# The Economic Outlook and Monetary Policy Before and After September 11, 2001

Presentation to the
Oklahoma Economic Forums

Sponsored by
Federal Reserve Bank of Kansas City

October 2001

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Thank you, it's a pleasure to be back in Oklahoma. And I appreciate this opportunity to talk about the national economy and monetary policy. I must say, though, I have a very difficult assignment this evening. The tragic events of September 11 have created considerable uncertainty about the national economic outlook, and we have little evidence in the form of newly released economic statistics to help us figure out the near-term course of the economy. In addition, because there is nothing in our recent economic history that remotely captures the extraordinary nature of the terrorist attacks on New York and Washington and the resulting shock to financial markets, the past may not be not be particularly useful in helping us predict the future.

What I would like to do today, in examining the economic outlook and monetary policy, is compare the state of affairs before and after the terrorist attacks. This should provide some understanding of where we might be headed. What I would like to emphasize in my talk, however, is that while many things have changed, *everything* has *not* changed. Clearly, the near-term outlook has deteriorated since September 11. But, the long-term outlook for the U.S. economy remains very positive.

So my talk has three parts. First, what did we know about the outlook before September 11? Second, how have the terrorist attacks changed the outlook and what was the Federal Reserve's response? And third, why am I still optimistic about the longer-run prospects for the U.S. economy?

The economy before September 11

Before September 11, economic growth had already slowed rather dramatically. Real GDP, which grew at a rate of over 4 percent per year from 1996 to 1999, slowed to a 2.8 percent rate of growth last year and to a meager 0.8 percent annual rate of growth in the first half of this year. Unemployment, which had reached a low of 3.9 percent last year, had edged up to 4.5 percent in July. Then, in August, unemployment rose sharply to 4.9 percent. And with the increase in unemployment, consumer confidence fell from its record highs.

The slowdown resulted from unexpectedly sharp increases in energy prices and from a re-evaluation of the prospects for corporate earnings, especially in the high-tech sector. Higher energy costs squeezed profit margins and reduced consumers' disposable income. At the same time, the stock market correction reduced consumer wealth and, through a negative

wealth effect, contributed to a slowing in consumer spending. As inventories built up on producers' shelves and on the showroom floor, manufacturers cut production. Little help came from our trading partners abroad as their economies softened simultaneously with ours.

But the news was not all bad. In fact, some evidence suggested that, by the beginning of September, the economy may have been bottoming out. Energy prices had fallen back to more normal levels, the tax rebate had boosted personal disposable income considerably, and consumer spending was holding up. In the manufacturing sector, activity continued to decline, but at a significantly slower rate. For example, the overall production index from the National Association of Purchasing Managers rose sharply in August, and the index for new orders actually showed an increase in orders for the first time since last year.

In addition, monetary policy had been eased aggressively over the course of the year. In particular, the Federal Reserve lowered its target for the federal funds rate—the rate banks charge each other for overnight loans of reserves—from 6 ½ percent at the beginning of the year to 3 ½ percent in

August—a full 300 basis points. Foreign central banks also cut their official rates.

Putting it all together, most economic forecasters before September 11 expected the economy would avert a recession and rebound in the fourth quarter. The Blue Chip Consensus forecast—an average of the forecasts of leading professional economists—indicated that real GDP would grow at a 1.6 percent rate in the third quarter and at a 2.6 percent rate in the fourth quarter. Next year, the consensus called for growth above 3 percent.

The economy immediately after September 11

Of course, many things changed on September 11. Clearly, the immediate impact of the terrorist attacks was negative—from disrupted retail sales, curtailed air travel, and cut backs in production. People focused on the tragedy and withdrew from many everyday economic transactions. These immediate effects alone will reduce third quarter output noticeably from earlier projections.

In the Tenth Federal Reserve District, most of the immediate economic impact from the terrorist attacks was concentrated, as you would expect, in the travel and tourism sector and in the retail sector. Along with

reduced pleasure and business travel, many conventions were cancelled or rescheduled for later in the year. Denver and Albuquerque both saw cancellations of major conventions. In the retail sector in the 10th District, most stores closed on September 11 and experienced slower than normal sales the rest of that week. Although sales recovered somewhat by weekend, they were still below normal. Department stores, furniture stores, and appliance dealers suffered the biggest declines while large discount stores, grocery stores, and hardware stores experienced relatively minor declines in sales. While fast food restaurants did good business, sit-down restaurants saw a significant fall off in business. Auto sales came to a standstill immediately after the attack, but gained strength later in the week.

In the manufacturing sector, the effects were less pronounced. Although a number of manufacturing plants reported lower productivity because of low worker concentration, very few shut down completely. A number reported problems getting inputs from suppliers because of the disruptions to the nation’s transportation system, both in the air and at the border along major north-south surface transportation routes. Most manufacturers are taking a “wait and see” approach and have not changed

production plans, although some production may have been shifted from the third quarter to the fourth.

The immediate monetary policy response

Monetary policy responded quickly to the crisis by supplying an unprecedented amount of liquidity to the financial system. Discount window borrowing on September 5, the Wednesday before the attack, totaled $195 million. On the day after the attack, September 12, it peaked at a record $45.6 billion, and a week later it had receded to $2.7 billion.

On the day after the attack, the Open Market Desk at the Federal Reserve Bank of New York injected $38 billion in liquidity through overnight repurchase agreements. By Friday September 14, RPs peaked at a record $81.25 billion; a week later, they totaled a more typical $1 billion.

In addition, the Federal Reserve established or expanded swap lines, totaling $90 billion, with the European Central Bank, the Bank of Canada, and the Bank of England to facilitate the provision of dollar liquidity to European, Canadian, and British banks.

Importantly and more basically, the Federal Reserve remained open and operating in the aftermath of the attacks to ensure the continuation of

vital payment services, including electronic transfers, check processing and currency distribution.

On a longer-term basis, the Federal Open Market Committee—the Fed's principal policymaking body—further eased the stance of monetary policy. On September 17, before the reopening of the stock markets, the FOMC lowered the federal funds rate target and the Board of Governors lowered the discount rate by 50 basis points.

Then, on October 2, the FOMC again lowered rates another 50 basis points. The federal funds rate target, at 2.5 percent, was reduced to the lowest level since the 1960s. The discount rate, at 2.0 percent, was reduced to the lowest level since the 1950s.

Partly as a result of the Federal Reserve's prompt actions, financial markets appear to now be operating smoothly.

Longer-term impact of the attacks

What about the longer-run economic impact of the attacks? Well, this is the part that gets very uncertain and speculative. We are very much in uncharted territory. As I said at the outset, there are no adequate historical precedents on which to base a medium term forecast for the national

economy. The closest previous event to the terrorist attacks is probably the attack on Pearl Harbor in 1941. But that is such a distant event, involving a well-defined enemy and in a very different economic environment, that drawing lesson from its aftermath is not likely to be helpful. Likewise, other historical events, like the Cuban Missile Crisis or the Iraqi Invasion of Kuwait or even the Russian debt default in 1998 in the wake of the Asian financial crisis, fail to adequately characterize the nature of the terrorist attacks on New York and Washington. None of them combine an attack on American soil with a likely military response and a significant shock to financial markets.

While it is difficult to add up the various crosscurrents hitting the economy to form a meaningful forecast at the present time, we can at least identify a number of the factors that will influence the path the economy takes over the next several quarters.

Just as the consumer played an important role in sustaining economic growth over the last year, so will the consumer play an important role going forward. A key uncertainty is whether consumers will continue to spend in light of what has happened. The decline in consumer wealth due to lower

stock prices, the rise in the unemployment rate, and further declines in consumer confidence all suggest weaker consumer spending going forward.

Likewise, businesses may continue to take a cautious approach to spending on new plant and equipment if earnings continue to be squeezed and consumers appear to be skittish.

On the other hand, fiscal policy is turning highly stimulative. Already, the federal government has increased spending and it's likely to be increased further in coming months. This change in the stance of fiscal policy will help stimulate the economy as we go forward. Exactly how stimulative fiscal policy will become is hard to say and will depend on the programs Congress enacts in the future. But the stimulus could come on several fronts, including greater defense spending, more spending on security here at home, reconstruction in New York and Washington, possible new or accelerated tax cuts, and various subsidies to private industries.

Putting these private and public spending effects together to form a forecast is difficult, and any such forecast must be viewed with even greater skepticism than usual.

Nevertheless, about a month after the attacks, Blue Chip Indicators conducted a survey of professional economists about their revised outlook for the U.S. economy. On average, those economists expected the economy would now dip into a recession in the second half of this year, before rebounding next year. In particular, the consensus forecast was for real GDP to decline at a 0.6 percent rate in the third quarter and a 1.3 percent rate in the current quarter. Next year, they predicted the economy would grow 1.4 percent in the first quarter, 2.9 percent in the second quarter, and 3.9 percent on average in the third and fourth quarter. So although these economists are projecting a recession, they foresee a relatively mild one followed by a strong recovery.

Long-run prospects

That brings me to the final part of my presentation—the longer run prospects for the economy. In my view, the U.S. economy remains fundamentally strong, and the long-run outlook is very good. So while the near-term outlook has clearly changed, the long-run outlook has not.

I have two reasons for my optimism about the long term—first, an innovative private sector and, second, good macroeconomic policy.

In the private sector, financial markets have been deregulated, the labor markets are flexible, and we have seen major advances in information technology. These developments have enhanced our ability to absorb disruptions and recover.

In addition, the long-term prospects for rapid technological progress and faster productivity growth remain largely undiminished. At a conference on the information economy sponsored by the Federal Reserve Bank of Kansas City in August, participants were uniformly optimistic that recent increases in productivity growth would persist.

One paper, co-authored by Lawrence Summers, the former Treasury secretary and now president of Harvard University, argued that "the pace of technological progress in the leading sectors driving the 'new economy' is very rapid indeed, and will continue to be very rapid for the foreseeable future. Moreover, the computers, switches, cables, and programs that are the products of today's leading sectors are general-purpose technologies, hence demand for them is likely to be [very strong in light of the fact that] rapid technological progress brings rapidly falling prices."

The continuation of productivity growth in the 2 to 3 percent range—up from 1 to 1 ½ percent in the 1980s and early 1990s—is of tremendous long-run significance. It means rising real wages and ultimately, rising standards of living. Stronger productivity growth will also help us with our long-run demographic issues with social security. Rising productivity growth allows us to support more retirees with fewer workers.

Turning to macroeconomic policy, I would suggest that both fiscal and monetary policy have positioned our economy well to deal with the kind of shock that we have experienced. The federal government budget surplus that we have enjoyed will allow fiscal policymakers to respond to the shock with increased spending for defense, reconstruction, increased airport security, and other worthwhile purposes. There is also potentially room for additional or accelerated tax cuts. Had our federal government not been running surpluses, these kinds of increased spending could not have been contemplated without risking a loss of confidence in financial markets and, potentially, sharp increases in long-term interest rates.

That said, in increasing government spending and cutting taxes it is important to enact programs that address current concerns without

jeopardizing long-run budget discipline. While we can afford to spend surplus revenues in times of recession and war, we should return to accumulating surpluses in times of expansion and peace.

Monetary policy has also contributed to the favorable long-term outlook for the economy. The aggressive easing of monetary policy earlier in the year and more recently has put a substantial amount of liquidity into the economy. Much of this past policy ease is still in the pipeline, however, since there are substantial lags between the time policy is eased and the time it begins to affect the economy. When this easing hits the economy more fully this quarter and next year, it should have a pronounced positive impact on consumer and business spending.

In addition to responding aggressively to the economic slowdown this year, the Federal Reserve has kept inflation low and stable. It's widely recognized that the greatest contribution the Fed can make to the goal of maximum sustainable growth in the U.S. economy is to keep inflation low and stable. And we have managed to do that.

Moreover, with energy prices falling and labor markets becoming less tight, the outlook for inflation remains very favorable. This is an important

factor because it gives the Federal Reserve maneuvering room should additional easing actions prove necessary.

So when you look at the longer-term prospects for the U.S. economy, I would argue that, in fact, things have *not* changed.

Conclusion

Let me conclude by summarizing my main points. First, before the recent terrorist attacks, the economy was slowing. Economic indicators were mixed, but some were actually pointing to a bottoming out of the economy. Second, the events of September 11 have greatly increased the uncertainty surrounding the outlook for the economy. Many private forecasters, nevertheless, are now predicting that the economy is in a recession, but that the recession will be mild and short-lived. Finally, despite the near-term turbulence, the long-run prospects for the U.S. economy remain bright. Faster productivity growth and good macroeconomic policy have positioned us well to deal with economic disturbances.

While some things may have changed, not everything has changed.