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[Parts of the World](#), [Europe](#)



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The Gulf war between Iraq and Kuwait in 1990-1991 led to an increase in petrol price and affected both The US and the EU negatively

The economic objectives of every nation are stabilization of the economy, keeping the level of inflation and unemployment below the target rate (Carbaugh, 2012, p. 481). All of the governments pursue these goals given the large abundance of external factors that affect the macroeconomic policies of the state. The main concepts for the determination of economic growth are of course the growth of Gross Domestic Product, which is comprised of Aggregate Supply and Aggregate Demand (Carbaugh, 2012, p. 482). Aggregate supply is a curve that displays the relationship between the price level and the total output supplied within a certain period in the economy (Carbaugh, 2012, p. 482). Aggregate Demand is the total amount of goods demanded in the economy, and is represented by a downward sloping curve, which shows the relationship between the price level and the total output demanded within a certain period of time in the economy (Carbaugh, 2012, p. 482). It is comprised of Consumer Spending (C), Investment (I), Government expenditure (G), and Net Exports (X), which is simply the difference between imports and exports. In determining the economic priorities, governments of the countries do implement set of macroeconomic policies, such as fiscal or monetary policy, and these concepts have its roots in Keynesian economics. Fiscal policy implies on altering Government spending in the economy and tax policies, whether monetary policy targets money supply and interest rates (Carbaugh, 2012, p. 486).

Given the explanation of the above-mentioned concepts, the analysis of this research will be based on the economic impact of the First Gulf War on US and European economies, and the macroeconomic policies that governments of the above-mentioned states had undertaken in order to stabilize the economy. The thesis is that Gulf War had negative impact on the US and the European economies.

It is necessary to explain the effects oil prices do have on the economies of different states. The more the country is dependent on the oil prices, the more fluctuating the economy becomes. The oil prices can go up for the reason of disruption of oil supply, which stem from OPEC countries, or from the increases in the demand for oil. The increase in the oil pricing, lead to inflationary pressure in the economy, mainly because oil is used in many industries, and in majority constituting the transportation costs. It is fairly easy to notice the increase in prices of complements, such as chemical products made from oil and input costs of oil for shipment, which is the input for the supply of oil. The industries that suffer from increased costs are airline industries, because they are paying extra for the fossil fuel, which is also expected to see the rising prices alongside with oil price shocks. The price level tend to increase: overall prices in the economy grow. Household purchases diminish in size, and people spend more on petrol or gas.

High oil prices do affect the component of the GDP, the Consumer Spending. As the oil shocks are accompanied by inflation, consumers have the same amount of money to buy fewer amounts of goods and services. People cut their spending and save more. The fewer consumers spend, the more economy will find itself in a recessionary position, which will result in

unemployment of discretionary businesses. The discretionary employment may face bankruptcy or use lay-off system to retrieve the aggregate supply-aggregate demand equilibrium.

Another effect is the contraction of Aggregate supply. As was mentioned above, oil prices influence consumer behavior as well as the decisions made by firms. By an increase in oil prices, firm tend to cut back on its production, thus the higher price of energy, the less production in the economy. The aggregate supply will fall and shift to the left (Tatom, 1991, p. 5)

Oil prices do significantly affect the foreign exchange rate, and be the cause of severe fluctuations. The more the country purchases crude oil in the international market, the more dependent it becomes on oil pricing. It is a common knowledge that US dollar is recognized in the world as a currency haven, as majority of the countries uses it for the purposes of the reserve currency. This implies on the fact that the value of US dollar does directly or indirectly affect the global economy. Oil or as it is called otherwise a “ black gold”, is also an integral part of the economic stability and competitiveness of the economy of many countries. Oil prices continue to remain one of the most important factors in determining the fate of the dollar. The negative correlation that exists between dollar value and oil price implies that low and stable oil prices have a positive effect on dollar, whereas high prices result in negative consequences. On the news it is possible to hear the claims that oil is putting pressure on dollar, or vice versa, oil supports the dollar. Positive and negative effects lead to dollar value appreciation and depreciation and determine the monetary policy of the countries. This means that changes in oil prices do considerably affect the value of the dollar, and values of other

currencies as well on the foreign exchange market.

The US remains to be one of the main countries to produce oil and one of the largest consumers of oil at the same time. According to 2011 estimates, the US oil consumption has exceeded 93 million barrels per day, alongside with the European Union, which levels at the second place by consuming in comparison only 18 million barrels per day. USA and the EU are in the top ten countries by total energy consumption (World Energy Statistics), and yet the energy consumption keeps increasing.

As oil shocks influence economies on macro-level, it is time to analyze the effects on the US and European economies. Particularly the same effects were taking place after Iraq invaded Kuwait in 1990. Prior to war the production of joint Iraq and Kuwait oil do account for 9% of world production (Hamilton, 2011, p. 18). As the war broke out, supply disruptions were accompanied by the fears that conflict will spill over to Saudi Arabia. If that happened, the consequences would have been much severe in nature and probably close to oil shock in 1970s. In the beginning of 1991, the military forces of Iraq destroyed oil infrastructure in Kuwait, by setting fire on Kuwait's oil wells. They detonated more than 750 oil wells and released billion barrels of oil to the environment (the Energy Library). Iraqi military forces damaged more than 85% of oil production (the Energy Library). This had a macroeconomic implication, as Kuwait was forced to cut back on its oil supply. The export of Kuwait's oil was stopped, which led to growth in oil prices in 1990s.

Many scholars believe that 1990 oil shock had aggravated recession in the US. James Hamilton stated that US recession was dated in July 1990

(Hamilton, 2011, p. 18). The Iraqi invasion to Kuwait brought soaring oil prices, and US had lost its both oil suppliers: Kuwait and Iraq. The prices of oil increased from \$18 per barrel to \$40 per barrel (Silk, 1991). Despite the price increase was not as strong and sharp as oil shocks in 1970; it had almost the same consequences on the macro-level. Soaring oil prices brought in the inflation into the economy and only intensified the recession. The US at that time had tight monetary policy as most of other European economies, and hesitated to take an action to cure the economy. The airline industries were hurt: the rise in fuel prices from 60 cents per gallon to \$1. 40 cents per gallon (Silk, 1991) after the invasion took place reduced the profits made by airline industries. The consumer confidence, alongside with investment spending was reduced, and this to a large extent led to the slowdown of the GDP growth.

Given 1990 oil shock some countries experienced slow in real GNP, such as United Kingdom, and Sweden (Hutchison , 1991, p. 35). Slowdown in industry was displayed in Italy and France (Hutchison , 1991, p. 35). Inflation was generally modest, and leveled at 4% across G-7 countries (Hutchison , 1991, p. 35). Nevertheless, high inflation was marked in United Kingdom and Sweden, and in 1990s inflationary pressure was evident in the United States. Prior to 1990, most central banks had chosen pre-emptive tight monetary policies.

However, some other economists argue that Gulf War was profitable for the US and its allies as it had caused large inflow of money into the economy. The war was fought out of inventories and US allies were responsible to pay the costs of war (Silk, 1991). It is estimated that US has made profits out of

Persian Gulf War in 1991st fiscal year and indeed could offset the full costs of the war. It was estimated by the Congressional Budget Office that US spent approximately \$15 billion on Operations Desert Shield and Desert Storm (Silk, 1991). However, what US received was valued at \$48 billion in 1991, which was \$33 billion more than the costs of the Gulf War (Silk, 1991). In comparison, the spending from the US coalition was as much as \$54 billion, and the amount repaid was only \$46.6 billion (Silk, 1991). This implies on the fact that US was required largely for its military expenses and could cover the deficits in its budget.

Another argument of those who deny negative effects of the Gulf War on the economy is that 1990's oil shock was only temporary, and in comparison to previous oil shocks, the economies did not feel its consequences. Norman Fielege was the first to present this argument, as the differences in the oil shock and elasticity's of demand differed considerably and did not reach the same effect as 1970s and 1980s oil price hikes (Tatom, 1993, p. 130). The prices fell back already in the second quarter of 1990 (Tatom, 1993, p. 138). To compare oil prices in 1990-1991 with oil prices in 1970s, it is evident that the 1990 oil shock was only temporary and did not have deep recessionary effect on the economy. Without adjusting prices to inflation (nominal prices), then it is clear that prices in 1990 doubled in the short-term, but then fell back again to its previous level (see Appendix A).

Tatom further argues by emphasizing the fact that the share of the US oil imports of GDP was merely 1%, therefore the effect of the oil shock was insignificantly low (Tatom, 1993, p. 133). One other argument presented in his work is that the energy dependence has fallen since 1973 oil crises

(Tatom, 1993, p. 133), so again the effect was small.

There are two generally accepted opinions on how equilibrium was restored after 1990 shock. One of the famous opinions is that prices returned back almost to its initial level, by the decrease in the demand for oil in the world market. The demand curve shifted to the left and brought down the prices. Lutz Killian conducted a research based on oil shocks and concluded that the high oil pricing after Iraqi invasion to Kuwait were entirely demand driven (Killian, 2009, p. 1063), and merely has something to do with supply disruptions. He has concluded in his study that aggregate demand shocks on oil have short-run positive effects on US economic growth (Killian, 2009, p. 1067). Nevertheless, it ends up with overall increase in the price level and lower real GDP (Killian, 2009, p. 1067). Although the regression analysis of the estimates was statistically insignificant, Killian concluded that fluctuations in the oil shocks' effect on the economy do depend on the set of measures that was used as a response by the Government (Killian, 2009, p. 1068). This implies on the possibility of implementing accurate and right policies to curb the effects of oil high prices.

Another belief lies on the notion that Saudi Arabia used its excess supply reserves to restore the export quantity of OPEC during 1990s (Hamilton 2011, p. 18). Aggregate supply shifted to the right to its initial level and resulted in equilibrium. Both of the opinions can be correct given the direction of the supply and demand curves (see Appendix B).

As was mentioned earlier, the US and many European economies are largely dependent on oil prices, but unluckily this is a negative relationship. What should be taken into account is the fact that if the recession is brought into



the economy by the oil shocks, then the oil is the only one element, which will result in its recovery. In the times of recession, the best fine-tuning tool for the economy is the expansionary fiscal policy. Recessions can be avoided, given accurate forecasts, by increasing Government spending in the economy. Expansionary fiscal policy will in turn improve the general condition: encourage consumer spending and prevent mass lay-offs. Another tool for fighting recession is of course the easy money policy. By increasing the money supply, the central banks will decrease the interest rates and stimulate growth in investment activity (Carbaugh, 2012, p. 486). As a result Aggregate Demand in the economy will increase alongside with increase in real GDP, which will rise by a multiple of the increase in investment. As all the oil shocks have particularly the same consequences on the world economies, it can be concluded that oil price shocks effects did not change over time. The pre-emptive tight money policy that was implemented by the European Central Bank and US Federal Reserve did not improve the situation, but only aggravated the recession. One of the measures to decrease the dependence on oil prices could be the reduction of the share of oil imports in GNP. As it is merely impossible to imagine that measure being implemented, given rising energy consumption, it is necessary to focus on monetary policy implications. In this situation it is important to know exactly what does oil shock influence: aggregate supply or aggregate demand. If it is aggregate demand, then countries shall target increasing money stock in the economy. If it is aggregate supply, then central banks should on the contrary reduce the money supply.

Given the less availability of the data and researches made on the effects of

the Gulf War price increases, it can be concluded that countries were hit much less by 1990 oil shock than by the oil shocks in 1973 and 1979. The latter shocks had a very aggravating effects on the economies of the majority of the countries, not only the US and Europe, but also Asian economic giants, such as Japan. The stagflation was present, unemployment and inflation were much more above the target rates and two macro-phenomena demanded rapid responses and effective macroeconomic policies.

The effects of the 1970s oil shocks were long-term, and did vanish only in the 1986. In comparison, the shock of 1990 was very different in its form. The shocks of 1970s were the direct results of the cartel disagreements. The excessive supply of oil from the OPEC members had caused negative expectations, and led to the oil hikes. In comparison, the oil shock in 1990 was the outcome of the two OPEC member conflict, literally speaking, and the invasion of Iraq to Kuwait. The Kuwait oil reserves were severely damaged by the Iraqi forces, as they had purposefully bombed them during the invasion. The oil spills influenced the cut in supply from Kuwait, and many world economies had temporarily lost the Kuwait's share of oil in the international oil market. The prices doubled, however, they were not persistent, and they fell back almost to its initial level in the second quarter of 1990. Moreover, the Kuwait's share of oil was filled in by the Saudi Arabia excess reserves, therefore countries did not suffer from shortage of the oil imports. The effects on inflation were only temporary; price level grew only in the first quarter after invasion took place. The macroeconomic policy of the easy money, which kept the interest rates low, was successful in

overcoming the short-term effects of the oil shock. Mainly because the oil shock of 1990s differed significantly from previous oil price hikes in size, in the availability of macroeconomic policies and in consumer elasticity (it was less elastic, because of less oil dependency than in 1970s), the effects of the price increases were not felt by the US and the European economies. The recession that started in Europe after 1990s was not related to Gulf War, but linked closely on the regional changes, such as collapse of the Soviet Union and the reunification of Germany. To crown it up, the Gulf War oil price increases affected the economies of the US and Europe only in the short term, but later did not have any consequences on the inflation and unemployment.

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## Appendix A

Crude oil prices 1970 - 2008 (BBC News)

## Appendix B

The simulation of supply-demand equilibrium for 1990 oil shock

Figure 1

## Equilibrium of oil market

### Figure 2

Iraq invasion to Kuwait caused supply disruptions and shifted the supply curve up. The price of oil increased.

### Figure 3

The equilibrium was stabilized by shifting of the demand curve to the left.

### Figure 4

The equilibrium was stabilized by additional oil supplies brought in the market by Saudi Arabia