STIRRED BUT NOT SHAKEN

THE ECONOMIC REPERCUSSIONS

MARTIN N. BAILY

Finding the right economic response to the crisis caused by the September 11 attacks is a vital part of showing the terrorists they have not undermined the strength of the United States and its allies. Americans had believed that they were safe from foreign aggression in their own country, but today many feel understandably nervous about the future. Consumer confidence is weak. According to a CNN/*Time* poll taken shortly after the attacks, 40 percent of consumers plan to cut back on spending and 42 percent plan to cut back their travel because of the attacks. Many businesses were directly affected by the crisis, and many others are cautious about making new investments.

Prior to the attacks, indicators were mixed. Consumer spending had been higher in August and seemed to be proceeding normally in early September. Motor-vehicle sales in the first ten days of September had been running at about the same level as in August, and chain-store sales were down only slightly. There were some signs that the economy was turning the corner.

On the other hand, investment remained in a slump, having fallen 15 percent in the second quarter. The August employment report was weak and construction spending fell during the month. The stock market was soft, and consumer confidence in early September was declining. On balance the economic portents were fairly negative. Instead of seeing the hoped-for rebound in economic activity, we were already seeing signs of very weak or even negative growth for the country's gross domestic product (GDP) in the third quarter. U.S. manufacturing had lost nearly a million jobs over the course of the preceding 12 months.

The United States was not the only country experiencing economic problems. Japan was in deep trouble, its economy declining and its financial system on the edge of collapse. Europe was holding up better, but forecasts were dropping there, too, notably in Germany, which is heavily affected by the worldwide demand for capital goods. A recent report showed that industrial production in the eurozone (the 12 countries that have adopted the euro as their common currency) had declined 1.4 percent in July. The newly industrialized Asian economies that rely on exports were facing the near-collapse of demand for high-tech goods and services. U.S. imports of computer-related products had fallen by $80 billion in 2001. Latin America was struggling as well, especially Argentina, and Turkey was having a particularly difficult time, too.

There is broad agreement that the terrorist attacks will push the teetering U.S. economy into recession and the global economy into a period of slow growth. U.S. GDP will likely decline by 1 percent in both the third and fourth quarters of 2001, with a much larger decline possible in the fourth quarter if consumers remain cautious. The forecasting group Macroeconomic Advisers estimates that the attacks destroyed $13 billion worth of private and government capital and lowered economic activity in the third quarter by $24 billion, when calculated at an annual rate.

Some industries were directly affected, notably airlines, hotels, and insurance companies. U.S. airlines announced the layoff of around 90,000 employees shortly after the attacks; the cutbacks in air travel immediately spilled over into other industries, as well. Boeing announced layoffs of around 30,000, anticipating that orders for its aircraft would fall. Many meetings and conventions were canceled, and tourism was down sharply. Layoff announcements can often be misleading, but there was little doubt that many companies were in difficulty.

The short-run impact of the attacks is broader than just the suffering of the industries directly affected. There has been an increase in uncertainty, fostering a desire among businesses and consumers to wait and see before undertaking major economic commitments. It is natural for each individual consumer to react

to such uncertainty by holding back on spending decisions. But the impact of such caution by all consumers becomes self-fulfilling, as a drop in total consumption brings on layoffs and rising unemployment, and thus less disposable income to spend. Businesses also react to uncertainty by holding back on capital spending, and that could slow or abort the needed recovery.

One piece of good news is that so far there has been no spike in oil prices. In fact, oil prices now have fallen because of weaker demand and the pledge by the oil-producing countries to maintain stability in the oil market. But the possibility of a disruption of the world's oil supply hangs over the global economy, and an extensive conflict could result in a sharp run-up in oil prices. If that happens, the recession will be deeper or longer than otherwise anticipated.

SHORT-TERM AND LONG-TERM CONCERNS

Sound policies are being pursued to restore confidence and bolster demand. Central banks around the world, notably the U.S. Federal Reserve Board and the European Central Bank, added liquidity to the global financial system, thus allowing banks to borrow cash and reserves more easily to tide them over shortages of cash or other liquid assets.

Fiscal policy, at least in the United States, should also serve to promote a recovery. A stimulus package is being added to the tax cut already enacted and the rebate checks already sent to taxpayers. Congress has passed a $40 billion emergency package of increased spending, available for rebuilding, for the military and for enhanced security needs. And a package of around $15 billion has been passed to help the airlines. In Europe, however, governments are bent on balancing their budgets, a serious mistake during a massive downturn. A better plan would be to temporarily set aside the targets of the European Stability Pact to allow the automatic stabilizers of fiscal policy to work.

Spending weakness will continue in the United States through at least the end of 2001 and probably into the first part of 2002.

Still, the chances are good that the economy will recover quickly. Once the inventory overhang caused by slackening demand is worked off and short-lived equipment wears out or becomes obsolete, production should resume and investment should begin again. The latest blue chip forecast suggests 3 to 4 percent growth by the second half of 2002.

Since 1945, the average length of recessions in the United States has been eleven months, a fact that suggests that recoveries come pretty quickly, unless there is some unusual drag on the economy. Beyond the natural resilience of the U.S. economy, the policy steps just described will start to take effect and will buoy the economy back into positive growth. Monetary policy always takes some time to work, but in general it does work. And over the next 12 months, a fiscal boost amounting to almost 2 percent of GDP is in the works, a combination of tax cuts already in the pipeline, additional defense and security spending, and the likely stimulus package.

There may well be some ugly economic numbers coming out in the months ahead, but the prospects for recovery are excellent. The United States will not go into a multiyear slump, so long as there is not a series of large-scale, successful terrorist attacks against the United States or a wider war. The prediction of a speedy recovery is based on the assumption that the United States and its allies find a way to contain the terrorist threat. Beyond this, there will be some lasting, moderate costs to the economy coming from increased uncertainty and what one can call a "security tax"—costs that will be built into the price of goods and services to cover new security procedures.

The fiscal stimulus package should put money in the hands of those most likely to spend. Its size should be large enough to be effective but not so large that it undermines budget discipline. President George W. Bush's suggestion of $60 to $75 billion in addition to the spending already under way seems about right for the immediate future, but it is important, for reasons of fiscal discipline, that these tax cuts and spending increases have sunset provisions or be consistent with long-term goals.

On the consumer side, further tax rebates should be targeted at

moderate-income taxpayers, including those that pay payroll taxes but did not receive the rebates handed out so far. This would be seen as equitable and it would not create problems for fiscal discipline down the road. It would give money to families with low and moderate incomes, who would be likely to spend most of it. Although tax rebates are not a surefire solution to economic weakness, they would nonetheless help in stimulating consumption.

One plan, proposed by the Princeton economist Alan Blinder, would have the federal government reimburse states that give temporary sales-tax holidays to encourage immediate consumer purchasing. An added benefit of his proposal would be the relief provided states that otherwise might have to raise taxes or cut spending to meet balanced-budget rules. Some form of transfer to the states by the federal government may become necessary to prevent states' fiscal policies from worsening the recessionary cycle.

The Bush administration's push to accelerate the permanent tax-rate reductions passed earlier in 2001 would avoid the political wrangling that usually attends fresh tax proposals. But these permanent tax cuts concern some as being too big over the long run and as undermining fiscal discipline. Any acceleration of the rate cuts should therefore focus not on the top rates but on immediately reducing the middle, 28 percent rate to 25 percent, instead of having it fall gradually over five years, which is the current schedule. This rate has its biggest impact on middle-income taxpayers and would not be too expensive in lost revenue (the acceleration would cost about $54 billion over the ten-year budget window).

Another worthy policy, suggested by the economists Lori Kletzer and Robert Litan, would be to provide wage insurance to those laid-off workers who suffer substantial pay cuts in taking new jobs. Under a wage-insurance program, the federal government would, for a fixed period of time, pay workers a portion of the difference between the wages they earn on a new job and the wages they were paid on the former job from which they were laid off. Such a program would cushion the blow of layoffs that

are now taking place and would encourage laid-off workers to take new jobs rather than collect unemployment insurance. Wage insurance is a controversial policy and it may be hard to introduce quickly in a short-run package, but it is a policy that has much to commend it in good times, and it would be very helpful now that more layoffs are a likely prospect.

On the business side, the current stimulus favorite is to allow more generous depreciation of capital spending to counter the massive drop in investment that has been a major cause of the weak economy. Accelerating depreciation would get an influx of cash into the hands of companies that are investing. A temporary investment stimulus could be more effective than a permanent one, based on the same logic that Blinder uses. The government would be saying to companies, Invest over the next year and get a tax break. If a company puts off the investment until later, the tax break will be gone. Under such a program, some companies may well decide to upgrade their computers or buy a new fleet of autos this year rather than waiting until next year.

Policies that would not be effective in stimulating the economy include a capital-gains tax cut or a cut in the corporate tax rate. Neither policy has been shown in econometric studies to provide much stimulus to investment. A cut in the capital-gains tax could even have the perverse effect of encouraging people to sell stocks, which would send the stock market lower—not a desired result.

Over the longer term, budget targets should not be abandoned. Both the United States and Europe face pressing budget problems in the coming years as their baby boom generation's move into retirement. For the United States, it is vital to keep paying down the national debt while the opportunity is there and before facing the massive increases in pension and health-care costs that are looming on the horizon. Saving the Social Security surpluses and even the Medicare surpluses is good policy for the long run. In addition, it is important for the United States to increase its national savings in the long run, even as it increases spending in the short run, to reduce its foreign borrowing. Running budget surpluses will help achieve both these goals. Good policy, in short, means easing the constraints on budget policy this year and maybe next,

but simultaneously re-examining the long-run budget prospects and looking for ways to preserve long-term fiscal discipline, which will keep long-term interest rates low and speed economic recovery.

Even before the September 11 attacks, the Congressional Budget Office had issued a new set of budget projections with sharply lower estimates of the surpluses. Since that time and since the attack, the prospects for a weak economy are far greater in the short run and the uncertainty about the long-run prospects for growth has increased. In addition, sharply higher spending on defense and security are likely for years to come. The short-run stimulus package, although necessary, will also have a small adverse effect on the budget outlook even over the long term, because it raises the national debt and the interest burden.

It is clear that the budget arithmetic has changed and the pledge to preserve the Social Security surpluses has been forgotten for now. Recessions and wars are expensive and it is only to be expected that if we spend more and tax less now, there will be less money available later. There should be a realistic debate about whether it is more important to preserve the entire tax-cut package passed earlier in 2001, or whether it is more important to preserve budget surpluses.

SUSTAINING GLOBAL GROWTH

A large inflow of global capital, due to a persistent trade deficit, has been a boon to the United States, fueling the country's strong economic performance in the 1990s. The U.S. trade deficit was also a boon to the rest of the world. Other countries were happy to sell their goods to Americans and to use part of the proceeds to buy American assets. The United States indeed has been the locomotive of global growth.

This pattern of international trade and capital flows, however, has created two problems for Americans. Net foreign indebtedness has risen sharply and keeps on rising (it increased by $445 billion in 2000), threatening future economic welfare with too

much foreign debt. Moreover, the strong dollar that resulted from the inflow of capital has undermined competitiveness and thereby weakened the U.S. manufacturing sector.

Over the next several years, the goal should be to rebalance the world economy by increasing the inadequate U.S. savings rate, exporting more, and importing less. In order for this rebalancing to work, other countries would have to develop their own investment opportunities, add to their domestic demand, and rely less on the United States as a market. As a result, the dollar would decline, particularly against the euro.

Since the September 11 attacks, the dollar has remained strong against the euro as the United States, so far, has retained its appeal as a safe and profitable place to put funds. And the U.S. stock market is weathering the crisis pretty well. Having fallen substantially in the period prior to the attack, it fell further immediately after the attacks. The Dow Jones Industrial Average on September 10 was down about 18 percent compared to its high, and then fell a further 14 percent after the attacks. It is striking, however, that by mid-October the market had regained much of the ground it had lost after the attacks. So far it seems there is confidence that a recovery of both the economy and profits in the United States will be as strong as or stronger than in Europe.

Clearly, other countries have to energize their economies and expand domestic demand, as there is a limit to the trade deficits the United States can run to fuel global growth. Around the world, policies that are overly reliant on manufacturing and exporting must be reconfigured to provide incentives for employment growth in the service sector. Over time the global economy will have to adjust to a lower trade deficit in the United States, and that almost certainly will involve a realignment of exchange rates and a stronger euro.

It is vital that Europe, in particular, do its best to sustain growth in the face of the new threat to stability. If the downturn worsens, further interest-rate cuts may be needed from the European Central Bank. Japan must also take forceful steps to avoid falling further into recession. Following the end of the 1980s boom, Japanese policymakers failed to take quick and decisive monetary and fiscal steps to reverse the resulting slowdown. Even

today, the Japanese government is unwilling to face up to and deal with the bad-loan problems of its banks. It must address its financial crisis and not become a stone dragging the global economy under water.

THE PRICE OF SECURITY

Human behavior tends to ignore the chances of catastrophic, large-scale disasters. We underestimate the probability of earthquakes or floods. Reflecting this pattern, the insurance premiums for airlines and skyscrapers did not reflect the possibility of their being destroyed by terrorists. Once a disaster does happen, the pendulum swings the other way, and we think the chances of its happening again are very high. An obstacle to invigorating the economy is that insurance premiums have soared, especially for airlines. Insuring against terrorist attacks will pose a problem, perhaps for a long time. From now on, it will be more costly to fly and to run airports and airlines. And it will be less attractive to build tall towers and create visible attractions like Walt Disney World.

There is a solution to sky-high insurance rates, albeit a flawed one. For decades, the United Kingdom has been living with the threat of terrorism from the Irish Republican Army, and the British government runs a risk pool to provide payments in the event of large economic losses from terrorism. The U.S. government may want to consider organizing such a risk pool for the airlines and other high-profile terrorist targets. Everyone pays into the pool, and if future losses are not great there is enough money in the pool to pay all the claims. If there is a massive claim, the government steps in and supplements the payout. Having the government provide insurance of last resort is the best way to deal with the current situation, but it is not ideal to put government in the position of providing guarantees for private companies. Government insurance for banks and against floods has provided stability for the economy, but these programs have also been subject to abuse or overuse.

Another enlarged uncertainty since September is that of corpo-

rate defaults. The probability of default on high-yield debt has sharply increased in many industries, notably in aerospace, services, and nondurable consumer goods. The risk of default was already very high in the telecommunications field, and it has risen further. Blue-chip corporations also face higher borrowing costs. They are now paying 2.5 percentage points above Treasury rates, compared to the 2.15 percentage points surcharge they were paying prior to the attacks and 1.25 percentage points paid in 1999. This shows that most of the rise in the risk premium was already in the market before September 11, but the attacks made things worse.

The increased risk premium faced by business borrowers should drop sharply or even disappear once the economy recovers, but it is a problem right now. Companies are cautious about investing to begin with and the increased cost of financing adds to their reluctance, thus contributing to recessionary conditions. One bright spot in this general picture of higher risk premiums is the very low rates being charged to mortgage borrowers. Cautious consumers have been reluctant to buy new homes, but the low rates are providing a powerful lure to bring them back into the market.

Internationally, there has been an increase in the risk of borrowing, with potentially serious consequences for emerging markets that were already weak. For example, Argentina is now paying interest on its debts at a rate 18 percent above U.S. Treasury rates, and Brazil and Turkey are also in trouble. It looks as if these three emerging countries will have to go back to the International Monetary Fund (IMF) for more help. The United States is likely to reluctantly go along with further IMF allocations to these countries or easier repayment terms rather than risk a new financial crisis to rival the one that plagued emerging markets in 1997–99.

It was well known that security at U.S. airports was dreadful, but no one really believed it would matter, at least not on the scale of what happened on September 11. So both the government and the industry concentrated on cost-cutting. No one wanted to pay the cost of a top-of-the-line security system and in-

stead there were low-paid ill-trained workers with frequent turnover operating the screening devices. Now we know that things have to change.

From an economic point of view, the cost in higher ticket prices of having an efficient but tighter security system at airports is a price worth paying. Security at El Al, commonly described as the best protected airline in the world, amounts to 7 percent of the airline's total costs, compared to 2 percent for U.S. airlines. (A percentage of El Al's security costs is paid by the Israeli government.) Maybe we do not need to pay that much, but it is time to do the calculation.

The issue of security, of course, extends well beyond the airline sector. There will be a "security tax" on economic activity for some time, perhaps indefinitely. Government spending will be higher and will have to be paid for with higher taxes. The war on terrorism will be expensive. Travel will not be as easy. Obtaining visas may take longer. Security precautions are costly and will add to prices. The security tax is already being felt in some sectors, as U.S. manufacturers have faced supply shortages as a result of trucks unable to enter the United States from Canada and Mexico.

Security measures can be expensive, but with innovation and the benefits of widespread use and production, costs will come down. When air bags were first introduced for passenger cars, the cost per air bag was high. Many people complained about having to pay for this "safety tax." Today, however, mass production has sharply lowered the cost and many consumers buy cars with multiple air bags. The world needs to develop best-practice approaches to security, practices that maximize safety while minimizing delays and disruptions. A security tax will modestly reduce productivity. Hiring 200,000 additional people to provide security at an overall cost (including salaries, benefits, support, and infrastructure) of $100,000 per employee would cost $20 billion. But even this seemingly large figure amounts to just 0.2 percent of GDP in a $10 trillion economy—not enough to cramp economic growth.

THE FUTURE OF GLOBALIZATION

The keys to the success of the U.S. economy in the 1990s were openness, mobility, and the benefits of globalization. Talented people from around the world were drawn to the United States to be part of the cutting edge of technology. Immigrants from China and India founded 30 percent of the start-up technology companies in Silicon Valley in the late 1990s. Without the skills these people brought with them, progress would have been less rapid. As well as the flow of people, the inflow of capital was essential to the investment boom that contributed heavily to the acceleration of U.S. productivity growth. And, of course, the international flow of goods and services was also essential in providing the building blocks of the new economy. In turn, technology development depended on finding global markets to justify the requisite risky investments.

Expanding globally became the accepted strategy for success among large companies during the 1990s. Improved computer and telecommunication technologies made it easier to operate a global company, and the profit potential in new markets provided a tremendous lure for companies that had reached the limits of expansion in their domestic markets. McDonald's had about 15,000 restaurants overseas in 2000, up from about 3,000 in 1990; it now has more restaurants overseas than in the United States. Taking a successful business system and applying it in new markets has been a key driver of profit growth for many U.S. companies and multinational corporations around the world.

International comparisons have suggested that an important driver of high productivity is competition against best-practice companies worldwide. U.S. auto companies changed their ways and improved efficiency as a result of the pressure of competition from Japanese automakers. Globalization also increases the intensity of competition and forces companies to change and innovate or be driven out of the market. Globalization has thus been an important driver of productivity advances.

Despite the benefits of globalization, there was a reassessment

of global strategy taking place at many companies even before the September 11 attacks. Globalization faces increasing political resistance. The violent protests at economic summit meetings in Seattle and then in Genoa showed the intensity of the opposition, even if the protesters were a tiny minority. A much broader group of people, in Europe, in the United States, and around the world, has misgivings about the path of the global economy. Many workers, especially those without college degrees, believe that globalization has hurt their standard of living. Nevertheless, the case for globalization is a strong one. Most economists argue that, although expanded trade can hurt groups of workers, on balance globalization is good for the living standards of the majority as well as for profits.

The forces that have driven globalization forward so forcefully in the past will still be there in the future. Many industries, like those that manufacture computers, semiconductors, or autos, are global industries. There is no turning back for these companies. But the speed and direction of globalization may shift.

In the 1990s, many companies believed they were facing a globalization imperative. Markets around the world were growing faster than in the United States, and they had to be part of that growth. The financial crises of the late 1990s started a change in perception. For example, it is no longer taken for granted that the Asian "tigers," those Asian economies that grew with remarkable speed in the 1980s and 1990s, will keep growing rapidly. The next shift came with the realization that having a strong U.S. brand can be a mixed blessing. Most customers still love McDonald's and Coca-Cola, but these brands now carry the risk of alienating a vocal part of the population.

The terrorist attacks have not changed the fundamental economics of globalization, but they have added to the concerns that were already developing. And they have raised the costs of travel and of doing business globally. The security tax and the impact of greater uncertainty affect domestic as well as global activity, but they do fall more heavily on economic activity outside the home country.

Going forward, companies will make more careful assessments

of the risks and rewards of global expansion. They will develop trade ties with and invest in countries that offer environments friendly to multinational corporations. That will be a loss for countries whose citizens perceive multinationals as an enemy, even though their economies could benefit from expanded trade and the inflow of capital and expertise that direct foreign investment provides. Forming alliances with domestic partners has often been a key element in companies' global strategies and will become even more desirable going forward.

Emerging markets have already been hurt by slow growth in the global economy, given their heavy dependence on exports. The growth forecast for these countries for 2001 had been cut to about half of the growth they achieved in 2000. Along with declining exports, emerging markets are finding the international flow of capital to their economies is declining sharply, too.

The end of the global boom should serve as a reminder to emerging countries of the need to maintain the economic reform effort even when economic growth picks up again. The right response to current economic conditions must come primarily from within emerging economies.

The international financial institutions can play a role in easing the short-term difficulties of emerging economies. They should monitor events and stand ready to make larger loans if contagion effects of the crisis begin to spread. It would be a mistake, however, to hand out large sums of money just because world growth has slowed down. Countries need to have in place policies that are robust and that can withstand the vagaries of the business cycle.

Since the destruction and loss of life at the World Trade Center, at the Pentagon, and in western Pennsylvania, the world has changed. The terrorist attacks exacerbated economic problems that were already apparent. But the fundamentals of the U.S. economy are very strong. Economic growth and the pace of globalization may be a bit slower in the next decade than they were in the 1990s, but globalization will proceed. Economic fears will be overcome.