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For immediate release

New Study Examines Market's View of Cost of War in Iraq

Military intervention to oust Saddam Hussein is likely to have a substantial negative effect on the US stock market, according to a new study by Andrew Leigh (Harvard), Justin Wolfers (Stanford) and Eric Zitzewitz (Stanford).

Instead of adding up the budgetary costs of war (as other analysts have done), the three researchers study what financial markets believe the effects of war will be on oil prices, the economy, and the stock market. They use a novel financial instrument – the Saddam Security. Saddam Securities trade on a new online exchange, tradesports.com, and pay \$10 if Saddam is ousted. The price of the security gives the market's estimate of the probability of war at any given time. Using trading prices, the authors examine how the market has responded to daily increases and decreases in the risk of war.

Leigh, Wolfers and Zitzewitz find that as the probability of war rises, oil prices rise – indicating that the market estimates that war is likely to raise oil prices by \$10 per barrel in the short term. Oil futures indicate that the oil price disruption is expected to last about 18 months and that war may slightly lower long-run oil prices. They estimate that any “oil dividend” of war with Iraq would be fairly minimal, however. For the US, it would equate to a one-time benefit of US\$250 per person.

Larger effects are found in the stock market. Using Saddam Security prices to estimate the probability of war, Leigh, Wolfers and Zitzewitz estimate that going to war will reduce the US S&P 500 by 15 percent, equating to a US\$1.1 trillion loss of wealth, compared with the no-war alternative. They also find that the US market is factoring in a number of scenarios, including a 70 percent probability that it will lead to market declines of 0 to 15 percent, a 20 percent chance of 15 to 30 percent declines, and a 10 percent risk of a fall in excess of 30 percent.

The results suggest that expert analyses may be missing some of the true costs of war.

As of mid-March, about 90 percent of the effect on the US stock market has been priced in. This implies that as war unfolds, there is a 70 percent probability that the US market will rally a little (i.e., if the war goes well), but a 30 percent probability that it will fall, potentially by an additional 15 percent or more.

Analyzing the response of stock markets in 44 other countries, the authors find that those most likely to be affected are countries that are major oil importers, or heavily enmeshed in the world economy. Those hardest hit are likely to be Turkey, Israel, and several European nations. War is associated with a 4 percent fall in the Australian stock market.

The study is available at www.stanford.edu/people/jwolfers. For comment, please contact Andrew Leigh (leigha@ksg.harvard.edu) or Justin Wolfers (jwolfers@stanford.edu).

About the authors

- Andrew Leigh is a PhD student at the John F. Kennedy School of Government, Harvard University, and an expatriate Australian
- Justin Wolfers is an Assistant Professor of Economics at Stanford Business School, and an expatriate Australian.
- Eric Zitzewitz is an Assistant Professor of Economics at Stanford Business School.