THE DAMAGES FROM INVADING IRAQ

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Abstract

The proposed invasion may be motivated as much or more by Iraq's oil as by their weapons. Control of Iraq would ensure Western supplies in the event that Saudi Arabia fell into the hands of fundamentalists. But this is an economic matter as well: the economic consequences of an invasion are likely to make it difficult to reap the rewards of military success. We can expect oil prices to rise and the dollar to fall. The result will be stagflation - on top of the present recession. Tourism will collapse, and the probably policy responses will make things worse. If the oil fields are set afire, as they were during the Gulf War, not only the political but also economic fallout will be lasting.

Key words: oil market, oil prices, war and oil, invasion Iraq, war e*conomic effects*

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The Administration says basically that only a 'regime change' in Iraq will suffice to protect us from the threat of weapons of mass destruction. Moreover such a change will bring democracy to Iraq and will contribute to peace throughout the region.

A skeptical note

Yet the evidence is ambiguous at best. To be sure Saddam has made threats; but the inspectors dismantled many of his facilities and British and American bombs have destroyed many more. There is no clear-cut evidence of any weapons of mass destruction, or of any facilities to build them. If there were such evidence, it would have been trotted out long ago. There may be some hidden stockpiles – yet chemical or biological weapons could be too old to be effective by now. But there may be some hidden up to date weapons, too. And evidently Iraq has not succeeded in developing nuclear weapons, though no doubt they have been trying.

What is clear, in fact, is that, far from being more menacing, Saddam is much less of a threat now than he has been in the past. His army is more or less half the size it was; his conventional weaponry is out of date; his missiles were used up and have not been replaced; most of whatever arsenal of mass destruction that he had has been destroyed by inspectors or bombing. And the regime is not popular; in the north, the Kurds are in more or less open revolt, while in the south of the country, the Shiite majority has long resented its exclusion from government. In short, Saddam appears to be weaker and less dangerous now than ever.

Nor does the administration seem to have developed a plan for what happens after Saddam is toppled. What would replace him? Would there be a new constitution? Who would draw it up and how? What would happen to the Kurds? And would the Turks consent to the emergence of an Kurdish state? (They recently threatened to go to war to prevent it!) And what will be done with those Shiites who might wish to join Iran...? The French and Russians have large investments in Iraq; will those investments be protected? Will they be invited to join in policy-making? It's understandable, of course, that the administration might not want to show its hand in advance. But in this case

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there is no evidence that it has a hand. These questions don't even seem to be on the table. The administration seems to have something else entirely in mind. If the administration is not thinking about the future of Iraq, and if Saddam is weaker and less dangerous, why has the urge to topple him come up now?

Oil

Texas oilmen figure prominently in the current US administration, and Saudi Arabia figured prominently in 9/11. It was not just the home of 16 out of the 19 hijackers; it was also apparent that internal pressures kept the regime from cooperating in the investigation. Moreover, it emerged that Saudi money had financed both the Taliban, and Al Qaeda. And, of course, Bin Laden himself – and his money - came from within the Saudi establishment, close to the royal family. Saudi Arabia, the world's largest oil producer, sitting on the world's largest and most easily tapped pool of reserves, could no longer be trusted to remain loyal and cooperative. The US depends on Saudi Arabia for imported oil. Oilmen are unlikely to opt for conservation and improved energy efficiency. What to do? Well, Saddam's weakness, together with his belligerence and general unpopularity, offers an opportunity.

Consider. There are about 35 to 40 years of oil reserves left in the US. Roughly 67% of the world's oil reserves are in the Middle East and a large fraction, 21% of world reserves (and roughly 40% of Middle East reserves), is in Saudi Arabia. If these fall into the wrong hands... it would be bad, but they could be replaced. Notably, Iraq's share in world oil reserves is about 11%; (compare this to the combined reserves of the US, Canada and Mexico, which amount only to 5.4 % of the world supply!) Now consider the nearby neighbors of Iraq: the United Arab Emirates have 9.5% and Kuwait has 9.4% of world reserves. Together, Iraq, Kuwait and the United Arab Emirates would account for almost 30% of known reserves. (Figures from Energy Information Administration, Jan. 2001) Suppose an invasion brought about a compliant government in Iraq, along with a large U.S. military presence...?

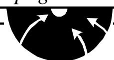
Possible gains

The main benefit from such an invasion would be gaining control over Iraqi oil, allowing the consolidation of its production with that of Kuwait, and the other Gulf States. The long-term presence of a large body of U.S. troops, newly based in Iraq, with new ports for the U.S. fleet in the Gulf, could encourage the integration of oil production, refining and shipping throughout the Gulf region, bringing the small, Westernized Gulf states together, along with Kuwait and southern Iraq, into a regional union, protected by the U.S. (Northern Iraq, at least the Kurdish regions, would presumably break free and go its own way.) The new confederation of Gulf oil producers would be solidly allied with the U.S. and the West, and would provide an important buffer should the Saudi regime be deposed and its oil fall under the control of anti-Western activists. To put it in perspective, if the Saudi regime maintains its control, a successful takeover of Iraq will ensure that the US and the West have 50% of the world's oil reserve well protected by newly established US air, land and naval bases. And in the event of a Saudi collapse, the West would still have 30% of the world's oil, and would not have to turn to Russia for energy.

But these benefits would only be realized if the Iraqi oil fields were seized intact. Oil facilities are easily destroyed, and fields can be set afire, as the Iraqis did when leaving Kuwait. It can take years to get production back online. It's unlikely that any benefits from the invasion could be realized in the short run.

Potential losses

On the other hand an invasion would create new tensions and intensify existing antagonisms throughout the Arab and Islamic world – and, indeed, in many other areas. An attack would be seen, reasonably enough, we suggest, as an oil grab, somewhat akin to old-fashioned imperialism. This would be deeply resented all over the world, and would be considered by many as undermining the principles of consultation and joint action through the United Nations. In the absence of any real evidence that Saddam poses a serious danger, the doctrine of pre-



emptive strikes would appear to be a cover for seizing Iraqi oil. And this could seriously destabilize pro-Western states, including those in the Gulf. Many oil-producing nations would be likely to join in an embargo, directed against the U.S. and perhaps the UK. An outbreak of anti-American and anti-Western sentiment, including terrorist actions, could be expected. Pro-Western governments might very well fall.

Of course, the U.S. would use its influence and diplomacy to try to prevent an embargo, and could sell from its strategic oil reserves, which have been built up in the last couple of years, to keep prices from rising too fast. However, diplomacy may not get very far in the face of the intense passions the invasion is likely to trigger, and the strategic oil reserves are very limited. They are too small to counteract a determined embargo. It will not be at all easy to keep prices down in the face of a major cutback.

Economic effects

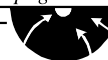
The basic expectation everywhere, then, has to be that oil prices will rise, perhaps sharply, from today's already high level of roughly $30 per barrel. Oil is now nearing its historical peak, which occurred during the oil price shock of the nineteen seventies - a price of $36 per barrel. Oil also went up sharply in the Gulf War.

Given the present state of the U.S. economy a serious rise in energy prices will erode consumer confidence. Consumer confidence dropped sharply in the previous Gulf War and triggered a strong recession (which helped to lose the presidential election for Bush senior). Anticipating this, and worried by the general uncertainties created by the invasion, short term overseas capital will be tempted to pull out of Wall St. (Stocks of defense contractors might be safer, but even there uncertainty may lead to caution, so they are unlikely to rise.) Funds will begin to return to the Euro and the yen. Wall St will start to fall, and the dollar will fall with it. The further loss of wealth will add to the pressures weakening consumers, and the fall of the dollar will add to the inflationary pressures generated by the rise in energy prices. Both will tend to deepen the recession, and as the recession deepens, the flight of short term capital will gather speed. The downward spiral will prove to be self-justifying.

Moreover, these recessionary pressures will feed into a downswing already well under way. It seems likely that the hopes for an early recovery were always overly optimistic. Had recovery come and stayed during the summer of 2002, the recession would have been the shortest on record. No U.S recession ever moved into recovery in such a short time period. The hopes for recovery were based on continued heavy spending by consumers already burdened with unprecedented debt - and who, in the upper income brackets, had already suffered huge capital losses! A further collapse of asset prices, as the bubble economy continues to deflate, will trigger a further decline in consumption spending. Moreover, investment has been low for a year now and the US unemployment rate, at more than 5.7%, is still rising.

In the recession triggered and exacerbated by the previous Gulf war the Fed was still able to come to the rescue by drastically cutting interest rate from 7-8 to 3.5 %. Today, however, with a current interest rate in the US of 1.75 % and in the Euro Area of 3.25 — and almost deflationary conditions – the central banks do not have much space to stimulate the economies. Nominal interest rates can go only to zero and then a liquidity trap is reached—with dangerous consequences as the Japanese economy has shown in the last ten years.

So the immediate impact of an invasion will be a tendency to exacerbate the recession, while at the same time triggering a cost-push inflation. What happens next would depend on the success of the invasion. In the happy event of a quick collapse of Iraqi resistance, so that the oil fields were seized intact, with little loss of life, and no wild rocket attacks on Israel or U.S bases, short term capital might begin to flow back to the dollar and Wall St – especially if reconstruction seemed to promise a new and more stable Western-allied oil patch in the Gulf. But this is very optimistic.



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Far more likely, the oil fields will be badly damaged, and the embargo at least partly effective. So oil prices will be driven up and will be expected to stay up. Terrorism is likely to stage a few more spectacular shows, driving the tourist and travel industry into the depths, worldwide. The U.S. recession will deepen, while inflationary pressures accelerate – 'stagflation'.

This scenario may then lead to what we would consider a disastrous move by the Fed – disastrous, but not at all unlikely. Namely, to curb inflation and strengthen the dollar, the Fed may feel impelled to raise interest rates. Such action will be unlikely to achieve either objective, but it will damage the real estate and housing markets. Prices in these markets are already widely thought to be over the top. Once they begin to come down, the correction is likely to accelerate, and could easily overshoot. In other words, real estate and housing could crash. If they did the effect on consumer spending would probably be dramatic – made all the worse by the recent, ill-advised toughening of the laws on bankruptcy, which will slow down recovery.

In the longer term, however, there will be an offsetting factor, which is, paradoxically, the war itself. If it turns out to be prolonged, calling for large increases in military spending, corporate America – the military-industrial complex – will benefit substantially. This will increase both employment and profits in manufacturing and high-tech.

However, it seems unlikely that this will be enough by itself, either to restore consumer confidence, or to bring about a favorable general climate encouraging investment. (Consumer confidence and spending fell during the Gulf War; investment did not pick up at all until the middle of the 1990s) Nor will increased military do anything to curb inflation – quite the opposite is more likely. With expected growth in the US running below 1 %, and in the Euro area below .5%, the advanced economies are too fragile at this time to withstand intensive shocks. Yet that is what an invasion would almost certainly bring. Not to mention a growing awareness that the central banks may be helpless in the face of such shocks. The economies of today are quite different than at the time of the Gulf war in 1990/91.

The bottom line? Even if the invasion is quick and easy, toppling Saddam and seizing the oil fields intact, the immediate and short run effects are likely to be negative: rising oil prices, short term capital flight, a plunge on Wall St and a falling dollar – plus a collapse of tourism and travel and a monetary policy running into a liquidity trap. Also, given the constraints on government spending, for example in the Euro-area, fiscal policy cannot come to the rescue. All of these will contribute to worsening the recession. But if it really is short and quick, short term capital might be induced to return, the fall in the dollar could moderate, and the rise in oil prices could be kept down as the U.S consolidates its new Gulf position. Even so the recession will get worse, and inflation, once set in motion, may prove hard to control.

But suppose the invasion does not go smoothly; suppose it faces stubborn and intractable resistance, that terrible weapons are launched against our troops and our allies, the oil facilities are destroyed and the fields set ablaze, and that terrorists assail Americans and Westerners all across the globe, while an oil embargo eats into our standard of living...

Maybe conservation and renewable sources of energy deserve a hearing after all.