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By

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America has shown its best side in recent weeks in the efforts to help the victims of the September 11 attacks. And it is showing its strength as it moves to strike back and tighten security at home. Dealing with the economic impact of these horrendous crimes has, appropriately, not been the first priority.

But, of course, the economic impact is important. And finding the right economic response to the crisis is a vital part of showing the terrorists they have not undermined the strength of America and its allies. Americans had believed they were safe from aggression in their own country, but today many feel understandably nervous about the future. Consumer confidence has fallen--according to a CNN/Time poll, 40 percent of consumers plan to cut back on spending and 42 percent plan to cut back travel. Many businesses were directly affected by the crisis, and many others are cautious about new investments.

In this testimony I will look at the state of the economy in the aftermath of the attacks, and at the economic policies that should be used in response to the crisis. Policies must be chosen that meet the needs of the economy for short run stimulus, while at the same time preserve the strong economic fundamentals that have supported the extraordinary economic performance of recent years. In short, how do we get America working again, while maintaining fiscal discipline?

The US Economy was Already on the Edge of Recession. Prior to the attack the economic data were mixed. On the positive side, consumer spending was higher in August and seemed to be proceeding normally in early September. Motor vehicle sales were running at about the same level as in August, and chain store sales were down only slightly. Excess inventories had been sharply reduced. There were some signs the economy was turning the corner. On the other hand, investment remained in a slump, having fallen 15 percent in the second quarter. The August employment report was weak and construction spending fell. Consumer confidence in early September was declining. My own view is that the balance of evidence was negative. Instead of seeing the hoped-for rebound in economic activity, we were already seeing signs of a very weak or even a negative number for US GDP growth in the third quarter. Meantime, US manufacturing has been in recession for some time.

Since the terrorist attacks, a recession in the United States and a broad global slowdown appear to be much more likely. The consensus estimate is for a decline of 0.6 percent in U.S. GDP in both the third and fourth quarters of this year. The amount of the decline in the fourth quarter is very hard to predict, however. The fundamentals of the US economy are sound. There is very little risk that we will fall into the kind of sustained economic weakness that has troubled Japan for a decade. But there is a risk there will be some very nasty economic data for a while. There is a chance of a decline of as much as 10 percent at an annual rate in the fourth quarter of this year. I do not think such a huge decline is likely, but the economy did decline by this amount in the second quarter of 1980 as a result of restraints on credit. If there is a large drop in GDP in the fourth quarter, it would be important to reassure Americans that the decline is a short term reaction and the economy will rebound quickly, just as it did in 1980.

The forecasting group, Macroeconomic Advisers (MA), estimates that the attack destroyed $13 billion of private and government capital. Some industries have been directly affect, notably airlines, hotels and insurance companies. US airlines have announced layoffs of around 89,000 (with 8,000 more at UK airlines). There are also immediate spillover effects from the affected industries. Boeing has announced layoffs of around 30, 000 over the next 12 to 15 months, anticipating that aircraft orders will fall. Many meetings and conventions have been cancelled and tourism is down sharply. Layoff announcements can often be misleading, as they sometimes exaggerate the extent of the net employment reduction that actually takes place. But there is little doubt many companies are in difficulty right now. MA estimates the impact of the attack was to lower economic activity in the third quarter by $24 billion at an annual rate—quite a hit given that the quarter only had three weeks left to run.

The short run impact of the attack is broader than just the industries directly affected. There has been an increase in uncertainty, fostering a desire to wait and see before undertaking major economic commitments. The Michigan consumer confidence survey showed a sharp decline after September 11. It is natural for each individual consumer to react to the uncertainty by holding back on spending decisions, but the impact of such caution by all consumers becomes self-fulfilling, as a drop in total consumption brings on layoffs and rising unemployment. Businesses also react to uncertainty by holding back, and that could slow or abort the needed recovery in capital spending.

So far there has not been much of a spike in oil prices. In fact, prices now have fallen in anticipation of weaker demand, and the pledge by oil-producing countries to maintain stability in the oil market. But the possibility of a disruption of oil supply hangs over the global economy. An extensive conflict could result in a sharp run-up in oil prices. If that happens, the recession will be deeper or longer.

What has been done to counteract the short-term economic weakness? The immediate imperative is to restore confidence and bolster demand and good policies have already been followed to do this. Central banks around the world, notably the Federal Reserve in Washington and the European Central Bank (ECB), have added liquidity to the global financial system. In a crisis, banks can find themselves short of cash or other liquid assets. The Fed and other central banks have allowed private sector banks to borrow cash and reserves more easily to tide them over until they can adjust. The integrity of the banking and financial system has to be maintained and the easing of borrowing requirements will ensure that. The global financial system is wide and deep and can absorb even a body-blow like this one.

Even before the crisis, there was a clear case for interest rate reductions. The Fed had been expected to make further rates cuts, but the ECB, over its short history, has been much less willing than the Fed to act to forestall or offset economic weakness, in fact it only has a mandate to maintain price stability. Following the crisis, however, the ECB came through and joined the Fed in a half percentage point cut in rates. Other central banks also responded. The fact that there was a coordinated response of central banks around the world is helpful to the US recovery.

Fiscal policy will help mitigate or shorten the recession. The US had already enacted a tax cut and mailed out tax rebate checks to millions and a further tax stimulus package is under discussion. The Congress has also passed a $40 billion emergency package of increased spending, available for rebuilding, for the military and for enhanced security needs. And a package of around $15 billion has been passed to help the airlines.

Even though spending weakness will continue in the US through at least the end of this year and probably into the first part of next year, the chances are good that economy will recover next year, even if no further policy stimulus were given. There is a natural pattern to business cycles. In the boom there is over-optimism that results in over-investment and over production. As demand weakens, excess inventories pile up and there is little need for further investment. The traditional ingredients of a recession are slumping investment and falling inventories and both were already evident before September 11 in the current slowdown. But once the inventory overhang has been worked off (I noted earlier the progress in this area) and short-lived equipment wears out or becomes obsolete, production starts to turn back up and investment bottoms out. The US economy is very resilient and bounces back from recessions. Looking at all US recessions since 1945, the average length of downturns has been eleven months, suggesting that recoveries come pretty quickly, unless there is some unusual drag on the economy. Beyond the natural resilience of the economy, the policy steps I have just described will start to take effect. Monetary policy always works with a lag, but the evidence is that it works. Around $20 billion of the $40 billion of additional Federal spending is expected to occur over the next twelve months.

The Importance of Global Growth The US is not the only country experiencing economic problems. Japan is in deep trouble, with not only a declining economy, but also a financial system on the edge of collapse. Europe was holding up better, but forecasts were dropping there too, notably in Germany, which is heavily affected by the world-wide demand for capital goods. A recent report showed Euro area industrial production declined 1.4 percent in July. The newly industrialized Asian economies that rely on exports were facing the collapse of high-tech demand. Latin America was struggling, especially Argentina, and Turkey has had a particularly difficult time.

It is heartening that there was a coordinated response to the economic threat by central banks. But the US must encourage its allies going forward to monitor their economies and take further steps towards stimulus as needed. It is vital at this time that Europe does its best to sustain growth in the face of the new threat to stability. The US has been the locomotive of the global economy for some time and needs help from Europe now. If the downturn worsens, further interest rate cuts may be needed from the ECB. Japan must also take forceful steps to try and recover from its recession. The latest figures on

Japanese industrial production were extremely weak. Japan must address its financial crisis and not become a stone dragging the global economy under water.[1]

Downside Risk The US and other stock markets had weakened substantially before the terrorist attacks, the Dow dropping by about 15 percent from a high in May through September 10. This was depressing consumer spending and weakening consumer confidence. European and other international markets had also been weak and they fell further in response to the attacks. US markets were closed, but once they re-opened, there was heavy selling as the Dow dropped another 14 percent. As this is written some of that sell-off had been reversed, but continued market volatility is likely.

One can make a good case that markets will be very weak going forward, but one can also make a good case that they will recover. The case for recovery is based on the fact that the attacks did very little real damage to the US capital stock or its ability to generate income and wealth. The 90s saw an explosion of new technologies that have greatly increased real economic wealth, both tangible and intangible and these assets have not disappeared. In addition, past experience shows that stock market weakness following crises generally has been rather quickly reversed. This was the case following the Kennedy assassination, the Iranian hostage crisis, the Gulf War, and others. Only the energy crisis of the early 70s was followed by sustained market weakness and that was a different kind of crisis.

Those who believe the market will continue to trend downward, on the other hand, can argue that stocks were probably over-valued before the slowdown and the terrorist attacks. Price earnings ratios were way above their normal historical range, built on the belief that profits would grow at extraordinary rates in the future. In this view, the economic slowdown combined with the terrorist attack has provided a reality check that will reduce market values for some time to come.

In short, no one knows how the market will play out, but it is at least possible there will be sustained market weakness or volatility. Markets have a tendency to ‘overshoot,’ moving too high in good times and too low in bad times. They may overshoot on the negative side in the current crisis and consumer and business confidence and spending would be hurt further in that event, and contribute to deeper or longer slowdown.[2]

Because of stock market weakness or for other reasons (such as oil price increases), the recession may turn out to be more severe than expected. And the question then becomes, what should be done about this risk. Should further expansionary monetary and fiscal policies be used now, or should we hold off?

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[1] Adam Posen has described the decisive actions Japan should take to deal with its financial crisis, see “Japan 2001—Decisive Action or Financial Panic,” *International Economics Policy Brief, Number 01-4,* Institute for International Economics, Washington DC, March 2001.

[2] The stock market and the economy are inter-related. If the stock market improves, this will help the economy recover. If the economy recovers, this will help the stock market improve. Causality does not just run from the market to the economy.

Monetary policy could do more if needed, by making further interest rate cuts. The danger of inflation seems very low, especially as slow growth around the world is depressing prices. Monetary policy has been an outstanding contributor to the growth and stability of the US economy and will surely continue that role if the going gets tougher. We can have confidence that the Fed will take whatever additional policy actions are needed.

An Additional Fiscal Stimulus Package I have mixed feelings about whether an additional fiscal stimulus should be given to the economy right now. On the one hand, such a package would provide an insurance policy against a deeper or longer recession than expected. On the other hand, there is a serious danger of undermining fiscal discipline over the long term and undercutting the policy stance that has worked so well over the past decade. I would prefer to wait a few weeks or so to see how the economy moves before actually passing the package, but it makes sense to put a stimulus package together now and have it ready to go.

A stimulus package should be designed to achieve the following goals. First, the tax cuts or spending increases should go into effect quickly. Second, they should either have sunset provisions or be consistent with long run fiscal goals. Third, the package should put money in the hands of those who will be most likely to spend it. The size of the package should be adjusted depending on the severity of the situation as it emerges over the next few weeks or beyond. Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Rubin have suggested that a total fiscal stimulus of $100 billion in FY 2002 may be needed. Given that roughly half that amount is already in the pipeline, the additional package should be designed initially to be around $50 billion. Perhaps another $30 billion of provisions should be debated, if it turned out that they were needed.

On the household side, I favor tax rebates targeted at moderate-income taxpayers, including those who pay payroll taxes but did not receive a rebate, or received only a partial rebate, in the first round. This would be seen as equitable and it would not create problems for fiscal discipline down the road. It would give money to families with low and moderate incomes that would likely spend most of it. I could also support the temporary sales tax rebate proposed recently by Alan Blinder. The advantage of this proposal is that it encourages people to spend now while the tax cut is in effect. Giving additional tax rebates is not a sure-fire solution to economic weakness, but it would help.

In a time of crisis it is important to achieve agreement and be ready for action. This is why I am suggesting tax rebates as the first priority. But if the political environment is receptive, it would also be appropriate to take a look at the social safety, which will become more important with a heightened risk of recession. One way to sustain consumer confidence is to make sure families are protected if job loss does occur. The unemployment insurance program is currently serving only a fraction of the unemployed and needs to be shored up. Workers are scared that their families will lose health insurance coverage if they lose their jobs, so COBRA and Medicaid programs should be re-examined to make it easier to retain adequate coverage. Even in the economic boom around 40 million Americans lacked health insurance coverage and a serious recession could easily make that problem worse.

A good policy that has been under discussion and that would support the safety net is wage insurance. Many workers who are laid off are able to take new jobs at wages that are comparable to or even higher than the wages they lost. But a significant fraction of laid off workers suffer substantial wage loss in new jobs, and many are discouraged from taking new jobs because they would have to accept lower wages. Under a wage insurance program, the Federal government pays workers a fraction of the difference between the wages they earn on a new job and the wages they were paid on their old job for a period of time. Such a program would cushion the blow of layoffs that are now taking place and would encourage laid off workers to take new jobs.[3] Wage insurance is a controversial policy and it may be hard to introduce quickly in a short run package, but it is a policy that has much to commend it in good times, and would be very helpful now that layoffs are a greater threat.

On the business side, there is a case for a temporary investment stimulus. This could be either an investment tax credit or a provision to allow the expensing of certain categories of equipment that, under current law, must be depreciated over time. I do not feel strongly about which of these two approaches is better. Either approach would get an influx of cash into the hands of companies that are investing. Paradoxically, a temporary investment stimulus would be more effective than a permanent one. We would be saying to companies: Invest over the next year and get a tax break. If you put off the investment until later, the tax break will be gone. A tax provision like this would not persuade companies to invest if they already had excess capacity or were near bankruptcy. But there are always bright spots even in a weak economy, and so some companies would decide to upgrade their computers or buy a new fleet of autos this year rather than waiting until next year.

Policies that would not be effective in stimulating the economy include a capital gains tax cut or a cut in the corporate tax rate. Neither policy has been shown in econometric studies to provide much stimulus to investment. For example, a recent study from the Congressional Budget Office estimated that reducing the top tax rate on capital gains from 20 to 15 percent would have almost no impact on private saving and economic growth.[4] A cut in the capital gains tax could even have the perverse effect of encouraging people to sell stocks and lead to further stock market declines.

A permanent reduction in the corporate income tax would be very expensive, in terms of the long run loss in revenue, relative to any stimulus effect it might have on the

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[3] This proposal is described by Lori G. Kletzer and Robert E. Litan in "A Prescription to Reliever Worker Anxiety," *International Economics Policy Brief, Number 01-2,* Institute for International Economics, Washington DC, February 2001.
[4] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," CBO Memorandum, August 1998.

economy.[5] In particular, it would take a large, expensive rate cut to give a significant boost to the stock market, and hence consumption.[6]

I am not in favor of accelerating the provisions of the tax cut package passed earlier this year. However, if accelerating some of the tax cuts is to be part of a compromise needed to achieve passage of a stimulus package, I would emphasize provisions that provide the most assistance to moderate income families, rather than the upper bracket rate cuts and estate tax provisions which affect only a small group of taxpayers.

Preserving Fiscal Discipline We should not abandon budget targets over the longer term. The US faces pressing budget problems in the future as the baby boom generation moves into retirement. It is vital to keep paying down the national debt while the opportunity is there, before facing the massive increases in pension and health care costs that are looming on the horizon. Saving the Social Security surpluses and even the Medicare surpluses was a good idea. In addition, it is important for the US to increase national saving in the long run and reduce its foreign borrowing. Running budget surpluses will help do this. Good policy, in short, means easing the constraints on budget policy this year and next, but simultaneously re-examining the long run budget prospects and looking for ways to preserve long term fiscal discipline.

Even before the September 11 attack the Congressional Budget Office had issued a new set of budget projections with sharply lower estimates of the surpluses. Since that time and since the attack, the prospects for a weak economy are far greater in the short run and the uncertainty about the long run growth prospects has increased. In addition, sharply higher spending on defense and security are in prospect for years to come. The short run stimulus package, while it may be necessary, will have some adverse effect on the budget outlook even over the long term, because it raises the national debt and the interest burden.

The danger of undermining fiscal discipline has already been seen in financial markets. Long term interest rates had declined in recent weeks with the slowing economy. Following the terrorist attacks, there was a sharp increase in the yield on 30-year Treasury bonds (see attached figure). This does not appear to have been the result of an increase in expected inflation (judging from the behavior of indexed bonds). Rather it expressed concern that long term budget discipline may have been undermined. The yield has fallen back subsequently, but remains higher than before the attacks. This is striking given that short term interest rates have fallen further and most forecasters have reduced their estimates of economic growth.

The Federal reserve has cut short term interest rates to stimulate the economy. In order for these cuts to have their full benefit, long rates must come down also. To achieve this, policymakers should re-affirm their commitment to fiscal discipline. This would help

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[5] See Joel Friedman and Iris Lav, “A Permanent Corporate Tax Rate Cut: The Wrong Medicine for Short-term Economic Ills,” Center for Budget and Policy Priorities, September 26, 2001.

[6] See William Gale, Peter Orszag and Gene Sperling, “Notes on Tax Policy in the Aftermath of the Terrorist Attack, *Mimeo,* September 28, 2001.

stimulate the economy today. Any fiscal stimulus package should be viewed in the context of long run budget goals. Wars are expensive and this war on terrorism will be expensive for years to come. We should expect that if we spend more now and in the future and if we also give more tax cuts now, then there will be less money available later. I would favor preserving the Social Security surpluses in future years even if we have to put on hold some of the permanent tax cuts. If the economy comes back very strong and there is more money available, then there is nothing to stop us from restoring the tax cuts.

Productivity and the Peace Dividend There is discussion today of the possible adverse effects on productivity of the increases in government spending. The peace dividend, it is argued, was a reason for the rapid growth of productivity in the 1990s. Yes and no. The surge in growth was heavily driven by technological advance. The decline in military spending did help make room for the increase in capital spending that, in turn did indeed contribute to productivity growth. However, *provided we preserve fiscal discipline* there is no need to sacrifice long run growth for greater security. We just need to make sure we pay for the increased spending. If we continue to run budget surpluses and pay down the debt in the years ahead, this will keep interest rates low and encourage investment once the economy recovers. If we allow the surpluses to erode, interest rates will be higher and investment will be lower.

Conclusion The destruction and loss of life at the World Trade Center and the Pentagon have been a terrible blow to the US and to the world. We should do our best to minimize the collateral damage to the US and the global economy.

- In the short term, some economic weakness is very likely. Predictions for US GDP in the fourth quarter are all over the place. We should be braced for bad news, just in case.
- The Federal Reserve and other central banks have acted quickly to preserve the financial system and lower interest rates to spur spending and investment. Monetary policy does work, given time.
- Other countries, and Europe specifically, should step up to the plate and help sustain global growth through the use of further expansionary policies as needed.
- The tax cuts already in place, and the increased spending coming on stream, will provide a substantial fiscal stimulus to the US economy.
- Based on the experience of prior cycles and given the expansionary monetary and fiscal policies already in place, we can expect a recovery by next year.
- It is worth having in hand a further fiscal stimulus package, either for use now as an insurance policy, or for use later if conditions deteriorate further than expected. The package should include further immediate tax rebates, including rebates for those who missed out on the last round. It should include an investment stimulus, either a temporary investment tax credit or a temporary provision to allow the expensing of equipment. Temporary tax cuts can be effective--spend now or lose the tax cut.

- The social safety net has become more important and needs to be shored up. Wage insurance would be a good policy. A capital gains tax cut or a cut in corporate incomes taxes would not be cost-effective in stimulating the economy.
- There is pressure to accelerate the tax cuts already passed. If this is done, move first on the cuts that help moderate-income families. Most importantly, however, let's not lose sight of fiscal discipline. It worked in the 90s and should be preserved once we get through the immediate crisis. Any stimulus package should be evaluated in the context of long run fiscal discipline.