In the aftermath of the Arab Spring, when oil prices were in the triple digits, El-Gamal and Jaffe (2013) analyzed the production histories of all major oil producers since 1970. They concluded that regime change, by itself, does not result in supply disruptions, while wars that destroy production infrastructure or obstruct the flow of oil do. Since the regional civil strife of the Arab Spring, global demand growth has been relatively weak due to technical progress and continued global economic sluggishness, and new unconventional oil sources began reaching the market at an accelerating pace. Therefore, they reached the conclusion that oil prices at the time were inflated by excess financial liquidity from central banks, together with a bubble-supporting story concerning Middle East geopolitics. El-Gamal and Jaffe predicted the following in late 2012: “If the outright war scenario is excluded, we expect prices to fall precipitously in the medium term (three to five years).” They did.

While prices have indeed plummeted, they have remained above their market-clearing levels, as evidenced by soaring inventories, due in large part to continuing military activity in Iraq and Syria and relatively new military activity in Yemen. However, the extent of military activity has not been sufficient to cause any serious disruptions in oil supply, or to raise expectations of such disruption sufficiently to lift prices back to 2011–13 levels. During those years of plentiful petrodollars, Saudi Arabia had accelerated its military spending to the point of exceeding Israel and the United States in military spending, not only per dollar of GDP, but also per capita. The resulting arsenal build-up, and ensuing war in Yemen, invites the distinction between passive military spending, which builds up a country’s arsenal and capacity, on the one hand, and active military spending, which depletes the arsenal and capacity, on the other.

In particular, this paper seeks to investigate the endogeneity (i.e., within the co-determination system) of so-called “oil-price shocks” due to military conflicts. For an oil exporter, is it possible that the commencement, extent, and intensity of military conflicts may be incentivized by low oil prices that result in significant economic and political pain? Indeed, at the current oil prices around $50 per barrel, Saudi Arabia and other major oil exporters have suffered massive fiscal deficits, and have drawn down their national savings at unsustainably high rates while also suspending most capital spending and tightening their belts to reduce consumption as much as possible. Government borrowing from domestic banks has also caused liquidity shortages and severely undermined the banking and private sectors the government needs to create growth and help transform the economy away from oil dependence.
The incentive may be overwhelming for such countries to escalate existing conflicts with militant Shia (e.g., Houthi) and Sunni (e.g., al-Qaeda and ISIL) groups, in hopes of driving oil prices back to their 2011–13 levels. Earlier episodes over the past four decades have shown that once prices rise after wars or similar major events, oil-rentier states have, in fact, abandoned their belt-tightening and reform plans and reverted to using petrodollar flows to support their exorbitant authoritarian bargains. Of greater immediate danger is the fact that, in some countries, such as Iraq, the scope and effects of war grew beyond the countries’ control and resulted in prolonged economic doom.

The model presented in this paper summarizes this pattern in an oil-revenue function that rises with a moderate level of geopolitical strife, but declines if the level of conflict grows too large. The model shows that if the gain from moderate geopolitical strife is sufficiently large, and if a desperate country has a severe shortage of civilian capital but abundance of military capital, as is the case for Saudi Arabia today, it would, indeed, be optimal for the oil exporter to convert some of its military capital into civilian capital by engaging in a military conflict of limited scope and extent. The resulting increase in petrodollar revenues would enable the country to placate its population with greater consumption and rebuild its civilian capital for longer-term sustainable growth.

The significant catch in this model and story is that the country must engage in just the right level of military conflict, and no more, otherwise the outcome will be much worse than the status quo. This is the great difficulty: Regimes will come under tremendous economic and political pressure and will be tempted to increase the scope and scale of their military operations in pursuit of petrodollars. However, they must know that wars, by their very nature, are unpredictable. Once war commences, the scope and scale may be increased by other parties, who are not included in this model, well beyond the optimal level for the modeled oil exporter. Wariness of this well-understood danger notwithstanding, the temptation to escalate will be too strong, and Winter Is Coming!