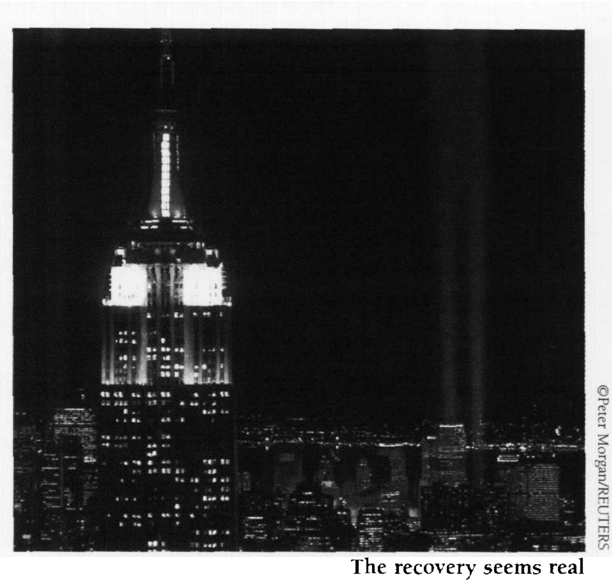
The fallout from terrorism

Security and the economy

Patrick Lenain, Marcos Bonturi and **Vincent Koen**
OECD Economics Department

The global economy has made a remarkable recovery since the terrorist attacks of September 2001. Still, there may be consequences that the economy will have to deal with for some time to come.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The recovery seems real

The road to recovery

The 11 September terrorist attacks in the United States inflicted casualties and material damage on a far greater scale than any terrorist aggression in recent history. The first and foremost cost was in human lives: over 3,000 people were killed, including office workers, aircraft passengers and hundreds of rescue personnel. Then, there was the destruction of physical assets: this was estimated in the national accounts to amount to US$14 billion for private businesses, US$1.5 billion for state and local government enterprises and $0.7 billion for federal government. Rescue, cleanup and related costs have been estimated to amount to at least US$11 billion. Lower Manhattan lost approximately 30% of its office space and scores of businesses disappeared. Close to 200,000 jobs were destroyed or relocated out of New York City, at least temporarily.

Shortly after the attacks, bio-terrorism came to the fore: lethal anthrax spores were found to have contaminated mail services, causing several deaths. Awareness of other possible threats rose, with nuclear plants, chemical factories, water supply and other critical infrastructure seen as potential targets.

Not only was the horrifying shock from these events enough to instil doubt in the most buoyant investor, but they quite naturally led to downscaled forecasts for the world economy. True, in September 2001 business confidence in the United States and most other OECD countries had already weakened considerably compared with 2000. But the attacks further dented confidence and the consensus forecast for US real GDP growth was instantly downgraded by 0.5 percentage points for 2001 and 1.2 percentage points for 2002. The implied projected cumulative loss in national income was half a trillion dollars.

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Real GDP shrank as expected in the third quarter, but held up in the fourth, as sharp falls in business investment were offset by buoyant consumption and government spending. Defence spending in particular grew by 9% in real terms. Still, several sectors were hit hard. The already struggling airlines suffered, as demand slumped and traffic collapsed. Aircraft orders were cut back. The insurance sector faced an unprecedented catastrophe. Hotels, restaurants, travel agencies and other tourism-related businesses confronted a sharp drop in demand. Still, one person's problem is another person's business and some firms saw buoyant demand, such as in security and information technology.

Wall Street was affected more than just physically. Financial markets registered a "flight to quality" in search of safety, and spreads widened between corporate and government bond yields and between emerging market and US bonds. But prices soon bounced back, often to above their pre-11 September levels. Spreads narrowed anew and volatility eased off.

All of this begs two basic questions: how did the economy get back on its feet so quickly after the shock? And is it business-as-usual for everyone, or are there areas of the economy that have been affected in a lasting way?

On the recovery, there is little doubt that swift and forceful public policy action played a key role. Take the near-destroyed financial market of New York that was shut down for several days. The Federal Reserve immediately indicated its readiness to inject virtually unlimited liquidity into the system to avoid payment failures and defaults. The effective Fed funds rate plunged to levels last seen in the early 1960s. The Fed worked with the European Central Bank, the Bank of England and the Bank of Canada to ensure dollar availability overseas. This, and the fast rebuilding of communications and power, ensured a smooth reopening of markets and a fast return to normal. Loans were repaid and the Fed's temporarily bloated balance sheet shrank rapidly. The system worked.

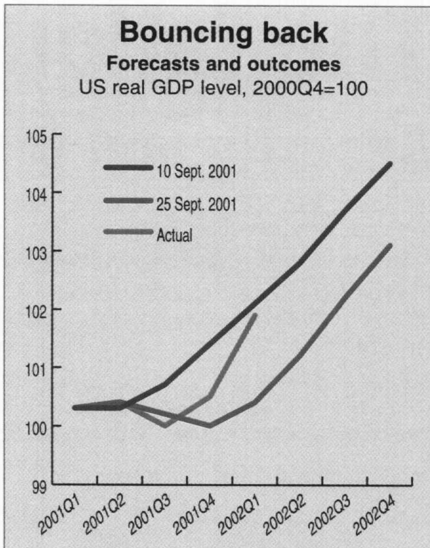
Monetary and fiscal policy helped too. Central banks around the world lowered interest rates substantially. In the United States, just three days after the attacks, Congress cleared a US$40 billion emergency spending package to help with relief at the attack sites of New York, Washington DC and Pennsylvania, and finance the beginning of the war on terrorism. A few days later, Congress authorised US$5 billion in direct grants plus US$10 billion in federal loan guarantees for the US airlines.

In short, thanks to good economic crisis management, including international co-operation, the short-term adverse economic impact of the September attacks was far less serious than initially feared. In fact, actual economic performance is rising back towards pre-September forecasts (see graph). Which brings us back to our second question about the medium term. Here, the answer is less certain, with little research available on the long-lasting economic impact of terrorism. But the September attacks did more than kill and cause damage, they showed the vulnerability of the free market system to hostile threats. This realisation was a psychological shock to people in the US and beyond. Little surprise therefore that the main lasting effects of 11 September should be found in protection and security.

Beyond the stepping up of co-operation in the fight against terrorist financing (see article by Clarie Lo on page 39), the foremost effect was in a renewed increase in defence spending in the United States, but also elsewhere. Higher spending in this area rolls back some of the so-called "peace dividend" of the post-Cold War period, which for many experts contributed to the strong US growth performance in the 1990s.

While military and security spending can add a short, sharp injection to the economy in terms of jobs and procurement, it runs the longer term risk of crowding out activity in the rest of the economy. (These aspects will be dealt with in a forthcoming working paper, see references.)

Besides defence outlays, the heightened terrorism threat has at least two other economic effects: insurance, with coverage for terrorism-related activities more expensive and harder to obtain than before September 2001; and security, notably at borders, with economic pressure mounting to tighten surveillance of goods (and labour) movements in a number of countries.



The blue line shows how strong forecasts were before 11 September. The pink line shows the downward revisions afterwards. The green line shows actual economic performance catching up with initial forecasts. *Source:* Consensus Economics (regular monthly survey and special post-11 September survey), US Bureau of Economic Analysis.

The insurance question

The losses from the September terrorist attacks for the insurance industry (including reinsurance) are estimated at US$30-58 billion. There is some uncertainty about payments on liability insurance, but even if the final cost is close to the lower estimate, insured losses in 2001 are likely to have been the highest ever, even outstripping the US$21 billion incurred when Hurricane Andrew hit Florida in 1992. The 1992 Los Angeles riots were the most expensive man-induced disaster to date, with claims of US$0.8 billion, almost entirely for property claims. In contrast, the 11 September attacks have led to claims on a variety of types of policies: life, property, auto, airplane, workers compensation and business interruption insurance.

Yet, despite the cost, no major bankruptcies have occurred in the insurance industry, in part because the risk was spread over a number of companies and countries. It is estimated that reinsurers, most of them European, will bear over half of the losses. The capital base of many insurance and re-insurance companies has been hit, though, and it is likely that several companies would not be able to withstand another similar shock.

Following the attacks, primary insurers and reinsurers have curtailed or dropped coverage for terrorism-related risk because of pricing difficulties. They have raised insurance premiums in several industries, particularly aviation and other transportation. Construction, tourism and energy have also been affected. Commercial property and liability insurance rates have jumped by 30% on average, with vulnerable "targets" like chemical plants and high office buildings seeing steeper increases.

These rises should be seen in the context of a sharp decline of premium rates in the 1990s, and even with projected hikes, reinsurance rates should remain well below the peaks reached in 1993, thanks especially to strong enhanced competition in the industry. The reduction in coverage, on the other hand, could squeeze growth if it curtails certain types of investment, such as in property.

Insurance firms may one day be able to price terrorism risk, though not for the foreseeable future. The risk of a large-scale catastrophe of the type that occurred on 11 September was previously considered low (and may still be low) and was seldom formally incorporated into premium rates. With time, this may change. After all, however great the surprise, terrorist attacks do not occur with perfect randomness, nor is there any particular technical impediment for incorporating them within a risk-management model, although such is the uncertainty attached to these events that the predictive accuracy of risk models would be on trial for some time. Nevertheless, a group of European insurance and reinsurance companies has recently announced their intention to set up a pool to cover against limited terrorism risk. In the United States, airlines are in the process of creating a mutual company, Equitime, with a similar purpose, although proposing the government as reinsurer of last resort.

Financial markets could play a key role too in increasing coverage. The market for "catastrophe" bonds has been thin since its launch in 1996, but efforts to repackage such bonds in forms more familiar to financial markets may increase liquidity and lead to a larger role for capital markets in providing alternative risk transfer mechanisms in the future.

The insurance industry is likely to take a few years to adjust. In the meantime, government intervention may be justified. Indeed, some OECD governments have long had schemes in place to cover terrorism risk, for example, the UK's Pool Re scheme established in view of terrorist threats from the IRA, and Spain's state insurance fund, the Consorcio de Compensación de Seguros. Many of these schemes were thought to be temporary responses to market failure. In time, it was argued, the insurance industry's capacity would develop and efficient risk-sharing arrangements would be established. The fact that many of these schemes have endured is an indication that either the market failure persisted, or that in some cases government intervention crowded out private sector opportunities.

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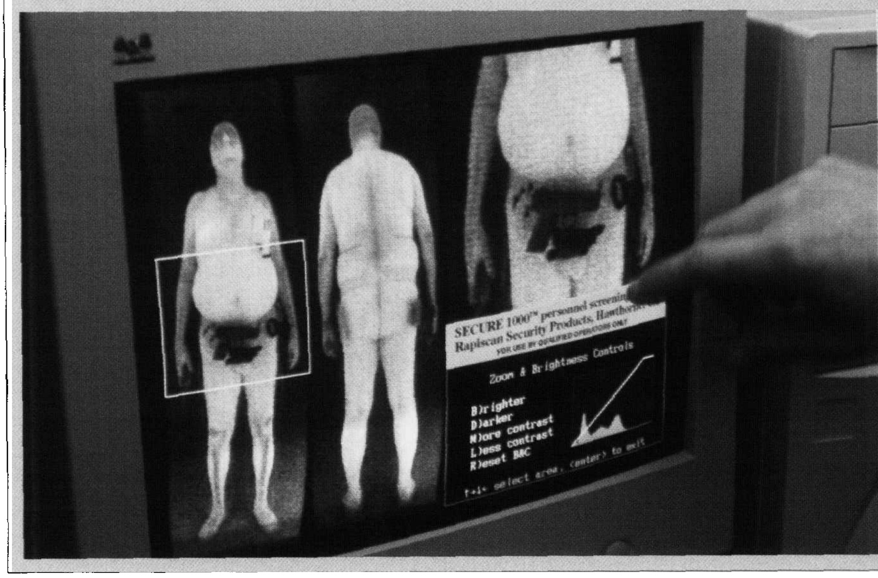
The design of support schemes is necessarily dependent on the particularities of domestic judicial processes. For instance, the UK's Pool Re scheme does not provide reinsurance for liability coverage and so would be less applicable in the United States where third-party liability is a major issue.

In sum, if government involvement proves necessary, it should be limited in scope, be conceived in partnership with the private sector and be accompanied by the introduction of some type of user fee. In that regard, it is possible that governments will need to act as an insurer of last resort, perhaps involving some international co-operation.

The attacks of 11 September reminded everyone of the importance of government. These partnerships would be vital for the insurance industry under what is known as a mega-terrorism scenario, for instance, even a small nuclear attack. No doubt experts in the industry are examining this possibility closely, for however imponderable such a scenario may be to most of us, 11 September proved that even improbable events have to be factored in.

Loaded traveller

A Rapidscan Security Products representative points to a scan revealing a hidden handgun during a demonstration of new screening devices at the Orlando International Airport in Florida, March 2002. The device shown is the Secure 1000, a low-energy full body x-ray scan. The devices were expected to come into use for passengers on a voluntary basis.



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Transportation: trade and trade-offs

Safe load?

Another medium-term economic fallout of 11 September is the effect on commerce, in particular, transportation. During the "new economy" boom it was perhaps forgotten that we live not in cyberspace but in a physical world where even goods ordered online still have to be packaged with real paper, processed and sent to their final destination. All of this means transport. But following the 11 September terrorist attacks, the air transportation system was shut off for four days and the Port Authority of New York and New Jersey closed its operations for two days. The entire US transportation system was subject to severe disruptions that reverberated throughout the world.

The most severe disruption occurred at the US-Canada land border, virtually stopping some half a million vehicles from doing their normal trade, worth some US$1.4 billion a day. Long waits affected many businesses, in particular the automotive industry where just-in-time supply chains simply could not operate. Security measures were gradually eased and more personnel hired to bring the flow back to near normal. The signing in December 2001 of the US-Canada "smart border" initiative to facilitate trade through improved technology and better co-ordination has helped. But that was a land border: what of intercontinental trade?

Tighter security requirements and a series of surcharges also affect the cost of transporting goods by sea and air. Notification requirements, more frequent coast guard inspections and escorts: all have resulted in longer waiting times. The same for airfreight, with higher insurance premiums and war surcharges, particularly for transport of goods in sensitive geopolitical zones, also pushing up costs.

Despite all of this, most indices six months after the attacks showed little increase in shipping costs, while some declined. The 5-10% increase in maritime shipping rates was quickly reversed, but airfreight rates were some 10% up by the end of the year compared with before the attacks. Easing demand and sharply lower fuel costs should otherwise have led to a decline; according to the Air Transport Association, the average price of fuel used by the US airline industry has fallen from 79.6 cents in September 2001 and 60.1 cents in December. So, because of the attacks, underlying transportation costs may have risen.

Some still believe that US borders remain too porous and advocate more controls. The US Customs Service has recommended initiatives to increase the security of containers, which account for some 60% of the volume of world trade. This would involve significant capital investment so that cargo might go through more expeditious customs procedures – a sort of "fast lane". Such requirements cost money and could affect delivery times. Yet affordable airfreight and lower overall shipping costs have helped to drive growth in recent decades, and several industries have been able to internationalise their supply chains as a result. They depend on speed and reliability of delivery and an efficient transportation system. Speed has allowed businesses to reduce inventories, for instance, and to raise productivity, not just in the United States, but in economies the world over. Making transport and shipping less affordable could affect growth in all countries, rich or poor.

Small differences in the cost of trading internationally can affect trade patterns.

Industry experts believe that post-attacks, the total cost of new security measures could amount to 1-3% of the goods' value. These are not insignificant amounts, though even small differences in the cost of trading internationally, compared with selling in domestic markets, can have a large effect on trade patterns. The possibility that security measures can undermine trade flows should not be discarded.

What can be done, for security is clearly important. A co-operative approach is needed between the private and the public sector in both the design and implementation phases. Even though a trade-off between security and efficiency of border crossings cannot be fully avoided in the short-term, it might be overcome in the medium term. New security measures can be devised in ways that do not diminish the efficiency of merchandise border crossings, using risk-management to ensure that the most sensitive cases are prioritised.

The air cargo security regime introduced by the United Kingdom in the wake of the Lockerbie disaster of 1988 is a good example in this regard. "Fast lanes" for containers originating from secure ports appear at first glance to be an efficient solution, but could be discriminatory, especially against developing countries. International co-operation and consensus building would help make new security measures more efficient, while reducing their potentially negative impact on trade flows.

The 11 September attacks were tragic and shocking in the extreme. The fact that activity appears to be bouncing back is testimony to the resilience that the OECD area, and the US in particular, have developed over the years. Managing risks simply forms part of the test ahead. ■

Reference

- "The Economic Consequences of Terrorism", Economics Department Working Paper, forthcoming, OECD, 2002.