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Stanford: Threat of war a drag on American wealth

New research by Stanford Graduate School of Business faculty members suggests that political experts are missing the mark in their punditry over war with Iraq.

The researchers say threat of war has already caused the U.S. stock market to shrivel $1.1 trillion in value, and when the bombs start to rain on Baghdad, America's wealth may shrink even further.

The study, co-authored by Justin Wolfers and Eric Zitzewitz of the Stanford business school, and Andrew Leigh, a doctoral student at the John F. Kennedy School of Government at Harvard University, examines the impact of war on oil prices, the economy, and the stock market.

As the probability of war rises, oil prices rise, indicating that the market estimates that war is likely to raises oil prices by $10 per barrel in the short-term, the Stanford report says. Oil futures, traded on the New York Mercantile Exchange, indicate that the oil price disruption is expected to last about 18 months and that war may lead to slightly lower oil prices in the long run. However, the researchers estimate that any "oil dividend" of war with Iraq would be fairly modest -- a onetime benefit of an average $250 per American.

The study's authors estimate that waiting for war has already reduced the S&P 500 by 15 percent, or the equivalent of a $1.1 trillion loss of wealth when compared with a no-war alternative. This decline reflects the market's average expectations of the cost of war, they say.

"What this means is that by mid-March, about 95 percent of the war's effect on the U.S. stock market has already been priced in and $1.1 trillion of the nation's wealth has disappeared," says Wolfers, who is assistant professor of political economy at Stanford Business School.

"From here on out as the war unfolds, there's a 70 percent probability that the market will rally a bit -- say, the war goes better than expected -- but there's a 30 percent probability that we're on the verge of another drop, which could be steep," says Zitzewitz, an assistant professor of economics.

To gauge the financial market's point of view on these impacts, the trio used a novel financial instrument -- the Saddam Security -- an Irish-based online exchange at http://www.tradesports.com that pays $10 per share if Saddam is ousted by June 30, 2003. The price of the security indicates the market's estimate of the probability of war at any given time. Using trading prices, the Stanford researchers examined how the market responds to daily increases and decreases in the risk of war.

Zitzewitz defends the unusual basis for the research, pointing out that the online site "essentially is a financial marketplace." He says conclusions drawn from it have more value than some expert's opinion that "in the marketplace you've got to put your money where your mouth is."