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Economic Outlook Post 9-11

Good morning and thank you. I appreciate the opportunity to be with you this morning to share my thoughts about the impact that recent events have had on the national economy 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 attack of September 11 was a shock heretofore unimaginable.

It was a tragedy so different from any other, that its full impact cannot be readily calculated. I visited Ground Zero recently. Despite countless hours of TV coverage, you really must see it first hand to fully grasp the human loss and physical devastation. Although the exact economic consequences are exceedingly difficult to predict, I will try to give you a sense of some of the issues that confront us.

Clearly, we currently are experiencing a period of quite weak economic activity. In fact, the NBER just yesterday determined that, in March of this year, the U.S. economy entered a recessionary period. The NBER — short for National Bureau of Economic Research — is a non-governmental organization that traditionally dates business cycles in the United States. Yesterday’s announcement underscores the fact that the events of September 11 had a sudden adverse impact on the economy. The economic recovery that — before September 11th — we had expected to begin this year, will be delayed. We expect the economy to improve next year, although 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, during the last 20 years or so, we’ve deregulated financial markets, we’ve developed more flexible labor markets and we’ve made major

advances in information technology. These efforts have enhanced the American economy's ability to absorb disruptions. And, importantly, these factors also have provided us with the foundation to foster solid economic growth.

State of economy prior to 9-11

In order to provide some background, let's take a brief look at the state of the economy prior to September 11th. 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 by a sharp retrenchment in business investment, particularly in high tech capital, and a deterioration in corporate earnings.

More broadly, we experienced weak economic growth in the first and second quarters this year, and the incoming news on the third quarter was mixed. Spending by households — notably on big-ticket items like 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.

Moreover, 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.

Fed's response to tragedy

With the terrorist attacks striking at one of the world's main financial centers, markets were severely disrupted by the events of the 11th. U.S. equity markets closed, and 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 this case, we did so by using a variety of measures to supply unusually large volumes of liquidity to financial markets until more normal market functioning was restored. The actions we took provided banks and other lenders with the extra funds they needed to meet the temporary surge in loan demand that occurred. This allowed the economy's payments and intermediation systems to continue functioning. Fortunately, it did not take long for markets to resume operating efficiently. Indeed, just a little more than a week after the event, liquidity needs became more normal and we were able to scale back our unusual activities.

Of course, in addition to these short-term emergency measures, we were faced with the challenge of determining the appropriate stance for monetary policy. In terms of this broader decision, the Federal Open Market Committee (FOMC) had to consider what the effect 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 some 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 9-11 — 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 persisted. Enough so, that the FOMC lowered the target federal funds rate by another 50 basis points at our meeting in early November.

Immediate economic impact

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. Furthermore, the tourist industry, which is closely related to the airlines, also reported huge declines.

More generally, overall consumer spending was off sharply in September. But all of this data has been very hard to interpret. For example, it's 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 expected retail sales to bounce back in October, and they did much more than anticipated. The headline number was boosted by a surge in motor vehicle sales, which, in response to very generous sales incentives, nearly matched their record level. Still, even outside of autos, retail sales recovered a good deal more last month than most analysts had expected.

Manufacturing, however, 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 significant drops in the orders received by manufacturers. They've also been important factors in the weak labor market reports we've seen this fall — for example, the unemployment rate jumped to 5.4 percent in October — and in the falling industrial production figures.

To summarize, some of the immediate effects of the attacks 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.

A look at the economy going forward

Looking ahead, we are likely facing a period of quite sluggish economic activity. The risk aversion by many businesses that I just noted could hold back their discretionary spending and plans to expand or enhance capacity for some time. This comes on top of the significant scaling back in investment that started last year.

Similar apprehension could depress household spending as well, even though it has held up fairly well to date. Here, consumer confidence will be an important factor. The readings on this coming out since 9-11 have been mixed. Confidence could be fragile, however, especially if the news from the job market continues to be negative. Furthermore, 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.

On the international front, growth abroad was sluggish, even before the attacks. This reflects 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.

Elsewhere on the international scene, oil prices have declined substantially. This clearly is a positive factor for most U.S. households and businesses.

In addition, spending likely will be supported by federal government policy. On the fiscal policy front, we have the cut in tax rates and rebate checks that have already shown up in peoples' wallets. Then, starting in early 2002, other provisions in last spring's budget bill will kick in to boost disposable incomes. Further 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 the cuts in taxes, the pace at which emergency aid is spent, and the exact form that the prospective legislation will take.

In addition to these fiscal measures, monetary policy clearly has not been sitting on the sidelines. The 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 pipeline. And beyond our borders, many central banks have cut their lending rates. These policy moves should eventually help foster growth in aggregate demand abroad, which in turn will help support U.S. exports.

Over the longer term, an encouraging development is the recent agreement by members of the World Trade Organization to launch a new round of multilateral talks. Aimed at further reducing tariffs and other barriers to international trade, these negotiations should lead to economic benefits both here and abroad. Indeed, open markets and expanded trade are one of the best ways to increase economic growth, particularly in developing countries.

Still, I must emphasize that we are facing a period of extreme uncertainty. Some of this uncertainty surrounds the potential for further shocks to the economy. For example, will there be another terrorist attack, and if so, how will it affect the economy? On the other hand, will our progress in Afghanistan continue to exceed expectations and result in a boost to consumer and business confidence?

Additional uncertainty centers on the reaction of households to the changing economic environment. Will they pare back spending to build up their “rainy day funds”? Or will they continue spending due to higher confidence levels, generous retail discounts and lower interest rates? Automakers already have extended their cut-rate financing programs; and mortgage refinancings have been extensive.

In the business sector, as technology advances, firms will need to upgrade their current equipment with more cutting-edge technology. But it is highly uncertain when this will show through to give a meaningful boost to overall investment spending.

We also face a longer-term uncertainty, namely how the emphasis on increased security will impact the economy. Clearly, there will be increased costs to businesses, households and governments to achieve and maintain a heightened degree of security. We’ll have higher insurance costs, too, not only explicitly through increased premiums, but also implicitly, as, for example, firms insure against disruptions to supply chains by carrying higher inventories.

Paying for higher levels of security on a day in, day out basis, while necessary, does increase the cost of doing business. This may lower the rate of productivity growth for a time. But to what degree is not at all clear. 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 up again.

Concluding comments

Although the exact timing is difficult to predict, we at the Chicago Fed believe the economy will improve next year. This is because of the policy moves that I described earlier, and also because, over the long term, the prospects for productivity growth remain favorable.

It is our economy’s flexibility and productivity that make me confident America has the resilience to withstand even the shock of terrorism, and that we will continue to move forward with strength and resolve.