

# Economic Impact of the Terrorist Attacks of September 11, 2001

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## Introduction

The International Atlantic Economic Conference was held in Philadelphia just one month after the September 11 terrorist attacks on the World Trade Center in New York and on the Pentagon in Washington, D. C. A plenary panel was held at the conference to discuss the economic impact of the attacks. John M. Virgo, the International Economic Society Executive Vice President, chaired the session made up of panelists William J. Baumol of Princeton and New York Universities, William W. Lang, Deputy Director for Policy Analysis at the Office of the Comptroller of the Currency, Chris P. Varvares, President of Macroeconomic Advisors, and M. Peter van der Hoek from Erasmus University in the Netherlands.

The first panelist, William J. Baumol, provided an overview of the terrorist attacks and their long-term economic impact. The long-run benefits for the economy of the catastrophe are a Keynesian stimulus and a replacement of obsolete facilities thereby improving efficiency and effectiveness.

The second panelist, William W. Lang, analyzed the economic impact of the terrorist attacks on the financial and banking sectors. He addressed concerns over the health and vitality of the banking industry, the immediate and short-term reaction of banking customers, and how the payments clearing and settlements system functioned under such stress.

The third panelist, Chris P. Varvares, evaluated the macroeconomic impacts of the terrorist attacks and the implications for business. A model developed by Macroeconomic Advisors shows the direct effects, immediate knock-on effects, and the medium-term effects on the economy. He evaluated the impact on such measures as capital stock, risk premiums, consumer confidence, fiscal policy response, and tax policy.

The last panelist, M. Peter van der Hoek, provided the European view of the impact of the attacks on public finance and policy. Since September 11, political coalitions in Europe have changed and the U. S. has brought political and economic pressure to bear in order to build a coalition with other countries to fight terrorism. New allies in the war on terrorism expect to be rewarded for siding with the U. S. The world economy is now more integrated than ever before. With central banks on both sides of the Atlantic moving to stimulate their economies, it is hoped that the economic downturn will be short.

Much has happened to the economy since the October conference. The original introductory remarks have been expanded to bring the reader more recent economic information to help place the panel discussion into a clearer perspective.

## Consumer Confidence

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Before September 11 the economy was already slowing down, leaving it vulnerable to the direct and indirect effects caused by the September 11 attacks. The index of leading economic indicators showed a deteriorating economy in the month before the attacks, falling 0.1 percent for August. Second quarter GDP figures reinforced concerns that the country was in a downward spiral, showing a mere 0.3 percent growth rate for the April-June period. Consumer confidence plunged in September to the lowest in five years, sinking to 97.6, compared to 114.0 the previous month. This was the largest one-month point drop since the 1990 Persian Gulf War.

At the same time, there were large swings in stock prices and options, an increasing gap between short- and long-term interest rates, falling airfares, and rising insurance premiums. The estimates of risks were quickly being repriced, further adding to a depressed economy. The insurance, airline, banking, travel, and services industries were repriced because of the higher costs of doing business due to the threat of terrorism. It was not just these industries that were affected. A trickle-down effect occurred for companies upgrading security systems and backing up their computer systems at offices and businesses throughout the nation. Adding nothing to increasing output or product quality, these expenditures represented a drag on an already weak economy.

Then came the outbreak of anthrax in New York, Washington, New Jersey, and other places, causing consumer confidence to erode even further. Threats of bioterrorism created concern that not only the economy but also the political activity of the country could be disturbed.

September's index of leading economic indicators continued to fall, suffering its largest drop in almost six years. The September index fell 0.5 percent to 109.2, compared to the August decrease of 0.1 percent. The drop means that the overall U.S. economy will continue to deteriorate at least through the first half of 2002 and possibly longer. Increasing jobless claims, falling stock prices, reduced manufacturing jobs, a weakening in the service economy, and a decline in housing permits were all instrumental in contributing to the September drop.

Rising job security concerns in October, plus the discovery of more anthrax cases, pushed the October Consumer Confidence Index to its lowest level in almost eight years. It plunged from 97 in September to 85.5 in October and was 50.3 points below what it had been 12 months before. Since consumer spending accounts for almost two thirds of GDP, such a sharp drop in consumer confidence means that the economic downturn could last well into 2002.

Although fourth quarter numbers are not in at the time of this writing, the last part of 2001 might be even worse than the third quarter. In the third quarter, spending on durable goods increased only 1.7 percent, compared to 7 percent in the second quarter. Even the first round of the tax rebates did little to stimulate consumer spending, with most people putting the rebate into savings or using it to pay down credit card debt.

### **Money Markets and Interest Rates**

For the tenth time in 2001, the Federal Reserve cut the federal funds rate in November. Since the attacks of September 11, the rate has been cut three times—on September 17, October 2, and again on November 6, with each cut being a full 0.5 percent. In fact, since January 2001 the federal funds rate has dropped a significant 4.5 percentage points from 6.5 percent to 2 percent. The question is, will the rate cuts be enough to reignite the economy?

With a sharp increase in October's unemployment figures, an economy shrinking at a 0.4 percent annual rate, and a decrease in activity in the manufacturing and service sectors, consumer confidence is rapidly deteriorating. This makes it difficult for the rate cuts by the Federal Reserve to have the desired impact. Companies probably will not take advantage of the lower rates to invest in the short run. They will not invest in new plants or equipment because most companies already have more capacity than they can use.

The actions by the Fed are intended to stimulate the economy by reducing borrowing costs. However, this process negatively affects others in the economy. Savings rates have dropped to their lowest levels in years, hurting those who are retired and are dependent, in part, on interest income.

The U. S. Treasury stopped selling 30-year bonds at the beginning of November, causing a shift in demand to 10-year bonds, driving down their yields. Home mortgages went down almost immediately, which encouraged mortgage refinancing as a way to stimulate the economy. The result was a drop in home mortgage levels to rates not seen since the 1960s. But with concern about rising unemployment, uncertainty about retaliatory terrorist attacks, and the length of the war in Afghanistan, more people than in the past may use that extra money to pay off credit card debt and other high-interest loans.

Further reductions by the Fed, if any, need to be less than half a point. The danger is that further rate cuts, which take several months to trickle through the economy, may end up fueling inflation by the end of 2002.

## **Unemployment**

Unemployment has continued to rise since September 11. The September unemployment figures were at 4.9 percent, relatively the same as in August. However, those figures did not reflect the impact of the September 11 attacks. Due to the timing of the Current Population Survey period, which is early in the month, the sharp contraction of jobs subsequent to September 11 in the airline and travel industries did not get reported. October's unemployment data, however, did show the initial economic impact.

October figures reported the largest one-month decline in more than 21 years. A staggering 415,000 people lost their jobs in the one-month period, with the rate jumping from 4.9 percent in September to 5.4 percent in October. More foreboding was the drop across so many sectors of the economy. Manufacturing, which has been on a downward spiral for several months, lost another 142,000 jobs. Though typically a strong sector, the services sector lost an alarming 110,000 jobs. Travel-related industries lost almost 60,000 jobs. Losses in the temporary employment agencies amounted to 107,000 jobs. Clearly, manufacturing and, to a lesser extent, the services industries are unlikely to rebound soon. For example, since the middle of 2000, manufacturing has lost well over 1 million jobs.

Further compounding the problem, the majority of the unemployed have no safety net to rely on. Many of the jobless workers are not eligible for unemployment insurance benefits, with less than 40 percent of Americans able to qualify. Since the lack of unemployment benefits will heavily impact those in the services industries, the October figures should be of particular concern to policy makers.

The terrorist attacks have drained more than 625,000 jobs from the economy since September 11. Unemployment figures will reach their peak at around 6 percent if there is a mild recession and could go as high as 8 percent should the recession deepen and continue into the latter half of 2003.

### **Deflation/Recession**

As the economy continues to unravel, fears of deflation arise. Third quarter economic growth declined at an annual rate of 0.4 percent for personal consumption expenditures, marking the first quarterly fall in almost 50 years.

If consumers feel that prices will continue to fall and hold off spending, additional job cuts can be predicted, and consumers will cut spending even further. Additional declines in interest rates through Fed monetary policy could lead to a liquidity trap, where the inflation rate falls below zero. Should housing markets continue to weaken, lower housing prices will accentuate a negative wealth effect for households.

Optimistic economists, the number of which is shrinking daily, argue that there will be a v-shaped recession. They predict a recovery as early as the first or second quarter of 2002. More and more economists, however, are starting to predict a u-shaped recession. Output levels will still probably be down at the end of 2002. A sluggish recovery seems likely since many companies still face overcapacity and high debt burdens. Dropping consumer confidence, coupled with the sharp increase in unemployment, will accentuate already existing overcapacity. With uncertainty about more terrorist attacks and businesses funneling monies into non-productive areas, such as increases in security, one may well expect a u-shaped rather than v-shaped recession.

### **World Trade**

How will the terrorist attacks transcend to the world economy? We are a global village. U. S. GDP makes up almost one-third of the world's gross global output, so what happens in the U. S. creates strong economic waves that will ripple throughout other economies around the globe. All will feel the impact of September 11.

Experts at the International Monetary Fund are projecting the weakest level of world growth in more than a decade, with weak European growth and a growing recession in Japan. Business confidence in much of Western Europe has plunged since September 11. In Germany, Europe's largest economy, economic growth has come to a virtual standstill. Production levels in Britain faced their largest drop in four years following September 11. The 12 nations adopting the new euro will be fortunate to see even a 1 percent growth rate in 2002. Announcements from the World Trade Organization are also dismal. Current estimates are that world trade will continue to stagnate around 1 or 2 percent, levels not seen in over two decades.

As in the U.S., the airline, hotel, travel, and tourism industries throughout the world have faced stark reduction. Consumer demand in Western Europe came to an abrupt halt and Asian countries are reeling from a large drop in demand for computer products and other related equipment. Both Asian and European nations are experiencing rising unemployment rates. Investors are virtually non-existent, hotels have empty rooms, and airlines are cutting back by as much as 20 percent. Asian countries already in recession are Japan, Taiwan, and Singapore, with Hong Kong and Malaysia close behind. Until the U.S., the European Union, and Japan make significant recoveries, East Asia will not see any chance of improvement.

Greater interrelationships between the U.S., Europe, and Asia mean that changes in American business confidence have a greater impact on world business today than in the past.

This fact needs to be integrated into traditional economic models that have not taken these growing interrelationships into account.

### **Stimulus Package**

Republicans and Democrats are divided on the type of stimulus package needed for the economy. The administration wants extensive tax cuts for businesses and upper-income people. Democrats want relief to go to low-income households and the unemployed, while relying on increased government spending. Republicans feel such Democratic proposals are too expensive and will lead to too much government expansion. Instead, they feel that by cutting taxes on businesses there will be less pressure to cut jobs, and they will have an incentive to purchase equipment which will help to restore confidence.

A popular idea espoused by the Administration is another tax rebate. One should keep in mind that people usually change their spending patterns only if tax cuts are seen as permanent. Indications are that the recent round of tax cuts are not having a great impact because only a small percentage of people intend to spend the money immediately. People in low-income households are even more likely to save their rebate due to concern over rising unemployment and uncertainty regarding job security.

A compromise solution will be worked out. It will most likely be a combination of tax rebates for business investment, extended unemployment benefits, and rebate checks for low-income people.

### **Conclusion**

The economic impact of the September 11 terrorist attacks on the world economy is just beginning to be felt. U. S. GDP is roughly 30 percent of the world's GDP, so a recession in the U. S. will have ripple effects worldwide. Yet, the country's financial infrastructure is sound and remains intact. Eventually, the blow to the economy through weakened consumer confidence, unprecedented cuts in the Federal funds rate, rising unemployment levels, fears of deflation, and low world growth will be overcome. The market will recover and people will go forward with a renewed sense of purpose. As economists from countries around the globe, it is our challenge to lead the way by fostering international relations in the field of economics. We need to search for new ideas and new concepts with our world community of scholars. Let us rise to the challenges of today and tomorrow in this fast-changing economic, political, social, and legal environment that we find ourselves in. *Atlantic Econ. J.*, 29(4): pp. 353-357, Dec. 01. ©All Rights Reserved