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## Iraq Instability and Oil Prices

*Recent events in the Middle East are weighing heavy on our minds. Given these events, we believe it is necessary to take a break from our Productivity trilogy to discuss the economic ramifications of the armed conflict in Iraq. We will return to our final productivity piece in future writings.*

Recently, we created a piece that outlined historical information regarding how Middle East instability has led to oil price increases in the past. We noted that since 1990, 21 “destabilizing” events have occurred in the Middle East. These periods of instability have led to an average oil price increase of 9.2%. Although, some events have had sharper teeth and led to much higher oil price spikes than others. With what we currently know, we do not believe that oil prices will radically exceed \$112 per barrel, and our research is indicating that prices will retreat by the end of the year.

With that being said what about other, less sanguine possibilities given the instability in Iraq? Please read on.

### What About Iraq?

With the ISIS (Islamic State of Iraq and Syria) jihadist militant group gaining ground, Iraq is currently the center of Middle East instability. The central grievances that have led to this crisis are national policies that appear to

discriminate against the minority Sunni Muslim population. ISIS is basically a military strike force of Sunni Muslims who are determined to gain ground and march on Baghdad. In the face of the hostilities, oil prices have been reasonably well-behaved, rising by about 4% so far this month.

Interestingly, ISIS has attempted to gain ground in the Kurdistan area but ran into well-organized resistance by the Kurds, who held their ground. This is an important factor, as it has become recognized that from a military standpoint, ISIS can be stopped. Currently, the vast majority of oil production in Iraq occurs in the southern half of the country. ISIS is moving from north to south and hasn't yet reached the country's major oil fields.



So, what about Iraq? The only country in the Middle East that exports more oil than Iraq is Saudi Arabia. What happens if, by a stretch of the imagination, ISIS not only attacks and takes over Baghdad, but also marches southward and takes over the major Iraqi oil fields? What happens if oil exports from Iraq are interrupted? Lots of questions – I'll attempt to provide some answers.

## **Sustained \$10 Price Increase**

So far, oil prices have increased by about \$4 per barrel. But, what happens if the mere threat of an interruption in Iraqi oil exports raises prices by another \$6 per barrel? This increase is within our base case forecast. But, contrary to our base case, what happens if oil stays at that level for a period of time? Our friends at J.P. Morgan have attempted to answer this question. Reports suggest if oil prices rise by \$10 per barrel and stay at that level for a period of time, we should expect GDP growth in the United States to be 0.4% slower than would otherwise be the case. Given the fact that the 12-month "real" GDP growth rate has averaged 1.6%, another drag on overall GDP growth would certainly hurt overall U.S. economic activity, but it wouldn't be catastrophic.

## **Oil Exports from Iraq Slow**

Taking a more Draconian view of the possibilities, what happens if ISIS drives southward and takes over the Iraqi oil fields? What happens if Iraqi oil production is cut in half for a period of time? Macroeconomic Advisers in St. Louis (a highly respected economic think-tank) modeled the impact on oil prices and global economic activity if this actually occurs. The data suggests that if half of the Iraqi oil production ceases:

- 1.5 million barrels per day of production would be lost. This makes up roughly 1.7% of global crude oil consumption. By Macro's modeling, this contraction in oil output would potentially raise oil prices by 45% or about \$50 per barrel.
- If this were to occur, presumably inflation pressures would mount quickly in the United States. The potential impact on gasoline prices would be a 20% to 25% price increase.
- GDP growth in the United States could move toward 0%, threatening a new recession.

## **Catastrophic Scenario Not Likely**

It is our opinion, at this time, that the more plausible of the above scenarios is the \$10 per barrel price increase, which we believe will correct over a somewhat short period of time. This would lead to slightly slower, albeit still positive, GDP growth for the remainder of this year. But it is good to know the downside to any geopolitical economic factor – be it real or unlikely.

We will be back next week.



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