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A September 11th Reflection

An Amazing Year of Surprises.

BY DAVID HALE

The first anniversary of the terrorist attacks on New York and Washington will be a reflective period for everyone about the consequences of terrorism for the world economy.

The most remarkable thing about the terrible events is that they did not have a more enduring impact on either business or consumer confidence. The U.S. economy had been in recession for three quarters before the attacks because of a collapse in telecom and information technology capital spending after a great boom during the previous three years. American firms responded to the attacks by slashing prices, especially for autos, and households responded by producing a far larger increase in retail spending during the fourth quarter of 2001 than most economists had imagined possible before the attacks. The surge in retail spending set the stage for a dramatic liquidation of inventories which then gave way to a consolidation during the first quarter producing 5.0 percent real output growth. As the

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year began, most economists were projecting that output growth would hover close to zero through the first half of 2002. Instead the recession which had been gripping the economy for nine months ended because of the rebound in consumer spending.

The Federal Reserve contributed to the improvement in consumer confidence by cutting interest rates 125 basis points during the weeks after the attack. The interest rate declines helped to fuel an already robust housing market. The household sector refinanced over $1.1 trillion of mortgages during 2001 and in the process extracted about $100 billion of capital gains for spending or other forms of savings. The wealth gains in the housing market also helped to offset the large losses in the equity market.

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The Bush administration had already tilted fiscal policy in an expansionary direction before the attacks by persuading Congress to enact a tax cut. The attack itself transformed the fiscal policy outlook by persuading Congress to abandon all restraint on spending. The defense budget is projected to increase by nearly $100 billion during the year ahead while other forms of discretionary spending are also expanding at a rate close to 10 percent. The new spending, on top of the tax cuts, turned the $127 billion federal fiscal surplus which existed twelve months ago into a $160 billion deficit, but bond prices have nevertheless rallied because of the weakness in private spending. The abandonment of spending restraint will pose long-term risks to the country's fiscal equilibrium but there is little doubt that it set the stage for fiscal thrust at precisely the moment when the economy was most vulnerable to a contraction of private spending.

In the weeks immediately after September 11th, there was a wave of pessimism in the global financial media about how terrorism would stop the process of international economic integration called globalization. Many feared that spending on security would significantly increase the cost of transportation while making everyone more risk averse about international investment. But governments came to the rescue of the globalization process by insuring that the Doha trade negotiations during November were successful at launching a new global trade round. The U.S. trade negotiator, Robert Zoellick, also was able to persuade a majority of the U.S. House of Representatives to approve the fast track trade bill enabling the president to pursue trade agreements without legislative intrusion. In the absence of Sept. 11th, it is unclear if the House would have rallied around the president. The Bush administration had to make concessions to protectionists for steel and lumber tariffs during the first quarter of 2002 in order to hold its coalition together, but by July these concessions did help to solidify majorities in both houses to give final approval to the fast track bill. As a result, the American President now has the power to pursue both broad based multilateral and bilateral trade agreements for the first time since 1994.

The terrorist attacks also had some unexpected benign side effects on American foreign policy. They helped to set the stage for a new alliance with Russia. Instead of clashing over the Bush plans to build a new anti-missile defense system, the U.S. and Russia are now collaborating on many issues, including expansion of Russia's role as a global energy supplier. The tensions which had been building with China over the missile issue also gave way to promises to share intelligence and collaborate in the war against terrorism. As during the cold war years, the U.S. has felt compelled to develop alliances with unpleasant authori-

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tarian leaders in Central Asia (Uzbekistan, Kazakhstan, etc.) but the new relationship with the U.S. could help to promote more economic opening in those countries at some point in the future. In fact, the Pakistani stock market has rallied by over 70 percent since September 11th because of investor perceptions that the government's new alliance with the U.S. will help to bolster the economy by improving prospects for both trade and investment. One of the best performing Pakistani stocks has been Lucky Cement, the only company with a cement plant on the border of Afghanistan. Investors perceive that the company will benefit from the rebuilding of Afghanistan's infrastructure by international aid agencies.

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The great unresolved issue still lingering from Sept. 11th is how the insurance industry will cope with the cost of future terrorist attacks. The destruction of the World Trade Center produced about $50-60 billion of losses for the U.S. property casualty insurance industry and wiped out nearly half of its capital. The Bush administration proposed having the government assume responsibility for 90 percent of the cost of future terrorist events which cost over $10 billion, but the issue has been gridlocked in Congress as a result of a conflict over tort reform. The Republicans want to limit the ability of tort lawyers to pursue claims relating to terrorist events while the Democrats want to give them free reign because of their role in providing large campaign contributions. Meanwhile, the insurance industry is raising prices aggressively in order to rebuild its capital. After dropping from 4.0 percent of GDP during the late 1980's to 3.0 percent of GDP recently, property casualty insurance premiums will probably rise back into a range equal to 4.0-4.5 percent of GDP.

The great contrast between the war on terrorism and previous wars is that a much larger share of the burden will fall directly upon the private sector rather than just the government. The higher cost of insurance will be one of several new costs falling upon corporate profits as a result of September 11th. During the past year, American firms are estimated to have hired over 300,000 new security guards as well as spending heavily on new forms of metal detection and other security equipment. While there is little precise data available about these expenditures, it would not be unreasonable to estimate that rising insurance prices and increased spending on security will probably cost American business about $100 billion per annum or nearly as much as the national defense budget will increase during 2002-2003.

As firms gain experience in managing security more effectively, they will learn to reduce costs and improve productivity of their new security employees. But there is little doubt that these costs will have a depressing impact on corporate earnings at a point in the business cycle when higher profits are needed to revive capital spending. As a result, the final legacy of September 11th will probably be a more subdued upturn in the global economy during late 2002 and 2003 than would have occurred if corporate profits were unrestrained by increased spending on security and insurance.

The major policy lesson from September 11th is the importance of confidence in sustaining growth. The nation was shocked by the events but other factors helped to revive spending. The Fed had been easing for nine months but had room to go further. The U.S. enjoyed a large fiscal surplus which made it possible for Congress to boost spending and cut taxes. Corporations slashed prices in order to entice customers out of their homes. Governments gave a boost to corporate sentiment by using the Doha trade round to demonstrate that globalization was not dead. Ironically, the great challenge facing the American economy at present is a loss of confidence resulting from corporate scandals. People perceive that they have lost hundreds of billions of dollars in the stock market because of accounting fraud and corporate CEO's using option programs to loot their companies before bad news appeared. The Bush administration has found it more difficult to calm public alarm about corporate misbehavior than the terrorist attacks. As a result, the stock market is falling because investors perceive that the corporate scandals will depress consumer spending and produce a double dip in the economy.

There is widespread expectation that the El Queda terrorists will strike again. There is no way to predict how such events will affect the economy until they actually occur. If the attack is a conventional one on an airplane or an embassy, it will not unduly depress sentiment. If the terrorists are able to strike with nuclear or biological weapons, the consequences will be far more profound. As a result, policy makers should be developing contingency plans for how to manage confidence in the aftermath of future attacks. It is essential that they have fiscal and monetary stabilization tools available to move as decisively as the U.S. authorities did after September 11th. Without adequate contingency plans, the greatest threat posed by the terrorists will not only be the loss of lives and property where they strike but the risk of a global recession. ◆