January 18, 2003

War Uncertainty Weighs on Economy

By DANIEL ALTMAN

As Washington decides whether to invade Iraq, uncertainty about a war is already weighing on the economy.

While consumers have not been overly discouraged by higher energy costs or the risk of another terrorist attack, business leaders are clearly hesitant to make new investments until the smoke clears.

Before going ahead with a big new project, asks Robert J. Barbera, chief economist of ITG/Hoenig, an investment firm, "wouldn't you wait a quarter?"

In the calculations of many analysts, he said, an invasion of Iraq is "90 percent likely to occur, and 80 percent likely to occur in the next 90 days." Those probabilities may have risen with the discovery of empty chemical warheads in Iraq on Thursday, which led some investors to dump stocks in favor of government bonds, and dollars in favor of euros.

The budgetary costs of any war and future reconstruction are unknown. Even if war with Iraq never comes, though, the economy will still have received some stimulus from the upswing in military and domestic security spending since the Sept. 11, 2001, attacks. But that has not been enough to overcome the drag on investment, which began to sag as long ago as late 2000, after the technology bubble burst.

Adding to the uncertainty that is discouraging big companies from starting to invest again, Mr. Barbera said, are the huge differences between the best- and worst-case outlooks in the event of war. An invasion could be quick, surgical and successful, clearing the way for a surge of investment on delayed projects. Or it could be long, messy and fraught with retaliations by terrorists.

"Geopolitical risks, such as the threat of war with Iraq, tensions over North Korea and terrorism, have added to the list of business concerns," said Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, in a speech on Tuesday. "These factors continue to leave businesses reluctant to invest."

Moreover, businesses can afford to take a wait-and-see attitude right now, Mr. Barbera added, because the economy is not exactly bursting with profitable opportunities. "You're not feeling like you're giving up something in growth by postponing investment," he said.

A more tangible drag on business is the relatively high price of oil, another consequence of uncertainty about the prospect of war. Oil prices are already up, with crude running above $30 a barrel. Unrest in Venezuela, a leading supplier to the United States, has not helped. Higher prices for oil and its useful byproducts are already pressuring industries from pharmaceuticals to trucking.

"I don't think there's going to be much more than what we're already paying in the market price," said
Samuel K. Skinner, chief executive of USFreightways. "We're already feeling it with the threat of war."

USFreightways can pass some extra costs along to customers through fuel surcharges, Mr. Skinner said, but the company may have to protect itself further by hedging against potential increases in the price of oil. "We're not hedging right now, though hedging is something we traditionally would look at," he said. "In retrospect, maybe we wish we had."

Analysts and executives alike expect the price of crude oil to stay high until the United States and its allies have a war well in hand.

"It is unlikely we would face major shortages of physical product as a result of any war," said Steve Turner, an oil analyst at Commerzbank in London, but "a short-term price spike in the coming three months is possible."

OPEC, the international oil cartel, has increased its production by about 1.5 million barrels a day to counter Venezuela's stalled exports. Yet the group is unlikely to try to stave off a war-induced jump in the price of oil, Mr. Turner said.

The removal of Saddam Hussein, on the other hand, offers a balancing factor — greater access by the world market to Iraq's vast oil reserves, which could bring the price down over time. The range of possible outcomes for oil prices has rarely been wider, except perhaps during the last conflict in the Persian Gulf.

When Iraq occupied Kuwait in 1990, ending shipments from that country, oil prices shot up to $35 a barrel from $17 four months earlier. As the United States massed troops in Saudi Arabia, the price began to fall.

Almost as soon as the invasion of Iraq began, the price slipped to $20 as it became clear the United States and its allies would win a quick victory. Talk of street-to-street fighting has led to worries that this conflict could take longer, though.

"The first thing we would worry about is the valuation of raw materials," said Ray Anderson, director of investor relations at DuPont, which uses tons of materials derived from crude oil in its manufacturing of plastics and chemicals. Buying financial hedges against high prices for oil byproducts is not easy. "They're just not very deep, liquid markets," he added. "We are largely, almost essentially unhedged in buying key oil-derived materials."

Some big users of oil-derived fuels have hedges built into their business. Bill Zollars, chief executive of the Yellow Corporation, said that virtually all of his trucking business was insulated from rising fuel costs by surcharges, which raise trucking fees automatically when fuel prices rises above certain thresholds. But he worries that his business might suffer indirectly if economic activity slows over all. And hedging itself adds to the cost of doing business.

By waging war in Iraq, the Bush administration could be taking a gamble with consumers' confidence in the economy. Ken Goldstein, an economist at the Conference Board, said that depending on its outcome, the war could either embolden consumers or, in the worst case, send them reeling.

"If the military action itself goes without a hitch," he said, "there would be a boost in terms of overall confidence. But countering that is the idea that we are no more going to bring Saddam out of Iraq than we brought bin Laden out of Afghanistan."

And Mr. Goldstein, like some others analysts, worries that any successful retaliation by terrorists in the United States could cause consumers to pull back.

"The potential to drop confidence like a stone is probably not from the bombing or fighting on the ground in Iraq, but more from the unintended consequences," Mr. Goldstein said. That concern was not present in the last gulf war, in which existing concerns about the domestic economy — not the side effects of the war — came to dominate consumers' mood.

Corporate executives are also worried about those unintended consequences. In a survey by TEC International, a chief executives' trade group, 41 percent of 1,142 responding members said their top concern was another major terrorist attack in the United States. More than two-thirds said a war in Iraq would have a negative impact on their business.

In the event of retaliation by terrorists, the United States could also be harmed indirectly through its allies. "There are reported to have been a lot of al Qaeda sympathizers in Saudi Arabia," Mr. Turner said, "who might feel moved to act against the royal family were Iraq to be attacked."

Alternatively, Mr. Turner said, Iraq might fight a "less clean war" on its own by attacking oil supplies elsewhere in the Middle East. That strategy could wreak havoc in the United States. If oil prices rise sharply, Mr. Goldstein conjectured, a double-dip into recession could be unavoidable.

If a war were to end quickly and easily, however, the situation could be the reverse. "You breathe a sigh of relief, and you get an upturn in capital spending," Mr. Barbera said.

Some companies do not have to wait until then. They are feeling the traditional wartime lift, even as head winds from Iraq threaten to unsettle the economy as a whole. Producers of systems that update or speed up older weapons, as well as makers of newer robotic or unmanned systems, are already filling orders from the Pentagon. But Iraq-oriented business may be the exception rather than the rule.

These days, "America fights come-as-you-are wars, because it takes so long to manufacture high-tech equipment," said James Fetig, a retired Army colonel who has worked for major military contractors. "Missiles and those kinds of things are usually in inventory by the time these things start." With shorter wars, he added, most business arrives afterward, when the Pentagon needs to buy replacement munitions.

At least a few direct suppliers have been operating at wartime levels since the terrorist attacks, however.

"There's been a constant buildup since 9/11," said Lee K. Aaron, a vice president at Alpha Industries, which makes jackets for all four services. "In many cases, our capacity has been full."

The Defense Department usually builds flexibility into its contracts with suppliers, so it may demand additional equipment at a moment's notice, Wolverine World Wide, which makes combat boots and other footwear, has contracts with the department that stretch over several years.

The company produces "a certain minimum, and they tell us using a purchase order whether they're going to need more," said Tom Mundt, Wolverine's vice president for strategy and communications.

Mr. Mundt said his company was operating at normal rates. Most reservists who might be called up to serve in Iraq, he explained, already have most of their equipment. The Defense Logistics Agency will make some immediate purchases, though, in the event of war.
"Initially, the big concern is going to be with rations and water," said Jack L. Hooper, a spokesman for the agency. "Fuel is going to be a constant consideration. However fast they want to prosecute an air and-or ground operation is going to depend on how quickly and efficiently the supply trains can keep up with the combatants."

Even after the fighting ends, forces in Iraq would continue to demand resources, as do those in Afghanistan, Guantánamo Bay and the Philippines. Through Dec. 11, the agency had processed 719,278 orders for $6 billion worth of nonweapons material.

Indeed, one thing could still drag down consumers' confidence even after a brief and successful war: "The slow, dawning realization," Mr. Goldstein said, "that the real work — in Bosnia, in Afghanistan and now in Iraq — is afterward."