

Economic Spotlight

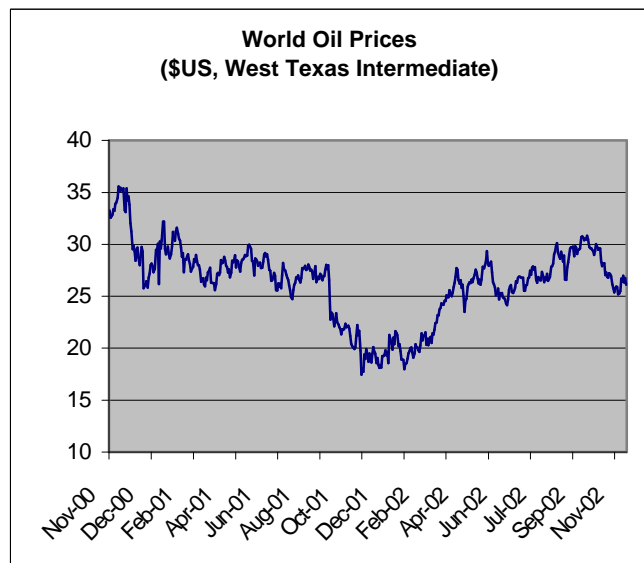
IRAQ AND THE OIL OUTLOOK

Summary

- The threat of war with Iraq continues to be a source of uncertainty for the short-term oil price outlook. Recent political and market developments, however, suggest that an Iraqi conflict is unlikely to cause substantial price increases of the type witnessed during the 1991 Gulf War.
- While the possibility of a broader Middle Eastern conflict cannot be discounted, this scenario is highly improbable in the near term. If hostilities are confined to Iraq as anticipated, disruption of Iraqi supply should not have a major or sustained impact on world oil markets.
- The potential for increased Iraqi production following resolution of the current crisis introduces significant downside risk to the medium and long-term oil price outlook.
- Oil markets do not display clear momentum in any direction at present. Uncertainties regarding a war with Iraq are counterbalanced by concerns about rising world production and weak global demand. Price expectations for 2003 lean in a slightly negative direction.

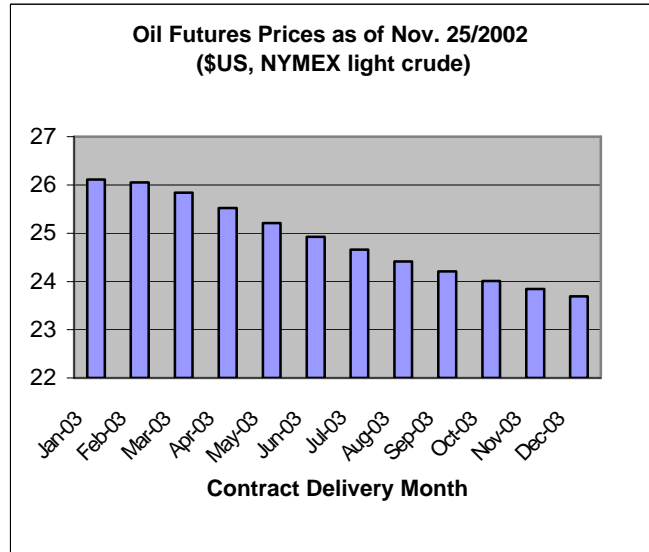
Background

- After reaching a post-September 11 (2001) high of almost \$31 in early October, oil prices have fallen by more than 15 percent in the past seven weeks. Diminishing concerns regarding the risk and ‘fallout’ of an Iraq war have been viewed as a significant factor in this decline.
- On November 8, 2002, the United Nations Security Council unanimously approved a resolution demanding renewed weapons inspections in Iraq.
- The new U.N. resolution calls for “immediate, unimpeded, unconditional and unrestricted” access to all facilities, and demands full Iraqi weapons disclosure by December 8, 2002. Any violation of its terms (including inaccurate disclosure) is considered a “material breach” of Iraq’s obligations.
- On November 10, the 22-member Arab League endorsed the latest U.N. resolution.
- On November 13, Iraq announced its intention to comply with the November 8 U.N. resolution. It is presently anticipated that the inspections process will resume before the end of November.
- While the U.N. resolution does not outline specific sanctions in the event of non-compliance (it warns only of “serious consequences”), the Bush administration has indicated that any Iraqi



violation of the resolution's terms would invite an immediate - and most likely a military - response by the United States and its allies.

- It is widely expected that the vote of the U.N. Security Council for an unambiguous and time-limited weapons inspection regime will bring clarification and/or resolution of the 'Iraq crisis' no later than the first quarter of 2003.
- Recent political developments have had little discernable impact on oil price expectations. Forward markets continue to predict that prices will exhibit a moderate decline over the course of 2003, settling in the range of \$23-24 (U.S.).
- Global demand remains weak. Demand growth of only 190,000 b/d (roughly one-quarter of one percent) is projected for 2002, while 2003 growth is forecast at just over 1 percent (about 1 million b/d).
- World production has risen in recent months. In October alone, production increased by approximately 1.25 million b/d.
- Although market fundamentals are generally considered to be rather weak, there are some concerns regarding the level of global oil inventories, which are now approaching 5-year lows.



Possible Scenarios

- There are three basic scenarios for resolution of the 'Iraq crisis': 1) successful inspections and/or peaceful disarmament of Iraq; 2) a 'short war' confined to Iraq, followed by a U.S.-led military occupation; and 3) an extended war, potentially spreading to other Middle Eastern countries.
- Under either of the first two scenarios (successful inspections or 'short and limited war') it is expected that Iraqi export potential will rise in the near to medium term, due to an expected relaxation of economic sanctions against Iraq.
- Under the 'short war' scenario, few analysts expect oil prices to rise substantially above the \$30 U.S. level - even in the near term. Weak global demand, and current Iraqi production levels in the range of 2 to 2.5 million b/d (roughly 3 percent of global production) do not suggest a serious disruption in global supply under this scenario.
- While a prolonged war extending to other Middle Eastern countries is widely considered unlikely, under this scenario oil price forecasts range from \$35 to \$50 for up to one year, followed by a major price reversion after the war's conclusion, as increasing non-OPEC supply competes with the resumption in OPEC production. Under this 'extreme' scenario, it is estimated that prices could fall as low as \$15 after the war's conclusion.

Assessment

- The unanimous nature of the November 8 U.N. resolution, and the support of the Arab League, have significantly increased the chances that the U.S. will gain substantial international backing for military action in the event of Iraqi non-compliance. In this case, the support - or at least the non-opposition - of key Middle East governments (such as Egypt) may be expected, greatly reducing the risks to regional stability and the probability of a 'wider war'.
- The Bush administration has signalled very clearly that it will demand the strictest possible interpretation and execution of the latest U.N. resolution. This will make it exceedingly difficult for the current Iraqi regime to "fully" comply with the resolution, given its nature and history.
- The recent mid-term elections in the U.S have significantly enhanced the political power and authority of President Bush and his Republican Party (which now controls both Houses of Congress). Legislative opposition to an invasion of Iraq may now be considered a non-factor.
- On balance, the evidence suggests that the U.S. administration is inclined to seize any reasonable pretext to effect 'regime change' in Iraq - a task that should not be unduly difficult, given the strength and scope of the November 8 U.N. resolution. Thus, a 'short, limited war' seems the most likely scenario. Successful inspections/disarmament is the second most likely scenario. In either of these two cases, an increase in Iraq's oil exports could occur within a year or less.
- Given the relatively fragile state of the U.S. economic recovery, the Bush administration will likely not hesitate to release oil from its Strategic Petroleum Reserve (SPR) in the event of a disruption of Iraqi supply (in order to mitigate potential price increases). The SPR currently stands and slightly under 600 million barrels.
- Current estimates of OPEC 'excess capacity' (excluding Iraq) are in the range of 5million b/d, further suggesting that a 'limited war' scenario would not seriously disrupt world oil supply for any appreciable length of time, provided that Saudi Arabia is 'on-side'.
- While the level of potential war damage to Iraqi oilfields is uncertain, most analysts expect a very brief conflict – suggesting that such damage may be fairly limited.
- According to one estimate, while infrastructure constraints could restrain the growth of Iraq's export capacity to approximately 1 million b/d for two to three years, production increases of up to 4 million b/d could be expected in the medium term (raising Iraq's potential share of world production from 3 to 8 percent). This could increase global oil production by as much as 5 percent, presenting significant downside risk to the medium term price forecast.
- While a military occupation of Iraq (with some form of U.N backing) is not expected to have a destabilizing impact on the Middle East in the near term, within 2-3 years this factor could become significant. A long-term U.S. military presence presents obvious risks for future political developments in the region.