Attack on Syria: the danger is in escalation

It is now looking all but certain that the United States will launch some form of attack on Syria. What is unclear is the severity and duration of the attack. Leaving aside the political ramifications, the immediate economic effects are likely to be limited (and are mostly already factored in). Opposing impacts on inflation and activity means that changes to central bank policy could be postponed. A prolonged campaign could have wider ramifications, not least if there is a risk of a geographical widening of the conflict.

Some kind of attack seems certain – and it has to be more than a pinprick

Barring an unexpected development – eg, proof that the chemical weapons attack in Damascus in mid-August was orchestrated by the rebel forces – it has to be assumed that the western powers (at least the United States, although not now the United Kingdom) will launch some form of attack on the Syrian regime.

Western warnings have so far been ignored by the Assad government. There is a perception that a response to the latest chemical weapons attack has to be more than symbolic. Repeating the Clinton Administration's ineffectual pinpricks is not an option. Any action has to have a significant effect, probably by degrading or destroying the government's chemical weapons and air capacity. This means a prolonged campaign by modern standards – perhaps of up to two weeks.

In terms of military impact, this will encourage the rebels, but will not give them an edge. They are too divided and there are too many groups that the western powers would prefer not to take power for this to evolve into a Libyan-style regime change mission. The current stalemate, with no side able to decisively defeat the other, is therefore likely to continue.

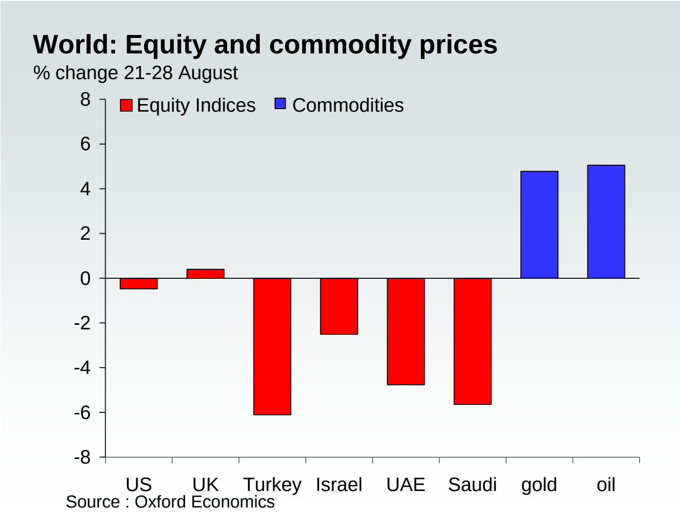
This assumes that there is no further foreign intervention, ie by either Russia or Iran. If there were, it would be a game-changer. Some of the recent increases in oil and gold prices presumably reflect the fears of a wider conflict, unlikely though it currently seems.

Little immediate geographic impact

The theatre of war in Syria is removed from any major trade route. The nearest significant ones are the Suez Canal and the Persian Gulf, neither of which is within striking distance of Syrian retaliation. While Iran could create problems in the Gulf, the new government in Egypt is unlikely to do anything to alienate western governments further.

Near-term economic impact limited

Because some form of action is expected, we have already seen some key prices rise, as well as falls in some equity prices. But these are not just related to geopolitical events. The first alleged chemical weapons attack actually took place on 19 March, in Aleppo. It too, was followed by rumours of an American attack on Syria. Yet oil prices (Dubai) fell from $103.94/bbl on 19 March to $96.10 on 17 April. They have since risen by just over $16, to $112.52/bbl on 28 August. But this will also be influenced by global economic developments. The immediate Syria-related price effect seems to be a rise of about $5.50/bbl, from $107.11 on 21 August – the date of the most recent



chemical attack – to $112.52. Similarly, although the price of gold has risen from $1,203.25/oz on 28 June to $1,425/oz on 28 August, the price rise most closely related to events in Syria is the $51 from $1,360/oz on 21 August. So what we have seen so far is a 4.8% rise in gold prices and a 5.1% rise in oil prices.

This is in line with the impact on equity prices. Not so much globally – the S&P500 is down less than 0.5% since 21 August and the FTSE-100 is actually up by about as much – but regionally. The major Middle East stock markets have fallen by between 2.5% and 6%. Meanwhile, yields on typical safe haven bonds have come down slightly, but by so little (down 9bps for the US 10-year Treasury, 3bps for the 10-year Bund) that it is impossible to ascribe them to any reason beyond day-to-day volatility.

Bear in mind that neither Syria, nor any of its neighbours except Iraq – which is unlikely to be attacked by Syria – is a major producer of oil or any other commodity. While much excitement has been raised regarding the Tamar and Leviathan gas fields in the Cyprus/Israel/Lebanon triangle, these have not yet been developed to any major extent. Commodity price rises are therefore based more on fears of wider ramifications and uncertainty than on any threat to production. Similarly, while there clearly has been a regional impact, the recent fall in global equity prices is more likely to be related to monetary policy developments – notably the likely taper of the Federal Reserve's quantitative easing from next month onwards – than to fears of a Syrian escalation. Note that the S&P500 rose after the attack on 21 August, only to fall back a few days later to pre-attack levels.

What to worry about

The immediate economic impact, therefore, of a limited western attack on the Syrian government is likely to be minimal. This does not mean that there will none at all. Even a short-term spike in commodity prices will have an effect on consumer prices as well as on activity. This is particularly the case in energy-intensive emerging markets, where higher commodity prices would add to the inflationary pressures already triggered by weaker currencies in the wake of the Fed's QE taper signals.

But the key issue would be if the conflict were to escalate. This could happen in two ways. The first, and perhaps most likely, would be if the initial attack appears to have little effect, and the aerial bombardment therefore is extended, both in time and with regard to targets, but with no clear exit in sight. The second, and more risky development, would be if President Assad's Iranian allies were to attempt to interfere with oil flows in the Persian Gulf. The likelihood of this would probably increase if the first development – an escalated campaign – came to pass. Under either circumstance, commodity prices would be likely to rise more and to remain higher for longer.

We have modelled the impact of a $10 rise in oil prices in Q3 2013, followed by a $15 increase in Q4 2013, remaining at that level in Q1 2014. Under this scenario, US GDP growth in 2014 would be 0.2% less than under our current forecasts; for the Eurozone, there would be a -0.1% impact; Japan would see growth 0.1% weaker; and China would face 0.4% less growth. Consumer prices would be 0.8% higher in the US in 2014, 0.9% higher in the EZ; 0.4% higher in Japan; and 1% higher in China, in each case with some further impact in 2015.

Impact in 2014 of $25 rise in the oil price				
Percentage point changes	USA	EZ	Japan	China
GDP	-0.2	-0.1	-0.1	-0.4
CPI	0.8	0.9	0.4	1

Source: Oxford Economics

Impact on monetary policy

One impact of higher oil prices and the higher inflation this would cause is, paradoxically, to postpone any central bank exit from quantitative easing. Central banks would be more likely to look at the demand-deflationary effect of higher prices in the near-term, than to pay much attention to a rise in inflation, the more so if that were perceived to be temporary.

Exchange rate volatility would increase

One sector where there almost certainly would be a swift impact is exchange rates, as investors try to find a safe haven. But which safe haven? So far, the main Syrian effect has been a move away from the dollar and into the yen and the euro. However, the Japanese authorities are unlikely to welcome a stronger yen and the euro is still subject to the impact of political crises, while the Australian and New Zealand monetary authorities are busy talking down their currencies. The Canadian dollar has risen, both as a result of its safe-haven status and as a commodity currency. Ultimately, however, the US dollar remains the most likely safe haven currency.

Could it get worse?

Unless a western attack triggers wider geopolitical involvement, the potential downside effects are likely to be limited to those outlined and illustrated above in the charts. But how likely is this? In the Libyan campaign in 2011, oil prices rose by $25/bbl over the course of the fighting. That conflict lasted eight months and disrupted supplies from a major oil producer. On the other hand, Colonel Qaddafi had no allies. It is always hazardous to draw parallels. In addition, the Middle East has plenty of other flashpoints, which, while not directly related to a western attack on Syria, could flare up and add to the financial market fall-out. But by itself, the immediate impact on activity and asset prices from a strike on Syria should be very limited.

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