

Oil 'shocks' can cause, or act as catalysts for, substantial damage to western economies as they did in 1973/4, 1979/80 and 1990/91. Western consumers are politically highly sensitive to oil prices at the retail level, as Prime Minister Tony Blair's Government painfully discovered in 2000. The interplay between the economy, environment and security of supply is a central issue as the debate over Britain's nuclear energy and gas has demonstrated.

In the Middle East itself, any considered analysis of the rise of Arab and Muslim radicalism has at its heart the impact of weakening oil revenues and economic opportunities in a world of rapidly rising population.

2 Economic Impact of War

Three broad points can be made about the possible economic impact of war. Firstly, there is great uncertainty about its timing and length - though the likelihood is that it would be short since the contending forces are very unequal in military strength - the destruction it would cause and the disruption, if any, of oil supplies. It is possible to discuss scenarios but foolish to make predictions.

Second, there are no general principles on the economic impacts of conflict. Modern warfare must be economically damaging, even for victors, since it absorbs scarce, productive resources - the opportunity cost. This opportunity is reduced for professional armies, however, since they are paid, equipped and exercised anyway. New spending could provide a stimulus, but there are macroeconomic and distributional issues about who pays and when.

It helps if someone else picks up the bill. Eighty percent of the cost of the 1991 Gulf War was paid by friendly Arab countries rather than the US-led coalition. More typically wars are financed through government debt, which passes much of the burden to future generations unless it is burnt off through inflation.

Recent wars have had very mixed economic consequences. The Korean War gave a powerful stimulus to commodity prices and growth, followed by a short, mild recession and then strong recovery. The Vietnam War at its peak in the late 1960s contributed to strong economic growth, but also growing government borrowing and inflation, the effects of which were felt years later in the crises of the 1970s. For Britain, the Falklands War had little discernable economic impact; but Suez resulted in a sterling crisis leading to mild recession.

Fig 1: Conflict & Shocks: Economic Effects

Source	Period	US Economy	UK Economy
Korea	1950-53	Boom, bust, recovery	ditto
Suez	1956	-	Sterling crisis mild recession; recovery
Vietnam War	(1966-72)	Growth, inflation	-
1st Oil Shock	1973	Inflation & recession	ditto
2nd Oil Shock	1979/80	Inflation & recession	Recession (Sterling rise)
Falklands	1983	-	Growth
Gulf War 3rd Oil Shock	1990/91	Recession then strong recovery	ERM dominates

3. Shocking?

Third, the economic impact of any war in the Gulf is difficult to separate from the effect of possible disruptions in oil supplies. The most recent comparable war in 1991 involved both military spending and an oil shock - although very limited and brief. Oil 'shocks' damage oil importing countries because they simultaneously depress demand and raise prices. All three 'shocks' have caused, or been a catalyst for, a serious downturn in western economies.

All three originated in politically inspired disruptions of supplies. The first, in October 1973, which tripled crude prices to previously inconceivable levels - almost \$10 - was the Arab boycott, a spin-off from the Arab Israeli dispute. Prices were held at that level by the Organization of the Petroleum Exporting Countries (OPEC) quota discipline with Saudi Arabia using spare capacity as swing producer to fill emergency gaps. The second was triggered by the 1979 Iranian revolution, which closed 5.6mn bd of production for six months and quadrupled prices to \$40. Continued disruption and wavering OPEC discipline kept prices above \$30 for several years until there was a collapse at the end of 1985.

From the standpoint of western economies, the most reassuring story is the third shock. In October 1990, Iraq seized the Kuwait oil fields - producing around 2mn bd - more than doubling crude prices to \$40 a barrel. But four months later extra Saudi output and the release of International Energy Agency (IEA) reserves - 2.5mn bd - forced prices back down to \$16, where they stayed, roughly, for most of the rest of the decade, despite much of Iraq's production being rationed through sanctions.

4. A Fourth Oil Shock?

With crude prices again exceeding \$30 we are now arguably experiencing a mild fourth oil 'shock'. Demand was depressed in the main consuming countries last year, so prices should be falling. Instead they have risen over \$10 in a year. War fever and uncertainty is undoubtedly a contributing factor, but not the only one; some analysts argue that the war premium is only two to three dollars.

OPEC has also been trying to assert some discipline over production with last year's quota production cuts, there are around five million barrels per day of spare OPEC capacity, half in Saudi Arabia. Serious disruption by strikes in Venezuela, which produces close to 3mn bd, has been a major short term factor though OPEC has now agreed to plug that gap in supply.

5. Reserves

Optimistic hawks in the US administration argue that this is about as bad as it gets. A quick, clean strike against Iraq could temporarily disable part of its production - around 2.5mn bd - but cause little extra damage. Prices might surge to \$40 or more for a few days or weeks, but markets would quickly appreciate that there is potential over supply rather than scarcity.

First, IEA reserves of four billion barrels that could be released in an emergency. These provide close to 90-day cover in the US, the European Union, Japan and Korea - and China is reputed to have accumulated a stockpile. These stocks could comfortably feed releases on the scale of the last Gulf War. Second, OPEC has 6mn bd of spare capacity, half in Saudi Arabia and substantial amounts in Iran (600,000 bd) and the United Arab Emirates (500,000 bd).

Whatever OPEC governments feel politically about an American invasion, self-interest would probably drive them to be accommodating. Saudi Arabia has a continuing interest in keeping overseas markets for its only export. This means maintaining a reputation for reliability of supply at reasonable prices.

Countries like Iran, Libya and Nigeria may take advantage of the situation to earn extra revenue and establish a larger market share in anticipation of a post-war free for all. Both Saudi Arabia and non-OPEC Russia have announced that they will step up production to head off any price shock. These factors clearly weigh heavily in the forward market, which prices oil for delivery in the next month higher than for a year's time.

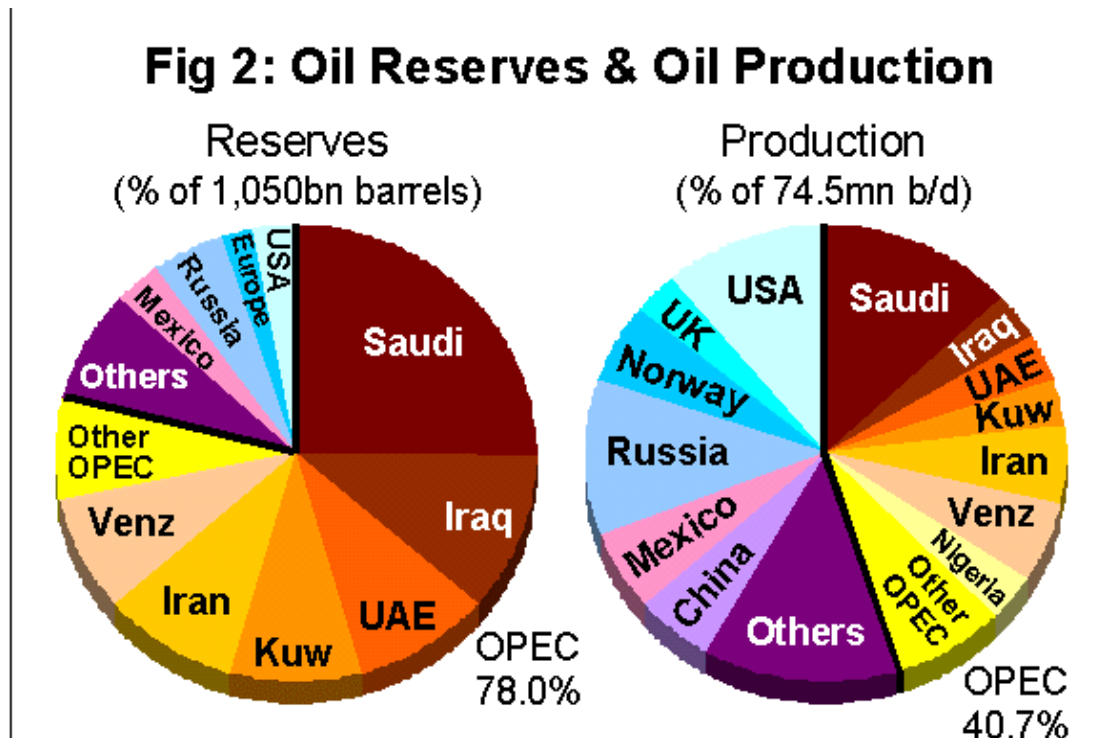
6. Mouth-Watering

At this point, western optimists and conspiracy theorists see some mouth-watering prospects. Iraq's installations are reputed to be in poor shape but could be brought back into full production with heavy investment, no doubt from countries that have served the allied cause.

As a client state detached from OPEC, Iraq could then turn the taps to full flow. Industry analysts believe production could reach 6 to 8mn bd in five years, rivalling and possibly replacing Saudi Arabia as dominant producer. With other non-OPEC members - notably Russia - exporting more, a buyers' market could emerge. OPEC and Saudi Arabia in particular would be forced to either cut production drastically or accept loss of control over price. The former seems implausible, leaving open the possibility of a new oil economy with less dependence on Saudi Arabia and without the threat of every political upheaval in the Middle East turning into a global economic crisis.

The story is beguiling, but unfortunately the numbers do not stack up in the long term. Iraq's share of global, proven oil reserves is only just over 10%; Russia's is 5%. By contrast the Saudis have around 25% and other Gulf states linked to Saudi Arabia a further 20% (see Fig 2). And, in a competitive, free for all world of low cost oil the Saudis and other Gulf states have a cost advantage. They can continue to produce profitably at very low prices (though the revenue loss of economic rent would be very painful). It is the high cost non-OPEC producers - new developments deep offshore or in remote

locations like Central Asia - that would be unviable. And potential alternative supplies like the vast Venezuelan oil shales would have no chance.



Any strategy based on the hope of Iraq opening up an era of cheap and abundant long-term supplies of oil, insulated from the House of Al Saud, is simply an illusion. If a war is successful in making new Iraqi supplies available and driving down the price, this will, in the long term, make the oil consuming world even more dependent than now on low cost Gulf supplies.

7. Massive Disruptions

There are other troubling doubts. The optimistic scenario, however plausible, could go badly wrong. There are three main sets of worries.

The first is that President Saddam Hussein may cause more disruption to supplies beyond his own. Anticipating an invasion, he could attack the main terminals and production centres in Kuwait and possibly Saudi Arabia. This would, however, be technically and militarily difficult. Without a successful invasion from Iraq or long-range missile attack of considerable precision, it is difficult to see how the necessary damage could be done.

The horror scenario is the use of weapons of mass destruction. But there is nothing, at least in the public domain, to suggest that Iraq is capable of sending a ballistic missile topped with a nuclear weapon or highly potent biological agents, which would hit - say - the Ras Tanura complex in Saudi Arabia and effectively disable it.

A more plausible, if less dramatic, risk is that the Iraqi regime organises an effective defence against the invasion, falling back on Baghdad and forcing the US to fight, house to house, without the advantages of high tech equipment and long range bombing. The 1993 Mogadishu experience was troubling. If this were to happen, it could possibly delay the war outcome for months and cause prolonged uncertainty and stability in international markets.

8. Regime Change

The third and most serious risk is if a new Gulf war were to hasten the collapse of the Saudi regime and the smaller Sheikdoms around the peninsula. Two sets of stresses might bear on a regime already believed to face a great deal of internal dissent and challenges to its legitimacy from Islamic radicals and others.

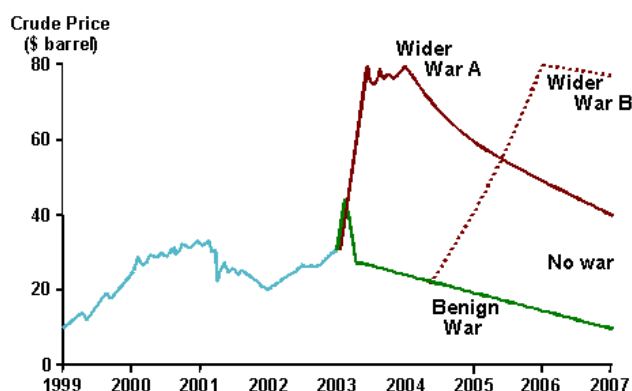
First, there would be an intensification of anti-western, specifically anti-US feeling, especially if tension in Palestine continued unresolved. Personnel changes might bring forward people less inclined to be accommodating over oil production. Or regime change could bring to power people with little interest in worldly problems such as oil, much like the mullahs in Iran in 1979.

A second strain on the Saudi regime would arise from Iraqi oil production contributing to a period of very low oil prices - say \$10 or below. The loss of revenue from low prices - or large enforced production cuts to sustain price - would be disastrous for the Saudi economy and its rulers. The population has grown from 9mn in 1960 to 21mn, with 32mn projected in 2015. Per capita incomes have fallen by 60% from the 1980 peak and could now be cut further. Beyond the ruling class, it is not a rich country: per capita annual incomes are around \$7,000 and disparities in living standards are striking. The ability of the state to provide cheap public services is directly undermined by falling oil revenues.

The potential for revolution is all too plain. Paradoxically, the race to create a pliant, secular, oil producing Iraqi state hastens the day that the Saudi regime will collapse, with potentially enormous consequences for oil supply.

It is quite conceivable that such an eventuality could well occur with a delayed reaction after a successful military operation and a return of prices to apparent, low, normality. Figure 3 sketches out these possibilities.

Fig 3: Oil Price Scenarios

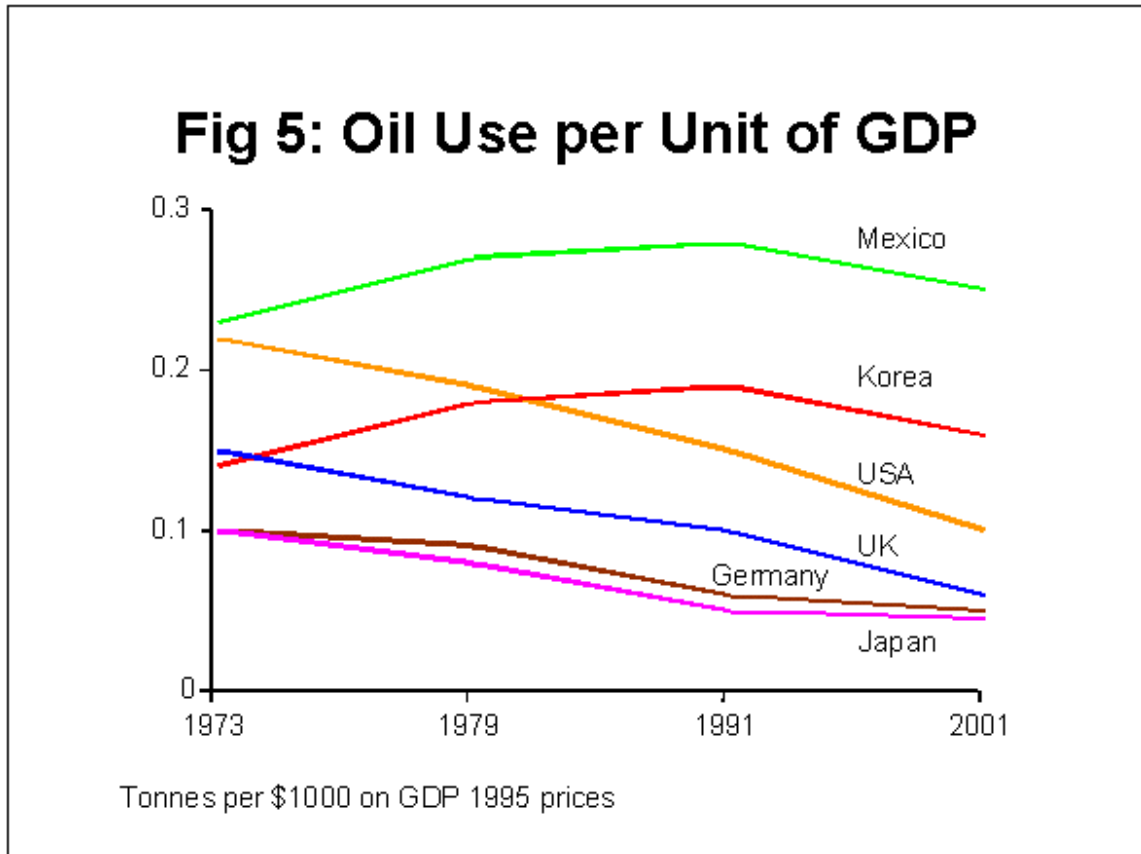


9. The Bill

The economic impacts of these various scenarios are bound to be complex. If we isolate the effect of increased oil prices, the International Monetary Fund estimates that a \$10 a barrel rise in the price of oil sustained over a year - roughly what happened last year - reduces global gross domestic product (GDP) by 0.6%. The impact varies from 0.8% of GDP in America, the Euro area and developing Asia - more in major importers like Korea, India and Thailand (see Fig 4). These are first round impacts and do not incorporate the effects of policy changes in oil importing countries, additional spending by OPEC countries, or the impact on confidence - currently brittle - amongst Western consumers and investors. These are also short-term impacts. Over time, rich countries, including the US, are becoming less dependent on oil - though this is less evident in developing countries (Fig 5).

Fig 4: Estimated Impact of Oil Price Increase of \$10 a barrel

	Real GDP change
World	-0.6
Industrial Countries	-0.6
US	-0.8
Euro area	-0.8
Japan	-0.4
Others	-0.2
Developing Countries	-0.4
Latin America	-0.2
Asia	-0.8
Europe & Africa	+0.2



Then there are the costs of the war itself. Some costs would occur anyway - such as pay for soldiers in a professional army. But there can be a big cost for hazard pay, medical support, fuel, communications, spare parts, replacement of damaged equipment and additional items. The cost of keeping the US army in the desert, even without fighting, is perhaps \$5 billion a month. There is then the potentially larger expenditure on reconstruction and nation building.

A rough benchmark is the total cost of the Gulf War, which was around \$80bn for the US and \$3.7bn for the British Treasury. The Pentagon has estimated \$50bn - 0.55% of gross national product - for a war in Iraq, but this assumes a simple operation and seems to exclude reconstruction costs.

The Congressional Budget Office similarly estimates \$50-60bn for a short war. The recently departed US Economic Adviser Lawrence Lindsay estimated \$100-200bn, assuming a degree of military difficulty.

William Nordhaus, in a Yale University study, has put direct military spending in a similar range - from a low of \$50bn to a high of \$140bn - but he also estimates occupation, peacekeeping, reconstruction and nation building at \$100-600bn over the next decade. He separately calculates the extra oil cost to the US of up to \$500bn for a difficult war and further economic costs of up to \$345bn. His maximum estimate is around \$1.6 trillion, which is approximately 2% of GDP every year for a decade.

One British estimate, from Keith Hartley in a recent paper for the Royal United Services Institute, produces a conservative, purely military, short-term cost of \$1.4-5bn compared with \$3.7bn for the Gulf War (of which £3bn was paid by other governments), \$6bn for the Falklands War (and subsequent garrison costs), \$1.4bn for Kosovo and \$700mn for Bosnia. Suffice it to say that the costs could well exceed those of previous military undertakings and be well in excess of Treasury estimates of \$1.6bn.

10. Recession

It is economically important how these war costs are to be paid. In a depressed economy with spare capacity, a burst of military hardware spending could have the effect of stimulating demand and increasing national output. But under current economic conditions, additional demand financed by government borrowing will spill over into inflation or imports, adding to the current account deficit, which is 5% of GDP for the US and 2% for Britain and their fiscal deficits - 3% and 1.5% of GDP).

Fiscal and current account deficits of the US in particular would require foreign investors to continue to buy large volumes of government debt. But there are already doubts about the sustainability of the dollar value. It is quite plausible therefore that worries about financing the twin deficit swollen by war, could help precipitate a sharp fall in the dollar, perhaps even collapse. This would raise the dollar cost of servicing debt in the US, forcing a fiscal adjustment that would further puncture consumer confidence. A dollar fall would also export recession to US trading partners. Worries over the funding of a costly and prolonged war could very easily precipitate a collapse of external and internal confidence in the US economy.

Imbalances in the UK are less extreme, and Britain is not an oil importer like the US. But a general down turn in oil importing countries could be bound to hit the UK. In particular the continued close alignment of the US and UK economies through private capital flows ensures that Britain would be likely to catch any transatlantic economic infection.

Those in Washington and London who are planning an invasion of Iraq probably envisage a scenario much like 1991: a quick successful campaign which leads to a very short oil 'shock' and only limited additional spending. The longer the war goes on, however, the greater the risk of a more serious 'shock' and greater costs. These would widen the US twin deficits on fiscal and current accounts and probably precipitate a sharp fall in the dollar and painful

adjustment, including a recession. This downturn would be transmitted to the rest of the world, including Britain though, in time, expansionary policy and the stimulus from post-war reconstruction.

There is also a plausible scenario in which a successful war, and the prospect of very low oil prices in the wake of rapidly expanding Iraqi production, brings about a weakening or even collapse of the Saudi regime and a threat to its production. This would then bring us back to something like the conditions in 1979/80, with the consequence of a world recession. Even if Saddam is defeated, he may still have a nasty - economic - sting in his tail.

Vincent Cable is a Liberal Democrat MP and Shadow Secretary of State for Trade and Industry. He was formerly Chief Economist for Shell and is currently a Visiting Fellow at Nuffield College, Oxford and at the LSE. He was inter alia International Economics Director at the Royal Institute of International Affairs and a former member of the UK Diplomatic Services.

