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Economic Performance and Policy Following the Terrorist Attacks

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The economy, struggling to emerge from a cyclical slump and partial reversal of the earlier business investment boom, now faces a near-term contraction generated by the negative shock of the recent terrorist attacks. Aggressively stimulative monetary and fiscal policies point toward rebound beginning in early 2002. The result will be a V-shaped pattern in economic performance. The Federal Reserve's appropriate dramatic infusion of liquidity to ensure efficient functioning of the banking system and capital markets following September 11 and subsequent lowering of its Federal funds rate target eventually must be reversed to avoid long-run inflation risks. Federal budget conditions and the thrust of fiscal policy are changing dramatically with the negative economic impact and new initiatives in response to the terrorist attacks.

- Real GDP, which grew at less than a 1 percent annualized pace in the first half of 2002 and likely declined in 2001Q3, is forecast to contract sharply in 2001Q4 and stabilize in 2002Q1 before rebounding to a healthy pace. Sharp near-term declines in consumption and demand will generate further reductions in production and employment, pushing up the unemployment rate, and elongate the inventory adjustment process. Corporate profits will fall dramatically through year-end, and the higher costs of capital will reinforce double-digit declines in business investment.
- Potential economic growth remains approximately 3 percent, and aggressive monetary and fiscal stimulus, along with lower energy prices, will generate accelerating demand and push GDP through its trendline growth in the second half of 2002. The result will be V-shaped economic performance.
- Headline inflation will fall with recent declines in energy prices, while core inflation will drift lower into 2002 in lagged response to softening demand, but the risk of renewed increases in long-run inflation has increased.
- The near-zero real short-term interest rates and sharply steeper yield curve accompanying the Fed's aggressive easing and anticipated near-term economic contraction eventually will reverse as short-term interest rates rise with signs of economic rebound.
- The federal budget now is forecast to be in deficit in Fiscal Years 2002 and 2003, reflecting the negative impacts of deteriorating economic conditions on tax receipts, newly authorized spending for emergency relief and national security, and the likely enactment of a new fiscal stimulus package. Any new fiscal initiatives should avoid short-term "quick fixes" that tend to fail in their objectives, and focus on permanent changes that enhance incentives in the short run and are consistent with long-run national priorities.

Assessing the economic impact of crises and shocks always requires wide confidence bands, and this episode has added uncertainty relating to the perceived threat to national security. Typically, the economic impact of crises is relatively short-lived, and the outlook for long-run potential growth is largely unaffected. Certainly there are risks that consumer spending and business investment decline for a sustained period. Amid widespread pessimism, however, several factors suggest that there are equal risks that the economic rebound will be more robust that commonly believed: the banking structure is sound and well capitalized; business inventory liquidation was already far along on September 11; monetary policy was stimulative leading into the crisis and the Fed's subsequent aggressive funds rate reduction has shifted that stimulus into high gear; the Economic Growth and Tax Relief Reconciliation Act of 2001 is being augmented by large increases in government purchases and more fiscal stimulus; and energy prices have fallen significantly.

Economic Conditions

Prior to September 11, economic growth was anemic, with modest growth in consumption but significant declines in industrial production, inventories and business investment, along with sharp declines in corporate profits. The negative shock associated with September 11th will generate a near-term contraction in economic activity, lowering and pushing out the trough in GDP. However, the current situation is far different from the 1990-1991 recession associated with the Gulf War. In mid-1990, when Iraq invaded Kuwait, economic conditions were stronger than presently, but the banking system was very fragile and grossly undercapitalized, the Fed’s monetary policy was too tight (the Fed had been lowering the funds rate grudgingly, which resulted in declining real money balances), the Bush (Senior) Administration and Congress were heading toward a compromise tax hike, and oil prices doubled from $20 to $40 per barrel. Aside from the current perceived threat to national security, in key respects conditions are far more favorable.

The jarring shock of September 11th will materially reduce consumer spending and business investment. Consumption is expected to fall sharply in September and October, and stabilize toward year-end. The negative influences of falling confidence and stock prices and job losses will be partially mitigated by lower interest rates (mortgage refinancings have soared since September 11, primarily in adjustable rate instruments) and lower oil prices. The decline in consumption in September will flatten 2001Q3 growth from its earlier 2.5 percent annualized pace, and combined with anticipated receding sales in October, will generate 3-3.5 percent annualized consumer spending decline in 2001Q4. Motor vehicle sales in September fell a less-than-expected 2.5 percent to a 15.9 million average pace, but even with aggressive sales incentives, further weakness is expected in October. Anticipated declines in housing activity will contribute to soft consumption of household durable goods. Consumption of services such as business and personal services will fall temporarily. Real consumption is expected to rebound modestly in 2002Q1.

The recent double-digit declines in business investment are projected to continue into early 2001 as a consequence of the near-term economic contraction, even deeper-than-previously-expected declines in profits, and higher costs of capital associated with the lower stock valuations and higher corporate bond yields. Accordingly, the share of business fixed investment of GDP, which had increased from 9.6 percent in 1990 to 14.6 percent in 2000, will continue to recede.

Ten consecutive monthly declines in industrial production combined with aggressive sales subsidies had resulted in three quarters of rapid liquidation of undesired inventories, and signs of stability recently had begun to emerge in the manufacturing sector. The anticipated decline in consumption will result in renewed increases in undesired inventories, elongating the inventory adjustment process. Production will be cut until demand picks up, and rebuilding desired levels of inventories is not expected to resume until Spring 2002.

The unemployment rate, which has risen from a low of 3.9 percent to 4.9 percent, now is projected to rise to approximately 5.75-6.0 percent. Prior to September 11, employment and aggregate hours worked were falling at a rapid pace, particularly in manufacturing: during June-September, declines in manufacturing payrolls of 308,000 resulted in 265,000 job losses in nonfarm payrolls. As an early indication of the near-term impact of the terrorist attacks on labor markets, initial unemployment claims surged 34 percent to 528,000 in the two reporting weeks following September 11.

The net export sector is expected to have only a minor impact on GDP, as both exports and imports decline with temporary reductions in worldwide trade. In the last year, exports fell 6.5 percent, and that pace is expected to accelerate with softer worldwide demand. However, further sharp declines in capital spending will accentuate the impact of weak domestic demand on imports, resulting in a stable to modestly reduced trade deficit.

Nominal GDP, which had accelerated to 7.6 percent growth in the year ending 2000Q2, decelerated sharply to 3.5 percent growth through 2001Q2. This trend reflects the combination of a cyclical slump and structural reversal of the earlier capital spending boom, both a consequence of the Federal Reserve's earlier monetary tightening (through Spring 2000, as the Fed hiked its Federal funds rate target, money growth had slowed sharply and the yield curve inverted), higher energy prices, and sharp declines in the stock market. With the GDP deflator rising 2.3% in each of the past two years, all of the slowdown in nominal spending reduced growth in real output (from 5.2 percent to 1.2 percent).

Now, with the negative shock to the economy, nominal GDP is projected to rise only fractionally in the second half of 2001, with real GDP declining fractionally in 2001Q3 and approximately 1.5-2.0 percent annualized in 2001Q4. Increases in current dollar spending and real output are projected to resume in 2002Q1 as the economy begins to stabilize.

Factors Point to Rebound in 2002

Aggressive monetary and fiscal stimulus, along with lower oil prices, and the sound underlying structure of the economy following a period of adjustment to a slower growth pace, are expected to generate a marked pickup in aggregate demand in 2002 and push economic growth above its trend line by the second half of the year. Importantly, the banking system is sound, well-capitalized and liquid, and aggressive inventory liquidation already had established the base for a rebound in production in response to a pickup in demand.

Prior to September 11, monetary thrust was accommodative. The Fed had reduced the funds rate from 6.5 percent to 3.5 percent, money growth had accelerated (from December 2000 through early September, MZM had grown 19.4 percent annualized and M2 10.3 percent) and the yield curve had steepened significantly. Following September 11, the Fed infused liquidity at an unprecedented pace. Amid crisis and immediate disruptions to the payments system and settlement problems, this was an appropriate and necessary response in order to ensure the safety

and soundness of the banking system and smooth functioning of capital markets. Most of the dramatic surge in money growth is in the process of washing out as the crisis-related settlement problems dissipate. While the negative shock to the economy temporarily lowers the natural rate of interest, the 1 percentage point reduction in the funds rate to 2.5 percent (50 basis points each on September 17 and October 2) represents more aggressive monetary stimulus, with expected significantly faster trajectory of money growth. In the near term, the demand for money will increase and money velocity will fall in response to lower interest rates. With a lag, accelerating money supply will generate a reacceleration of aggregate demand.

In fiscal policy, the Economic Growth and Tax Relief Reconciliation Act of 2001 has been followed by Congressional authorization of rapid increases in government purchases and spending, and an additional package of tax cuts and spending increases is now being debated.

The tax cuts are unambiguously positive for economic growth, supporting activity in the short run and modestly lifting long-run potential growth. Approximately $40 billion was distributed in July-August, and tax relief of $70 billion (0.7 percent of GDP) in 2002 (the largest amount will be generated by adjustments to withholding schedules effective January 1, 2002) will be followed by modestly larger amounts in succeeding years. The tax cuts have several shortcomings that limit their positive contribution. Firstly, the cuts in marginal tax rates on the last dollar of income for the majority of taxpayers are relatively modest, which constrains positive supply side responses: of the estimated $1.35 trillion in tax relief over 10 years, approximately $875 billion is generated by cuts in marginal rates, but nearly one-half of that is attributable to the rate reduction in the lowest tax bracket from 15 percent to 10 percent, retroactive to January 1, 2001, while the rate cuts to the higher 4 brackets are much more modest and implemented more gradually (they were reduced one percentage point effective July 1, 2001 but are not scheduled to be reduced again until 2004). Secondly, the lengthy phase-in of the tax cuts may also delay the economic responses. Thirdly, the final structure of the tax cut legislation, with selected sunset provisions put in place to comply with artificial budget constraints imposed by Congress and complex transition rules that provided some retroactive tax relief, sapped credibility and may temper the positive economic impact.

Whether the tax cuts are perceived to be temporary or permanent influences their economic effects. The impact on spending of the tax cuts in 2001 may have been constrained to the extent the July-August cash disbursements were perceived as one-time rebates rather than advances on retroactive tax cuts provisions. Scheduled changes in tax withholding in 2002 presumably should provide a greater sense of permanence; however, anticipated sizeable increases in government spending and the dramatic deterioration in budget conditions may give the impression that some future scheduled tax cuts may be reversed. Expected permanent increases in defense spending since September 11 and associated diminished expectations of future budget surpluses underline that point. This perception may temper the portion of the increases in disposable income that is spent.

Since September 11, Congress has authorized $40 billion in additional government spending for emergency relief and national security and $15 billion more for financial subsidies to the airline industry. Outlays for defense and emergency relief, which will largely be counted in government purchases and add directly to GDP, likely will be significantly larger than the authorized amount--perhaps double. (To put the amount into context, the Gulf War in 1990-1991 cost approximately $60 billion, of which most was reimbursed to the U.S.) The government's financial subsidies, such as those to the airline industries, are not counted in GDP.

A $100 billion rise in government purchases during 2001Q4-2002Q4 would add 1 percent to GDP; faster spending in the near term would magnify annualized additions to GDP.

Amid debate about an array of new fiscal stimulus measures, the Bush Administration has proposed an additional $60-$75 billion in tax cuts and spending increases geared specifically to lift the economy from anticipated near-term recession. While program details have not been determined, a package of this approximate amount likely will be enacted.

Oil and energy prices have fallen significantly following September 11, reflecting declining worldwide demand and the market's expectation that supplies will not be disrupted. Insofar as demand for energy is relatively price inelastic in the short run, these price declines increase consumer purchasing power for non- energy goods and services and reduce business operating costs. If the lower prices stick, they represent a positive for the economic outlook. As a benchmark, wide swings in oil prices have had large impacts on recent economic performance: the sharp decline in oil prices following the 1997 Asian crisis contributed to the economic boom in 1998-1999, while the dramatic rise in oil and energy prices in 1999-2000 has been a drag on economic activity.

Financial market responses to the crisis have been predictable: a sharp decline in short-term interest rates and steeper yield curve reflecting flight-to-quality and expectation of near-term economic contraction and Fed easing; wider yield spreads on corporate and mortgage-backed bonds over Treasuries; and falling stock valuations. The U.S. dollar has fallen only modestly, reflecting in part the continued serious structural difficulties in Japan, deterioration in economic performance in Europe and elsewhere, and heightened global uncertainty. These factors mitigate the relative decline in expected rates of return on investment in U.S. dollar-denominated assets. Real short-term interest rates are near zero and heading into the negative territory. While such levels are consistent with low expected rates of return on investment associated with recessionary conditions, they are inconsistent with sustainable trendline growth. Short-term rates will rise and the yield curve will flatten with signs of economic rebound.

Fiscal Policy and Budget Conditions

Prior to September 11, the quality of the fiscal policy debate had deteriorated into partisan misstatements about surpluses, tax policy and the social security trust funds. Record-breaking surpluses had been reduced by the economic slump, and some policymakers questioned the merits of The Economic Growth and Tax Relief Reconciliation Act of 2001, particularly as it seemingly impinged on social security financing. The politics of surpluses generated just as many misunderstandings as the politics of deficits. The tragic events of September 11 have radically changed the political environment and the thrust of the fiscal policy debate, as well as budget conditions. In the current uncertain circumstances, while the particular size of the budget surplus or deficit carries little economic significance, the allocation of national resources and how it is affected by tax and spending programs remains crucial. Policymakers must avoid fiscal "quick fixes" that will not have their intended effects and are only wasteful or generate inefficiencies, and focus on policies that are consistent with longer-run national priorities.

Comments on the Tax Cuts and Federal Finances. By Fiscal Year 2000, tax receipts had risen to their highest share of GDP in over 50 years, and the budget surplus had reached an all-time high. Based on commonly accepted assumptions, projections of surpluses rose dramatically, pointing toward a full paydown of all publicly-held debt. Barring extreme and unsustainable trends in the public debt, there is no magical size of a budget imbalance--surplus or

deficit--that is best for an economy; more important are the tax and spending structures underlying any budget imbalance, and their implications for the allocation of national resources and economic performance. The tax relief provided by the 2001 legislation was relatively small compared to estimated GDP growth during its 10-year implementation and even assuming no economic feedback, which is unreasonable, tax receipts would remain above their average long-run share of GDP throughout the projection period.

Cutting through the rancorous and largely misguided debate about social security financing, the tax cuts have little implication for social security or important questions about the program's long-run structure: the social security trust funds exist only as book accounting entries, and have no budget or economic meaning. All tax receipts, whether generated from personal or corporate income taxes, excise or estate and gift taxes or FICA contributions, go into the government's general fund, and all government spending, including social security benefits, is disbursed from the general fund. For years the accounting entries in the social security trust funds have been shuffled around to provide the illusion of solvency, even though social security's unfunded liabilities are huge. Ironically, the recent debate about "lock boxes" made transparent the eventual need for general funds to shore up the trust funds, which itself is inconsistent with traditional precepts of social security financing. The bottom line is that the government will meet its obligations to pay social security benefits whether or not the trust funds exist, so the separate accounting of social security only confuses the fiscal policy debate; it has even muddled the debate about social security reform. The dramatic change in the fiscal debate since September 11 ironically has temporarily tabled the social security financing rhetoric.

Post-September 11 Budget Conditions. The negative impact of the near-term economic contraction, acceleration of government spending authorized immediately following September 11, and anticipated enactment of an additional fiscal stimulus package will culminate in a dramatic reversal from record-breaking surpluses to budget deficits in 2002 and 2003. The longer-term budget outlook has also deteriorated significantly. Precise estimates hinge on the shape of the economic rebound and the degree to which new fiscal initiatives are temporary or become permanent.

Even if the economy rebounds from contraction in the second half of 2001, growth in 2001 will fall to near 1 percent and below 1.5 percent in 2002, and the unemployment rate will rise to approximately 5.75-6 percent and linger there through 2002. This will reduce tax receipts by approximately $70 billion in 2002 and raise outlays for unemployment compensation and income security programs. Congress already has authorized $40 billion for emergency relief and national security and financial subsidies for the airline industry, but actual spending likely will be dramatically higher. Including the Bush Administration's fiscal proposal, new spending increases and tax cuts likely will exceed $130 billion. With a wide confidence band, the cash flow budget may run $25-$50 billion deficits in 2002 and 2003.

Longer-run budget projections also will be changed significantly. A large portion of the funds allocated for emergency relief will be one-time outlays, but permanent sizeable increases in defense spending are expected. Moreover, past experience suggests that some of the spending initiatives presently viewed as temporary will be difficult to 'un'-appropriate, and become permanent. The shift in defense spending is the most striking budgetary change. From 1989 to 2000, defense spending was reduced sharply, and its share of GDP fell from 5.6 percent of GDP to 3.0 percent, its lowest in recent history. Those reductions generated over half of the decline in federal spending as a percentage of GDP during the period. Anticipated permanent increases in defense and national security spending will reverse that trend.

Significant changes in the path of government spending and tax receipts resulting in several years of budget deficits imply an abrupt end to the recent declines in the publicly-held debt. In 2000, the public debt had receded to $3.4 trillion, or 34.7 percent of GDP, from its peaks of $3.8 trillion in 1997 and 49.5 percent of GDP in 1993. Depending on the long-term pattern of interest rates, this halt in the reduction of publicly-held debt will accentuate the deterioration in the budget outlook, particularly for longer-term projections, since in earlier projections, the gradual elimination of the publicly-held debt had generated an elimination of net interest outlays.

New Tax and Spending Initiatives. In the current environment, there is little opposition to the rush toward short-term fiscal stimulus. Amid Congressional debate about a wide array of spending increases and tax cuts, the Bush Administration has proposed a package totaling $60-$75 billion above new spending already authorized. While the initiatives may be well intended and some additional steps may be sensible, the risk is that fiscal "quick fixes" historically have not been economically effective. Further, fiscal policymakers risk launching a wasteful spending spree that may be hard to control and harmful to long-run economic performance. Similarly, targeted tax cuts geared toward short-run concerns tend to tarnish the tax structure and distort economic activity without achieving their intended effects. Consideration must be given to the nature of the problem and longer-run national priorities.

The timing and magnitude of economic responses to fiscal stimulus are highly uncertain and raise doubts about attempts to use fiscal policy for short-run stabilization. Historically, "quick fix" fiscal stimulus has not worked, either because the policies were poorly structured or the economic response came too late. Moreover, the size of the fiscal package measured by changes to the surplus (deficit) is a notoriously unreliable indicator of fiscal thrust; *ex ante* fiscal policy "multiplier" analysis is equally unreliable. Current circumstances are particularly tricky, as the magnitude and duration of the impact of the negative economic shock is largely psychological relating to international conflict and terrorism; this heightens uncertainty about the efficacy of short-run fiscal stabilization. In these circumstances, any additional new spending should be carefully justified, and the impulse to abandon fiscal discipline should be avoided. Any new tax cuts should be permanent changes to the tax code that avoid the distorting allocative effects of deductions, exemptions or credits for specific types of activities or temporary "quick fixes".

Although caution is encouraged, speeding up implementation of the personal tax cuts scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001 would lower marginal rates, raise disposable income, highlight the permanence of the tax cuts, and remove any near-term disincentives to spend in anticipation of future rate cuts. Permanent reductions in payroll taxes would lower the marginal tax rates for the most workers, raise disposable income and spread the tax relief evenly. While increasing the unfunded liabilitities of the social security trust funds, this also would splash some cold reality on the illusory nature of social security accounting. One-time rebates, such as against payroll taxes, while increasing disposable income, would provide no economic incentives, and their temporary nature would limit their short-run economic boost. Special deductions, exclusions and credits for specified activities, particularly temporary ones, tend to change the mix or timing of spending but not the magnitude; also, by suggesting the short-sightedness of fiscal policymaking, they encourage a tax-driven mentality and reintroduce misguided distortions of the past.

Attempts to raise investment should involve raising expected after-tax rates of return on new investment. Permanent reductions in corporate tax rates would increase expected rates of

return on investment and also would diminish the double taxation of dividends and the distorting effects of corporate taxes. Cuts in capital gains taxation would raise returns on existing capital as well as new investment. Temporary cuts or credits would influence the timing and mix of investment decisions but would not address the factors underlying the reversal of the earlier investment boom. While a permanent capital gains tax cut would increase expected rates of return, with positive impacts, a temporary measure may generate tax selling with adverse effects.