

# Market Responses to Economic Stress

Little Rock Downtown Rotary Club  
DoubleTree Hotel  
Little Rock, Arkansas  
November 20, 2001

**O**n September 10, the U.S. economy was limping along but with the promise of faster growth before too long. The next morning, the country suffered grievous and vicious terrorist attacks. As a result of these attacks, and the subsequent anthrax attacks, our economy has suffered a significant shock and serious short-run disruptions. Today, I want to share with you my conviction that our long-run economic prospects, though changed in detail, remain bright and unchanged in fundamentals.

There are many strengths in our situation, and we ought not to be pessimistic. I'll concentrate my remarks on one of these strengths—the rapid response of U.S. markets to changed circumstances. Our economy is resilient, both because our people are resilient and because we rely so greatly on decentralized markets. These markets will assist us in reallocating our economic resources in ways that will deal effectively with the new realities we face.

Before proceeding, I want to emphasize that the views I express are mine and do not necessarily reflect official Federal Reserve positions. I thank my colleagues at the Federal Reserve Bank of St. Louis, especially Bob Rasche, for extensive assistance. However, I retain full responsibility for errors.

## SHORT-RUN ECONOMIC IMPACT

The quantitative impact of the September attacks is now becoming clear. Disruptions to transportation and logistics throughout the country and sharp reductions in consumer purchases in the immediate aftermath of the attacks were

sufficient to generate negative economic growth for the third quarter, now measured at 0.4 percent (annual rate). Clearly, the airline and hotel industries, and related services, have been greatly affected. At present, consensus forecasts are for significant negative growth in the current quarter. The National Bureau of Economic Research may designate the current period as a recession, the first since 1990-91.

No one knows how long these effects will persist. Presently, forecasters look forward to a resumption of growth in the first half of next year. Nevertheless, uncertainty about the possibility of future terrorist attacks increases the downside risk to such forecasts. Events such as new discoveries of anthrax contamination, lack of quick progress in identifying the perpetrator(s) of the anthrax letters, home mail delivery by postal workers wearing rubber gloves, and the apparent accidental crash of American Airlines flight 587 on November 11 all increase the general level of anxiety. While the short-run impact of such uncertainty on consumer and business behavior is difficult to quantify, it certainly is not positive. On the other hand, there is some probability—which I do not know how to estimate—that the FBI will identify and apprehend the anthrax terrorists and dispel much of the anxiety over anthrax. Our uncertainties are not all on the downside.

What we do know is our markets will do a good job in reallocating resources. I am not saying that the affected industries, firms and employees will not suffer great pain; I am saying that the economy as a whole need not, and I believe will not, suffer great pain. Resources—both capital and labor—will flow from some industries to other ones and the aggregate economy will grow.

## THE LONG-RUN OUTLOOK

It is my conviction that the U.S. economy contains very powerful forces promoting growth and full employment. Our society rewards entrepreneurs and innovators. We are much better off living in a society where people may be sometimes excessively exuberant—as some may have been in the late 1990s—than one in which few are prepared and able to take risks. Our strengths include a resilient people, efficient markets, and low inflation. In the Federal Reserve, we have made clear for many years our commitment to maintaining low inflation, and that commitment is widely believed in the financial markets.

Our culture and institutions reward entrepreneurial activity. They are intact, completely undiminished by the September tragedies. People are motivated by the intellectual and financial rewards of building companies, developing new products and services, and serving markets. They will be looking for opportunities to move the U.S. economy forward.

We are already seeing such forces at work. Manufacturers of equipment generally used to prevent bacterial contamination of food have applied electron beam technology to decontaminate mail sent through various Washington, D.C., postal facilities. At this point, neither the cost nor the necessity of applying this technology broadly has been determined. Researchers at the Mayo Clinic have announced the development of an apparently reliable one-day test for anthrax exposure. If approved by the FDA, this test will save valuable days either in starting a course of treatment for infected individuals or reassuring others that their health is not at risk. Researchers at Saint Louis University have been studying the dispersion patterns of dust and cat allergens. Until recently, their research objective has been to alleviate allergy suffering and to prevent lead poisoning. Now they are examining whether their findings can assist in understanding how biological agents such as anthrax spores are dispersed. These are examples of how existing technology is transferred to address newly emerging problems and to develop new products and services in an entrepreneurial environment.

There are many other opportunities for new approaches to the solution of old problems or to define solutions for emerging problems. The provision of security for our transportation systems, our food chain, our energy generation systems, and our borders will consume significantly more resources than have been required in the past. Innovative approaches will be required. For example, in the immediate aftermath September 11, severe logistical bottlenecks developed at both Canadian and Mexican border crossings as detailed inspections of thousands of trucks were implemented. Since the passage of NAFTA, some industries—for example automobile production—have become highly integrated across the three North American economies. The bottlenecks that emerged forced the temporary closure of a number of production facilities because parts could not be delivered “just-in-time.” Experts have concluded that it is not likely that thorough security inspections can be completed efficiently at centralized sites such as border crossings. If so, then without substantial innovation, some of the cost savings that have been realized in recent years through reduced inventories will be lost.

While I have no expertise in this subject, it is possible to imagine approaches that might reduce such production disruptions. Satellite tracking technology is now in common use by trucking companies. Entrepreneurs can conceivably extend this technology to monitor vehicles that have been inspected and sealed at dispersed points-of-origin so that full truckloads can be cleared through border crossings electronically.

Before September 11, there was much discussion about excess capacity in the telecommunications industry. As a result of the attacks, business contingency planners are rethinking the costs and benefits of concentration versus dispersal of production sites and computer facilities. The attacks demonstrated that the Internet satisfied the original design specifications that were laid down by the Defense Department long before this technology was adapted to civilian use. Communication through e-mail was maintained for many firms in New York City even when the wired telephone system failed. With a revision in the assessment of the likelihood of future

attacks, the case may be tipped in favor of more decentralized facilities. In this event, there may be a substantial increase in demand for fiber optic communications capacity.

Improved technology for passenger and baggage screening at major airports is also an area where there is considerable potential for profitable innovation. This technology issue is separate from the issue of whether screening services should be produced by private sector firms subject to federal supervision or produced by federal law enforcement personnel. Airlines now recommend that passengers arrive at major airports two hours in advance of departure time to allow for check-in and security clearance, an increase of one hour from the recommended lead-time prior to September 11. This additional lead-time is a substantial increase in the cost of airline travel to consumers above and beyond any higher ticket prices or user taxes to cover the expense of the more intensive security screening.

My personal experience, matching the experience of many others I've talked to, is that the time involved in check-in and security screening is highly variable, increasing traveler frustration and amplifying the increased cost of airline travel. Over the long run, such increases in cost can be expected to provoke significant substitution of other modes of travel, particularly for short and intermediate distance trips. Nevertheless, even after such substitution, the total time costs of travel will be increased. The additional travel time, aggregated over all travelers over the course of a year, represents a significant resource loss to our society. Innovations in security screening processes and improved techniques for managing passenger flow through screening points have great potential.

Government policies and the structure of our labor and capital markets enable entrepreneurs to be successful. Those conditions are in place, undepreciated. Relative to other industrialized economies, job entitlements in the United States are relatively low. Seniority practices, job security provisions of negotiated labor contracts, plant closure notification laws, and the like provide some short-term job security to workers. However, in the face of a major shock that significantly shifts

demand permanently away from the output of one industry and toward the output of another industry, these provisions only affect the transition from an initial environment to the new environment. For example, airlines currently are experiencing costly adjustment to reduced passenger loads because seniority lists for pilots are not aligned with flight certification lists for the optimal mix of equipment. Adjustment of capacity requires the recertification of more senior pilots on smaller planes. Once the retraining has been accomplished, these firms will be able to operate efficiently at the lower level of demand.

Firms and jobs are created and destroyed continuously in our economy so that ultimately our resources are utilized in the most productive activities. This characteristic has been noted frequently over the past several years as an explanation of why "high-tech" has penetrated production processes here more quickly and more intensively than in other countries. Thus, I believe that the transition to an economy that consumes a higher level of security can be accomplished with little if any disruption of the long-term productivity trends that are the source of our increasing standard of living.

Regulatory conditions are also favorable for a smooth adjustment of our economy in light of the new threat of terrorism. A market system works most effectively when prices can signal where resources can be used most effectively. In the current situation, we are much better positioned than was the case in some significant historical situations. With the outbreak of the Korean War, price controls and rationing of critical materials were instituted. One example of the effects of those policies is that investment in large structures and the production of automobiles were disrupted by rationing of steel. Credit controls were also imposed on mortgage and consumer credit. All of these regulations interfered with the ability of the market system to direct resources to their most productive uses.

In 1974, at the time of the first oil shock, the remnants of the Nixon wage-price controls still governed energy markets. Everyone who held a driver's license at that time will remember the long lines at gasoline stations in many parts of

## FINANCIAL MARKETS

the country. Simultaneously, gasoline was readily available in other areas. The price control system prevented the market system from allocating fuel to its most productive uses.

A market system works most effectively when price signals are not confused by inflationary expectations. There is no evidence that behavior since September 11 has been motivated by fear of inflation. We saw a few lines at gas stations on that day, based on unfounded fears of a physical shortage rather than a fear of sharply higher prices. I emphasize this point because in previous crises—again, the outbreak of the Korean War is a clear example—fear of rising prices considerably complicated the situation. That we take price stability almost for granted is a great strength of our current condition.

Equally important, a market economy requires that households and firms be able to make and receive payments reliably. In the immediate aftermath of September 11, the Fed provided a huge amount of liquidity through various channels and made cash readily available so banks could keep their ATMs stocked. In these and other ways, the Federal Reserve has worked long, hard, and effectively since September 11 to keep the payments system working. Within days, as financial markets and the transportation system began to function again, the increased demand for liquidity subsided and the Fed allowed the short-run liquidity injections to mature.

I've emphasized that near-term adjustments are already occurring in the events of September 11. These adjustments need not have a major persisting aggregate economic impact. Let me use a sailing analogy, drawn from my many years of sailing small boats. I know the racing mark I have to go around, but sometimes get pushed off course by an adverse wind shift or squall. Those short-run events do not prevent me from reaching my objective, although they may make my passage slower. The natural state of the U.S. economy is growth and full employment. We'll get there.

I do not want to minimize the size of the current shock; I do want to caution against maximizing it. The economy has pushed ahead following previous shocks. In my personal experience, I

think back to the Korean War, the Cuban Missile Crisis, the Kennedy assassination, the 1974 and 1979 energy shocks, and other events. I will not try to rank them against the current situation. But I am confident given our prior experience, given our economy's characteristics and the characteristics of our people, the economy will be fine. We will get back on course before too long.

## CONCLUDING COMMENTS

I've emphasized the importance of competitive markets in speeding the adjustment of the U.S. economy to new circumstances. Low inflation, and solid expectations of continuing low inflation, are also of great importance. We enjoy other strengths that lead me to be optimistic. Before the attacks, the federal budget had a substantial surplus, which meant that the federal government could apply necessary resources to meeting our military and homeland security needs without a prolonged debate about whether we could afford these outlays. Moreover, the banking system and insurance industry were well capitalized. Large insurance losses have not shaken the financial stability of insurance firms, nor are banks financially stressed as they were at the time of Gulf War and Desert Storm in 1990-91.

Finally, by accident of timing, we already had in place substantial monetary and fiscal stimulus on September 11. Monetary policy had eased, and fiscal policy had, too. Further easing steps are in place. For all these reasons, I am not only optimistic about the long run but believe that we will see signs of renewed economic growth before too long. I have no way to set a precise timetable for renewed growth, but agree with professional economic forecasters that we need to think in terms of months rather than years.

My message is that the coming revival is not an accident. It is a consequence of the fundamentals of the U.S. economy, which are as strong now as they have ever been. Let me re-emphasize that the timing is uncertain and that we could have nasty surprises ahead of us. But we have lots going for us and ample reason to be thankful in this Thanksgiving week.