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475 WALL STREET, PRINCETON, NEW JERSEY 08540 TEL: 609-529-1300
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ECONOMIC WORKING PAPER SERIES

Evaluating the Economic Consequences of an Israeli – Iran Military Conflict

By Bernard Baumohl
Chief Global Economist

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Evaluating the Economic Consequences of an Israeli – Iran Military Conflict

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SUMMARY

The failure of diplomatic efforts to convince Iran to suspend its uranium enrichment program, plus growing concerns it is edging closer to becoming a nuclear military power make an Israeli air strike on Iran likely before the end of 2008.

The global political and economic repercussions of such a confrontation will be vast and long lasting. The precise fallout will depend on whether Israel can achieve a quick and effective strike, or if the incursion fails and degenerates into a wider, more protracted war that disrupts oil supplies and ends up fortifying Iran's current Islamic leadership.

An extended war will drive oil prices beyond \$200 a barrel and precipitate a global economic recession. However, a quick surgical strike that "safely" destroys or cripples Iran's key nuclear enrichment facilities, with little or no military retaliation by Teheran, could bring crude down below \$85 a barrel within weeks and set the stage for an acceleration in global economic growth. Built into that scenario is the presumption that the current Islamic regime would also suffer a lethal political blow domestically and be replaced with a government that pursues a more moderate and cooperative policy with the West.

WHERE DO MATTERS STAND NOW?

The latest round of Geneva talks between Iran and a group representing six world powers (U.S., Britain, France, Germany, Russia and China) have failed to produce any meaningful results. Though the Islamic regime has not ruled out negotiations over its nuclear program, it has steadfastly refused to abandon uranium enrichment. Not only has Teheran vowed their country would never give up their right to enrich, it also threatened to massively retaliate against anyone taking military aim at their nuclear facilities. To demonstrate its combat readiness, Iran's Revolutionary Guard fired a series of mid- and long-range missiles, as well as high-speed torpedoes in July. Though the missile demonstration fell short of what Teheran hoped to achieve (at least one missile misfired and some photos were doctored), their threat to strike back has to be viewed as credible.

There is now a shared perception by Israel, the U.S. and most other Western countries that Teheran's main strategy for the time being is to obfuscate, confound and delay talks in an effort to stave off a military attack during the final months of President Bush's term. Given Bush's close relationship with Israel, Teheran feels their country is most vulnerable to an Israeli strike between now and the end of this year. Our sources say Iran's ruling clerics are convinced that after January 2009, Israel's window of opportunity to launch an attack is greatly diminished. The reason? The next President will likely pressure Israel not to take any pre-emptive action against Iran in order to give the new Administration an opportunity to conduct its own policy review. But Israeli leaders know such an assessment by an incoming White House foreign policy staff will take time, and that is precisely what Iranian officials need as they rush to complete their first atomic bomb. Once that is accomplished, Teheran is betting the international community will gradually acquiesce to the reality that one more country has joined Pakistan, India and Israel as regional nuclear powers.

A nuclear-armed Iran, however, is Israel's greatest fear. Iran President Mahmoud Ahmadinejad has repeatedly predicted the end of the Jewish state and he has dedicated military and financial resources towards its destruction. "The Jerusalem occupying regime must be wiped off the map," he said.¹ Given Iran's history of relying on terrorist groups to help carry out its foreign policy goals, Israeli officials see these threats by a soon-to-be nuclear armed Iran as an unacceptable risk to its security. As a result, Israel has vowed to block that country from becoming a nuclear military power.

Iran and Israel are thus on a collision course, with both sides equally determined to use all available resources to protect their national interest. We believe a military confrontation between the two is all but inevitable, that it will commence sometime between September and November of this year, and that the outcome of this conflict will have an enormous impact on the global economy.

BACKGROUND

- Since the 1979 Islamic revolution, Iran viewed Israel as an “illegitimate regime” and has since fervently worked to see its demise.² Teheran routinely uses terrorist groups as surrogates to carry out its foreign policy goals and has for years financed, armed and trained Hezbollah, Hamas, and the Islamic Jihad to attack Israel. Most recently, Iran has funneled long-range missiles to Hezbollah in Lebanon and to Hamas in Gaza. If launched, these missiles have the potential of reaching every major city in the Jewish state.

IRAN’S PURSUIT OF NUCLEAR WEAPONRY

- Iran’s nuclear activities can be traced back to the 1950s under the Atoms for Peace program initiated by the United States. Though the Islamic Revolution briefly suspended their nuclear program after 1979, it was reactivated in the 1980s. By the 1990s, suspicions arose that Teheran secretly approved a plan to acquire the technology to build a nuclear weapon. To this day, Islamic leaders claim their country’s atomic program is dedicated solely for civilian use and not for the purpose of making a weapon. However, US and Israeli reconnaissance photos and ground intelligence substantiate that Iran is not only moving ahead with plans to produce enough highly enriched uranium for a bomb, but also working on a missile delivery system capable of carrying a nuclear warhead.³

Admiral Mike Mullen, Chairman of the US Joints Chief of Staff, concluded in July 2008 that Iran was “still on a path to get nuclear weapons.”⁴ The US National Intelligence Estimate (NIE) concluded late last year that Iran may have enough enriched uranium for a bomb as early as next year.⁵ This matches the conclusion by Israeli intelligence, which feels Iran is on an irreversible course to getting a nuclear weapon, and is within a year of reaching that goal.⁶

Even the UN’s atomic watchdog, the International Atomic Energy Agency (IAEA), fears Iran is concealing a nuclear weapons program. This past May, the IAEA issued a tough 9-page report noting that Iran’s nuclear work is now “a matter of serious concern” and that the country has been in defiance of U.N. demands to stop all enrichment activity.⁷ IAEA officials also expressed “alarm” to have come across documents held by Iranian engineers containing blue prints for a missile that appears designed to carry a nuclear weapon.⁸ IAEA chief Mohamed ElBaradei told an interviewer on June 2008 that Iran is saying it “could build the bomb in a relatively short period of time” and specified it could be as soon as “six months to a year.”⁹

While Iran continues to refute it has such intent, the West view these denials as lacking credibility given the Islamic regime’s past deceptions with the UN, their current concealment of nuclear enrichment activity and the ambiguity of their own recent comments. “The big powers are going down,” Ahmadinejad told foreign ministers attending a conference in Teheran in July. “They have come to the end of their power, and

the world is on the verge of entering a new, promising era.”¹⁰ Even the country’s supreme leader, Ayatollah Ali Khamanei, who has the final say on all major issues, views nuclear enrichment as a non-negotiable right and that Iran will “continue with its path.”¹¹ To underscore their commitment, the country surprised the world by announcing this summer that it doubled the number of centrifuges for uranium enrichment, from 3,000 to 6,000. Nuclear experts say even 3,000 centrifuges would have been adequate for Iran to produce enough uranium for one atomic bomb next year.¹² Further questions about their intention arose in late August after Iranian scientists attempted to fire a rocket into space. Such a project can be used to launch a satellite, or serve as a long-range ballistic missile capable of delivering a nuclear warhead to any city in Europe, or even the US.

THE DANGER SEEN IN ISRAEL

A nuclear-armed Iran represents the greatest threat Israel has faced since its founding 60 years ago. Their overriding fear is *not* that Iran will fire a nuclear missile at Israel, since that would be a suicidal act by the Islamic regime. (Teheran knows Israel would instantly retaliate with its own nuclear arsenal.) The real danger for Israel is that a nuclear device from Iran could find its way into the hands of a terrorist group who can strap it on a suicide bomber for detonation in an Israeli city. Given Israel’s narrow geography, just a single nuclear blast can wipe out the Jewish state.

There is one other more subtle but still grave risk to Israel. Once Iran is able to build and deliver an atomic bomb, the hovering threat that it could be used one day against Israel could prompt a migration of educated citizens, businesses and capital out of the country. Such a flight of people and money would be a devastating blow to Israel and its economy, and Iran would not have to fire a single missile to achieve this.

UN SANCTIONS UNSUCCESSFUL SO FAR

For more than three years the UN has pressured Iran to suspend its nuclear enrichment activity. By March 2008, the Security Council approved its third round of economic sanctions against the country, all to no avail. While they do create annoyances for Iran and have hurt certain segments of its economy, their effectiveness has been undermined by two developments.

First, with oil prices fluctuating between \$105 and \$145 a barrel, Iran earns far more income from petroleum exports than it needs for its domestic budget. It has averaged more than \$2 billion a week from oil sales alone during the first six months of 2008.¹³ We estimate that any price above \$70 to \$80 a barrel provides Iran with enough of a budget surplus to amply finance the arming and training of terrorist groups.

The second reason sanctions have failed is because China and Russia were always reluctant partners in imposing more harsh UN penalties. Both countries have lucrative business deals with Iran and do not want to risk crippling its economy. China is developing oil and gas fields in Iran, while Russia continues to sell it nuclear technology worth billions

of dollars. Nor is it just China and Russia that have economic ties to Iran. Companies from Austria, Switzerland, and Germany have trade agreements as well.¹⁴

Thus so long as oil is priced at lofty levels and with Russia and China ready to veto any UN sanctions with real teeth, the US, Europe and Israel do not have a strong enough hand to compel Iran to stop enriching uranium. Moreover, it's unlikely we'll see additional UN penalties in coming months given the recent frayed relations between Russia and US. Even in the remote chance the UN succeeds in passing new sanctions, it is certain to fall short of the economic chokehold needed to get Iran to give up its current nuclear path. Indeed, many key Israeli officials fear the whole sanctions machinery process is now dead in the water.¹⁵

COULD A NUCLEAR IRAN ACTUALLY PROMOTE STABILITY IN THE MIDDLE EAST?

There is a contrarian's view that argues a nuclear-armed Iran will actually bring stability to the Middle East. This conclusion is based on the belief that if Iran and Israel both possess nuclear weapons, whereby each has the ability to wreak catastrophic human casualties and economic destruction on the other, it would neutralize their military capabilities and avert the outbreak of a major war in the region. The two countries would simply view a nuclear confrontation as unwinnable. The historical precedence for such deterrence is, of course, the U.S. and the Soviet Union during the early post-World War II period. The strategy of mutually assured destruction (MAD) succeeded in preventing war between the two superpowers and arguably helped usher in an era of détente.

But the argument for deterrence, while sound in principle, is not workable in this instance. Mutual assured destruction leads to deterrence *only if government leaders on both sides* are rational and recognize the horrors of a nuclear war. The problem for Israel is that Iran is led by radical theocratic clerics who regularly extol the virtues of suicide bombings, especially if it helps bring down the Jewish state.

Moreover, Ahmadinejad's speeches are often colored with messianic references of a divine savior, known as the Mahdi, who will appear at the End of Days, an event Iran's fundamentalist leaders are said to be hastening. These are not conditions that permit mutual deterrence to take hold. Deterrence rests on the moral imperative that life is better than death. It cannot function when one party, Iran, praises martyrdom and articulates a manifestly apocalyptic destiny for Israel.

Government officials in Jerusalem therefore believe that Iran would view favorably the opportunity for a terrorist group to detonate an atomic weapon inside the Jewish state -- if its ruling clerics could escape culpability.

TIME IS RUNNING OUT

With Iran determined to master the technology of building a nuclear weapon and Israel equally resolved to block it, a clash is all but inevitable. Israeli leaders have not wavered in the past to destroy nuclear plants where they pose a potential threat to their country. In 1981, eight Israeli F-16s flew 560 miles undetected and dropped bombs on Iraq's Osirak nuclear reactor. This raid, which took place just 18 miles outside of Baghdad, totally destroyed the reactor---yet left much of the surrounding area undamaged. In September 2007, Israeli jets flew into eastern Syrian and bombed a nuclear installation that was close to completion. Both of these missions were carried out without warning. Iran, however, poses a danger of much greater magnitude to Israel. The failure of economic sanctions to stop the Islamic regime from enriching uranium has heightened pressure on Israel's leaders to act on their own.

STRATEGIC TIMING: WHY NOW?

There is a high probability that Israel will carry out a strike against Iran before the end of 2008, and that it will most likely commence between September and November. Such a mission, however, will be complicated and fraught with risks. The Iranians learned important lessons from the Osirak raid and have subsequently constructed a complex, redundant and concealed network of nuclear facilities across the country. Some of the most sensitive installations exist underground, or are bored into mountains. For Israel to execute a successful strike this time, it will need to gain every possible military and political advantage. Top Israeli policymakers believe they can maximize these advantages between now and the end of the year. We list below five key tactical military and political factors that could lead Israel to strike Iran in the next few months.

(1) ISRAEL'S RELATIONSHIP WITH PRESIDENT BUSH

No previous American president has been as supportive of Israel than George W. Bush. However his term is coming to an end and many Israeli officials doubt the relationship will be as close with the next Administration. Their best opportunity to gain a critical military advantage against Iran is while Bush remains in office. During the summer, America's highest ranking military and intelligence officials visited Israel for discussions on Iran. They included the US Chairman of the Joints Chief of Staff, Mike Mullen (the first visit to Israel by a JCS in a decade), Director of National Intelligence Mike McConnell, Chief of US Naval Operations Admiral Gary Roughead and General William Wallace, who heads the Army Training and Doctrine Command. Aside from sharing intelligence information, our assessment is that the US has granted Israel permission for their fighter-bombers to fly

out of military bases in Iraq.¹⁶ Taking off from these remote locations would significantly reduce flight times to reach nuclear targets in Iran and likely catch Iranian air defenses off guard.

While McCain and Obama certainly support the Jewish state and sympathize with its national security concerns, neither will be inclined to give Israeli jets access to Iraqi bases -- at least not at the start of their Administration. But time is not on Israel's side. Given the difficulty of their mission and the progress Iran is making on its nuclear weapons program, Israeli military planners do not want to risk having the next US administration deny them access to these bases.

(2) RUSSIA IS SHIPPING LETHAL SURFACE-TO-AIR MISSILES TO IRAN

Israel is also under pressure to strike before Iran deploys one of Russia's most lethal surface to air missiles, the S-300 air defense system. Our sources say some components of these missiles have already been shipped to Iran and they may be fully operational by 2009. The S-300s is one of the world's most sophisticated radar-missile systems. It is highly accurate, capable of tracking up to 100 targets at the same time, and delivering a warhead more than 100 miles away, regardless of whether the target is flying at low altitudes or 100,000 feet high. They are reported to have a kill ratio of 90%. The S-300s are also difficult to locate and destroy since they are situated on trucks and have the advantage of mobility.¹⁷ Once these missiles are in the field, they will greatly enhance Iran's air defenses and jeopardize Israel's military operation.

(3) POLITICAL WINDS

An unusual confluence of international political events also makes an Israeli strike likely the next few months.

- French President Nicolas Sarkozy is in the middle of a six-month stint as president of the European Union (EU). Sarkozy is regarded as the most pro-Israel French President in half a century. He has been highly critical of Iran's nuclear enrichment program and well aware of the threat it represents to Israel. Sarkozy sees a nuclear-armed Iran as "unacceptable" and warns that if the Islamic regime does not cease enriching uranium, it will face an "extremely firm" response, adding that "Israel will not be left alone" in its confrontation with the Islamic regime over nuclear weapons.¹⁸ Should Iran refuse to back down, Sarkozy would be in a position to shape foreign policy for the 27-nation EU in a manner that's more favorable towards Israel in the event it carries out a strike.

- A similar expression of support for Israel came from British Prime Minister Gordon Brown. He cautioned Iran that it could suffer serious consequences if it defies the international community and continues to enrich uranium.¹⁹ Though these are comforting words for Israel, it's not certain how much longer Brown will be able to retain his post as the Britain's leader. His Labour Party lost important seats in Parliament this summer.

Should new elections be scheduled, next prime minister may not see the same urgency about Iran as Brown does.

- Russia's recent invasion of Georgia and the missile defense agreement the US signed with Poland have greatly imperiled a diplomatic solution to Iran's nuclear activities. The resumption of cold war tensions makes it unlikely the US and Russia will find much common ground in coming months on how to stop Iran from building a nuclear weapon.

So a key question arises now. How might Moscow react if Israel goes ahead with an air strike against Iran?

We believe Moscow may be in a bit of a foreign policy bind here. After invading Georgia, a democratic and sovereign country, Russia is now deprived of taking the principled stance that international disputes can be resolved through negotiations, and not by force. It would be hypocritical for Russia, after telling the world to "forget about any talk about Georgia's territorial integrity," to now criticize Israel for taking steps to protect its own national security by eliminating a growing nuclear threat.²⁰

Other recent developments suggest Moscow may do little more than reprimand the Jewish state if it strikes Iran. For example, it's worth pointing out that Russia has in recent weeks spoken warmly of Israel, even publicly praising it for slashing military assistance to Georgia and ending the training of Georgian commandos. "We are very appreciative of Israel's position of not selling offensive weapons to a conflict area," said one of Russia's top diplomats in August.²¹ Even Russia's UN Ambassador officially thanked the Jewish state for cooperating with Moscow. Perhaps most intriguing was an urgent discussion that took place at the Olympics. After Russian troops occupied Georgia, Prime Minister Vladimir Putin sought out Israeli President Shimon Peres in Beijing for a private talk. Afterwards Putin said "I am not indifferent to Israel's concerns over a nuclear-armed Iran. There should be no doubt that Russia does not want a nuclear Iran."²²

It is arguable whether these supportive words to Israel signal a shift that Moscow is prepared to take a harder tone against Iran. But there should be no doubt that Putin, at the very least, is aware that if the Islamic regime can not be stopped from fulfilling its nuclear ambition, Israel will take unilateral military action.

(4) ARAB COUNTRIES FEAR A NUCLEAR IRAN

Iran's ambition to be a nuclear military power is not just a concern to Israel but to virtually every Arab country in the region. Most Sunni-led Muslim nations are unnerved by the specter of a nuclear-armed Shiite Iran, especially given that regime's history of assisting terrorist cells inside Saudi Arabia, Jordan, Kuwait, Iraq, Egypt, and Lebanon. Arab leaders worry that once Iran becomes a nuclear military power, it may think its bargaining power and status in the region has increased immensely. Iran could use this additional clout to shape OPEC oil policy, pressure Arab countries to pursue a more anti-Western policy, or feel emboldened to intervene in the internal affairs of countries around the Persian Gulf, North Africa, and the Asian sub-Continent.

These concerns are justified. Recently, a top Iranian diplomat ominously attacked the very legitimacy of all the Arab monarchies in the region. “Soon another crises will grip the Persian Gulf area and that is the legitimacy crises of the monarchies and traditional systems in the region,” warned an Iranian Deputy Foreign Minister this summer.²³

Arab officials are increasingly speaking on record blasting Iran for its nuclear policy. One United Arab Emirates newspaper editorial wrote: “Teheran would be well-advised to take notice of the growing global convergence of states opposed to its nuclear program.”²⁴ A worried Egyptian foreign minister told US Secretary of State Condoleezza Rice in July, “We don’t want to see another military nuclear power in this region.”²⁵ Even Libyan leader Muammar Gaddafi, who for years was in conflict with the West, openly criticized Teheran’s leaders. “What Iran is doing stems simply from arrogance.”²⁶ He added that Iran’s nuclear ambition and lack of cooperation with the UN is the result of “pure vanity.”²⁷

Israel has tried to capitalize on the concerns of its Arab neighbors. In the last several months, Israeli officials have been engaged in a flurry of direct, as well as indirect, talks with Syria, Saudi Arabia, Egypt – and even Hamas and Hezbollah. These are highly sensitive discussions which Israel hopes will, in the end, prevent or minimize any military reprisals once it strikes Iran. (To keep its borders quiet, Israel may agree to return Shebaa Farms to Lebanon and part of the Golan Heights to Syria.)

Israeli officials know that a raid on Iran’s nuclear installations will bring angry condemnations from Arab leaders. But beyond these finger-wagging protests, most Arab officials will secretly admit relief if the strike ends for now Iran’s nuclear military ambition.

The greatest worry for Israel is how Hezbollah and Hamas react. No one expects them to remain idle when Israel goes after Iran. Both groups are expected to fire missiles into the Jewish state. But Israeli military planners are hoping that a quick, successful strike against Iran --- plus the ongoing secret talks with Syria and the two terrorist groups over territory and prisoner exchanges----might result in Hamas and Hezbollah showing restraint.

(5) IRAN DISMISSES AN ISRAELI STRIKE

Finally, there is Iran itself. Though they have fortified air and sea defenses and flexed their military muscles before the world by firing a sample of their missiles, their polemic nowadays is to play down the chance of an attack by Israel or the U.S. “Don’t worry,” Ahmadinejad said during a summer conference in Kuala Lumpur, “there won’t be any war in the future...The Bush era has come to an end. He is not in a situation to change circumstances in his favor.” The Iranian president described the notion of an attack on its nuclear plants as a “funny joke.”²⁸

These comments, if repeated often enough, can potentially lull Iran’s military into a lower level of alert, another advantage Israel may choose to exploit in the months ahead.

U.S. AND ISRAELI ELECTIONS: THE TIMING OF A STRIKE ON IRAN

US ELECTIONS

We believe an Israeli strike against Iran is likely to occur before the next President takes office in January. Within that time frame, Israel may choose to act in September or October, rather than after the election. Why these two months? To begin with, an Israeli strike after the election runs the risk of a war that may drag into the new term of the next US President. Since no President wants to confront such a crisis his first days in office, Israel may seek to complete its mission well before the January inauguration.

Moreover, had the decision been made to strike shortly after the election, the US president-elect would almost certainly press Israeli officials to postpone any military action. Obama, for example, has spoken frequently of the need to engage Iran in direct talks, hoping such an approach will improve communications, lower tensions and perhaps bring a peaceful resolution. McCain prefers a firmer policy with Iran, but he too will likely urge the Jewish state to stand down so his new Administration can craft a plan to deal with Iran.

Any request by a President-elect to postpone a strike puts Israeli leaders in a difficult bind. They do not want to jeopardize their relationship with the new American president by ignoring his plea. On the other hand, Israel is well aware Iran's nuclear clock is ticking. So any delay in taking out its enrichment facilities carries several risks: (a) Iran could begin deploying Russia's lethal S-300 surface to air missiles; (b) The next US Administration may no longer be willing, or able, to provide Israel with access to bases in Iraq; (c) Each additional day brings Iran closer to constructing one or more atomic bombs.

Thus, the easiest way out of this quandary, some in Jerusalem believe, is by striking before the US presidential election.

ISRAELI ELECTIONS

One factor that could potentially alter the timing of a strike is the political turmoil in Israel. Prime Minister Ehud Olmert, who has been the target of numerous corruption probes, will give up his post in mid-September when his Kadima party elects a new leader and tries to form a coalition government. The two leading contenders to replace Olmert are Israeli Foreign Minister Tzipi Livni (a former Mossad agent) and Transportation Minister Shaul Mofaz (previously a defense minister and a former army chief of staff). Both see a nuclear-armed Iran as an existential threat to Israel. Trumping both these candidates in popularity polls, however, is hawkish Benjamin Netanyahu, who as head of the Likud party, has called for early general elections. All three principal candidates share the view that Iran's nuclear enrichment activity is a transcendent national security issue, one of such

gravity that it requires immediate resolution. We believe the current domestic tumult in Israel will therefore not distract military and political leaders from taking action.

STRIKE SCENARIOS

Israeli military planners have long prepared contingency plans in the event Iran refuses to suspend its uranium enrichment program. After more than a year of aerial reconnaissance and ground intelligence from inside Iran, they believe an operational mission to destroy, or significantly damage, its key nuclear facilities and its missile defense system is achievable.²⁹

Since Israel does not have the capacity to launch several waves of attacks at such great distances from home, some of their fighter-bombers are expected to take off from U.S.-controlled bases in Iraq. From these locations, the Israeli air force will be roughly 5 to 20 minutes flying time from nuclear facilities in Natanz, Esfahan, Parchin, Lashkar-Abad, Darkhouin, Ramandeh, Mo-Allem Kalayeh, and Arak. Other chief targets will be Iranian air defenses as well as its mobile long-range missiles to minimize retaliation. Nor have military strategists ruled out strikes against Iran's oil refineries, which many view as the country's real Achilles' heel. Though it is the second largest oil producer in OPEC, Iran still has to import nearly 40% of its daily gasoline consumption. Even with these imports, the government has been forced to ration gasoline by allocating about 26 gallons per private car per month.³⁰ This dependence on imports for gasoline means that any military confrontation with Iran could be brief, especially if its refineries are hit.

One hurdle that makes this mission particularly complicated is the operational aspect of "safely" destroying a nuclear facility without damaging the containment area that houses enriched uranium. Never before in history have nuclear enrichment facilities been deliberately bombed. If the containment structure is breached, it could leak uranium and cause an environmental catastrophe that would encompass Afghanistan, Pakistan, and even India, and result in the deaths of many civilians.³¹ (Bear in mind the two nuclear facilities Israel destroyed in 1981 and 2007 were under construction, so the risk of leakage was minimal.) A critical (and time-consuming) part of this mission, therefore, has been the effort to place transponders and laser markers at specific locations to help guide Israeli weapons more precisely toward their targets.

HOW MIGHT IRAN RETALIATE?

Following an Israeli strike, Iran is expected to retaliate in four ways.

(1) Iranian Revolutionary Guards will attempt to launch Shahab 3 missiles towards Israel. These rockets have sufficient range and can carry conventional explosives, as well as chemical and biological agents. The problem for Iran is there have been numerous flight test failures of the Shahab and so this weapon is not fully reliable. It's also a liquid fuel

rocket that requires filling prior to launch, a process that leaves the weapon vulnerable to being identified from the air.³² Once launched, however, its estimated flight time to Israel is anywhere from 11 to 14 minutes.³³ The Shahab 3 also lacks a sophisticated guidance system. Its circular error probability has been estimated at about 2.5 kilometers, which means it does not have the capability to hit a precise target (such as Israel's nuclear complex in Dimona) but it can cause significant damage and casualties if it falls on a populated area.³⁴ While the missile's guidance technology is unremarkable, one containing a biological or chemical warhead can produce casualties far beyond its range of accuracy.

Iran claims to have 600 Shahab 3 missiles in its arsenal, but U.S. intelligence estimates the actual number may be 60 or less.³⁵ To counter the Shahab, Israel believes it has an effective anti-ballistic missile system in the advanced Arrow-2. Its Arrow defense system has successfully intercepted a target that simulated a Shahab 3 medium-range missile. In addition, Israel's military is being integrated into an advanced American early warning system, a step that would alert it the instant Iran fires a missile.³⁶

(2) Iran's second retaliatory front will be in the Persian Gulf where it has threatened to interrupt maritime traffic and block the Strait of Hormuz. About a fifth of the world's oil passes through the Gulf, most of it destined for America, Western Europe, Japan, and China. Any attempt to disrupt the flow of oil will be met with resistance by US, French and British naval forces. Currently, there are two US naval battle groups in the area, the USS Abraham Lincoln, which carries 70 fighter aircraft, and the USS Peleliu, with its expeditionary strike force of planes and helicopters. But in the last few weeks, the Pentagon decided to beef up its forces there and ordered two more US aircraft carriers and their battle groups to the area.³⁷ Together, US and allied naval forces in the region will be the largest since the First and Second Gulf Wars, greatly improving the ability of the West to thwart Iran from interfering with oil tanker shipping.

(3) A third front will come from Iranian-trained terrorist groups who are under orders to sabotage Western assets in the region. However, Saudi Arabia and the United Arab Emirates have been quietly working with Western intelligence to monitor these groups and prevent such actions. For instance, Kuwait said it is "finalizing its emergency plans" in anticipation of a war with Iran.³⁸

(4) The fourth line of attack will originate from Israel's northern and southern borders. Over the past year, Iran has been shipping longer range and more destructive rockets to Hamas in Gaza and to Hezbollah in Lebanon. Back in 2006, Hezbollah rockets flew less than 50 miles inside Israel. The newer versions have a range of 185 miles, so in many ways these weapons actually pose no less a threat to Israel than Shahab missiles. Hezbollah fired nearly 4,000 less sophisticated rockets against Israel during their battle in 2006.³⁹ Now both terrorists groups are equipped with missiles that not only fly farther but also carry larger warheads. A March 2008 report by U.N. Secretary-General Ban Ki-moon did not dispute Israel's claim that Hezbollah now commands at least 10,000 long-range rockets and 20,000 shorter-range ones.⁴⁰

Given the great concern these rockets would be used during a war with Iran, Israel has stepped up third party talks with Syria, Hezbollah and Hamas on issues of returning land and exchanging prisoners. These discussions have been intense and even productive.

One top Syrian official went on record to admit that the negotiations were making progress.⁴¹ This raises some intriguing questions, such as whether Syria will urge Hamas and Hezbollah to hold back any retaliation in the event Israeli jets strike Iran. As improbable as this may seem, talks between Israel and Syria (with Turkey as the intermediary) has had at least one consequence. They have irritated Iran's President Ahmadinejad and its Supreme Leader, Ayatollah Ali Khamanie. Both have voiced their disapproval with the ongoing dialogue. Sources close to Ahmadinejad said he was stunned by news of renewed peace talks between Syria and Israel. A recent article in *al-Sharq al-Awsat*, an Arab newspaper in London, reported that Ahmadinejad saw these talks as a violation by Damascus of their two countries' mutual responsibilities toward one another. An aid to Supreme Leader Khamanie actually warned of serious "consequences and fundamental changes" in Syrian-Iranian relations if Syria signs a peace agreement with Israel. "Iran does not recognize a state called Israel in the region and isn't happy other Islamic states such as Turkey and Syria are negotiating with it."⁴² Turkey, a predominantly Sunni Muslim state with a secular government, has good ties with Israel and is playing an increasingly prominent role as a Middle East mediator. So concerned was Ahmadinejad that these talks may cause Damascus to distance itself from Teheran that he rushed off to Turkey in mid-August (his first visit to that country) in part to undermine those negotiations.

ECONOMIC REPERCUSSIONS

We believe an Israeli foray into Iran will have far-reaching implications for the global economy. While it is impossible to anticipate all the hypothetical military outcomes, the key determinants of how US and foreign economies react will probably be based on the following factors:

- (a) Is Israel able to carry out a brief surgical strike that effectively destroys Iran's enrichment facilities?
- (b) How will Iran retaliate? Will there be a severe disruption in oil supplies from the Persian Gulf and/or attempts by terrorists to sabotage Western interests in the region?
- (c) Will the Israeli assault lead to a wider war in the Middle East?

To assess the economic consequences, our report examines what we believe are the three most probable scenarios.

Scenario 1 - Israel Destroys Iran's Nuclear Enrichment Capability; Only Minimal Retaliation Follows From Iran. No Major Disruption in the Flow of Oil.

In the first scenario, Israel takes out, or significantly damages, Iran's nuclear enrichment facilities. It assumes Israel's air raid is precise and brief, and does not escalate into a broader or protracted war. Furthermore, U.S. British and French naval forces are able to keep the Persian Gulf and the Strait of Hormuz open to maritime traffic. Another critical assumption here is that the Israeli strike undermines the current theocratic leadership and lays the groundwork for a change in government that is more moderate and cooperative with the West.

Scenario 2 - The Israeli Strike Fails and Triggers a Bigger War; Oil Traffic is Disrupted

The second scenario looks at the economic implications should the Israeli strike fail, or fall significantly short of its mission to disable Iran's nuclear weapons-making ability. We further assume Iran carries out its threat to retaliate against Israel, the U.S. and allied forces in the region. The clash escalates into a wider war, with Iran having success at interdicting oil shipments in the Persian Gulf for a month or longer.

Scenario 3 - No Military Strike By Israel in 2008

In this scenario, Israel decides not to attack Iran in 2008 and allows the current dynamic to continue into next year with a new US Administration. Withholding military action this year means the dispute with Iran will likely take one of four possible tracks in 2009:

- (1) Iran finally bends to international pressure and completely halts its enrichment activity.
- (2) Iran agrees to produce only low levels of uranium enrichment and is willing to submit to full international inspection.
- (3) Israel decides to strike Iran in 2009 or 2010.
- (4) Israel is resigned to Iran being a nuclear military power.

(Reminder: The scope of this report is limited to calculating the economic fallout should Israel strike *this year*.)

ECONOMIC IMPACT

Scenario 1 - Israel Destroys Iran's Nuclear Enrichment Capability; Only Minimal Retaliation Follows From Iran. No Major Disruption in the Flow of Oil.

OIL PRICES: To gain maximum military advantage over Iran, the Israeli strike will occur with suddenness. (There was no prior warning with the attack on the Osirak plant in Iraq and the nuclear installation in eastern Syria). We expect initial news of the raid to quickly ignite a firestorm of international criticism against Israel. Investors, fearful that Iran will now carry out its threat to disrupt oil supplies, immediately bid up the price of crude to record levels. Within the first 24 to 72 hours, oil could surpass its previous high of \$147.27 a barrel (reached July 11, 2008) and settle between \$175 to \$225 for a week or so.

Shortly thereafter, as it becomes apparent the Israeli strike was quick, effective, and over, the cost of crude should drop. How rapidly it falls will depend on Iran's ability to retaliate. In this scenario we assume its capability to do so has been greatly weakened. With its nuclear weapons program destroyed or crippled and Persian Gulf maritime traffic largely undisturbed, the threat from Iran soon fades. In the absence of any meaningful reprisals, the risk premium tagged to oil should shrink and bring the price down toward \$70 to \$85 a barrel within three months after the air strike.

ASSET VALUES: The price of other commodities and financial assets will roughly follow the same cycle as oil. During the early moments of the military strike, anxious money managers are expected to shift assets to safer destinations. **Gold** is expected to leap beyond its record \$1,033.90 an ounce (reached March 17) and climb towards \$1,200. The price for the benchmark **10-yr Treasury** note should appreciate sharply, with the yield dropping to 3.3% - 3.50%. News of an Israeli raid on Iran will also trigger a sell-off in the equity market, dragging the S&P 500 below the 1,200 low reached on July 15, 2008. The **dollar**, on the other hand, may face several cross currents in the opening hours of the conflict. Some currency traders will be inclined to sell dollars, convinced that soaring oil and commodity prices are going hurt the greenback. Yet other investors are likely to rush into the safety of US Treasuries when geopolitical tensions are high, a move that lifts demand for dollars. We believe an attack on Iran will sufficiently unnerve financial markets to result in a net increase in the purchase of dollar-denominated securities. Our forecast thus calls for the US currency to appreciate to 1.37 per euro and 124 versus the yen.

But, again, as worries of a drawn out war with Iran recedes, the price for **oil, gold and Treasuries** should swiftly head back down. Within three months, our forecast calls for the precious metal to begin dropping towards \$650 to \$750 an ounce, with oil slipping to around \$80. As geopolitical risks fade and energy costs slide, the outlook for the economy and corporate profits improve. As a result, investors will reduce their holdings of fixed income securities and shift to assets promising higher returns. The sell-off in **10-year Treasury notes** will push the yield up to 4.85%. In this scenario, we also expect to see the **dollar** strengthen further to 1.28 per euro and 129 versus the yen. Propelling the US

currency higher will be the expectation of a quicker economic upturn here relative to other industrial countries and rising US short-term rates. All this will lead the **S&P 500 index** to rebound about 30% off its summer low, to 1570.

ECONOMIC IMPACT: We do not believe the brief spike in oil prices past \$200 a barrel will have a lasting impact on the economy. Obviously consumers and business leaders will miss a few heartbeats as everyone concentrates on news of the Israeli strike and its fallout. But once it becomes evident the military raid is over and the disruption to oil supplies negligible, the stage is set for energy prices to tumble. The average retail price of **gasoline** should slide toward a range of \$2.45 to \$2.85 a gallon within four months. Since lower gasoline prices frees up funds for other kinds of spending, we expect to see a moderate increase in both consumer and business expenditures. The subsequent pick-up in outlays will revive economic activity and, we believe, also hasten the recovery in the housing and financial sectors. All this sets the stage for the US to lead the world in the next economic upswing. Under scenario one, **real US GDP** will expand by 3.2% in 2009, from an estimated 1.7% in 2008 and 2% in 2007. **Eurozone GDP** should grow 2.5% in 2009, following a projected 1.4% increase this year and 2.6% in 2007. World GDP will grow 4.3% in 2009, after 3.8% in 2008 and 5% in 2007.

Scenario 2 - The Israeli Strike Fails and Triggers a Bigger War; Oil Flow is Disrupted

OIL PRICES: Israel's attempt to bomb Iran's nuclear enrichment facilities does not succeed, or falls significantly short of its objective. Iran retaliates forcefully against Israel and the West. The conflict deteriorates into a protracted war and causes major disruptions in the supply of oil from the Middle East. This scenario will drive up the price of crude to between \$200 and \$300 a barrel and lingers there nearly a quarter, threatening to shut down global economic activity. The retail price of regular gasoline in the US climbs to \$5 to \$7 a gallon, with Europe seeing it surge to between \$11 and \$14. At these lofty levels, most industrial and emerging nations will experience severe economic dislocation.

To help stabilize the oil market, the US and other members of the International Energy Agency are expected to tap their strategic petroleum reserves. Our view is that the additional oil from these reserves and the global economic downturn will drive the price of crude down to a range of \$140 to \$175. Some may argue that oil prices should fall even further since both Saudi Arabia and Kuwait have promised to activate contingency plans and increase oil output in the event Iran interdicts shipments of crude. But we doubt prices will fall much below \$140 in 2009 under this scenario for several reasons:

- (1) The Saudis and other producers may not be able to move fast enough to increase output.
- (2) Even if they could, the extra oil from their Khursaniyah and Khurais fields consists mostly of the much less preferable heavy crude. This type of oil is more difficult and costly to refine and produces less products.

(3) The hit and run tactics by Iranian gun boats in the Persian Gulf and periodic attacks by terrorist groups on nearby oil facilities will compel traders to add a hefty risk premium on crude.

ASSET VALUES: A more intense war in the Middle East should unleash an even greater re-allocation of funds than scenario one. Global investors will park a record amount into **gold**, lifting it to a range of \$1,300 to \$1,500 an ounce. Others are expected to add far more **Treasury** securities to their portfolios, driving the benchmark **10-yr note yield** down to below 3%. The outbreak of a dangerous Middle East war during the initial weeks should lift the value of the **US dollar** to around 1.35 per euro and 130 yen. Investor anxiety will also drive stocks down, with the **S&P 500 index** tumbling to 1170 or lower.

However, should the conflict with Iran linger more than a few months, we expect the mindset of investors will begin to shift. More attention will be placed on what a prolonged clash will mean for future US military outlays and more broadly, the implications for the federal budget. The Bush Administration has already projected a record deficit of \$482 billion for FY 2009 --- even in the absence of a Middle East war. When you combine the shortfall in tax revenues from a weaker economy with the prospect of higher defense spending, the cost of rescuing the financial and housing sectors, and the government's growing liabilities to finance entitlement programs, the budgetary red ink could easily swell close to a trillion dollars by 2010. Expectations that the government will need to flood the bond market with new debt could pummel the price of **10-yr. Treasury** notes. Our forecast calls for the note yield to climb past 5% within six months to a year. The **dollar** will retreat late in 2009 and approach a new low of 1.63 against the euro and 104 versus the yen. Equities should fare badly as the uncertainty about future oil supplies and the war reduces investor appetite for stocks. In this scenario, the **S&P 500 index** may remain stuck in the range of 1150 to 1230 range for much of 2009.

ECONOMIC IMPACT: A protracted war can vary in severity and duration. If it lasts beyond a quarter, it will sharply curtail U.S. and foreign economic growth. Indeed, we see most industrial countries in a full-fledged recession in this scenario.

Any attempt to quantify the economic damage with precision in this instance is a useless exercise. Economic forecasting models tend to break down when faced with a severe external shock, especially with oil above \$200 a barrel for an extended period of time. Undoubtedly, economies around the world will be gasping for air. Some US industries such as airlines and automobiles will likely seek out federal assistance to prevent all out bankruptcy. Unemployment may surge as companies struggle with declining sales. The jobless rate could hit 8% in 2009 --- the highest since 1983---from an estimated 5.4% this year and 4.6% in 2007. Moreover, the deterioration in the labor market will further delay the recovery in housing and greatly complicate efforts by financial firms to improve their balance sheets.

Nor is it just developed economies that are in danger of falling into recession. Several key emerging countries are at risk as well. China and India, for example, face serious hardships should Iran's retaliation end up disrupting oil shipments for more than a few weeks. Neither country has established an adequate reserve of oil for such an emergency. India, which imports about 75% of its oil, has a petroleum reserve that contains

approximately two weeks worth of supplies. China has to import nearly half of its crude- -- with most of that supply coming from the Persian Gulf. China's emergency reserve consists of just three to four weeks worth of oil. Thus a prolonged disruption of oil shipments may cause China and India's economies to sputter out within a month or so, and bring down most of the other Asian economies. (Asia's developing countries are currently growing at their slowest pace in five years.) Under scenario two, the **US economy** will shrink by nearly 2% in 2009; **Eurozone** contracts by 1.5%, and **World GDP growth** will manage to stay positive, but at a sluggish 2% next year.

Scenario 3 - No Military Strike By Israel in 2008

OIL PRICES: In the absence of an Israeli military strike on Iran, we assume the current stalemate continues in 2009. The UN Security Council could approve additional sanctions against Iran, though this appears unlikely given the recent breakdown in US- Russian relations. There will certainly be more saber rattling in the Middle East late next year.

In this scenario, the price of oil during 2009 will depend on both the severity of the global economic weakness *and* the level of tension between Israel and Iran. The economic slowdown now underway has already brought the price of **crude** below \$110, and it is expected hover between \$110 and \$145 in the first half of next year. We do not believe the price will fall below \$100 for any sustained period of time given the unresolved issue of Iran's nuclear program. Indeed, the closer Iran gets to acquiring an atomic bomb, the greater the expectation that Israel will launch a pre-emptive strike. By the second half of 2009, talk of war in the Middle East will loom large again and push oil toward \$150.

ASSET VALUES: In scenarios one and two, asset prices were held hostage to the fallout from an Israeli attack. Under scenario three, valuations will be more directly influenced by macroeconomic fundamentals, at least in the first half of the year. We expect the international political climate to be relatively calm the first few months of 2009 as the new US president tries his hand at diplomacy to resolve the dispute with Iran. During this presidential honeymoon phase, we would not be surprised to see Iranian leaders speak positively of negotiations to defuse tensions. **Gold** is expected to bounce around \$775 to \$875 an ounce at this time. Lower commodity prices and the view that banking and housing are slowly on the mend should strengthen the **dollar** to 1.42 per euro and 122 for the yen in the first half of 2009. Also bolstering the greenback will be the Federal Reserve's decision to raise short-term interest rates in 2009, while economic weakness in Europe may force the European Central Bank to consider reducing its benchmark rate. **Yields on 10-yr Treasury** notes will fluctuate within the range of 3.80% to 4.15% during the first six months. The prospect of faster economic growth and improved profitability should increase demand for equities. Our forecast calls for the **S&P 500 index** to rise to 1400 by June of next year.

But these trends are expected to reverse course as Iran's nuclear enrichment program stirs up investor anxiety again in the second half of 2009. The recurrent failure of

diplomacy to resolve the issue revives the specter of war in the Middle East, with threats and counter-threats between Israel and Iran likely to push the price of **gold** up to between \$1,000 and \$1,200 an ounce and oil toward the upper level of the of \$135 to \$150 range. Short of an actual war, the **dollar** will depreciate after investors seek out commodities as a hedge against a weakening US currency. Our projection is for **the dollar** to slip to 1.60 per euro and 103 versus the yen by year-end 2009. Another major headwind for the dollar is the expectations of an exploding US budget deficit, one that appears headed toward the \$1 trillion mark early in the next decade. Domestic and foreign investors holding US paper may begin to switch out of dollar-denominated securities as Washington prepares to swamp the market with a record amount of new debt. Our forecast calls for the **10-yr Treasury note yield** to rise to 4.5% by mid 2009 and 5.20% at end of the year. Equity investors, worried about the repercussions of a future war with Iran, will reduce their exposure to stocks and drive **the S&P 500 index** down to 1250 by the end of next year.

ECONOMIC IMPACT: Iran's nuclear ambition remains a lingering concern to investors and policymakers, but it will not play a dominant role in shaping the global economy or financial markets in the first half of the year. An incipient economic recovery will take shape in the US by spring 2009. The housing sector should produce more concrete signs of bottoming out. Financial firms will also be on a better footing after spending nearly two years fixing their balance sheets and raising capital.

All this economic progress could stall the second half of the year as headlines focus on the renewed tensions with Iran and of a pending war in the Middle East. In addition, the Federal Reserve will have started its monetary tightening cycle by then. Higher interest rates combined with rising oil and commodity prices (due to heightened geopolitical risks) as well as shrinking exports will cut short the infant recovery. We believe the US economy will lose steam by the end of the year. Under scenario three, we're projecting GDP growth in the US to be 1.8% in 2009, with much of the slowdown taking place the last two quarters. In the Eurozone, housing and banking woes will hamper its economy in the first half, with the rebound in energy prices tilting the region closer to recession in the second half. Our forecast calls for Eurozone growth to weaken to 1.2% next year. World GDP growth will drop back to 2.7% in 2009 under this scenario, the slowest in five years.

CONCLUSION

For the first time in history a fundamentalist theocratic regime, enriched with petrodollars and known for funding terrorism around the world, is within reach of having its own nuclear weapon. To Israel and most of the international community, the prospect of a nuclear-armed Iran is a chilling one and there have been numerous efforts to pressure Teheran to abandon its enrichment program. However, after three years of negotiations and several rounds of multilateral economic sanctions, the Islamic regime continues to forge ahead and is now on course to having one or more atomic bombs, perhaps as early as next year. Once armed with such a weapon, many fear Iran will be in a stronger position to carry out two principal foreign policy goals: To destroy Israel and to assume Shiite Islamic dominance over the mostly Sunni Middle East.

We believe a military confrontation between Israel and Iran is highly likely, and will probably take place before the end of this year. When faced with a nuclear peril in the past, Israel has always taken pre-emptive action and done so with stealth and silence. If Israel carries out a strike against Iran, it will have a profound and lasting impact on the global economy. While it is difficult to anticipate all the consequences, we have presented here some broad scenarios. All show the economic fallout will be acute and widespread.

FORECAST SUMMARY

Scenario 1 - Israel Destroys Iran's Nuclear Enrichment Capability; Only Minimal Retaliation Follows from Iran. No Major Disruption in the Flow of Oil.

	2007	2008	2009
Real GDP Growth (%)			
US	2.0	1.7	3.2
Eurozone	2.6	1.4	2.5
World	5.0	3.8	4.3
Oil (\$, yr-end)	96	145	95
Gold (\$, yr-end)	835	1,050	700
S&P 500 (yr-end)	1,468	1,310	1,570
US \$ (yr.-end)			
vs Euro	1.46	1.37	1.28
vs Yen	111	124	129
10-Year T-note yield (% , yr-end)	4.03	3.60	4.85

Scenario 2 - Israeli Strike Triggers a Bigger War; Oil Flow is Disrupted

	2007	2008	2009
Real GDP Growth (%)			
US	2.0	1.3	-1.8
Eurozone	2.6	1.2	-1.5
World	5.0	3.5	2.0
Oil (\$, yr-end)	96	220	155
Gold (\$, yr-end)	835	1,350	1,175
S&P 500 (yr-end)	1,468	1,170	1,230
US \$ (yr.-end)			
vs Euro	1.46	1.35	1.63
vs Yen	111.45	130	104
10-Year T-note yield (% , yr-end)	4.03	3.0	5.2

Scenario 3 - No Military Strike By Israel in 2008

	2007	2008	2009
Real GDP Growth (%)			
US	2.0	1.7	1.8
Eurozone	2.6	1.4	1.2
World	5.0	3.9	2.7
Oil (\$, yr-end)	96	120	150
Gold (\$, yr-end)	835	800	1,150
S&P 500 (yr-end)	1,468	1,300	1,250
US \$ (yr.-end)			
vs Euro	1.46	1.43	1.60
vs Yen	111.45	111	103
10-Year T-note yield (% , yr-end)	4.03	3.7	5.20

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