A Proposal to Evaluate Macroeconomic Impacts of Terrorism within a Framework of Dynamic General Equilibrium Models

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Abstract

When determining the budget for public policy on anti-terrorism, we need to have an estimate of the costs that a terrorist incident is likely to bring about. A simple way to calculate the costs is to sum replacement costs of damaged tangible assets. It may be misleading, however, because a terrorist attack can occur beyond the national border of the targeted country. This paper proposes an alternative way to quantify the economic impacts of terrorism. A crucial (but realistic) assumption is that a terrorist incident leads to a rise of risk premium for the targeted country to raise funds in the international financial market. The heightened risk premium can have impacts on the targeted country's economy. First, the increased premium pushes up the cost for residents of the country to borrow from abroad, thereby preventing the consumption smoothing of households over time. Second, the raised premium, which reduces capital inflows to the targeted country, depreciates its currency and makes it expensive to import capital goods. Thus, dynamic interrelationships among macroeconomic variables play an important role in the propagation mechanism of terrorism shocks. Under the assumption mentioned above, the paper examines how macroeconomic variables respond to the increased risk premium within a framework of dynamic general equilibrium (DGE) models for a small open economy.