



Worth Noting

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Worth Noting is the journal of research and conferences company L21. It is focused on issues of relevance and interest to senior executives.

Way back in February last year, we made a few predictions about the consequences of military action in Iraq prior to the commencement of war.

Although it was not then a *fait accompli*, we believed that war would be declared in a matter of weeks. We also made a few predictions about the economic consequences of military action in Iraq and almost two years on, it is time to see how those predictions stack up against subsequent events.

Our Predictions in February 2003

“The impending conflict in Iraq has a different set of variables. This time, the goal is not to defend the status quo by defending the sovereignty of an invaded country (like 1991) but to change it. The U.S. goal is to disarm Iraq but within this objective is the goal of regime change – or stated differently, getting rid of Saddam. This has a number of ramifications ...”

WN, Feb 2003

We went on to argue that the ramifications would be as follows:

“First, this means that Saddam has very little to lose and the prospect that biological or chemical weapons if available might be used is a very real one ...”

“Second, even if any U.S. led coalition succeeds in defeating Iraq quickly (which we believe is still the most likely outcome), because a regime would have been displaced, significant time and money must be spent on administering the transitional Iraq. This is where experts wildly disagree on the costs since it is unclear how difficult and how long a presence by U.S. forces is required in a post-Saddam Iraq.”

"[Finally] any successful regime change in Iraq means a significant redrawing of the political-economic map in the Middle East. Any transitional and ultimately new regime is likely to be a strong U.S. ally and pro-Western regime."

WN, Feb 2003

The first prediction obviously did not occur. Saddam did not have significant WMDs at his disposal let alone stockpiles of them. The final Kay Report delivered several months ago saw the chances of discovering stockpiles of WMDs 'extremely remote' simply because the inspection teams do not believe Iraq have them.

On this point, it is worth noting that U.S., other international agencies, and even the U.N. agency were not entirely incorrect about Saddam and his WMD ambitions. The final Kay Report indicated that there was substantial evidence to believe that Saddam had clear intentions to resume the mass production of WMDs once sanctions imposed by the U.N. came to an end. The reason why Saddam was so evasive regarding his obligations to give a 'full and frank' disclosure of his WMD capability and intentions was because he wanted to push the U.S. and U.N. to an agreement that sanctions would indeed be lifted should Iraq be found clean. Saddam's ideal situation was that sanctions were lifted and he would be allowed to resume his WMD production uninhibited. His worse case situation was that even if Iraq was found not to have 'stockpiles' of WMDs following thorough inspections, sanctions would remain. The West's (mistaken) believe that he had WMDs was therefore used by Saddam as both a bargaining tool to eventually lift sanctions and as a bluff to heighten Iraq's military standing.

The Report indicates that Saddam knowing he would not prevail militarily did not want war but went too far in bluffing the U.S. and U.N. This aspect of the Kay Report is largely ignored by most media only keen to report the non-existence of existing stockpiles of WMDs.

The second prediction was largely accurate. Coalition forces did quickly overrun the Iraqi forces. There were several factors for this. First, there was a mass disintegration of the normal Iraqi army. Largely conscripted to fight, they largely gave up and abandoned their posts knowing they could not possibly fight the superior U.S. led forces. Second, the much touted Iraqi Republican Guards whom the Coalition believed were formidable turn out to be otherwise.

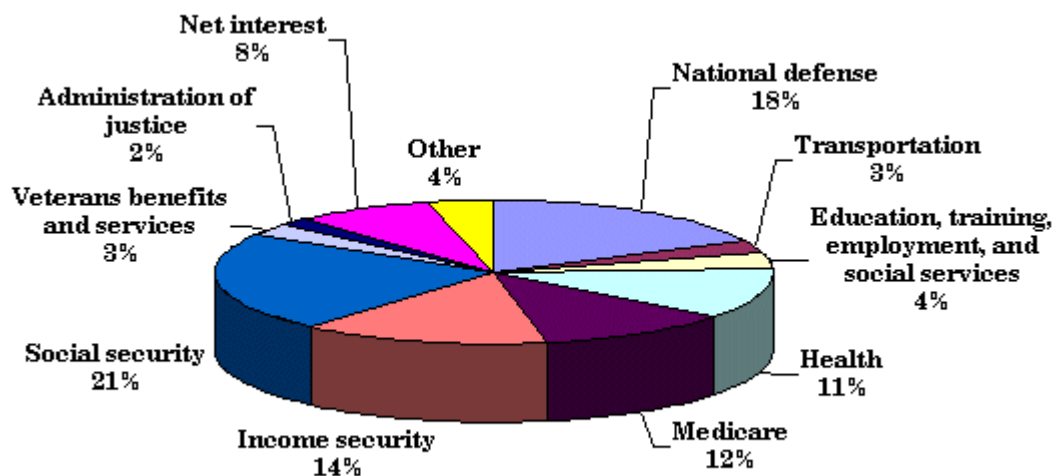
In fact, General Tommy Franks who led the Coalition forces was perhaps too successful. The formal war was over so quickly that forces that were once part of Saddam's army and are fighting now as insurgents could not be confronted, captured and disarmed. Moreover, because the U.S. chose to completely disband the Iraqi military and police forces immediately after the formal phase of

the war, current insurgents were allowed to regroup and rearm amid the chaos that appeared shortly after the formal defeat of Saddam's forces.

What about our argument that significant time and expense will be needed to administer a post-Saddam Iraq? This is where we noted that experts differed radically on how much the war and post-war effort would cost. The cost of administering Iraq post-war is currently about US\$150 billion and counting. The current administration is talking about having troops in Iraq for another four years. In terms of costs, much will depend on how successfully the new Iraqi administration (after elections in January) is in establishing a reliable and professional army and police force. Most experts believe that this is the key issue because there will be a reduced need and presence of U.S. troops. This will also quell some of the unrest since not all the insurgents are Islamic extremists hell-bent on creating a hard-line fundamental state. Many of the insurgents merely are fighting against the presence of foreign troops.

The current situation seems like it will follow what we called the 'Bad Case' Scenario back in February 2003. The war and post-war occupation will cost the U.S. about US\$460 billion. This was contrasted with our then 'Worse Case' scenario which would cost US\$760 billion. With the 'Bad Case' scenario, the situation is far from ideal but is no where near a Vietnam War type situation.

Below is a chart on how the U.S. Government spends their budget. Note that the 'National Defence' figure of 18% does NOT include Iraq. Iraq should take up between 0.3%-0.6% of the budget for the next 3-4 years. Hence, Iraq is a notable but not glaring aspect of the U.S. budget.



Source: Office of Management & Budget, 2004

Most news media reports would indicate that the whole of Iraq is in chaos. This is actually a misrepresentation. Insurgent and terrorist activity is restricted to a few cities and towns such as parts of Baghdad, Mosul, Kirkuk and Falluja. Very large parts of the country are actually relatively peaceful and functioning normally. This is not to downplay the dangers that have taken the lives of over 1000 U.S. troops and other Iraqi civilians since war formally ended. It is more to point out that the situation is on the 'bad case' side of things, but not in the disastrous or unforeseen side of things from the Coalition's perspective.

Finally, is our prediction that the subsequent administration in Iraq would be a pro-U.S. and Western ally correct?

This depends on the results of elections in January. If Interim Prime Minister Allawi or someone similar wins the elections, and if the internal Iraqi police force can control the internal violence, Iraq will become a viable state and exist as a moderate ally with the West in the region. These are only 'ifs' but probably the most likely outcome within the next couple of years.

Once again, contrary to majority news reports, extensive surveys taken by the BBC indicate that the vast majority of Iraqi citizens cautiously support the U.S. action and occupation and prospects for their future provided that U.S. troops leave the country as soon as possible. This indicates that the degree of optimism in Iraq is much higher than the impression created by daily reports that focus just on the small number of troubled areas.

Impact on Oil Prices Prediction in February 2003

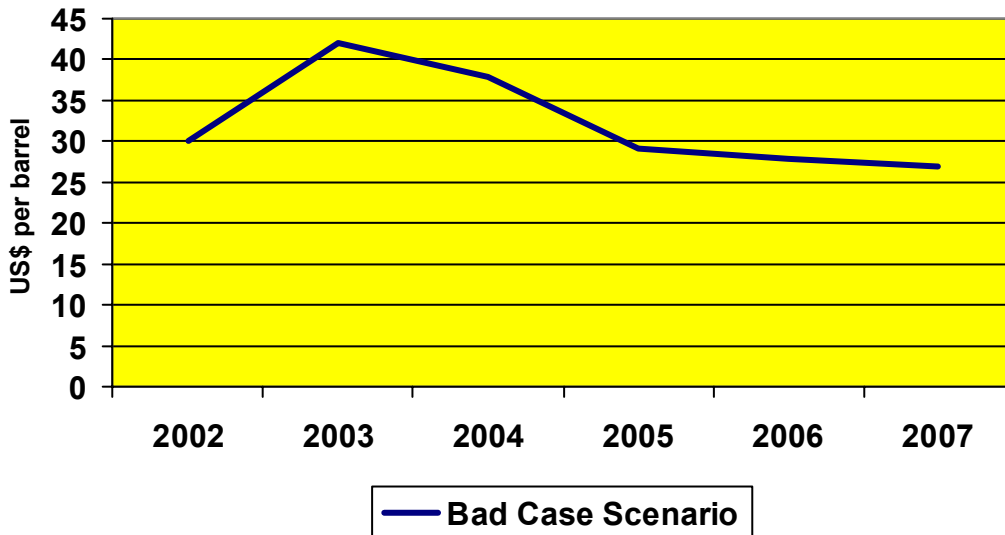
Oil prices have been much more difficult to predict. Back in February last year, we predicted that:

"We have little doubt that a short war with a quick American-led victory and a relatively successful transition period in Iraq would have little impact on oil prices and the world economy ... Indeed, with the current price of oil at about US\$30 a barrel, there has already been a 'war premium' factored into it – we estimate about US\$5 a barrel. Given that the immediate shortfall in Iraqi non-production during and following a quick war would be easily met by current excess production and OPEC promises of increased quotas, prices per barrel are likely to fall to US\$25 per barrel or below."

WN, February 2003

Given that the current situation was what we called the 'Bad Case' Scenario (short war, relatively long occupation period), this was what we predicted about oil prices back then.

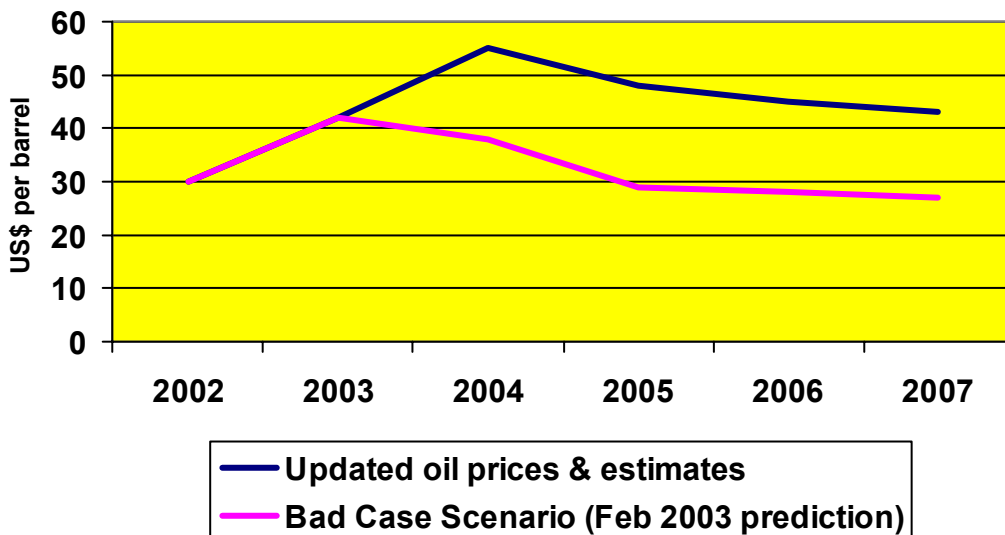
Price per barrel of crude oil – Feb 2003 prediction



Source: L21 WN, Issue III, Volume IV

We were clearly incorrect. The price of oil following the Iraq War has been closer to US\$50 a barrel. A correct chart is more like the one below:

Updated oil prices & predicted future prices vs. L21 Feb 2003 prediction



Source: L21 WN, Issue III, Volume IV; OPEC

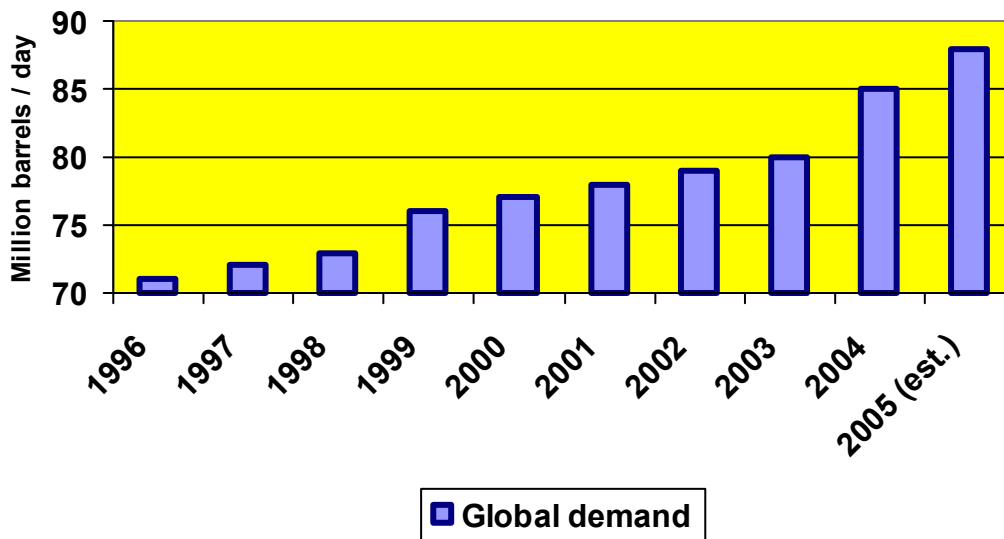
Where did we go wrong? The price difference is about US\$16-US18 a barrel between what we predicted and actual fact.

It does not seem that the situation in Iraq has had a huge impact on the price of oil. Why? Because Iraq was not expected to produce cheap, efficiently extracted crude oil for another five years anyhow.

We took this consideration into account in producing the February 2003 report but we forgot one immutable law about world markets, and in particular about supply and demand: they do not stay the same. In other words, if you are wondering why oil prices have gone up so much, it's simply a demand and supply issue. Actual supply and short-term potential supply capacity has remain steady whilst demand has gathered pace faster than expected.

Consider the chart below.

Global demand for crude oil



Source: International Energy Agency

There have been stand-alone situations that have caused oil supply fears that have led to immediate price spikes. One example is Russian producer Yukos' dispute with the Russian Government. But these stand-alone shocks are relatively easily negotiated.

It is more the demand side that has driven up the price. Demand has largely come from a recovering U.S. economy and a booming Chinese economy that seems insatiable as far as consumption of oil is concerned. Global demand is now 750,000 barrels per day more than was anticipated eighteen months ago. In July 2004, for example, OPEC spare capacity was only 600,000 barrels per day.

Therefore, short-term supply capacity does not meet short-term demand increases. OPEC has only been able to increase capacity by 400,000 barrels per day in 2004 and is able to increase production by only 700,000 barrels per day in 2005.

Indeed, there are longer term fears that increasing Chinese demand will be difficult to meet and oil prices will stay above the US\$40 per barrel mark due to this factor alone.

There is also something quite large brewing here. Ten years ago, estimates by most experts believed that demand for oil would outstrip supply permanently only by about 2030-2040. But it seems that these estimates are way off. Some experts are now predicting that demand will outstrip supply by 2010. Whilst we now consume about 80 million barrels of oil per day, by 2015, it could be closer to 135 million barrels per day.

At the current rate, demand simply cannot be met. Price rationing will increasingly be used (i.e., raising oil prices to reduce the reliance on crude oil). More developed economies will search more and more for oil alternatives but developing ones like China will consume oil unabated.

Back to the Iraq issue, what is happening in Iraq is really only a small part of the ongoing story of oil. Expect oil prices to remain above the stated target only eighteen months ago of US\$22-\$26 per barrel irrespective of what happens in Iraq.