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The Post-9/11 Economy

By **BRIAN S. WESBURY**

The terrorists of 9/11 had bigger plans than just killing people and blowing up buildings. They hoped that the attacks would send shock waves through the American financial system and severely harm the U.S. economy. In December 2001, Osama bin Laden said that the attacks had "shaken the throne of America and hit hard the American economy at its heart and its core."

The economy was already in recession on 9/11, and was theoretically vulnerable. At the time of the attacks, industrial production had fallen for 11 consecutive months, new orders for durable goods were down 8.5% from the previous year, retail sales were barely growing and the unemployment rate had jumped by a full point to 4.9%.

For the most part this recession had gone unrecognized. In July 2001, The Wall Street Journal's semiannual survey of 54 economists found only five with forecasts of negative real GDP growth. The attacks changed this quickly.

Roughly two weeks after 9/11, a Bloomberg survey found 22 out of 30 economists predicting recession. Many feared that the direct and indirect costs of security would reduce profits and productivity, consumer spending would slow sharply, deflationary pressures could worsen, and fearful businesses would lower investment, boost inventories and think more local and less global.

But someone forgot to turn out the lights. According to the National Bureau of Economic Research, the recession officially ended in November 2001, just 50 days after 9/11. Retail sales, excluding autos, were higher in October 2001 than they were in August. Real GDP expanded at an annualized rate of 1.6% in the fourth quarter of 2001, and since then has grown at an annual real rate of 3.2% -- roughly equal to the 50-year average.

What a great story: The vibrant U.S. economy takes a tremendous blow and not only remains standing, but rebounds almost immediately. A free market economy is the ultimate hardened target -- the equivalent of 65 feet of steel-reinforced concrete. The story should end right there. But, it doesn't. The markets and economy are still reverberating with the impact of that day. Not from the actual attack, but from the reaction of government agencies and private industries.

In the three months after 9/11, the Fed cut the federal funds rate four times -- three 50 basis point rate cuts and another of 25 basis points. The nominal funds rate fell from 3.5% to 1.75%, while the real rate fell from a positive 1% to a negative 1%. Before this, the Fed had already cut interest rates seven times in 2001. These cuts pushed interest rates below neutral, and with the normal lag, the economy was already responding. The final four were an overreaction that we are still dealing with to this day.

The price of gold stopped falling in early 2001, was up 8% by the time of the attacks, and since then has climbed another 124%. The dollar fell 7% against the Euro between July and early September 2001, and since then has fallen another 40%. Oil prices fell in the immediate aftermath, but have more than tripled in the past five years. Excessively accommodative monetary policy is one of the key reasons for rising commodity prices and a falling dollar.

Low rates also fueled a housing boom. With the federal funds rate eventually falling to a low of 1%, the demand for housing and the price of residential real estate rose above an already strong trend. Lately, with interest rates back up to more normal levels, the bloom is finally coming off the turbocharged housing market.

Hotels were hammered after 9/11, and the industry pulled in its horns. Ironically, in New York City, as fears that travel would remain subdued and a gold rush into housing took hold, many hotels were converted into condos. But today, there is a shortage of hotel rooms, prices are surging, and housing demand is slowing. It is these unintended consequences that are often overlooked.

A significant reason for the Fed's sustained and absurdly accommodative policy was the fact that real business fixed investment fell for nine consecutive quarters between the first quarter of 2001 and the first quarter of 2003. This was the worst period of decline in business investment since the data were first collected in 1947.

Even though consumer spending and the housing market recovered quickly from recession and the attacks, business investment and the stock market did not. There were many reasons for this. The deflation of the late 1990s and early 2000s created massive uncertainty and undermined decision making. In addition, business didn't need new computers or software after a binge of spending to prepare for Y2K. And finally, because the tax cut of 2001 phased in lower rates over five years, entrepreneurs were encouraged to push as much activity into future, lower tax years as they could. Phased-in tax cuts always reduce growth in the early years.

But this wasn't all. The surprise terrorist attacks raised the risk level associated with business investment. While entrepreneurs thumb risk in the eye every day, 9/11 increased perceived risks and reduced perceived returns. No matter how many times the Fed cut interest rates, stocks and investments were pulled lower because the risk-reward ratio was still out of balance. Shifting it back in a positive direction could not be accomplished with monetary policy alone.

By taking the battle to the enemy in Afghanistan (in 2002) and Iraq (in early 2003), and beefing up security here at home, the Bush administration reduced the perceived risks from terrorism. CBS news polls show that the percentage of Americans who think it is "very likely" that there will be another terrorist attack in the U.S. within the next few months has fallen from 53% in October 2001 to roughly 27% in early 2003 to 17% today. With no U.S. attacks in five years, and many successful intelligence operations against terror cells, perceived risks continue to fall.

Moreover, in May 2003, scheduled cuts in marginal tax rates were accelerated, while capital gains and dividend tax rates were cut sharply. These tax cuts immediately lowered the cost of capital and raised after-tax rewards. This caused a shift in the risk-reward ratio, and business investment turned on a dime. Real business fixed investment has now climbed for 13 consecutive quarters, at an annual rate of 7%. While some say it is immoral to cut taxes and at the same time fight a war, it was these two actions working together that finally turned the entire U.S. economy around.

Many assumed that 9/11 would slow globalization, but the opposite happened. Both imports and exports had fallen in the year before the attacks, but turned around in its aftermath. U.S. imports and exports have both grown over 12% in the past year and global trade is a larger share of U.S. GDP than at anytime in at least 135 years. Productivity growth and rising corporate profits act like shock absorbers, allowing the economy to grow rapidly despite higher costs for security.

In the end, it was not the attacks, but the reaction to them that has defined the economy for the past five years. Monetary policy has a very limited ability to fix problems that are not directly related to liquidity, and often causes more problems than it cures. Much more important is for the government to get out of the way, keep tax rates low, and use our armed forces and intelligence capabilities to protect America. A capitalist economy, as long as it is kept free, is the ultimate hardened target.

Mr. Wesbury is chief economist with First Trust Advisors L.P. in Lisle, IL.