THE TERRORIST ATTACKS IN THE UNITED STATES

The terrorist attacks in the United States are a negative factor for economic development, which was already weak. In the coming quarters the predominant effect will be a drop in output and demand, not least in sectors that are hit directly, for example financial markets, aviation and recreation. In addition, the increased uncertainty may weaken the confidence of households and firms. In the somewhat longer perspective, the reconstruction of infrastructure will involve increased investment; demand will also be reinforced by increased public spending. In the main scenario, the terrorist attacks have a downward effect on growth in the next four quarters, with a limited net effect after that. There is, however, a risk of the effects being more substantial on account of continued uncertainty and unrest.

EFFECTS IN THE COMING QUARTERS

In the short run the economic effects will materialise in a variety of ways:

- The immediate effect of the terrorist attacks is a direct loss of production. Certain activities were suspended in connection with the attacks and production decreased in others. The impact on GDP growth in the coming quarters can amount to several tenths of a percentage point.
- The attacks can also lead to a more permanent drop in output, concentrated to the regions and sectors that are affected directly. Examples of such sectors are finance, aviation, insurance and tourism. In the United States their combined share of GDP is between 6 and 9 per cent.
- A short-term drop in consumption is another probable consequence of the attacks. In the past, periods of increased uncertainty, such as war or political crises, have affected spending on durables and residential investment, for example.

The effects in the coming quarters will probably be substantial. By itself, the impact can warrant a downward revision of GDP growth this year and next of several tenths of a percentage point.

EFFECTS IN THE COMING YEARS

The effects in the coming years are likely to be conditioned by the loss of capital stock, increased public spending, tax cuts, monetary easing and the development of people's confidence in the future.

To illustrate how the economy could be affected, certain effects have been separately simulated in a global econometric model (Table B6).[17] The first simulation assumes that the capital stock is reduced by USD 40 billion in 2001 Q3.[18] The second assumes that public spending in the coming years is increased by an additional 5 per cent a year, and the third that share prices fall about 10 per cent.

Table B6. Deviations from the base scenario for the United States. Difference in annual percentage change figure (current-account balance: difference in annual change; instrumental rate: difference)

	Capital stock*			Public consumption**			Share prices***		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
GDP	0.0	0.0	0.0	0.4	0.3	-0.4	-0.4	-0.2	-0.2
Investment	0.1	0.0	-0.1	0.5	0.0	-0.8	-1.0	-1.0	-0.4
Private consumption	0.0	0.0	0.0	-0.1	-0.8	0.0	-1.0	-0.8	-0.4
Inflation	0.0	0.0	0.0	0.2	0.5	-0.6	-0.2	-0.4	-0.4
Current-account balance (% of GDP)	0.0	0.0	0.0	-0.1	-0.2	0.0	0.0	0.6	0.2
Instrumental interest rate	0.03	0.00	0.00	0.7	0.5	-0.4	-0.8	-0.4	-0.2

* The capital stock shock is modelled as a fall of 0.2 per cent, which is equivalent to a capital loss of about USD 40 billion.

** Public consumption is assumed to be stepped up 5 per cent in year 1 and another 5 per cent in year 2; this increase includes an expansion of military expenditure by about 15 per cent a year.

*** The share price fall is modelled as a permanent 0.3 per cent increase in the risk premium for shares; in NiGEM the increased premium also has a direct effect on corporate investment decisions.

The modelled effects of the decreased capital stock are small. In the event of a negative shock that reduces the capital stock, economic equilibrium is restored through increased investment. The moderate impact of the loss of capital tallies with experience of other types of disaster, such as floods, earthquakes and landslides, where the effect turned out to be slight even though the short-term loss of production was considerable.[19]

17 The National Institute Global Econometric Model (NiGEM) from the National Institute of Economic and Social Research, London.

18 The figure of USD 40 billion is an assumption, not an estimate; estimates from the insurance sector range from USD 15 billion to 50 billion.

19 The twenty most extensive disasters between 1971 and 1995 were reviewed for the turn of the millennium in the annual report to Congress from the U.S. President's Council of Economic Advisors. Although the damage in a number of cases (e.g. hurricane Andrew in 1992 and the California earthquake in 1994) amounted to more than 1 per cent of GDP, the effect on GDP was so limited that it did not show up in the average annual figure.

A major increase in public spending is foreseen in the years ahead. A package totalling about USD 40 billion has already been initiated. Half of these public funds has been earmarked for the reconstruction of New York and half for defence and security. Moreover, support will be provided for the industries that have been hit, e.g. aviation. Further tax relief for households and firms, in the region of USD 50-60 billion, has been proposed. More spending on defence is likely, too. The additional public expenditure after the attacks could total the equivalent of up to one per cent of GDP.

The terrorist attacks have led to increased uncertainty and this can affect household and business confidence. Dwindling optimism about the future can have a number of economic effects. One of them, falling share prices, has already been seen. That in turn has a negative impact on both investment and consumption; the depressive effect is considerable but fades comparatively quickly.

The overall assessment of the net effects of the terrorist attacks in the United States is that, according to the simulations, they will be considerable in the short run; but when allowance is made for existing and foreseeable measures of economic policy, the consequences for growth prospects in the coming years are probably small.

The net impact on inflation prospects will probably be slight. Inflation increased appreciably in connection with the Korean, Vietnam and Gulf wars. After the terrorist attacks, both financial market pricing and survey data on attitudes indicate that inflation expectations have, if anything, fallen.

EFFECTS ON CONSUMER CONFIDENCE AND HISTORICAL PARALLELS

The indirect effects of the terrorist attacks in the United States could be more extensive than assumed above. Historically, political unrest and war have tended to weaken consumers' confidence in the future. The escalation of the Vietnam war and the resignation of President Nixon coincided with consumer confidence's largest and second largest drop, respectively, in the last four decades. Consumer confidence also declined sharply both when the United States invaded Panama and when Iraq invaded Kuwait.

In that saving is currently low - as can be seen from the household saving ratio as well as the deficit on current account - the situation is precarious. Increased anxiety can elicit or accelerate an adjustment of the imbalances that leads to larger effects on the real economy. If people perceive the attacks as the beginning of a long period of uncertainty, there is a major risk of consumption and investment falling more appreciably.

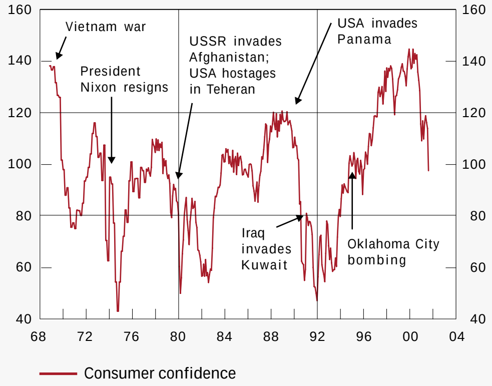
Comparing the present situation with earlier period of military conflict is difficult. Both the Korean and the Vietnam war entailed an increase in defence spending (about 15 and 10 per cent of GDP, respectively) that is hardly relevant today. Iraq's invasion of Kuwait and the subsequent Gulf war are somewhat more recent events but they, too, did not affect the domestic economy and civilian life in the United States as directly as the present attacks on New York and Washington. The Gulf war probably contributed to the weakness of growth in both 1990 and 1991 but the recovery was comparatively rapid.

An important difference from the situation in the early 1990s is that the present scope for measures of economic policy is greater. Inflation was then above 5 per cent and the consolidated public sector showed a deficit equivalent to about 5 per cent of GDP. The situation in the rest of the world also differs appreciably. High growth in Japan and the strong expansion in Europe after German reunion provided a strong international driving force for the United States in the early 1990s. Today, economic activity is slowing more simultaneously throughout the world.

EFFECTS ON POTENTIAL GROWTH

The long-term effects that the terrorist attacks may have on potential growth are difficult to assess. One effect that will presumably be permanent is tighter security requirements and more extensive administrative routines, both in aviation and in other sectors. Increased transaction and transport costs are negative for potential growth. On the other hand, reconstruction implies a modernisation of capital stocks, which may be associated with some positive externalities via technical innovations. Increased defence expenditure may have a similar effect. All in all, the combined effects on potential growth are probably limited.

Figure B5. Consumer confidence in the United States. Index



Source: Conference Board.