# The Economic Cost of Terrorism

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In striking the World Trade Center, al Qaeda attempted an assault on the institutions of capitalist democracy. A prominent economist with a Chicago-based investment firm says it failed, asserting that U.S. institutions and the economy have largely recovered from the attacks.

Osama bin Laden announced in a video taped sometime late in 2001 that the September 11 attacks "struck deep at the heart of America's economy." Fortunately he was wrong. The U.S. economy was scraped and bruised on that terrible day, but it is clear that the heart of the American economy is still beating strongly.

The U.S. economy has proven to be highly resilient. Despite an estimated $120 billion of damage and a great deal of anxiety, one year after the attacks the U.S. is in the midst of an economic recovery.

Any examination of the impact of the September 11 attacks on the U.S. economy is complicated by many simultaneous events. According to the National Bureau of Economic Research, the U.S. economy entered into recession in March 2001, and as we now know the first three quarters of 2001 posted negative growth. By the time of the attacks, industrial production had fallen for eleven consecutive months and U.S. stock prices were already declining, especially in the high-tech sector.

More recently, accounting scandals have created doubts about the veracity of corporate financial statements. These scandals have undermined confidence and created a great deal of concern among investors. The reaction of policy-makers could have made matters worse by over-regulating business, but the corporate fraud legislation signed into law by President Bush does not do excessive damage and will help calm market fears.

Ultimately, corporate irresponsibility is a transient issue. Law enforcement and the punishment of dishonest companies by market forces will force chief executive officers (CEOs) to clean up their books. Ninety-nine percent of American business people are law-abiding and the recent scandals are likely to create an environment of significantly less fraud.

Despite these negative developments, within 45 days of the September 11 attacks, aggregate demand had recovered to its previous trend, and real gross domestic product (GDP) fell by less (-0.3 percent) in the third quarter of 2001, which included the impact of the attacks, than it did in the second quarter (-1.6 percent), just before the attacks. While the airline and hotel industries are still experiencing a depressed level of activity, other spending has not only recovered, but more than offset travel-related losses.

While some recent economic data seem to suggest a new set of potential weaknesses in the economy, not all of the data point in a negative direction. Initial unemployment claims continue to fall, retail sales remain robust, housing activity is strong, and inventory levels remain low. Despite fears, the U.S. economy appears to remain on solid footing.

There are three reasons for the resilience of the U.S. economy. First, the Federal Reserve cut interest rates three times in the wake of the attacks after cutting rates eight times in the eight months preceding them. Second, in May 2001, President Bush signed into law the first tax cut since 1986 and the Congress passed a stimulus bill, which included business tax cuts, in early 2002.

Finally and most importantly, productivity continued to grow throughout the U.S. recession. This is an abnormal development, indicating strong underlying potential growth. Then in the first two quarters of 2002, non-farm productivity shot upward by 4.8 percent at an annual rate, boosting real GDP growth and solidifying the recovery.

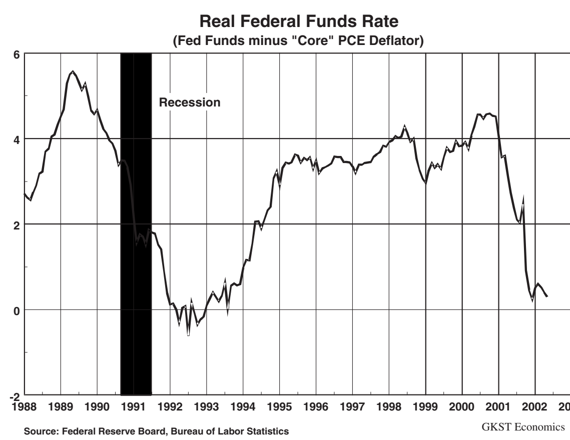
With both cyclical (monetary and fiscal) and secular (productivity) trends pointing upward, the U.S. economy is actually in better shape than it has been since mid-2000. While the added costs of transportation, security, insurance, and increased infrastructure protection will act as a drag on U.S. growth in the years ahead, these costs should be readily absorbed by strong long-term growth in productivity.

When compared to the losses sustained in past wars, the costs of the September 11 attacks and the resulting counter-attacks in Afghanistan are small. The United States has prospered despite World Wars I and II, the Korean War, the Vietnam War, and Desert Storm. American resilience in the face of these conflicts is the result of a commitment to a democratic free-market system. Despite the fact that al Qaeda attacked a beacon of capitalism in the center of world finance, the entrepreneurial spirit remains alive and well in America.

## Making Things Worse

Economic resilience, however, does not eliminate business cycles. Well before September 11, the U.S. economy was showing clear signs of weakness. Industrial production peaked in September 2000 and fell every month between then and August 2001. Employment peaked in March 2001, and 495,000 jobs were lost prior to the attacks. In addition, U.S. stock markets had already taken a beating. By September 10, the Standard & Poor's (S&P) 500 Index was down 28.5 percent from its peak and the NASDAQ Composite Index was down 66.4 percent.

Despite continued strength in consumer spending and retail sales, the recession was dated as beginning in March 2001, five months before the attacks. There is much debate about what caused the drop in stocks and the recession, and many believe that they represent the aftermath of an investment bubble. However, the catalysts for recession are not so clear.




The Federal Reserve had pushed real interest rates up in 1999 and 2000 to their highest level in over 10 years (see chart). Taxes as a share of GDP reached a peacetime record level in 2000 as well. At 20.8 percent of GDP, taxes took the largest share of the nation's output since 1944 when the United States was fighting World War II. With both real interest rates and taxes at very burdensome levels, the economy was bound to have difficulties.

Fortunately, on January 3, 2001, with the federal funds rate at 6.5 percent, the Fed began a series of interest rate cuts. Because the funds rate was so high when the easing began, it was not until May 2001, when the funds rate fell below 4.5 percent, that it was low enough to positively impact the economy. The six to nine-month lag between the rate cuts and the actual response of the economy meant that any real recovery was not likely to begin until November 2001.

As al Qaeda was executing its plan, prior policy actions by the Fed and the Bush Administration had already set the stage for a recovery. By early September, the fed funds rate had been cut in half to 3.25 percent. President Bush had championed the best-timed tax cut in history, giving Americans more freedom to spend their earnings. The attacks may have delayed the recovery, but they certainly did not cause the recession.

## Immediate Economic Consequences

The short-term impact of the attacks was tremendous. Total losses of life and property cost insurance companies an estimated $40 billion. This direct cost pales in comparison to the indirect costs. Shopping centers and restaurants across the country were closed for at least 24 hours; high-risk office buildings (such as the Sears Tower in Chicago) were evacuated; planes were grounded; and the stock market ceased trading for four consecutive days.

In September 2001, retail sales fell by $6 billion (2.1 percent); durable goods new orders fell $11.6 billion (6.8 percent); and new claims for unemployment insurance surged by 50,000, the biggest monthly jump since August 1982. Industrial production fell 1.0 percent in September. When stocks finally opened for trading on September 17, the S&P 500 fell another 7.0 percent while the NASDAQ fell 9.9 percent, before bottoming on September 21.

Major airlines immediately cut scheduled flights by 30 percent, and even with fewer flights, planes were not full. Hotels experienced a surge in vacancies and the economy shed 1.1 million jobs in the final four months of 2001. Through December 29, 2001, the Bureau of Labor Statistics attributed 408 major layoff events (defined as those shedding 50 or more jobs) as a direct or indirect result of the attacks, with 70 percent of those layoffs in the air transportation and travel industries.

In addition, because of closer scrutiny at border crossings and shipping terminals, bottlenecks appeared in supply-chain management systems. Durable goods shipments fell $9.2 billion in September 2001 as transportation issues played havoc with order flows and drove up shipping costs.

This list of damages is far from complete. Airlines immediately received a $15 billion government assistance loan and are still asking for more. Insurance costs have skyrocketed, with some premiums up 300 percent or more from pre-attack levels. An insurance gradient has been created that increases the cost of doing business the closer companies are to centers of political and financial power.

At the same time, the costs of security also increased sharply. In addition to an increase in the number of security guards at most major urban buildings, time-consuming security procedures have been implemented. Some firms have gone as far as installing X-ray machines and metal detectors.

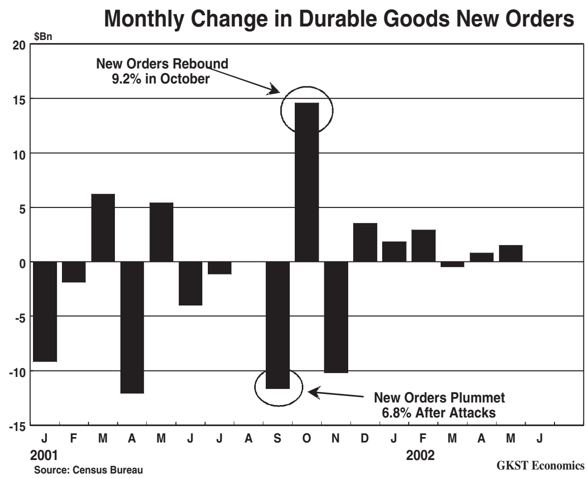
From an incentive standpoint, the September 11 attacks shifted the risk-reward ratio in the U.S. economy. Not only were risks (from business disruption and losses) higher, but rewards were lower due to rising security costs. Following so closely on the heels of a sharp downturn in manufacturing activity, a recession, and a collapse in stock prices, the shift in investment incentives was cause for great alarm.

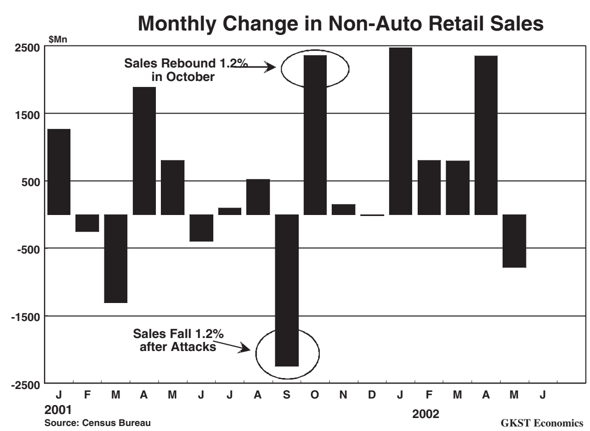
## Recovery

Nonetheless, the U.S. economy bounced back. Within days, consumers and businesses were back up and running. Automobile manufacturers instituted 0.0 percent financing and auto sales soared. Auto sales fell from 16.4 million units at an annual rate in August 2001 to 15.9 million units in September, which was boosted by the late-month initiation of the incentives. Then, in October, auto sales soared to 21.3 million units at an annual rate, an all-time record high.

Other retailers also cut prices, and declines in September were offset by October gains. Excluding autos, retail sales fell 1.2 percent in September, but rebounded by the same 1.2 percent in October (see charts pg. 12). To complete the pattern developing here, the third chart below shows how durable goods new orders fell 6.8 percent in September, only to rebound 9.2 percent in October.

It is important to remember that any rebound in business




activity was muted in 2001 because of the ongoing recession. The economy returned to its trend line almost without delay, but that trend was still weak. Despite the devastation from the terrorist attacks, real GDP grew 2.7 percent at an annual rate in the fourth quarter.

To the surprise of many, consumers were steadfast, and instead of spending money traveling, they spent it on more domestic endeavors. Late in 2001 and early in 2002, movie theaters set record after record for revenue. New homes sales also rose to a record level in 2001, while electronic and appliance store sales rose by 23.3 percent at an annual rate in the fourth quarter.

A surge in demand for U.S. flags after September 11 even gave the global economy a lift, as domestic manufacturers were forced to lean on Chinese factories to supply more than half of the record $51.7 million of flag imports in 2001.

Consumer behavior may have changed, but the overall pace of spending was barely affected by the September 11 attacks. Part of the reason for this was the quick reaction by the Federal Reserve to cut interest rates three times in late 2001. By pushing the federal funds rate down to 1.75 percent, the Fed virtually guaranteed a brisk increase in economic activity in mid-2002. In addition, the interest rate cuts prior to the attacks were also beginning to lift the economy after the normal lags.

## The Secret Weapon

But perhaps the most important driving force behind America's resilience has been strong productivity growth. One of the greatest tests of the strength in underlying productivity trends is the performance in those trends during economic downturns and external shocks to the economy. Clearly, the U.S. productivity performance during the 2001 recession and following the September 11 attacks was spectacular.

A wave of new technology has cascaded across all industry sectors in the U.S. economy. The combination of advances in semiconductors, software, and communication technology is transforming the United States from an industrial-based economy to an information-based economy, much like machinery allowed the transformation from the agricultural to industrial eras.

While high-tech stocks have collapsed in recent years, the inventions and creativity driven by huge investments in the 1980s and 1990s continue to boost the efficiency of U.S. businesses. Supply-chain management solutions, real-time information access, the mapping of the human genome, on-line shopping, paperless trading, Global Positioning System tracking devices, and retail price scanners are just a partial list of the technological leaps made in recent decades.

More importantly, recent surveys show that current businesses are using just 20 percent to 25 percent of the technology available to them. As a result, it can be said with some certainty that productivity growth will remain on a strong upward path in the years ahead. This will boost incomes and profits while holding down inflation—the perfect environment for wealth creation. Productivity is the secret weapon of capitalism. Without it, there is no growth. With it, external shocks, such as the attacks of September 11, are much less painful.

## Growing Stronger From Adversity

Since the founding of the United States of America, the experiment in free-market democracy has produced incredible results. From a small set of colonies, the United States has become the world's largest and most productive economy.

Between 1947 and 2001, inflation-adjusted real GDP grew at an average annual rate of 3.5 percent from $1.5 trillion to $9.3 trillion. In 2001, U.S. real GDP was still $23.1 billion higher than it was in 2000, despite the physical losses from the September 11 attacks and a recession.

While there are many who believe that the United States has reached its full potential and may be entering a period of sub-par economic growth, this is by no means certain. Many have prophesized this in the past and have been wrong. Added costs of security, transportation, and insurance are all potential drags on growth. But these costs are minor when compared to the potential growth rate of U.S. real GDP.

Technology is already helping to reduce the costs of security and will continue to do so in the future. Moreover, neural networks, real-time database search capabilities, and scanning equipment will add to the effectiveness of security in the future. While some fear for their privacy, it is becoming harder and harder for terrorists to operate in the United States. As Americans become more assured of their safety, travel will rebound.

Most importantly, the realization that the United States is not immune to direct attack is a significant development. Prior to the attacks, insurance premiums and estimates of risk were too low. Now, with insurance premiums up and stock prices down, the market is most likely overestimating the risk. Over time these reactions will balance out.

In addition, the attacks have done what nearly 90 years of political attempts at détente could not - created a close alliance between Russia and the United States. Now the second largest producer of oil in the world, Russia has become a major player in energy markets, helping bolster a recovery by holding down world oil prices.

## Conclusion

Capitalism is more than buildings and airplanes. It is embodied in the institutions and individuals of a society. While terrorists murdered a great deal of financial talent in their evil and cowardly acts on September 11, U.S. institutions and the vast majority of its creative talent remain intact.

The end result was a quick reversal of economic fortunes. From one month to the next, Americans stopped and reflected, became resolved about fighting back, and then returned to work as the most productive citizens in the world. Osama bin Laden missed his mark.

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