



## In this Issue:

Number 171  
October 2004

**Terrorism:  
Forecaster's  
Nightmare**

**NABE/GIC Meeting  
a Success**

**NABE in 21st  
Century: Meldrum**

**National Accounts  
Tour**

**Outsourcing to Asia**

**China Currency Peg**

**Global Pocketbooks  
and Payments**

**EU Enlargement:  
Implications**

**Industry Outlook**

**Contributed Papers**

**Annual Meeting  
Pictures**

**NABE Foundation  
Established**

**Sen. Talent's  
Association Health  
Plan**

**IT and the Economy**

**Member News**

**Chapter News**

**Calendar**

## Terrorism and the Economy: A Forecaster's Nightmare

By Bernard Baumohl

Economic forecasters have never had it easy. As any of them will tell you, even the best-devised forecasting models can occasionally be way off the mark with their predictions. I remember **Walter Heller**, years after leaving the White House as President Kennedy's adviser, throwing up his hands in exasperation during a conference because consumers refused to behave in accordance with econometric projections at the time. "Consumers can be very flaky," he said. "And if you are wrong on their behavior, your forecasts go out the window." The late **Otto Eckstein**, founder of Data Resources Inc., summed it up more sublimely: "No matter how much progress we make understanding how the economy works, it seems we're always one equation behind."

As difficult as forecasting was back then, the job of predicting economic activity has become more complicated in the post 9/11 era. One of the subliminal lessons that emerged from **NABE's annual meeting** in Philadelphia was that forecasters are struggling as never before with the issue of geopolitical risk. The reason I say subliminal is because no single session explicitly dealt with this topic, yet it seemed to surface and weave its way through many different discussions during the 3-day meeting. How does one account or quantify in a forecast model the pervasive fear of terrorism and the likely use of weapons of mass destruction on U.S. soil?



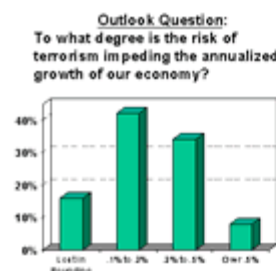
## Geopolitical Risk Must Be Taken More Seriously

Geopolitical risk is nothing new to economists, of course. We've always had to deal with foreign coups, assassinations, wars, and even disruptions in the supply of key commodities. But their effects on the U.S. economy were usually ephemeral. Forecasters didn't dwell much on event risk in the past because these situations either had no palpable impact on the U.S. economy, or were rarely enduring. Today, there is a growing sense within the economics profession that geopolitical threats have to be taken much more seriously. Never before has the U.S. confronted so many potentially catastrophic risks all at once. After all, we are told repeatedly by Washington that a devastating terrorist attack in the U.S. is not a question of if, but when.

This mindset has begun to materially affect the psychology and confidence of investors, business leaders and consumers. Yet, one is hard-pressed to figure out how this anxiety can be quantified in a forecasting model. This dilemma surfaced most vividly when everyone gathered to hear NABE present the results of its latest **surveys**. One recent question in the survey asked members to identify what they perceive as the single greatest threat facing the U.S. economy. Topping the list by far was terrorism and defense. The record budget and current account deficits ranked lower. But here's the irony. While NABE forecasters admitted that terrorism and other geopolitical dangers was their foremost fear, this had



### The Impact of Terrorism on the U.S. Economy



What is the greatest short-term risk to the U.S. economy?

Defense/Terrorism	40%
Government Deficit	23%
Inflation	9%
Unemployment	6%
Excessive Consumer Debt	5%

Source: NABE Policy Survey, August 2004

virtually no bearing on their economic forecasts, which were mostly upbeat.

Still, the issue of event risk seemed ever present at NABE sessions this time. During the **Industry Outlook** discussion, **John Felmy**, chief economist at the American Petroleum Institute, said geopolitical factors have already begun to strain consumer finances. Oil prices are soaring and every penny increase in gasoline prices drains another \$1.3 billion from household cash flow. **Tom Davis**, Motorola's top economist, warned that many corporate chiefs today are terribly anxious about the potential for massive economic dislocation stemming from a terrorist attack. In another room, **Dan Waggoner** of the Atlanta Fed argued that geopolitical shocks could easily derail the forecasts of even the best economists.

*Carl Tannenbaum, who presented the NABE Outlook at the Annual Meeting, produced this slide to show how the terrorism question was handled in two recent NABE surveys. The NABE Policy Survey, released on Aug. 17, 2004, and the NABE Outlook, released on Oct. 4, 2004, both asked about the impact of terrorism on the economy. The Policy Survey concluded that "Terrorism remains the biggest short-term problem facing the U.S. economy this year, according to 40% of respondents, up from 19% in March." The Outlook, released on Oct. 4, 2004, asked about the impact that terrorism was having on current forecasts of U.S. economic growth. As Bernard Baumohl correctly states, "this had virtually no bearing on their economic forecasts [NABE Outlook], which were mostly upbeat." The Policy Survey does not include an economic forecast.*

## Cost of Terrorism

Perhaps the most riveting session at this NABE conference dealt with the cost of terrorism. Economists in the room were shaken by comments from **Stephen Flynn**, a national security expert at the Council on Foreign Relations. "9/11 represented just the first wave of 21st century warfare where catastrophic terrorism will be directed at non-military targets," he said. The U.S. may have the most powerful military the world has ever seen, Flynn added, but stateless terrorists will find ways to adapt, identify America's vulnerability and strike hard. American lives and businesses will suffer as never before. Flynn's principal argument was that the U.S. is wholly unprepared at this time to prevent such domestic attack. "We are living on borrowed time." Case in point: While the CIA has concluded that the most likely way weapons of mass destruction would enter the U.S. is by sea, the federal government is spending more every three days to finance the war in Iraq than it has provided over the past three years to prop up the security at all 361 U.S. commercial seaports. Here's another disturbing factoid from Flynn: After three years since 9/11, the total number of CIA agents collecting human intelligence around the world is less than the total number of FBI field agents in New York.



## Demise of the Insurance Industry?

Co-speaker **Robert Hartwig** of the Insurance Information Institute offered his own bleak assessment. Hartwig bemoaned the fact that Washington was not releasing data it has on terrorism to help insurers better price premiums for terrorism insurance. Without adequate actuarial information, insurers could quickly lose much, if not all, of their reserve capital in the event of an attack. To illustrate the case, Hurricane Andrew, which slammed into southern Florida in 1992, was the world's most expensive natural disaster, costing insurance firms \$21 billion. In contrast, the single two-hour attack on 9/11 resulted in a \$32.5 billion hit to insurers. Hartwig then described one of his nightmare scenarios: one well-executed attack in New York City involving the release of anthrax could cause 173,000 deaths and more than \$90 billion in insurance losses. Such an incident would consume 25 percent of all capital insurers set aside for paying claims. "We could well see the end of the insurance industry as we know it," Hartwig warned.

## Thinking the Unthinkable

Where does all this lead to? One of the biggest challenges NABE economists will have in the years ahead is to think the unthinkable. It is not a stretch to say we are now in a perennial war against terrorists who can move with great stealth and unleash enormous human and economic destruction in a society as open as the U.S. Fear of terrorism and other geopolitical threats will thus loom over economics for the foreseeable future. As a result, I believe many of the relationships and assumptions that underlie current forecasting models will undergo radical changes in the coming months and years. Clearly, there will be no dearth of topics to discuss at upcoming NABE meetings.

**Bernard Baumohl**, a NABE member and former economics correspondent for Time magazine, is director of [The Economic Outlook Group](#) and author of a new book, [The Secrets of Economic Indicators: Hidden Clues to Future Economic Trends and Investment Opportunities](#) (Wharton School Publishing).

A print version of the October issue, without the photos, graphics, and hyperlinks, is here. ([PDF 50 K](#))

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