Economic Commentary
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Economic Implications of an Attack on Iraq

- The odds of a US preemptive strike on Iraq have been rising in recent weeks and now stand at more than a 50% probability. Therefore, it is deemed prudent at this time to examine the economic impacts such an outcome will have on the economy.

- Based on past experience with the Gulf War (1990-91), an all-out attack on Iraq will have the most impact on four major areas: (1) the energy sector; (2) consumer spending; (3) financial markets and (4) the fiscal and monetary policy environment

- It is virtually certain that attacking Iraq will result in a short-term spike in energy costs. During the Gulf War oil prices peaked at just above US $40 a barrel. This could happen again. Crude oil prices have risen as high as $30 a barrel in recent weeks ($28.40 currently), and they are already higher by $5 - $6 a barrel because of the anticipation of war with Iraq.

- The IMF has estimated that a sustained $10 increase in crude oil prices reduces US real GDP by 0.6 percentage points. Also, it is important to note that the $40 peak during the Gulf war was in 1990 dollars. Factoring in inflation since 1990, a similar increase at this time would require oil prices to rise to $56. Moreover, since the North American economy has become more energy efficient by 20% over that past 10 years, it would take a hike in oil prices to US $67 a barrel for the attack on Iraq to have the same effect it had back in 1991 on the US economy.

- The impact on the economy will depend on two factors: (1) the duration of the war and (2) the containment of the conflict. If the war is short-lived, i.e. lasting two to three months the effects will be small, if it lasts longer, the effects will start to mount with the duration of the conflict. If the war is contained within Iraq, the effects will remain limited, but if it spreads outside Iraq and affects Kuwait, Saudi Arabia, Iran or other parts of the world, then the effects will get more serious. The one obvious industry that is expected to suffer the most from the conflict is the airline industry and the travel and allied industries.

- Therefore, as long as the duration is brief and the war is contained within Iraq's borders the negative economic fallout is expected to be limited and not sufficient to derail the current economic recovery. From Canada's vantage point, the negative economic impact of the war is likely to be smaller than in the United States, because unlike the US Canada is a net exporter of oil. Within Canada the oil-dependent manufacturing sector which is concentrated in central Canada (Ontario and Quebec) will be more adversely impacted while the energy producing sector largely concentrated in the West and the East will be positively impacted. Moreover, since Canada is not directly engaged in the war and since the Canadian dollar has been undervalued relative to its US counterpart, the negative consequences should remain more muted for Canada than they would be for the USA.

- During the Gulf War of 1990-91, there was a sharp drop in consumer and business confidence and a contraction in retail spending that begun during the critical Christmas season. The same can be expected to happen again. Since consumer spending accounts for 60% of aggregate demand and since consumer spending has been the mainstay of the current recovery, the impact of the war may have serious consequences for the recovery. As long as the duration and scope of the war remains limited, it should not derail the economic expansion

- The impact of the war is likely to be negative for equity prices but positive for fixed-income (bond) prices, as funds flow to the relative safety of government securities. Assessing the impacts, however, is complicated by the fact that financial markets have already started to price in the risks of the expected war with Iraq. At current levels, the P/E ratios for equities are starting to look attractive while US treasuries appear expensive. As long as the duration of the crisis remains limited and since financial markets are already pricing in the impacts of the war, any further declines in equity prices (rise in bond prices) is expected to be limited. Hostilities will however, heighten financial markets volatility in the short-term and most certainly cause significant sector rotation.

- The impact on share prices will be varied as energy and defence related stocks move up while airline and tourism related stocks move down. In terms of commodities, oil and natural gas prices would rise sharply and gold would benefit from safe-haven buying. In contrast, non-energy commodities such as base metals and forest products would suffer initially as commodity markets assess the potential effects of the war on the global economy. The US dollar and the Swiss franc would also be -as with previous geopolitical crises- likely destinations of global capital seeking safe haven. This environment, however, has not proven to be beneficial for commodity-based currencies such as the Canadian dollar and emerging-market currencies. Again, all of these effects should prove short-lived as long as the crisis remains short-lived and under control.

- Depending on the outcome of the war, its intensity, geopolitical results and duration, it may also roil financial markets through two other channels. First, if it heightens concerns about the outlook on inflation, it may reverse the favourable trend of the past few years in fixed-income prices. Second, it might affect the international value of the US dollar and impact negatively the already precarious flows of international capital to the US on which the US already depends heavily to finance its current account deficit.

- If the war turns out to involve a prolonged and costly struggle, and/or if it spills over into other countries in the area or around the world, -in recent days we have seen threatening actions from North Korea, the possibility that Iran may have a covert nuclear arms program going and civil unrest and oil production interruptions in Venezuela and possibly Nigeria- and/or if chemical or biological weapons are used, then all bets will be off with regard to its impact on the stock market, consumer behaviour and the nascent economic recovery.

- On the other hand, it is important to take into account the positive offset that military action in Iraq will have on the economy in terms of the ramped up government expenditures to pay for the military operation. In September, 2002, NABE's panel of economic forecasters has projected the unified US budget deficit for FY 2002 at $167 billion and for FY 2002 at $175 billion. These estimates, which do not take account of the military action against Iraq are subject to up-ward revision of between $100 to $200 billion based on calculations made by ex-Fed governor and Senior White House economist Lawrence Lindsay (the 1990-91 Gulf war cost the US $80 billion at today's prices).

- However, the price tag this time around could prove significantly higher as international support and contributions to the fight might end up to be lower than with the Gulf War. As the jump in US government outlays might amount to between 1-2% of GDP, the positive effects might more than offset the negative effects if the war proves short and successful. In this best-case scenario, the US will still have to deal with the negative consequences in the run-up of its debt in the medium term.

- In terms of the monetary policy environment, the Federal Reserve has already taken pre-emptive action on November 6^{th} by cutting the fed funds rate by 50 basis points while a further cut in rates is conceivable, especially if the action on Iraq proves to meet with unexpected resistance or complications. Under such circumstances it would not be unreasonable to expect the Bank of Canada to follow suite by a cut of its own, especially if consumer confidence and retail spending begin to be adversely affected on this side of the border.

- In summary, the risk of war with Iraq is increasing with the odds of war now exceeding 50%. The possibility of war is already been factored in by financial markets and to a lesser extent with consumer confidence, with negative effects for the economy. The best case scenario is the peaceful ouster of Saddam Houssein from Iraq without the need for military intervention. If this were to happen financial markets and consumer and business confidence would respond positively and give a boost to the US and global economy. The next-best scenario, is the ouster of Houssein through a brief, surgical military action that proves successful. In this case the economy goes through a brief adverse shock, but quickly regains its momentum and the fragile recovery is assured. Oil prices fall by $5 to $7 a barrel and this propels the global economy to an expansion by the end of 2003. The worst-case scenario is that the conflict becomes protracted and/or expands in scope with the US not successful in achieving both its military and geopolitical objectives. In this case we will see a return to recession in the US, a marked deterioration in global growth with severely negative implications for financial markets and the Canadian economy, implications that are very hard to quantify or contemplate at this point. Let us all hope for a successful resolution of this crisis.

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