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MACROCOSM

911: Why It Matters, Why It Doesn't

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Understanding the macroeconomic impacts of 911 -- real and imagined, economic and political.

In today's anniversary remembrances the media will no doubt portray 911 as a critical turning point in American civilization. We have looked for similarly grandiose meanings of 911 in terms of the economy and the market. We explored the potential for the revival of capitalism's "animal spirits" from the ashes of 911 (see "In Crisis, Opportunity" September 12, 2001) and we looked at the potential for stimulus from increased spending on military and security (see "43,600 Broken Windows" October 24, 2001). But all that seems to have been trivial or illusory. The reality is that, for the economy and the market, 911 has meant very little in and of itself. Instead it has acted only as a force to accelerate, exaggerate, or distort dynamics that were already in motion.

Many investors have made big mistakes over the last year by failing to understand that. We believe, to a large extent, the mania for a "V"-shaped recovery that dominated economic discourse from November 2001 to April 2002 was a psychological after-effect of 911. It was a form of wishful thinking, revealed by the extent to which its proponents wrote not about economic realities but about such factors as the "indomitable spirit of America." This was epitomized by the public relations campaign carried out in New York City with the slogan "Bring Back the Bull," urging investors to conquer terrorism by bidding up stocks. For a while, last December and January when equity valuations were back up to March 2000 levels, it seemed that investors were actually doing it. Of course it had to end in tears.

Perhaps 911 had its most tangible economic effect on **the Fed**. Within hours of the attacks the Fed announced that it would supply all the monetary liquidity the banking system demanded -- and it followed through. Initially, it even abandoned its inefficient operating mechanism based on rate-targeting, letting the fed funds rate float as a by-product of liquidity supply and demand. We had been calling for years for the Fed to redress the deflationary dearth of dollar liquidity that had been gradually choking the economy -- and we hoped that the accidental intervention of tragedy on 911 might force the Fed's hand.

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Up to a point, it did. In the shadow of 911 the Fed was forced for a time to supply any and all liquidity the market needed. And now, the Fed has yet to take back any of the 1.75% in rapid-fire rate cuts made after 911, even though the economy shows signs of recovery, and even though those cuts was deemed at the time to be only a temporary response to an emergency.

Would the Fed have gotten the funds rate down to 1.75% eventually with or without 911? Perhaps -- the economy was already in recession before 911 (although almost all Wall Street economists were denying it at the time), so a gradual series of cuts may have been in the cards all along. But the fact is 911 motivated the Fed to rapidly ratchet rates down to a level that finally helped relieve a deflationary liquidity scarcity, which might not have occurred without the tragedy.

The shock of 911 and its residual uncertainties must surely be contributing to the lingering risk aversion that remains evident throughout the economy. But at least with the gold price stabilizing and with the dollar well off its deflationary highs of last year, the Fed appears to have stabilized monetary uncertainty. And that appears to be contributing to a gradual overall thaw in investor risk aversion.

911 also had important accelerative effects in the political domain, spilling over into the economy and the markets in profound ways. Before 911 politics had been dominated by gridlock, with the two major political parties operating as a duopoly that reached its zenith in the "hanging chad" electoral crisis in November, 2000. In an important sense gridlock was good for the economy because it minimized the risk of chaotic policy change. Neither party had much power over the other, so policy changes were necessarily both incremental and based on compromise. This filtered out the best policy initiatives, but at least it filtered out the worst.

911 was a destabilizing shock to the political duopoly, endowing **President Bush** with enormous popularity and political power. The Democrats have scrambled to redress this power asymmetry -- not by reducing Bush's power, but by increasing their own. Chaotic policy change has emerged as a by-product of re-stabilizing the duopoly at a higher level of political power.

The Democrats seized on the **WorldCom** accounting scandal, and developed it into a populist frenzy for reform. Bush remained essentially passive, seeing nothing to gain and lots to lose by defending "corporate crooks." So Republicans facing re-election this year had no choice but to adopt the mania for reform themselves -- and even overshoot the Democrats in their calls to punish errant CEOs. The result was the **Sarbanes Oxley Act**, the most sweeping economic regulatory initiative in two generations. In that sense, free-market capitalism has been a victim of 911.

After Sarbanes Oxley, Bush's reticence to risk his 911 political capital was on display in the short-lived White House effort to promote a package of investment-oriented tax cuts in the wake of last month's Waco economic forum. The administration is eager now to assign blame for the apparent failure of this project to Republican **House Ways and Means Committee Chairman Bill Thomas**. With his well-earned reputation for high-handed willfulness, Thomas is an easy fall-guy.

But our information, coming from sources both on and off Capitol Hill, indicates that the White House was at least as much at fault as Thomas. While the West Wing economic team headed by **Larry Lindsey** stroked prominent supply-side activists such as **Steve Moore** and **Bruce Bartlett** as part of the exercise to develop and publicize the proposal, no similar outreach was provided to Thomas or senior committee staff. Essentially, Thomas was expected to do the administration's bidding without having any real input on the design of the package or a strategy for its legislative consideration. In a climate of paranoia among the congressional GOP about any program that can be painted as favoring "the rich," as well as renewed apprehension about rising budget deficits, this amounted to a strategy for still-birth.

Indeed, it's debatable that the White House ever intended for it to be anything other than that. Our analysis is that with his sky-high post-911 approval ratings, President Bush is left without political motivation to pursue a strong domestic agenda that might entail some risk to his poll numbers. To the extent, in other words, that Bush's current block of support includes traditional liberal Democrats who would be less likely to continue supporting him as an aggressive tax-cutter, he's not likely to want to pay the price of standing up for such an agenda. That the project appeared to peak with the White House briefing Lindsey staged late last month for Moore, Bartlett and a handful of other supply-siders is telling. For the White House, the purpose all along was much more about *appearing to want* to cut taxes than it was about actually *getting* taxes cut.

Now the Bush administration contemplates military action against Iraq, and such action would potentially have far-reaching and chaotic spillovers into the economy. We trust that Bush's decisions will be taken in light of the facts. But there is an intense risk that he will be tempted to "wag the dog" in order to rebuild his power asymmetry in the wake of the corporate corruption issue, and in light of his distaste for political risk in economic debates. In that way, 911 remains a sword of Damocles hanging over the economy. TM