



## **AIB Corporate & Commercial Treasury**

# **Market Comment**

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### **Economic and Financial Impact of Terrorist Attack on US**

**There are no historical precedents for the terrorist attack on the US on which to make a sound assessment of the likely long-term economic and financial implications. Using other “key world” events over the past 40 years as a benchmark may not be appropriate.**

1. Events such as the Iraqi invasion of Kuwait and the Gulf War (1990/1991), the stock market crash of 1987, The Yom Kippur war (1973), JFK’s assassination (1963), the Cuban missile crisis (1962), etc. may provide some guidance as to the possible economic effects of recent events in the US. However, what is equally relevant is how the US and the other major economies within the G7 were performing prior to the shock or disruption in question. The evidence is mixed. On this occasion, the attack on the US occurred against the background of a very fragile international economy, where the US was close to recession and where the global economy was living with a number of serious imbalances such as the record US current account deficit and an overvalued US dollar. As a result, the economic effects of 11 September could be much more damaging than other shocks.
2. This was the first time in modern history that the US sustained a major attack from forces outside its national territory. Hawaii, the 50<sup>th</sup> State, (ref. the attack on Pearl Harbour in 1941) was not admitted to the Union until 1959.
3. There is a risk that economists could exaggerate the economic consequences of the attack on the US (such as the start of an ‘economic winter’). However, there is also the possibility that traditional forecasting methods, based on extrapolation of the past and a purely ‘economics based focus’ on the future, could underestimate the fundamental changes to result from recent events in the US.
4. While the near term direction of the economic effects is clear, the magnitudes are not. It is too early to be making anything other than tentative judgements as to the economic consequences. Economists will present new scenarios to replace old ones but businesses need to be more cautious. There is a need to consider the implications of a range of scenarios for their risk management strategies.
5. There were several predictable near term effects such as lower official and short-term interest rates and a fall in equity prices. Yield curves also steepened as

- longer term rates rose for fear of increased bond issuance and the risks of war. These financial market movements were based on the realistic expectations that US and global economies would weaken or go into recession. The US has been a 'buyer of last resort' for much of the global economy in recent years. Reduced US domestic demand will adversely affect the growth prospects for other economies.
6. The attack represented a significant psychological blow to the US and to the international community. The nature of the attack has raised terrorism (as seen by Westerners) to new horrifying heights.
  7. A major factor is whether the attack on New York represents a one-off event. We could face more attacks. There is evidence to suggest that the planned attack on the US was more widespread than actually occurred. Furthermore, there are also indications of planned follow-up attacks on the US and on European cities. The fear factor associated with 'thinking the unthinkable' has adversely affected economies beyond the US. It will take time for this fear to recede.
  8. The events in New York and Washington on 11 September represented a major direct attack on the US economic and political system. They have put the US on a war footing, raised fears of a new 'cold war' and sparked concerns that the US could become more isolationist in the years ahead. This could threaten the foundations of the economic success of the past decade, which was based on the triple lock of financial market deregulation, the technological revolution and the more open international trading environment in goods and services.
  9. While the attack on the US could not be seen as sufficiently large to have a directly devastating effect on the US **economic system**, it nevertheless will have a number of short, medium and long-term effects on many business sectors and economies in the US and beyond. New York, the second largest state, represents 8% of the US economy but the serious disruption to the financial system could have wider consequences. Financial markets are still not back to normal. In the foreign exchange markets, trading remains thin with considerable inter-day volatility.
  10. As regards the immediate economic outlook, the spotlight is on the likely reaction of US consumers but the economic issues go way beyond this sector. Investment and international trade effects could be just as significant.
  11. Despite the 'cheerleading' by the US administration and the US Federal Reserve about the medium to longer-term favourable outlook for the US economy, the initial evidence is that the US economy has suffered an economic seizure in the aftermath of the attacks. Alan Greenspan said last week that the US economy had ground to a halt. It will take some time for the data to yield the knock-on effects of events on 11 September. We will have to wait until at least November for appropriate data. In the meantime, uncertainty will prevail.

12. Financial markets can adapt to bad news but abhor uncertainty. As a result, we face an extended period of market volatility. US equity markets were overvalued prior to the attack on 11 September. The market was waiting for evidence that US earnings would recover in the next 6-12 months. However, post 11 September, these hopes have been dashed. As a result, equity prices have fallen. Up to the end of trading on 21 September, the Dow had fallen by 14.3%, the NASDAQ by 16.1% and the Wilshire 5000 by 11.9% since 11 September. However, over the past month, the Dow has fallen by 21% and the NASDAQ by almost 26%. It would be foolish to predict that we have reached a bottom even if the market offers value in a number of sectors. Apart from the negative reaction to the sectors badly affected by the events in the US, equity markets are also suffering from the generalised loss of confidence.
13. We now face into an unknown military conflict. Opinion is divided as to whether the US can 'win' a war in Afghanistan. The short-term economic effects of the expected US military response are unclear. Comparisons will be made with the Gulf War in 1990/1991. A close examination of the period shows that the subsequent recession was not "caused" by the Kuwait/Iraq conflict. Oil prices rose sharply in 1990, contributing to a fall in consumer confidence. Between August 1990 and January 1991, the US Conference Board's consumer confidence index fell by 47 points. Charts show that there is a high correlation between the trend in consumer confidence and the growth in consumer spending. On this occasion, oil prices have remained stable to lower as OPEC sides with the US and the market recognises the dampening effects of weaker global economic growth and the decline in the airline industry on the demand for oil. There is unlikely to be a "CNN effect" on this occasion (as in the Gulf war) which reduced consumer spending as consumers sat watching television.
14. In the longer term, economies and financial markets will adjust to a long-term "war on terrorism". However, there will be a number of longer-term negative effects. First, the benefits deriving from the "peace dividend" associated with the ending of the Cold War in which defence spending was reduced, budgets moved into surplus and private sector investment boomed (the crowding-in effect) will be reduced or reversed. Second, the risk premium on equities will rise as the markets reassess the threat of international terrorism on the free market. This also underlies the fall in equity prices noted above.
15. The US Federal Reserve cut official interest rates by 0.5% to 3.0% on 17 September. The Fed remains biased towards further easing. The Fed has eased by a cumulative 3.5% since the start of the year. The Fed is expected to cut again. The next FOMC meeting is on 2 October. Another easing by 0.25% is possible. The Fed could reduce the Fed funds rate to 2.5%. This would be close to zero in real terms. Due to the Fed's market operations, the actual rate may trade below the official target rate.

16. It will take time for lower interest rates to stimulate the economy. Usually, Fed easing is accompanied by a boost to equity markets, a reduction in long term interest rates and a weakening of the dollar. These channels usually take up to 9-12 months to produce a stronger economy. However, on this occasion, the dollar appreciated strongly in the first half of 2001, long term rates rose and equity prices fell. The usual transmission mechanism for monetary policy, therefore, has malfunctioned on this occasion. With growing uncertainty, there is no guarantee that easier fiscal policy in the form of lower personal taxes or higher federal spending will boost the economy.
17. It seems very likely that the US economy will have entered a recession in the current quarter (Q3'01) with an annualised decline in real GDP of up to 0.5%. By Q4'01, however, the annualised fall in real GDP could be between 3-4%. On this basis, the average growth in real GDP in 2001 would be 1%, down from 4.1% in 2000. It is possible that the decline in real GDP could be extended into Q1'02. A recovery could commence in Q2'02 with a gradual strengthening of the rate of activity in the second half of the year. Assuming annualised growth rates of 2%, 3% and 4% in Q2, Q3 and Q4 of 2002 respectively, the average change in US real GDP in 2002 would be -0.2%. On the basis of the growth rates for 2001 and 2002, the rate of unemployment in the US would rise to 6% or higher. This will have a further adverse effect on equity market sentiment.
18. In Europe, the short-term economic picture remains slightly better than in the US, but only because Europe lags the US in the economic cycle. In the euro area, the ECB and EU governments continue to talk optimistically about the "economic fundamentals". However, with unemployment heading back towards 9% and the area still beset with fiscal and structural problems, it is difficult to be optimistic about prospects for the zone. Economic growth is close to zero on a quarterly annualised basis.
19. The ECB cut official rates by 0.5% on 17 September shortly after the Fed's cut. The official refinancing rate now stands at 3.75%, down 1% so far this year. The ECB sees the new rate as being "appropriate" to current conditions. However, the ECB's view of the appropriate rate structure for the euro area is about as stable as a paper bag in a gale. The euro area is expected to weaken further with a technical recession a possibility. The ECB is likely to cut rates by another 0.5% before the end of the year. The harmonised rate of inflation is officially expected to fall to below 2% in the early part of 2002.
20. In the UK, the Bank of England's Monetary Policy Committee cut the official refinancing rate by 0.25% to 4.75% on 18 September. There appears to be a three way split among MPC members on the appropriate level of interest rates. The latest move was a cautious one, coming on the same day that the annual rate of core inflation rose to 2.6% i.e. above the government's target of 2.5%. However, this is not expected to deflect the MPC from further easing. A cut in the refinancing rate to 4.5% is forecast when the MPC meets on 3/4 October.

21. On a trade weighted basis, the dollar has lost 4.6% since its peak in early July 2001. However, it has remained remarkably strong against the euro and sterling. Clearly, investors are not convinced by the attractiveness of the euro. The bank of Japan has intervened to prevent an excessive appreciation of the Yen. Intervention has occurred around the Y117 level. Sterling has weakened against the dollar as the UK is seen as vulnerable to the threat of terrorist attack and is militarily aligned with the US. However, the \$1.45-\$1.50 range is expected to contain most of the movement in cable over the next few months.
22. A usual feature of currency markets is that rates tend to move significantly in very short periods. The EUR/USD rate has remained within a relatively narrow range since 11 September. Indeed, the dollar has strengthened slightly over the period. Nevertheless, there must be an increased risk to the dollar in the light of recent and prospective events. The dollar is overvalued against the euro and the threat of US recession and increased economic and political risks should make it more difficult for the US to finance its huge current account deficit. Despite the recent stability, therefore, a sharp move in the euro towards \$0.95 and £0.65 should not be discounted. Our latest currency forecasts are set out in our latest **Monthly Market Focus**.
23. Our forecasts envisage that the euro could make further ground on the dollar over the next six months towards parity. However, we remain more optimistic for the dollar over the longer term. By mid-2002, the US economy is likely to be in recovery. Its economic system will remain the envy of other economies and the dollar is likely to recover. However, because government is likely to play a more active regulatory and interventionist role in the economy, after the events of 11 September, the rate of productivity growth could slow down, thereby reducing the US's lead over other countries. This will also limit the dollar's scope for renewed outperformance.
24. For Ireland, the period of rapid economic expansion is behind us. The rate of economic growth is forecast to remain very high this year at about 6%, compared with 11.5% in 2000. However, the rate of expansion has weakened significantly through the year. The economy has suffered from a number of shocks - the shake-out of the technology sector and foot and mouth. Furthermore, the growth in the labour supply is slowing rapidly while cost competitiveness has been eroded by excessive growth in wage and non-wage costs in some sectors. As a result, and taking account of the latest developments, we believe that the rate of growth in real GDP in 2002 will slow to about 4%. Details are set out in our latest **Monthly Market Focus**. We remain optimistic about our medium term prospects with rates of growth of 5% per annum on average over the post 2002 period.

### **John Beggs Chief Economist**

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