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Assessing the Impact of Recent Events on the Economy

Good morning and thank you. I appreciate the opportunity to be a part of your very busy program here in Chicago.

As President of the 7th District of the Federal Reserve System, which includes the upper Midwest, I'm well aware of the important role manufacturing plays in our region's economy.

In fact, on our board, we have a number of directors representing different facets of the manufacturing sector:

- Bob Darnall, former CEO of Inland Steel,
- Jim Farrell, chairman and CEO of Illinois Tool Works, Edsel Ford, director of Ford Motor Company,
- Jim Keyes, chairman and CEO of Johnson Controls, and
- Tim Leuliette, senior managing director of Heartland Industrial Partners.

Although I'd love to talk about manufacturing in detail today, I thought it would be more timely to talk about the impact that recent events have had on the national economy as a whole, and how this affects our prospects for economic growth going forward.

In a glossary of terms used by economists, a shock is defined as an "unanticipated or unusual event that has a noticeable impact on the economy or a financial system." The tragedy of September 11 was a shock heretofore unimaginable.

The World Trade Center stood as a symbol of an international city and our free-enterprise financial system. We are still processing the destruction of the towers and the devastation to New York and Washington — the stories of heroism and loss are almost more than we can absorb. As we reflect on the lives shattered by the attacks, we also ask, "What will be the impact on our lives going forward?" Because going forward is what we must do, as a nation, a democracy and a free-enterprise system.

As hard as it is, we must try to assess the economic implications of the tragedy in order to make sound policy decisions. The unprecedented nature of these events makes it extremely difficult to think about how to construct a useful analysis. Still, we can cobble together some knowledge and experience to get a very rough idea of how the events of the 11th likely have already affected our economy and how they may affect it going forward.

In my remarks today, I'd like to touch briefly on the following elements:

- One, the state of the economy before the attacks and the immediate effects of the attack — including disruptions to the financial markets, consumers, and businesses — and the Federal Reserve's responses to those disruptions,

- Two, the secondary effects — including issues involving consumer and business confidence, potential stimulus from government policy, rebuilding efforts, and the global economic situation; and

- Three, the longer-term impact — notably, the costs of maintaining increased security.

State of economy

In order to provide some background, let's begin by taking a brief look at the state of the economy prior to September. We experienced robust growth in the second half of the 1990s, driven in large part by fundamental improvements in productivity. Then, the economy entered a slower period in the second half of 2000. It was precipitated largely by a sharp retrenchment in business investment, particularly in high tech capital, and a deterioration in corporate earnings. As you are well aware, the manufacturing sector slowed appreciably, with manufacturing production falling more than 5½ percent between September 2000 and August 2001.

More broadly, we experienced weak economic growth in the first and second quarters this year, and incoming news on the third quarter was mixed. Spending by households — notably on big-ticket items such as cars and houses — was holding up fairly well. There also were a few tentative signs that some portions of manufacturing may have been bottoming out, though, overall, manufacturing was still struggling. The incoming employment reports were negative. This included the one for September, which mainly reflected labor market developments prior to the 11th. And weak corporate earnings did not bode well for firms' capital investment projects.

In short, there were a few tentative signs that the economic outlook was deteriorating less rapidly; but, on balance, the economy remained weak in the third quarter. Against this backdrop, we experienced the shock of September 11.

Immediate effects

With the terrorist attacks striking at one of the world's main financial centers, markets were severely disrupted by the events of 9-11. Not only were U.S. equity markets closed, but many other financial markets — even those for U.S. government securities and interbank trading in federal funds — encountered major problems in executing trades.

One of the primary missions of the Federal Reserve is to maintain the stability of the financial system and contain any systemic risk that may arise in financial markets. Accordingly, it is our responsibility to try to help markets deal with problems such as those experienced following the attacks and to help minimize the spillover of those problems to other sectors of the economy.

In the days immediately following the attacks, I received a number of calls from CEOs and other business people around our five-state region. I'd like to share with you an example of the type of problem they were reporting.

Many people who contacted me were worried about things as basic as how they were going to meet their payroll. For instance, one of the CEOs I spoke to had to meet his company payroll on September 13. The company had planned to do so using funds it had invested in the commercial paper market. But, as you may recall, these markets came to a virtual standstill for a couple of days following the attack.

It looked as if the company was not going to be able to cash in its investment. It would have to figure out an alternative way to meet its payroll obligation. As it turns out, the company was able to borrow funds from its bank to meet its payroll, in part, because the Federal Reserve was able to reassure banks that any demand for increased liquidity would be met.

In normal times, banks with short-term funding needs use the federal funds market to borrow from banks with excess reserves. Many of these transactions flow through a few major players who intermediate much of this market. And if the overall demand for reserves rises, the trading desk at the Federal Reserve Bank of New York uses its open market operations to provide enough liquidity. This enables the system to maintain the target federal funds rate set by the Federal Open Market Committee (FOMC).

Following the attacks, however, the intermediaries in the fed funds market had difficulty communicating with one another, and there were numerous problems in executing trades. But, fortunately, other channels exist to help us through times of crisis. Depository institutions, such as banks, can borrow directly from the Fed at our so-called "discount window" to satisfy short-term liquidity needs. Immediately after the attack, we needed to communicate to these institutions that this avenue was available. We issued a statement saying, "The Federal Reserve System is open and operating. The discount window is available to meet liquidity needs."

Borrowing at the window soared. We reached a record of nearly $46 billion on the day after the attacks. By comparison, such lending averaged less than $200 million in the week before the attacks.

The Fed made other special provisions to provide liquidity to the financial system. One example was how we handled check clearing. Early on, we decided to continue crediting depositors' accounts, even though, with our planes grounded, we couldn't debit the drawee banks. Of course, that backed up our check pro-

cessing system, and the result was record levels of float in Chicago alone, nearly $33 billion over the course of a single week. Nonetheless, it gave the commercial banks confidence that they would have the balances they needed to continue lending.

We would normally offset such a surge in float through open market operations. But in this case, we didn't. We decided to keep the extra liquidity in the system. Indeed, not only did we not offset the float, but we conducted open market operations to inject extra reserves into the system.

On the morning of Wednesday the 12th, the New York Fed resumed trading. The Fed decided to supply unusually large volumes of liquidity to financial markets as needed until more normal market functioning was restored. We knew that as a result, the actual federal funds rate might trade below its target; in fact, the effective funds rate ranged between 1¼ and 2¼ percent between September 17 and 20, well below its target of 3 percent at that time.

The Fed also was active on the international scene. It established or enlarged 30-day swap arrangements with the European Central Bank, the Bank of Canada and the Bank of England. This enabled these central banks to provide dollar-denominated liquidity to assist, if needed, banks in their countries in settling dollar-denominated transactions.

Together, these various actions left banks and other lenders with the extra funds they needed to meet the temporary surge in loan demand and allowed the economy's payments and intermediation systems to continue functioning. Fortunately, markets resumed relatively quickly and are now operating efficiently. Just a little more than a week after the event, borrowing at the discount window and Federal Reserve float returned to more normal levels and federal funds were once again trading at their target rate.

Of course, the activities I just described were short-term emergency measures that were scaled back as liquidity needs became more normal. In addition, we were faced with the challenge of determining the appropriate stance for monetary policy. In terms of this broader decision, the FOMC had to consider what the effects of the attack would be on activity in the overall economy.

Because the attacks significantly heightened uncertainty in an economy that was already weak, it appeared likely that some households and businesses would enter a wait-and-see mode. Given this environment, we decided that an easing of policy was appropriate. Accordingly, the FOMC cut the target federal funds rate by 50 basis points twice soon after the attack — once on September 17 before the resumption of trading by the major equity markets that had been closed since September 11 — and again at the regularly scheduled meeting on October 2.

At the time of our October meeting, it was evident that the immediate impact of the attacks on the economy was quite negative. Over the course of the next month, it became apparent that a good deal of this weakness had persistedâ??enough so, that the FOMC lowered the target federal funds rate by another 50 basis points at our meeting in early November.

One of the sectors of the economy that had been and continues to be severely affected is the airlines. As you know, air travel has fallen precipitously. To give you a sense of scale, air passenger miles declined 2 percent back in 1991 following the Iraqi invasion of Kuwait in 1990. This was after years of steady increases. Today, some experts are speaking of double-digit declines in passenger miles this year. Furthermore, the tourist industry, which is closely related to the airlines, also reported huge declines.

More generally, overall consumer spending was off sharply according to data for the month of September as a whole. But these data are difficult to interpret, since it is hard to gauge how much of the decline reflects the fact that people were in shock and glued to their television sets for some time after the attack. We do know that motor vehicle sales bounced back late in September and surged in October to match their record level, boosted by generous sales incentives. Still, the job market has weakened perceptibly, as evidenced by the jump in the unemployment rate to 5.4 percent in October. This does not bode well for consumer spending.

In terms of business' production, overall disruptions to supply chains appear to have been limited, and firms have largely worked around those that did take place. Some of the largest problems we heard about were the substantial delays encountered in crossing the U.S./Canadian border. But even these appear to have been substantially reduced for now. On the U.S./Mexican border, however, problems remain.

Manufacturing also continues to be very sluggish. Many businesses appear to be continuing their cautious approach. They are putting capital spending plans on hold and taking very conservative inventory positions. These reactions have been reflected in sharp drops in the orders received by manufacturers.

To summarize, some of the immediate effects have dissipated: the financial markets are functioning and economic activity is proceeding. However, some major industries — notably travel and tourism — remain disrupted, and, as I will discuss further, it is unclear to what degree overall spending by households and businesses has weakened and how persistent this weakness will be.

Secondary effects

Going forward we are facing a period of extreme uncertainty. Some of this uncertainty surrounds the potential for further shocks to the economy — be they military actions, or threats of additional terrorism. A few analysts have raised the specter of another shock, namely that the war could boost oil prices and weaken the economy, as it did during the Gulf War. While this clearly is a possibility, oil prices have declined substantially.

Even without any further shocks, however, we are likely facing a period of quite sluggish economic activity. As I noted, many businesses appear to be becoming more risk averse. They are delaying unnecessary or discretionary spending and scaling back plans to expand or enhance their capacity. Similar apprehension could hold back household spending as well. Here, the data on consumer confidence coming in since 9-11 have been mixed. Confidence could be fragile, however, especially if the job market continues to be negative. Of course, the income losses associated with a weaker employment picture would be a direct factor restraining consumer spending. So, too, would wealth effects associated with declines in the stock market earlier this year. All of these factors could weigh on the economy going into next year.

We are somewhat more certain, however, that spending will be supported by federal government policy. The monetary policy decisions I described earlier, as well as previous actions by the FOMC, mean that there is a good deal of monetary stimulus already in the pipleline.

On the fiscal policy front, cuts in tax rates and rebate checks have already shown up in peoples' wallets. And other provisions in last spring's budget bill, that will further boost disposable income, will kick in

starting early in 2002. Additional stimulus can be expected from the $40 billion of emergency budget authority signed into law immediately after the attacks as well as from tax and spending legislation currently under consideration in Washington.

Of course, the effects of these measures will depend on a variety of factors. For example, how much households adjust their spending and saving in response to cuts in taxes, the pace at which emergency aid is spent, and the exact form that the prospective legislation will take.

Another factor to consider is the rebuilding efforts that will be going on in New York and Washington. Rebuilding can have a positive impact on the local economy — with increased construction and business activity. But its effect on the national economy tends to be relatively small. For example, the rebuilding efforts following Hurricane Andrew in 1992 were significant locally, but did not have a palpable effect on gross domestic production for the nation.

On the international front, even prior to the attacks, growth abroad was weak, reflecting in part the impact of the U.S. slowdown on our trading partners. Given the current weakness in our economy, the United States is unlikely to provide any noticeable boost to the global economy in the near term. Nor are we likely to receive much help from more robust activity abroad. However, nations throughout the world recognized the downside risks to growth posed by the terrorist attacks, and many central banks have cut their lending rates in its aftermath. As in the U.S., these policy moves should eventually help foster growth in aggregate demand in those nations.

Longer-term impact

Finally, the terrorist attacks will have a longer-term impact on our economy. How? Through the increased spending by businesses, households and governments to achieve and maintain a heightened degree of security. Some of this will come in the form of higher insurance costs, not only explicitly through increased premiums, but also implicitly. For example, firms will insure against disruptions in their supply chains by carrying higher inventories. In addition, heightened security and other measures could make transportation flows less timely and thus more costly. For example, as the United States tightens its borders with Canada and Mexico, the amount of time it takes to transport cargo between the countries could be increased.

Paying for higher levels of security on a day in, day out basis, while necessary, does increase the cost of doing business. Furthermore, persistently higher costs may lower the rate of productivity growth for a time. No doubt we will make innovations over time that will lower these costs and reduce the negative impact on productivity. And once the economy adjusts to the higher levels of perceived risk, productivity growth should pick back up. I believe that, over the long term, prospects for productivity growth and the economy remain favorable. This should become evident once the unusual forces that are restraining demand abate.

Conclusion

In concluding, I want to emphasize that the terrorist attack on America was a tragedy so different from any other, that its full impact cannot be readily calculated. The exact economic consequences are exceedingly difficult to predict, but I've tried to give you a sense of some of the issues that confront us. Generally speaking, the economic recovery originally expected to begin later this year will be delayed, and although it is likely that the economy will improve next year, the timing is uncertain.

Having said that, we must not lose sight of our prospects over the broader horizon, which have not been diminished by the events in September. As Alan Greenspan noted recently, the American economy has become increasingly resilient to shocks. During the last 20 years or so, we've deregulated financial markets, developed more flexible labor markets and made major advances in information technology. These efforts have enhanced our ability to absorb disruptions. And, importantly, these factors also have provided us with the foundation to foster solid economic growth.

This is a time of great uncertainty. Nonetheless, most of my colleagues around the Federal Reserve System believe that our economy has the power and resilience to withstand even the shock of terrorism. I do too. And I'm confident that we will move forward with strength and resolve.