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## IDSS COMMENTARIES (76/2006)

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### **Mideast Conflict – A Silver Lining? Mixed Economic Impact Likely**

Richard Carney\*

3 August 2006

THE recent rise in violence in the Middle East, triggered by the Israeli-Hizbollah and Israeli-Palestinian conflicts, points to the likelihood of prolonged instability in the region. How could that ever be a cause for optimism?

In the short-term, several negative effects on the world economy are likely. Oil prices increase whenever investors perceive an increased risk in its delivery; in this case, they are particularly worried about Iran getting dragged into the conflict, which could lead to the mining of the Straits of Hormuz. But even without Iranian participation, high oil prices remain a serious concern since it causes consumers to spend more on gas, leaving less money to spend on other things, and making the purchase of a new car especially unattractive. It also leads to higher prices on other goods as they become more expensive to manufacture and deliver. Consequently, consumers buy less.

The same goes for business. They tend to make fewer purchases of energy-consuming machinery, and delay making other big-ticket expenditures. As a result, pressure builds for a recession.

#### **Impact on US economy**

At the moment, the United States economy is walking a tight rope between staying out of a recession, and keeping inflation under control. If Federal Reserve chairman Ben Bernanke keeps interest rates high, or continues to raise them to keep inflation under control, he could push the US economy into recession. On the other hand, doing nothing, or lowering interest rates, could lead to intolerably high inflation, which is usually a worse sin. Recall that the outbreak of the Iran-Iraq war in 1980 preceded the 1981 recession, and the Iraqi invasion of Kuwait in 1990 preceded the 1991 recession. So, the US economy is probably going to get worse before it gets better, and when the US economy

gets the sniffles, the world economy usually catches cold too.

Increasing and/or prolonged Middle East violence will also push gold prices and US bond prices higher since these are viewed as safe investments in times of uncertainty and when inflationary pressures mount. The stock market would also languish under such circumstances. For example, during the course of the Suez Crisis in 1956, the Standard & Poor's 500 Index dropped 5 percent.

Thus, the short-term outlook for the world economy is quite bleak, indeed. But what about the long-term prospects?

Unfortunately, or fortunately, US automakers are going to have an even tougher road ahead since they rely on the sales of SUVs to remain profitable. High gas prices are going to allow Toyota and Honda to trounce them even further.

### **Upside of the Middle East crisis**

However, prolonged conflict in the Middle East creates several positive long-term opportunities for America, and the world. The worsening of the situation in the Middle East will help Democrats in their quest to win a majority of seats in the US Senate in this November's mid-term elections. They may gain in two ways. One, voters will seek a change from the current Republican domination of government as a result of disaffection with Bush's war in Iraq. Second, and perhaps even more importantly, because the health of the economy tends to have the biggest influence on voters at the ballot box, they will seek a change from the status quo, and vote for Democrats. This will give Senate Democrats the voting power they need, and the public support, to rein in Republican excesses.

But of even greater long-term significance is the impact on the energy industry. With oil prices remaining intolerably high, alternative energies are looking increasingly attractive, and making more economic sense. Likely the biggest beneficiary will be nuclear power because it can provide large quantities of cheap electricity more reliably than other alternative energies, such as solar and wind power. Not only is it making more economic sense, but it is also politically and environmentally sensible too.

High prices at the pump means consumers (voters) will support government funding for alternative energy sources, and will be more willing to overlook nuclear energy's past transgressions (e.g., Chernobyl and Three Mile Island). Also, it gives the US greater control over its energy supplies since they will be domestically based, and not as reliant on foreign producers — an even more important security concern in this age of terrorism.—This would be appealing to

Republican voters concerned with national security, and may help to overcome resistance from the Republican-friendly oil industry. Further, support for nuclear power among the world's largest oil consumers – the European Union, US, and China -- could also generate lasting cooperation in energy research and in related matters of (inter)national security, and reduce tensions over access to oil. But if Democrats gain more political leverage in Congress, nuclear power has an even greater chance of success because of its environmental benefits.

## **Nuclear Power**

Global warming poses an imminent danger according to scientists who study it – and as starkly portrayed in Al Gore's recent movie, "An Inconvenient Truth". Nuclear power offers an excellent option for generating the large amounts of cheap energy in a short period of time needed to reduce the imminent dangers of global warming. New technology also makes nuclear power plants much safer than the past, not to mention that the main reason for Chernobyl was that they took egregious shortcuts on safety design. There are problems with nuclear power, to be sure, such as disposal of the nuclear waste. But compared to the imminent problems of global warming, nuclear power is an increasingly attractive palliative.

And, as some observers view it, insofar as money used to buy oil gets funneled to terrorist organizations, reliance upon nuclear power will slow this down. Thus, nuclear power is an increasingly attractive weapon in the war on terror, and in the battle against global warming. And we have the Middle East conflict to thank for this potentially positive inflection point.

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