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Economic Policy Following the Terrorist Attacks

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America has shown its best side in recent weeks in the efforts to help the victims of September 11. 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, understandably, feel 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.

This policy brief will look at the state of the economy in the aftermath of the attack and at the economic policies that should be used in response to the crisis. Those 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 (and the world) working again, while maintaining fiscal discipline and continuing the thrust of openness and globalization?

The Global 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. There were some signs the economy was turning the corner. On the other hand, investment remained in a slump, having

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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 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.

The United States 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 worldwide demand for capital goods. A recent report showed that 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 Brazil and Argentina, and Turkey has had a particularly difficult time.

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.

There is broad agreement that the terrorist attack will push the US economy into recession and the global economy into a period of slow growth. US GDP will likely decline in both the third and fourth quarters of this year—the consensus estimate is for a decline of 0.6 percent in each quarter. The amount of the decline in the fourth quarter is very hard to predict, however. Most likely the decline will be moderate, but a decline of as much as 10 percent at an annual rate is not impossible. The economy declined by this amount in the second quarter of 1980 as a result of quite mild restraints on credit. I do not think such a huge decline is likely, but if it happened it would be important to avoid an overreaction. There would be a rebound in the next quarter, as there was 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 affected, 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, anticipating that aircraft orders will fall. Many meetings and conventions have been cancelled and tourism is down sharply. Layoff announcements can often be misleading, but there is little doubt many companies are in difficulty. 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. 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 central banks have allowed the 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 rate 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 its mandate emphasizes price stability. Following the crisis, however, the ECB came through and joined the Fed in a coordinated half percentage point cut in rates. Other central banks also responded.

Fiscal policy in the United States will help mitigate or shorten the recession. A tax cut was enacted and rebate checks have been mailed out to millions of families. 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. In Europe, however, governments have been planning spending cutbacks to meet preplanned budget targets. Such actions would be a serious mistake, a return to the economics of Herbert Hoover, who exacerbated the Great Depression by trying to balance the budget in a massive downturn. Instead, the targets of the Stability Pact should be temporarily set aside to allow the automatic stabilizers of fiscal policy to work.

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 1970s was followed by sustained market weakness and that was a different kind of crisis.

Even though spending weakness will continue in the United States through at least the end of this year and probably into the first part of next year, chances are good that the economy will recover next year, even if no further policy stimulus was given. There is a natural pattern to business cycles. In the boom there is overoptimism that results in overinvestment and overproduction. 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 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 11 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 12 months.

The Importance of Global Growth

The United States has been running a large trade deficit for years. The counterpart has been a large inflow of capital from the rest of the world, running recently at a rate of about 4 percent of GDP. The combination of weakness in the American economy and increased uncertainty in the global economy is likely to discourage that capital inflow until the dimensions of the crisis are resolved. The United States has traditionally been a “safe haven” country, but the United States is now at the heart of the crisis, so my guess is that the net effect of the attacks will be downward pressure on the dollar. As long as the dollar decline is orderly (and so far it has been) this could help the US economy. US manufacturing would be helped if there were a substantial shift in the dollar/euro exchange rate. Of course from the viewpoint of the rest of the world, and from Europe in particular, a drop in the dollar would reduce the US demand for imports, contributing to the weakness in Europe in the short run.[1] (I should note that predicting exchange rates is a dangerous game. An alternative scenario is that investors still see future economic growth and profits as being higher in the United States than in other countries. In this case the dollar will stay strong.)

The policy mindset in too many countries is to view the manufacturing sector as the heart of the economy. In fact, manufacturing employment in all the advanced economies has declined as a share of total employment and will keep declining. Service sector employment is 60 percent or more of the total in the industrial countries. In Asia, Europe, and around the world, local policies must be examined to make sure that the growth of service jobs is encouraged. The world economy as a whole cannot export its way out of the current economic downturn. The future of growth in the global economy depends on expanding service demand and, over time, adjusting to a lower trade deficit in the United States.

It is heartening that there was a coordinated response to the economic threat by central banks. But

1. A rising euro would also have advantages for Europe, holding down inflation and allowing more freedom for monetary policy to counteract weakness.

the United States must encourage its allies going forward to monitor their economies and take further steps toward 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 United States 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 avoid falling further into recession. It must address its financial crisis and not become a stone dragging the global economy under water.[2]

The Stock Market and 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 reopened, there was heavy selling as the Dow dropped another 14 percent. As this was being 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 1990s 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 1970s 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 overvalued 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 policymakers should think about how to respond if this occurs. Consumer and business confidence and spending would be hurt further in that event, and contribute to deeper or longer slowdown.

The appropriate response, if the recession turns out to be more severe than expected, is to use monetary and fiscal policy more aggressively. (I have focused on the stock market as the main source of downside risk, but policy should also respond to a weaker-than-expected economy that was brought about for other reasons.[3]) Monetary policy could do more if needed, by making further interest rate cuts. The danger of inflation seems very low, while the danger of a sharp decline in real output seems high. 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.

The United States is a target partly because it is the symbol of the success of market-driven international economies. Globalization breaks down barriers, eliminating traditional divisions, and traditional customs at the same time....In a horrible way, the attacks were part of the backlash against globalization.

A further fiscal stimulus package should be developed and 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

2. 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 01-4,* Institute for International Economics, Washington, DC, March 2001.

3. The stock market and the economy are interrelated. 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.

over the next few weeks or beyond. The Federal Reserve has 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.

On the consumer side, I favor a payroll tax rebate targeted at moderate-income taxpayers including those who got nothing from the rebates handed out so far. 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. As an alternative to a payroll tax rebate, I could also support the proposal Alan Blinder has just made. He suggests a temporary rebate of state sales taxes. This idea has the advantage of encouraging consumers to spend now rather than later, thereby giving the economy an immediate boost.

A good policy that has been under consideration even in a strong economy 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.[4] 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—the reasoning is the same as for the Blinder sales tax proposal. 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.

What can be done to preserve the benefits of globalization? The first step is to provide better security, which is needed both for globalization and to boost consumer confidence and assist the economic recovery.

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. A cut in the capital gains tax could even have the perverse effect of encouraging people to sell stocks. We do not want to encourage further stock market declines.

I am not in favor of accelerating the provisions of the tax cut package passed earlier this year. However, I recognize that the stimulus package will have to involve compromise, and that some acceleration of the tax cuts is likely. In that case, I would favor bringing forward the child-care credit and the rate cuts for the lower income tax brackets that provide the most assistance to moderate-income families.

Preserving Fiscal Discipline

We should not abandon budget targets over the longer term. Both the United States and Europe face pressing budget problems in the future as the baby boom generation moves into retirement. For the United States, it is vital to pay down the national debt in the next 10 years or so while the opportunity is there and 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 United States 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

4. This proposal is described by Lori G. Kletzer and Robert E. Litan in "A Prescription to Relieve Worker Anxiety," *International Economics Policy Brief 01-2,* Institute for International Economics, Washington DC, February 2001.

simultaneously reexamining the long-run budget prospects and looking for ways to preserve long-term fiscal discipline.

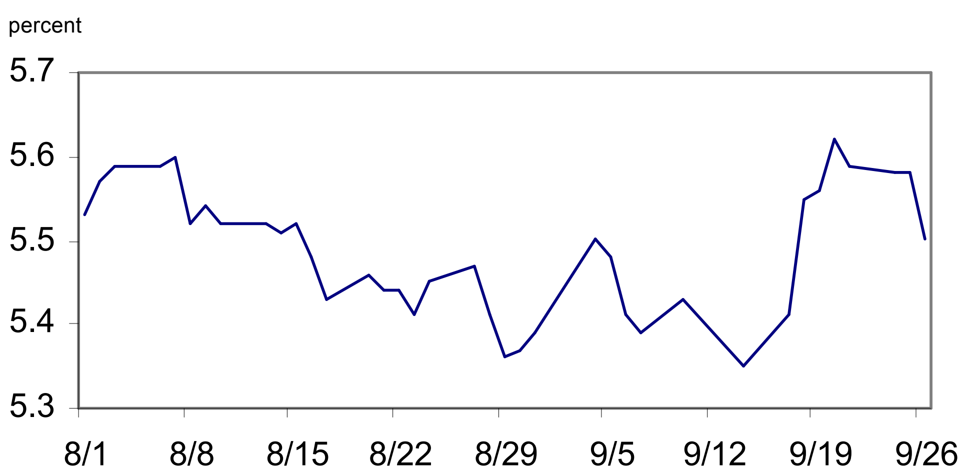
Even before the September 11 attack the Congressional Budget Office had issued a new set of budget projections with sharply lower estimates of the surpluses. Since that time and since the attack, the prospects for a weak economy are far greater in the short run and the uncertainty about the long-run 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 also have an 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 is already visible in financial markets. Long-term interest rates had declined in recent weeks with the slowing economy. Following the terrorist attack, there was a sharp increase in the interest rate (the yield) on 30-year Treasury bonds (see figure 1). This does not appear to have been the result of an increase in expected inflation, rather it expressed concern that long-term budget discipline may have been undermined. The yield on 30-year bonds has fallen back a little subsequently, but remains higher than before the attack, even though most forecasters have reduced their estimates of economic growth.

The Federal Reserve has cut short-term interest rates to stimulate the economy. But in order for these cuts to have their full benefit, long rates must come down also. To achieve this, policymakers should reaffirm a commitment to fiscal discipline over the next 10 years in order to help stimulate the economy today.

The first step is to find out where we stand. I urge Congress to ask the Congressional Budget Office to make its best estimate of the impact of recent events on the budget outlook over the 10-year budget window. This estimate should include a realistic view of the likely level of nondefense spending. Recessions and wars are expensive and some part of the previous budget and tax package probably has to give. It makes sense that if we spend more now and give more tax cuts now there will be less available later. I favor preserving the Social Security surplus in future years even if we have to give up on some of the future tax cuts. If, in the years ahead, the economy comes back strong and there is more money available, then we can go ahead and make new and easier choices.

Figure 1 US 30-year Treasury Bond yield, 2001



Source: Federal Reserve Board.

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 make room for the increase in capital spending that 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.

Globalization in the New Environment

The US economy enjoyed extraordinary economic performance in the 1990s and a key to the success of the new economy was openness, mobility, and the benefits of globalization. Talented people from around the world have been drawn to the United States to be part of the cutting edge of technology. Many of the start-up technology companies in Silicon Valley and elsewhere were founded by immigrants. Without the skills these people brought with them, progress would have been less rapid. In addition to the flow of people, the inflow of capital to the United States has been important. It was essential to the investment boom of the 1990s that contributed heavily to the acceleration of US productivity growth. And, of course, the international flow of goods and services is essential to growth. Despite being at the heart of technology development, the United States is a net importer of information technology equipment. Growth in the United States has relied on global sourcing which has provided the building blocks of the new economy. And technology development has depended on finding global markets to justify the risky investments required.

International comparisons have suggested that an important driver of high productivity is competition against best practice companies worldwide. US auto companies have changed their ways and been forced to improve efficiency as a result of the pressure of competition that arrived with the Japanese companies. Europe has staked its future on the benefits of a single market where companies cannot hide in sheltered domestic industries. As well as its traditional economic benefits, globalization increases the intensity of competition and forces companies to change and innovate or be driven out of the market.

If the September 11 attacks were to result in a significant curtailment of globalization this would be a victory indeed for the terrorists. The United States is a target partly because it is the symbol of the success of market-driven international economies. Globalization breaks down barriers, eliminating traditional divisions, and traditional customs at the same time. Western music and movies attract young people in every country. Women in Western countries enjoy a level of equality and freedom that is very threatening to many men in traditional societies. In a horrible way, the attacks were part of the backlash against globalization. This is particularly ironic because globalization can help poor countries develop. The more economies there are that area developed economically and part of the global community, the fewer candidates there will be for terrorist organizations.

US trade representative Robert Zoellick has proposed launching a new trade round as a defiant response to the disaster. This would be a great way to make it clear that we are not going to be intimidated. The industrial countries should resist any internal pressures towards protectionism as unemployment rises and, instead, launch a new global trade round at Doha this November.

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The Need for Better Security

Americans are understandably angry at the brutal crimes that have been perpetrated and will strike back. America's allies are committed to joining a multilateral effort against terrorism and I am confident that progress will be made in containing the threat. But despite our best efforts, this is a problem that will not go away any time soon. Too many people, including many with financial resources, hate the policies of the United States and its allies and resent the global power the United States wields. The success of the latest attacks showed the severe weaknesses in our security provisions. Further terrorist acts in the future seem almost inevitable and a major effort will have to be made if such attacks are to be thwarted.

Without diminishing the culpability of the persons that committed these mass murders, it is important to accept and respond to the gaps in our security shield. We have let ourselves be vulnerable to attack even though we knew of a plentiful supply of fanatics dedicated to killing Americans. It was well known that security at US airports was dreadful. Low-paid, ill-trained workers with constant turnover were operating the screening devices. I am no security expert, but from an economic point of view, the cost in higher ticket prices of having an efficient but tighter security system at airports and of having a trained and armed guard on many or even every airline flight is a price worth paying. We can learn from the experience of Israel, Latin America, and countries in Europe where terrorism has been more prevalent. El Al spends 4 percent of its costs on security and the Israeli government chips in another 3 percent. That is 7 percent in all, compared to 2 percent for a US airline. Adding 5 percent to ticket prices would not be cheap. Maybe we will not need as much security on every flight as El Al has. But maybe we do. It is worth looking closely at the costs and benefits.

The security problems extend well beyond the airports. In Washington, people are taking out their unread copies of the security report issued last February (the Hart-Rudman report). It warned "the United States finds itself on the brink of an unprecedented crisis of competence in government" as talented people do not want to work for the government any more because of low pay and lack of motivation. Frequent mistakes by the FBI in recent years have severely undermined confidence in that agency. The electronic wizardry at the intelligence agencies did not provide adequate warning of the September 11 attack. For now at least, the motivation part will be solved. The low pay has to be addressed and the leadership of the security agencies should be asked to review why the intelligence and security failure occurred.

I applaud the efforts announced by the Administration to improve security. Setting up a new Cabinet position for Homeland Security is a step forward. I do not know how much more money will be needed overall—in some cases funds should simply be redirected. I am sure that high quality people must be offered adequate financial rewards, so that they can afford to stay in government and protect all of us.

There will be a 'security tax' on economic activity for some time and, maybe, indefinitely. Government spending will be higher and will have to be paid for in higher taxes. Wars are expensive and the war on terrorism will be expensive. The private sector will also pay a tax that will be passed on to consumers. Travel will not be as easy. Obtaining visas may take longer. Security precautions are costly and will add to prices. Capital flows may be diminished. The security tax has been very visible as US manufacturers faced supply shortages as a result of trucks unable to enter the United States from Canada and Mexico.

Security measures can be expensive, but with innovation and the benefits of widespread use and production, the costs will come down. When air bags were first introduced, the cost per air bag was high. Many people complained about having to pay for this 'safety tax.' Today mass production has sharply lowered the cost and many consumers buy cars with multiple air bags. The world needs to develop best practice approaches to security, practices that maximize safety while minimizing delays and disruptions. In the end we must pay the security tax. That is far better than the alternative.

Preserving the Policies that Have Supported Globalization

US trade representative Robert Zoellick has proposed launching a new trade round as a defiant response to the disaster. This would be a great way to make it clear that we are not going to be intimidated. The industrial countries should resist any internal pressures toward protectionism as unemployment rises and, instead, launch a new global trade round at Doha this November. In the context of the global threat the democracies of the world now face, the petty squabbles over beef or foreign sales corporations seem absurd. Hopefully we can rise above our differences and make real progress toward elimination of the remaining barriers to trade and investment that presently hinder economic growth.

Western countries must not respond to the crisis by closing doors and turning people away. The terrorists were apparently all Islamic extremists but they do not represent the majority of Muslims. Discrimination against Muslims is wrong and would not work. The next terrorists would come into the country with passports that concealed their backgrounds. The United States, where most citizens have origins in other countries, recognizes the importance of openness. There would be a severe cost to isolationism.

Emerging economies benefit from globalization and will suffer if its progress is slowed. Emerging markets have already been hurt by slow growth in the global economy, given their heavy dependence on exports. The growth forecast for these countries for this year had been cut to about half of the growth they achieved last year. They will be hurt again by the aftereffects of the terrorism. Besides declining exports, emerging markets are finding the international flow of capital to their economies is declining sharply.

To an extent, the global economic weakness serves to aggravate the effects of structural problems within the emerging economies. Dealing with deep structural problems is politically difficult and when there is a global boom there is a temptation to go slow on reform efforts. The end of the global boom should serve as a reminder to emerging countries of the need to maintain the economic reform effort even when economic growth picks up again.

The international financial institutions can play a role in easing the short-term difficulties of emerging economies. They should monitor events and stand ready to make larger loans if there are significant contagion effects of the crisis. It would be a mistake, however, to hand out large sums of money just because world growth has slowed down. Countries need to have in place policies that reduce their longer-term vulnerability to financial crises. Also, efforts to improve the international financial architecture should be continued and not put on a back-burner following the events of September 11.

Conclusion

The destruction and loss of life at the World Trade Center, the Pentagon, and in western Pennsylvania have been a terrible blow to the United States and to the world. We should do our best to minimize the collateral damage to the United States and the global economy.

- In the short term, some economic weakness is very likely. Predictions for US GDP in the fourth quarter vary greatly. We should be braced for the worst, 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 for use either as an insurance policy, or to use if conditions deteriorate further than expected. The package should include further immediate temporary or one-time tax rebates, either payroll tax rebates or a sales tax rebate. 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 or invest now or lose the tax cut.
- Wage insurance would be a good policy. A capital gains tax cut or a cut in corporate incomes taxes would not be 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 1990s and should be preserved once we get through the immediate crisis. Find out where the budget stands now and what is needed to make sure that adequate surpluses will be restored in future years. Even if some of the rate cuts were accelerated, it may be necessary to freeze others in order to reduce the tax drain over the 10-year budget horizon. If the money is there later, the cuts can go ahead.
- If policymakers undermine the commitment to fiscal discipline, long-term interest rates will rise and slow the economy's recovery.