

KATRINA'S ECONOMIC IMPACT

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The human tragedy caused by a natural disaster is not often followed by a nationwide economic tragedy. Of course, it is an economic tragedy for the people directly involved, who have lost homes, businesses, and other possessions, but after a brief negative impact on production and employment in the region that is inundated, there is usually a burst of economic activity as the work of repairing infrastructure and homes and other buildings begins. After a time, the affected region ends up with better homes, highways, and other infrastructure than they had before the disaster.

There are features of the Katrina disaster that will make recovery slower and more difficult than in more typical natural calamities, but I shall elaborate on those later. First, it is important to reflect on how lucky we are to start with an extremely healthy national economy compared to the economies of many European countries and compared to our own economic history. At 4.9 percent, the unemployment rate is close to what economists think is full employment; inflation rates and interest rates are extremely low relative to historical averages; and productivity growth has been very high, despite a somewhat disappointing number in the last quarter.

Consequently, our overall economy is in a position that it can shrug off a temporary blow. Moreover, advances in information technology and deregulation have greatly increased the flexibility of the economy and the speed with which it can react to

negative surprises. Just one anecdote—a recent Wall Street Journal article described the speed with which RR companies were able to reroute trains around damaged track. That would not have been possible without the assistance of computers and the elimination of the restrictive regulatory regime that existed in earlier decades.

My old employer, the Congressional Budget Office (CBO), did one of the first studies of the aggregate economic impact of Katrina. They point out that the whole state of Louisiana accounts for about 1.2 percent of total U.S. production and Mississippi 0.7 percent. If half of that production were lost for three months, it would lower the annualized total U.S. growth rate by 1.3 percent in the third quarter and by 2.7 percent in the fourth quarter.

But the CBO expects a much more rapid recovery than these numbers imply. Many people are already hard at work in the area, and construction will really pick up in the fourth quarter. The CBO expects that total production growth will be depressed less than 1 percent in the last half of the year and be higher than in pre-Katrina forecasts in the first half of next year. This pattern of a short-run loss followed by a pick-up will be reflected in employment statistics. Expect some very bad news for September with national employment falling between 150,000 and half a million but a pick-up soon after that. Many of the evacuees are finding jobs in other locations already. You might have seen the *Washington Post* story about the job fair held for them in this area. Many from New Orleans have been moved to areas where job markets are much tighter than at home and they will probably never return.

The pattern of effects that I describe does pose a problem for our Federal Reserve System. At a superficial level, you first have a reduction in the supply of goods and

services because of the loss of production. Then quickly you have a surge of demand because of reconstruction efforts. Reduced supply and increased demand imply higher prices, something that the Fed doesn't like. That would argue that they continue the upward march of interest rates that they started some time ago. But life isn't that simple. The initial loss of production in Louisiana and Mississippi had dampening effects that rippled through the economy. The incompetent government response to the storm has also rattled business confidence. Some economists are not quite as optimistic as I am, and there is some danger that they are right. Maybe the Fed should temporarily suspend the upward march of interest rates. I've been asked by reporters what I think they will do. I suspect most of the people sitting around the FOMC table tomorrow don't yet know.

I did note earlier that there are some aspects of this disaster that accentuate the short-run negative effects compared to those usually experienced. First and foremost is the effect on energy prices. Gasoline prices are already falling some, but they are still higher than they were before the tragedy. This negative shock comes on top of earlier price increases, making it difficult for the economy to adjust. The response of consumers to earlier increases seems to have been to pay higher gas prices by reducing saving. But personal saving is now essentially zero, so the storm-related price increases may start to eat into other consumption. In addition, about 15 percent of the nation's supply of natural gas comes from the region. About half of that supply has already been restored which is quite remarkable. But problems remain with the other half.

Another problem relates to so much of New Orleans being below sea level. The floodwaters must be pumped out and will recede more slowly than with a typical flood

upriver. This will delay the start of reconstruction. Nevertheless, the reconstruction boom will be substantial, even though delayed slightly.

Adding it all up, the economic damage done by the storm is likely to be temporary and followed by a little economic boom. Unfortunately, the response of our government to all this has not been edifying, to say the least. I won't delve into the incompetence shown in the initial response to the tragedy by all levels of government—federal, state, and local. That has already been aired at length by the media and will be subject to more official investigations than we probably need.

But as the *National Journal* put it, the looting of stores has ended, but the looting of the U.S. Treasury has just begun. We may throw around money without asking fundamental questions about who merits relief and who doesn't. What's worse, some would like to use the storm as an excuse to delay or eliminate spending cuts provided for in the 2006 budget that have very little to do with the disaster and to aid those who have only a remote connection—Iowa farmers who will pay a little more to ship their grain, northern fuel burners who will pay a bit more for heating oil, and on and on. Everyone's favorite ideas for tax cuts are also being trotted out. Ironically, even some ideas for investment incentives are being included when I can think of few things that provide more of an incentive for investment than a destructive hurricane.

People seem to have lost all sense of proportion. Over \$60 billion has already come from regular appropriations. Government flood insurance will probably total \$10 billion. Private insurance and private charities will throw in very substantial amounts of money. As the government's total budget is soaring past \$2.5 trillion, we seem to have lost sight of the fact that you can still buy a lot of stuff for one billion dollars. I fearlessly

predict that New Orleans will have grave difficulties figuring out how to spend the huge amounts of money that will be thrown at it and that some of the spending will still be going on years from now.

That was the pattern that followed 9/11. NYC took a very long time to figure out how to spend the vast amounts of money given it, and I have heard—though I have not researched this myself—that they still have not spent all of it. And that effort involved paltry sums compared to plans for Louisiana and Mississippi. They will receive many times the amount spent on other natural disasters and maybe almost as much as spent for the wars in Iraq and Afghanistan and for reconstructing those whole countries.

With people being aided this time who have never been aided in other natural disasters, this storm is setting precedents that will make all future disasters incredibly expensive unless we start to reconsider our first reactions.

As a nation, we have not yet figured out how to deal with natural disasters, even though it is inevitable that we shall experience some almost every year. Federally subsidized flood insurance was supposed to provide an answer for floods. Communities were required to develop plans that discouraged building in dangerous areas. In less vulnerable places, flood insurance was to be compulsory for anyone directly or indirectly assisted by a federal program such as FHA or deposit insurance, and it was hoped that others would buy it voluntarily. Those who did not buy it were supposed to bear the resulting property losses.

The basic idea is probably unrealistic. It is hard to imagine a poor Mississippi farmer living in little more than a shack buying flood insurance. It is also hard to imagine denying people aid because they did not buy insurance. Our nation is too compassionate

for that. But does that mean that even rich people who chose not to buy insurance should be assisted? And if anyone is assisted, should it be by federal, state, or local taxpayers? Certainly, we all knew that New Orleans would be in deep trouble if a major storm hit. There have been articles saying that for years. Was there, therefore, an obligation for the state and local governments to set aside contingency funds? Of course, the revenue sources of some local governments were wiped out altogether, and there is talk of rescuing their bondholders. Is this a worthy cause, or should investors in bonds be expected to bear the risks of devastating floods?

Katrina has raised many questions of this type. It provides a golden opportunity to improve our policies.

One could say that this is not the time to worry about good policy and that we must send aid even if it is not well targeted. It's just money and the United States is so wealthy that we have plenty of that. However, there is some danger that fiscal profligacy could have some very bad indirect effects. Our economy is crucially dependent on inflows of foreign investment to help us finance a huge trade deficit and a deficit on investment income. Indeed, in the first quarter of this year, we needed foreign governments and private investors to invest more than \$2 billion per day in this country. If they decided to reduce that commitment, or even worse, decided to withdraw funds already invested, the dollar would tumble, the Fed would have to greatly raise interest rates to defend the dollar or else its depreciation would be inflationary, and a recession would be inevitable.

If you were a foreign investor witnessing the initial incompetence of all levels of government as we responded to the storm or witnessed the fiscal irresponsibility that

followed, would you think this a great place to put your money? Well, I hasten to say there is absolutely no sign of foreigners losing confidence in us. Indeed, the dollar marginally gained value on average last week.

Why haven't we suffered more? Our public policies may be wanting, but our private economy is extremely strong. And our public policies are not so bad when compared to the public policies of other major developed economies. As a friend of mine says, "We are the best looking horse in the glue factory." We benefit enormously from that fact.

So Katrina is unlikely to have a long-lasting negative effect on the economy as a whole, despite the devastation and suffering it caused particular families and businesses. We are incredibly fortunate as a nation. Our economy is so strong and so wealthy that we can easily endure making some very serious policy mistakes.