

A Katrina Recession?

The economic consequences of the hurricane.

BY IRWIN M. STELZER

WE DO NOT YET know enough to make a definitive estimate of the amount of time it will take to get the pipelines pumping at full capacity, all of the refineries up and running, the port operating on a normal basis, and other parts of the Gulf Coast economic structure back into pre-Katrina shape. But we know a lot more than we did in the first days after the storm.

We know that, unlike the local residential sector, the nationally important economic infrastructure will recover surprisingly quickly. This reflects, at least in part, the unambiguous incentive that the private sector oil, pipeline, transport, and other companies have to restore their flow of revenue and profits, compared with the more ambiguous incentives that government workers have—to get the job done, to be sure, but also to be certain that a few years hence they do not find themselves before a congressional committee trying to explain why they sacrificed some procedure such as competitive bidding to the exigencies of the moment.

We also know that early reports of the time it would take to restore many of the damaged facilities were understandably, but fortunately, pessimistic. At this writing, the important 5,519-mile Colonial pipeline, which delivers almost 100 million gallons of gasoline, heating oil, and other petroleum products to 12 states every day, is capable of running at normal flow. Entergy, the

hard-hit area's largest electricity supplier, has restored service to more than two-thirds of its 1.1 million customers, despite serious damage to some of its facilities. Chevron reports that most of its offshore facilities were not damaged, and that within a week it had restored oil output to half of normal levels. The U.S. Minerals Management Service reports that only (that's my adjective) about 900,000 barrels per day of oil production is now being lost because of Katrina—about 5 percent of our needs. By the time you read this, the port of New Orleans will be a few days from reopening for business. Release of internationally held stockpiles of gasoline, made available after initial objections by gloating German economic and labor minister Wolfgang Clement, is driving down gasoline prices. Little wonder that stock prices have been benefiting from what Wall Street calls "a relief rally," as in sighs of.

It will probably take longer to get the natural gas transmission and distribution systems fixed, since repairs can only be effected when the systems are turned off and there is no danger of leaks. But Entergy did manage to maintain gas flow to the New Orleans Sewage and Water Board to generate the power required to pump water out of flooded areas. Despite that achievement, however, there is every likelihood that natural gas supplies and inventories will be tight, and prices higher—perhaps 30 percent higher—this winter.

Finally, we know that in disasters such as this America's ultimate defense is the flexibility and resilience of its free market economy. Observers were amazed at the speed with which

the New York economy and the nation's financial markets recovered after the World Trade Center was destroyed. When the full story of Katrina is finally told, they will be equally amazed at the speed and efficiency with which cargoes and freight were rerouted, employment agencies responded to the needs of displaced workers and employees, firms arranged living facilities for employees so that they could show up for work, and financial markets adjusted share prices and futures contracts to take account of the flow of information concerning the effects of the storm.

None of this means that the damage was trivial: Insurance industry sources are predicting the "largest insured loss in history," perhaps as much as \$45 billion—and that excludes flood insurance, which is the responsibility of the federal government. But even the disgruntled mayor of New Orleans, a buck-passer par excellence, reported "significant progress" by mid-week.

So much for the immediate impact: a supply reduction in the energy industries, a demand shock for consumers filling their tanks at prices previously unimaginable, with another shock to come when the heating bills start arriving this winter. The more important question is the longer-term outlook, which can only be appraised against the background of the economic conditions prevailing before Katrina made her visit.

Over 2 million new payroll jobs have been created in the past year; the unemployment rate has dropped to 4.9 percent (a four-year low) even as the labor force participation rate has risen; 86 percent of Americans say they are completely or somewhat satisfied with their own jobs, and 91 percent say they "love" (32 percent) or "like" (59 percent) their jobs, according to *The State of the American Worker 2005*, a valuable compilation prepared by Karlyn Bowman, Washington's premier poll analyst.

The jobs market is not the only sector of the economy that had the Fed worrying more about over-heating than a slow-down before Katrina hit:

- The manufacturing sector is

Irwin M. Stelzer is a contributing editor to THE WEEKLY STANDARD, director of economic policy studies at the Hudson Institute, and a columnist for the Sunday Times (London).

showing signs of strength, as orders and production remain strong;

- the service sector continues to grow;
- the housing market provides upside surprise after surprise;
- consumers have picked the auto lots and showrooms clean in response to the mouth-watering incentives offered by domestic manufacturers;
- double-digit profit growth continues to add cash to the piles already in corporate treasuries.

This doesn't mean that before Katrina every sign pointed towards continued growth and rising employment. Federal Reserve Board chairman Alan Greenspan worried aloud about "froth" on regional housing markets, the politicians' unwillingness to control spending, and imbalances in world trade. Consumers were growing nervous and telling pollsters they would be less likely to visit their local Wal-Mart as \$2.50 gasoline bit into their overstretched budgets, even as they signed on to the time-bombs known as interest-only mortgages.

That said, Katrina is unlikely to throw America into recession, unless consumers are so shaken by gasoline shortages and prices that they forsake the malls and realtors' offices in favor of their couches and television sets. Such a retreat is far from certain since good news on the pace of recovery of crude production and refinery capacity, plus a drawing-down of reserves here and abroad, have already brought prices to around pre-Katrina levels.

Former Fed governor Larry Meyer perhaps put it best when he pointed out, "Hurricanes typically have surprising little effect on the economic outlook. . . . Forecasters . . . often exaggerate the effects of discrete events," a view shared by Goldman Sachs economists, who write, "Most [natural disasters] have had little discernible effect on aggregate activity. . . . On balance, the impacts are hard to find in the national data." As the chairman of the President's Council of Economic Advisers, Ben Bernanke

put it, "I expect it's going to be absorbed easily."

Most forecasters seem to have taken Meyer's caution to heart, and avoided a doomsday scenario. David Malpass, global economist at Bear Stearns, has advised the firm's clients that "the U.S. and global economies will continue growing relatively fast despite the hurricane damage and high oil prices." Katrina, he believes, will cut third-quarter GDP, but add to fourth-quarter GDP as rebuilding expenditures accelerate. Economists at Goldman Sachs are a bit more cautious, but nevertheless are predicting a "near-term loss of output followed by a larger rebound."

But don't be fooled into believing that the massive, government-financed reconstruction effort, the government's gift of \$2,000 debit cards to victims, and other plans to spend money reconstructing a city at six feet below sea level—a charming triumph of can-do optimism and politics over common sense and economics—will somehow make America richer. A nation can't get rich by spending money to replace assets that have been destroyed. If that were indeed a path to enhancing the wealth of a nation, the government should encourage people to torch their houses, or at the very least break all their windows, and hire someone to rebuild and to repair the damage.

Nor is it clear that even the best-planned reconstruction program can revive New Orleans. Before Katrina obliterated much of the city, its population was declining; its real estate industry was wracking up some of the highest commercial vacancy rates in the country, inducing Sam Zell's Equity Office Properties Trust, the nation's largest owner of office buildings, to sell off its holdings; and its population was over-weighted with households classified by the Census Bureau as "Female householder, no husband present, with own children under 18 years." Those accounted for almost half of all households with children—more than twice the national average. If demography is destiny, that bodes ill for New Orleans's future.

In the end, the accuracy of all fore-

casts depends on a big unknown—how government policy will take shape. The president has already asked Congress for some \$60 billion for immediate relief and rebuilding, and is expected to face the legislators with a bill that will eventually total as much as \$200 billion, ten times what was allocated to New York City after the terror attack some four years ago. The effect of that infusion of funds into the economy just might be offset by the deferral of cuts in the inheritance tax, as Senator Hillary Clinton is demanding, and abandonment of plans to make some of the Bush tax cuts permanent.

Then there is the Fed. The president cannot threaten the central bank's vaunted independence by suggesting what it should do about interest rates. But although any discussion of monetary policy would be barred by the desire of both parties to assure the continued independence of the Fed, insiders are certain that Bush used the occasion of his private lunch with Alan Greenspan to make clear his view that the economy has received a shattering shock. Unspoken subtext: stop those interest-rate increases, at least for awhile. Washington's politicians think Greenspan would be mad, just a few weeks after Katrina hit, to raise rates when the Federal Reserve's monetary gurus convene on September 20.

Wall Street, on the other hand, is convinced Greenspan knows that the effects of Katrina are transient, that fiscal policy is about to loosen still more as the federal government borrows its billions of reconstruction and relief funds, and that the economy will resume the growth that has it headed towards tight labor markets and rising inflation, as Michael Moscow, president of the Chicago Fed, and Janet Yellin, president of the San Francisco Fed, pointedly noted last week.

So the gap between Wall Street and Washington never has been greater, with the traders predicting another interest rate increase this month, on the assumption that Greenspan will want to preserve the Fed's anti-inflation credibility with the financial community, and the political types saying,

“He wouldn’t dare,” unless he wants to squander the Fed’s political credibility by refusing to delay an anyhow trivial rate rise for a month or so. But there is agreement on one point: When the dust settles—more precisely, when the water ebbs—the economy will resume its growth and the Fed will resume its program of rate increases.

Finally, our politicians will have to consider whether they want to do anything about the fragility of the energy supply system. The shortage of refining capacity is so acute that the deactivation of 5 percent of our capacity for a month—the apparent final estimate of Katrina’s impact—sent gasoline prices soaring. And we remain heavily dependent on Saudi Arabia’s shaky regime, Venezuela’s anti-American president, and such uncertain sources as Nigeria for our crude oil, for which we compete with a Chinese government willing to subsidize its companies’ efforts to secure supplies of crude. But when gasoline prices rise to levels that might make Americans reduce their consumption and therefore dependence on overstretched refineries and imported oil, instead of cheering, politicians promise to lower those prices, either by beating up on oil companies and “gougers,” or by lowering state and federal taxes on gasoline and diesel fuel. No surprise: These are the guys who brought you a multibillion-dollar energy bill loaded with subsidies but devoid of anything that might increase our energy security.

What we do know now that we didn’t know just a week or so ago is that we are headed for a one-half to one point drop in the rate of economic growth in the next few quarters from its first-half rate of 3.6 percent, followed by a rebound; a rise in the federal deficit as a president eager to refurbish his reputation for “compassion” and a Congress headed for a reelection campaign open their hearts and your purses to the displaced; and an increase in the intensity of the will-he-or-won’t-he guessing game as the September 20 Federal Open Market Committee comes closer. ♦